

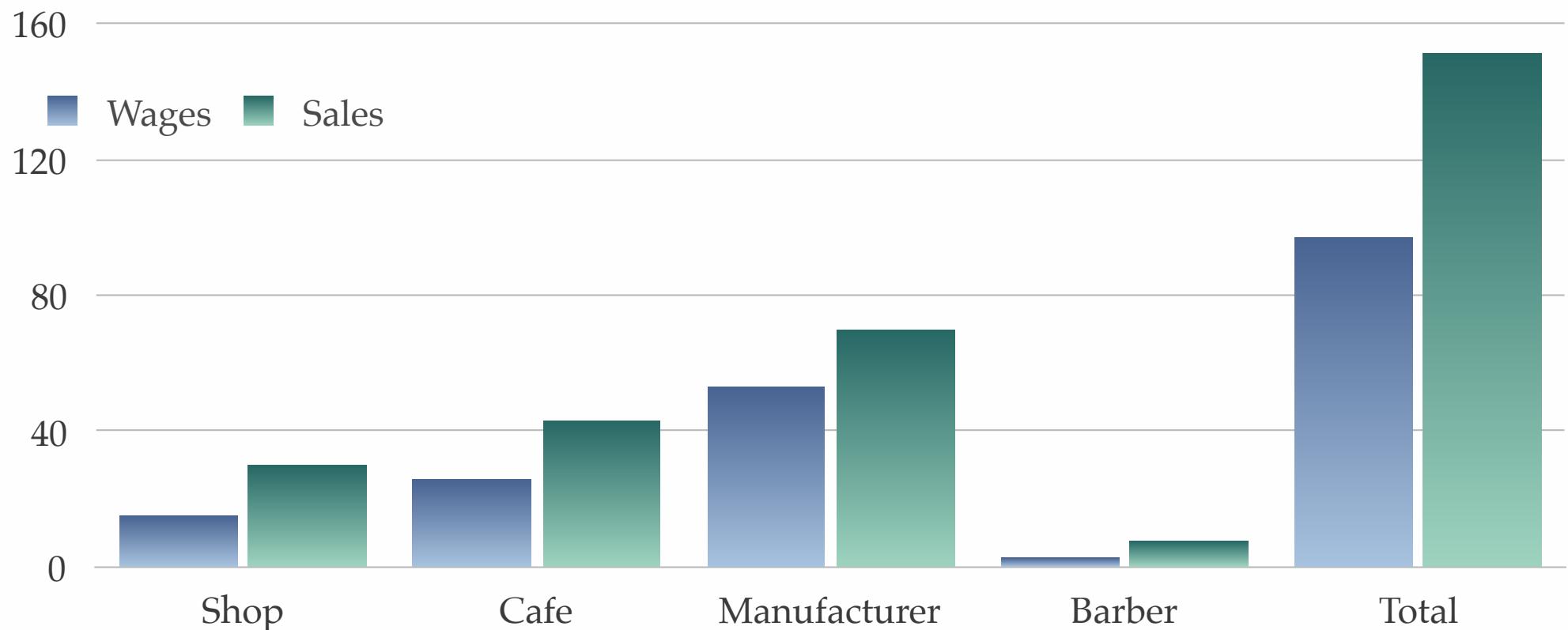
THE CREDIT CRUNCH AND THE POLITICS OF AUSTERITY

IR102, Topic 7
David Woodruff

I. KEYNESIAN DEMAND ANALYSIS, REGIMES OF ACCUMULATION, AND SECULAR STAGNATION

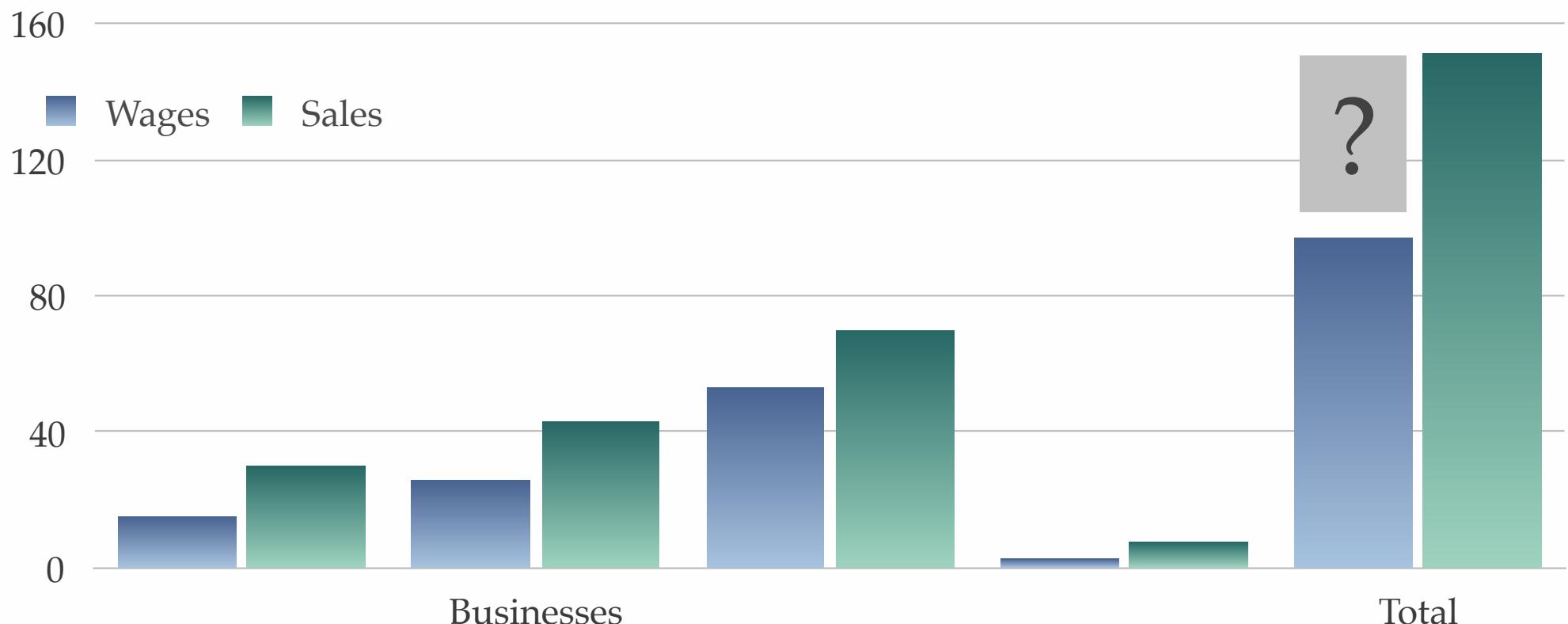
The demand dilemma

Successful businesses sell more than they pay in wages



The demand dilemma

Successful businesses sell more than they pay in wages



So even if employees spend all their wages, that's less than total sales! *What makes up the difference?*

The demand dilemma: how can consumers afford to buy everything produced?

- Sales price of goods = costs + profit
- Costs = wages + other stuff
 - Wages < Sales price of goods
 - Help! Who's going to buy everything?
- Wait: I left out the profits! What happens to them?
 - Spent on consumption (but probably at a lower rate than wages)
 - Saved (no help there)
 - **Invested** (Hooray! Spending without sales!)

Sources of demand

• All stuff bought =	GROSS DOMESTIC PRODUCT (GDP) =
• Stuff bought by consumers +	HOUSEHOLD FINAL CONSUMPTION
• Stuff bought by government +	GOVERNMENT FINAL CONSUMPTION
• Net stuff bought by foreigners	TRADE BALANCE
• Stuff bought for investment	GROSS FIXED CAPITAL FORMATION

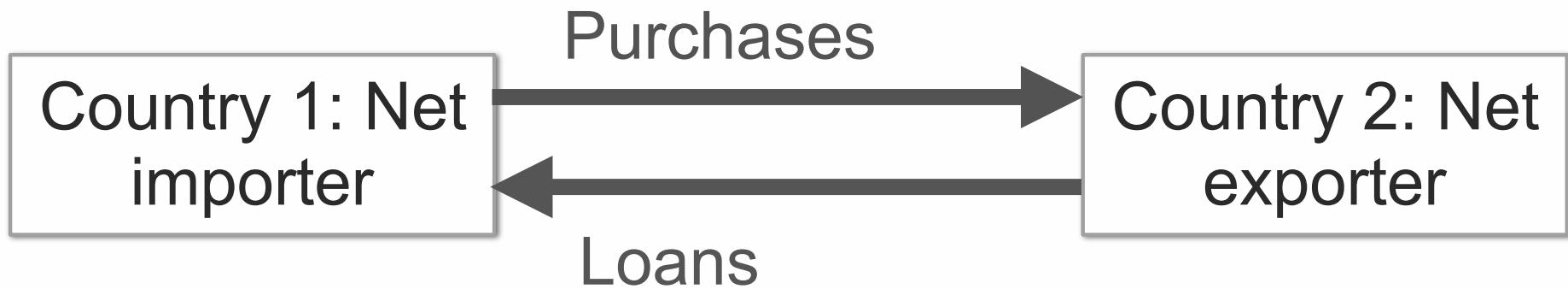
The case for demand management

• All stuff bought =	Keynes' worry
• Stuff bought by consumers +	
• Stuff bought by government +	
• Net stuff bought by foreigners	Not every country can export more than it imports
• Stuff bought for investment	Makes us dependent on fickle moods of investors



- Government should be in charge of investment
- Demand management: Government should spend more than it takes in (deficit spending) when necessary
- Internationally: Symmetric adjustment

Demand and international adjustment



- *Symmetric adjustment:* Country 1 reduces consumption (exports more of own production, buys less from Country 2), Country 2 expands consumption (buys more of own production and that of Country 2)
- *Asymmetric adjustment:* Country 1 reduces consumption

Why would you have a system promoting asymmetric adjustment?

- Cut-off of loans may *force* adjustment on Country 1 (net importers)
 - Non-market sources of loans (multilateral institutions) tend to impose consumption reduction as condition
- Very difficult to force adjustment on Country 2 (net exporters)
- In a world of more than two countries, exporters may view their success as a result of ‘competitiveness’, not systematic demand imbalances
- ‘Original sin’ of Bretton Woods system, where most powerful country (US) also a big exporter when it was set up
- Urgency of systemic resolution reduced by large and very sustained US trade deficits, capacity to finance them for very long periods

US Trade Balance (%GDP), 1970-2014



OECD data: <http://stats.oecd.org/gate2.library.lse.ac.uk/index.aspx>

Regime of accumulation (Block 2010)

- “A system of production relations for the dominant sectors of the economy incorporating both the technologies and the social relations of production.”
- **“A way of organizing and stabilizing the structure of demand so that firms will be willing to sustain high levels of investment.”**
- “Financial mechanisms that support both the system of domestic production relations and the structure of demand.”
- **“International arrangements that create complementaries in trade and financial flows in relation to the rest of the world.”**

Demand

High wages

Welfare state

Finance

Enterprise

Investment

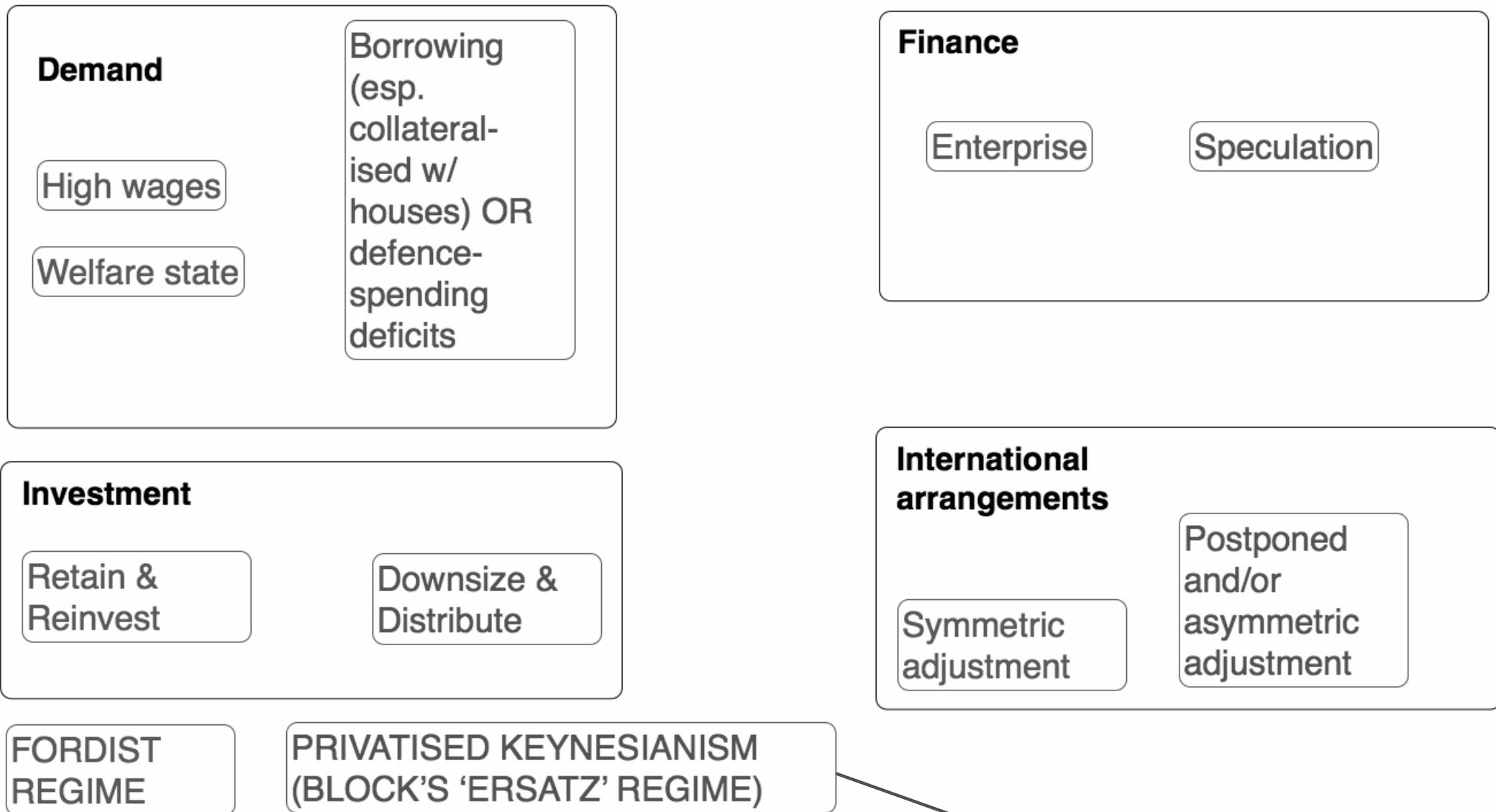
Retain &
Reinvest

International arrangements

Symmetric
adjustment

FORDIST
REGIME

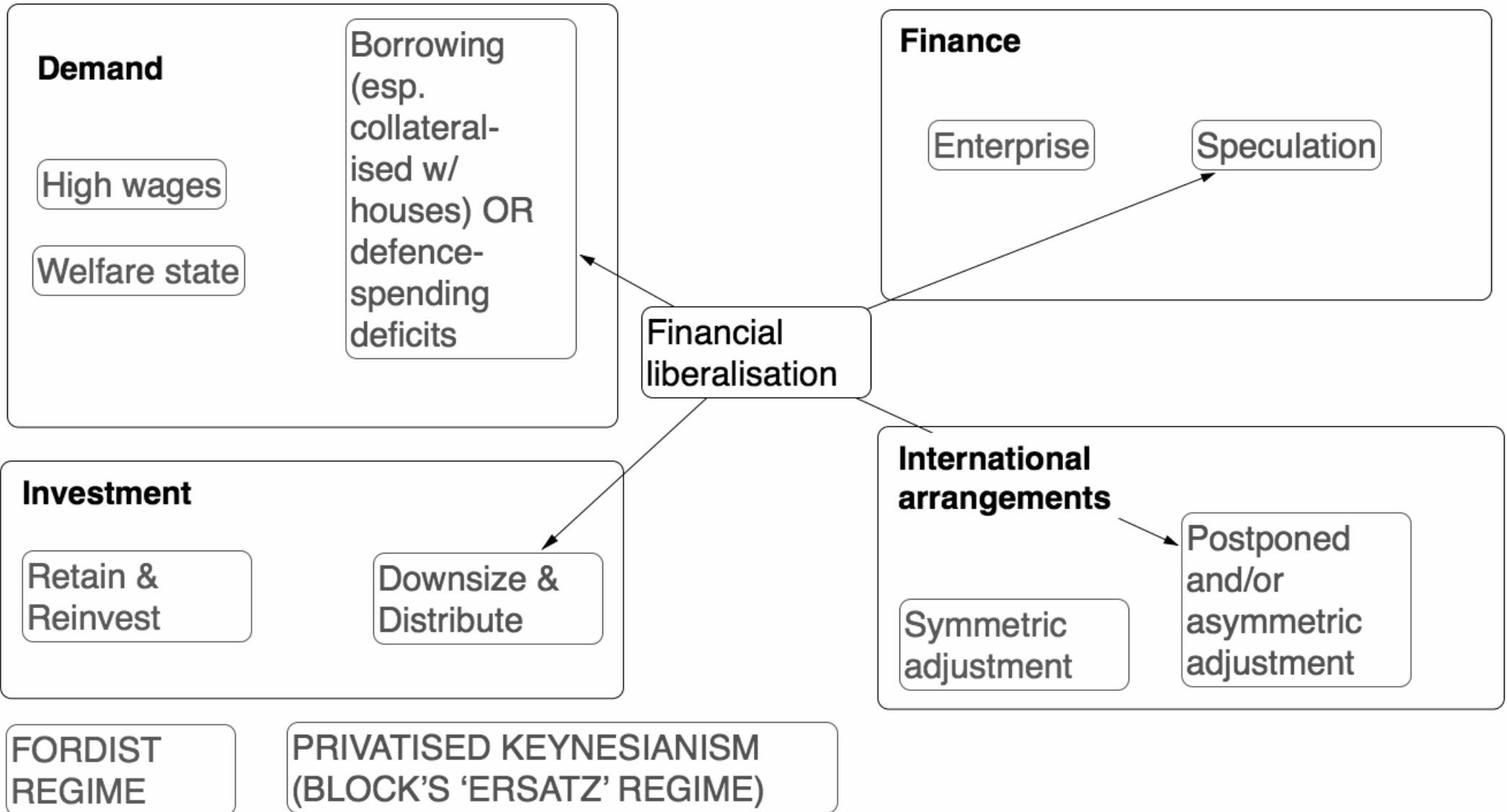
1945-1970s. Also known as 'embedded liberalism' (see 'Keynesian economics' section of yesterdays' lecture)



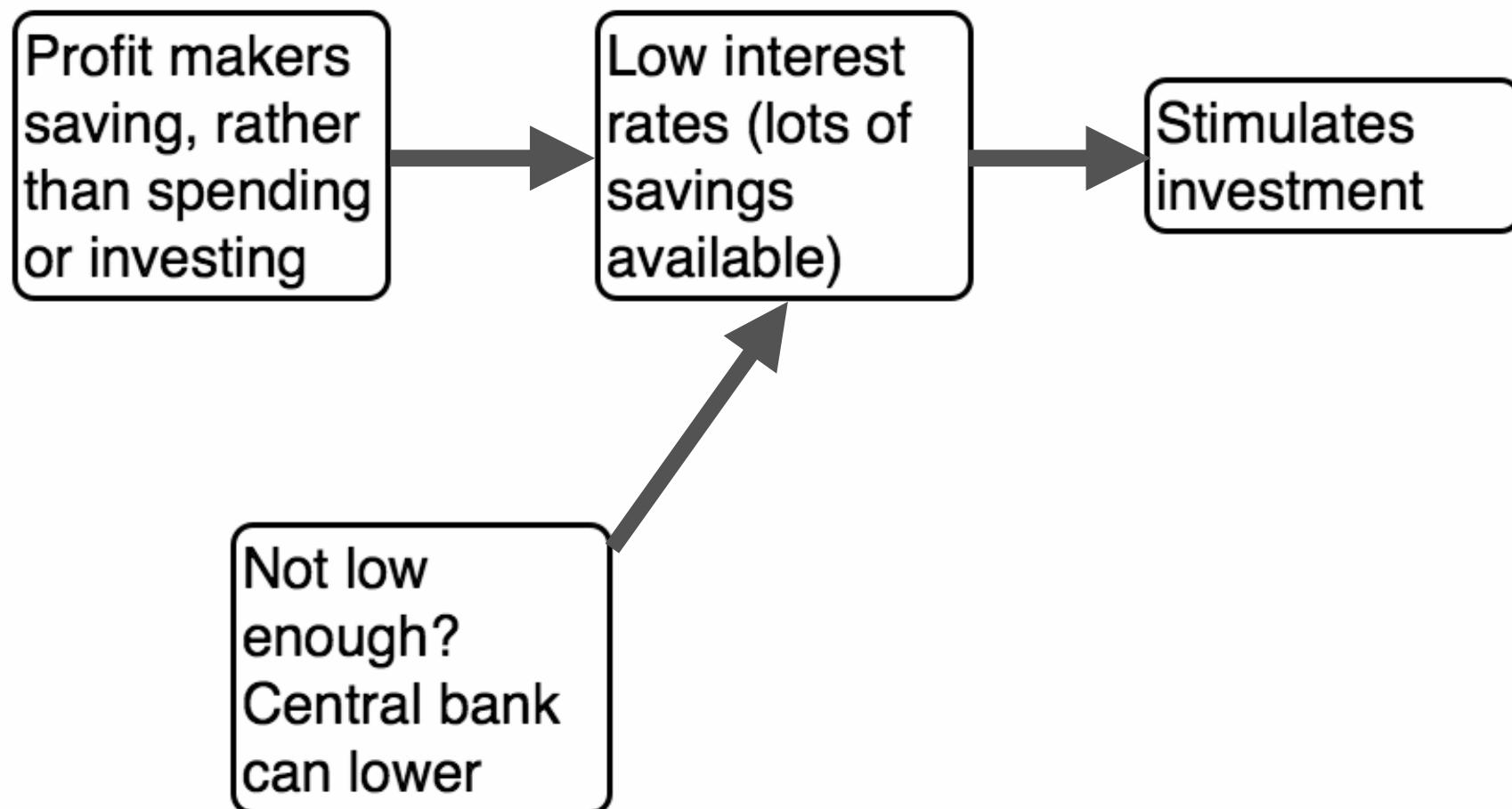
1980s-2008>. Associated with ‘neoliberalism’, often used to summarise this era

Privatised Keynesianism

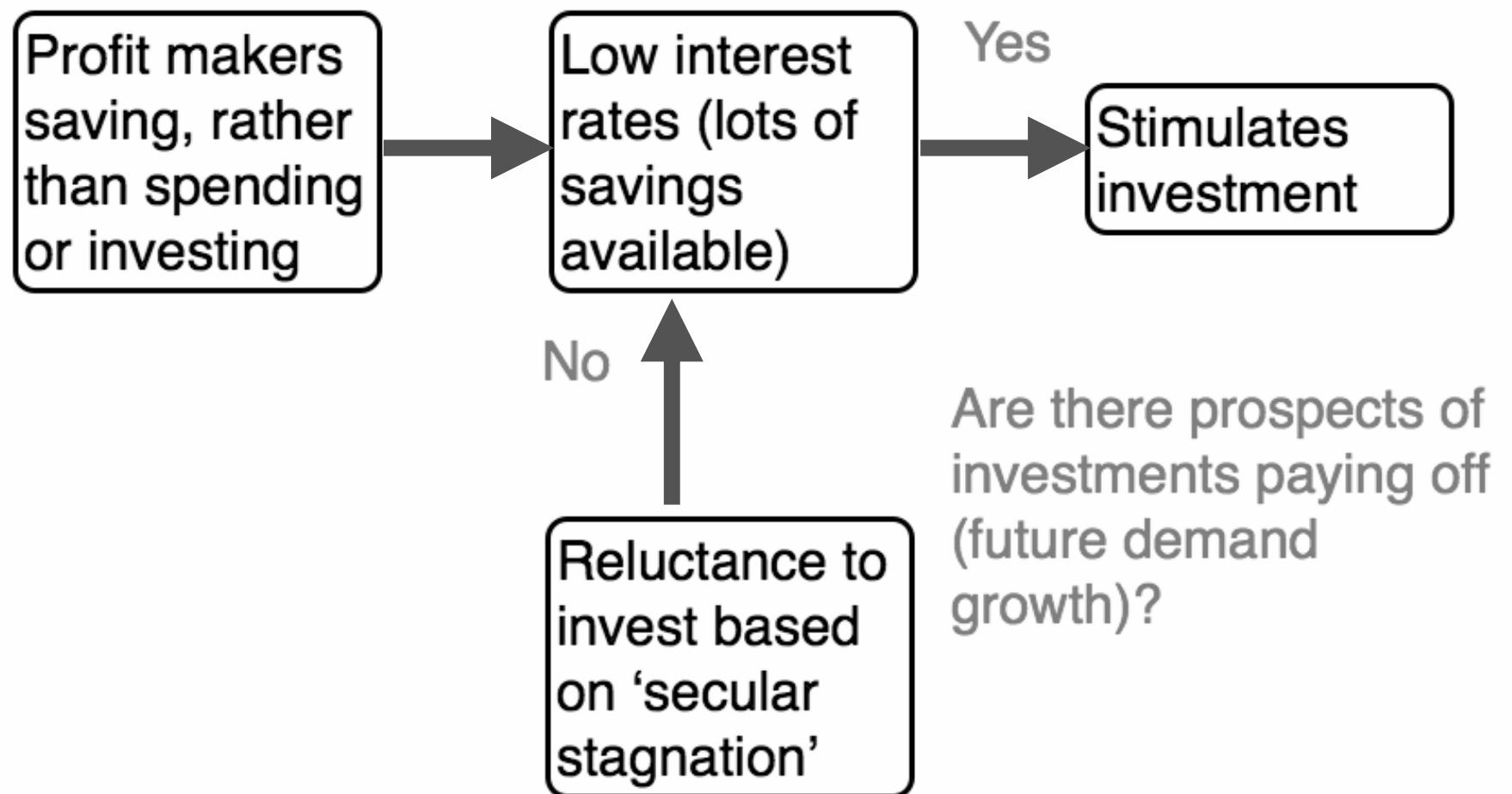
- Privatised Keynesianism (Colin Crouch)
 - Keynesianism stimulated demand via government spending
 - If this is no longer available, or considered available, how can politicians appeal to (especially middle class) voters?
 - If people own assets (esp. housing), and those assets rise in value, they can borrow against them, and spend
 - Consumers not government, do the deficit spending
 - Goes with deregulation of finance, to make lending available



Isn't there an alternative way to deal with inadequate demand?

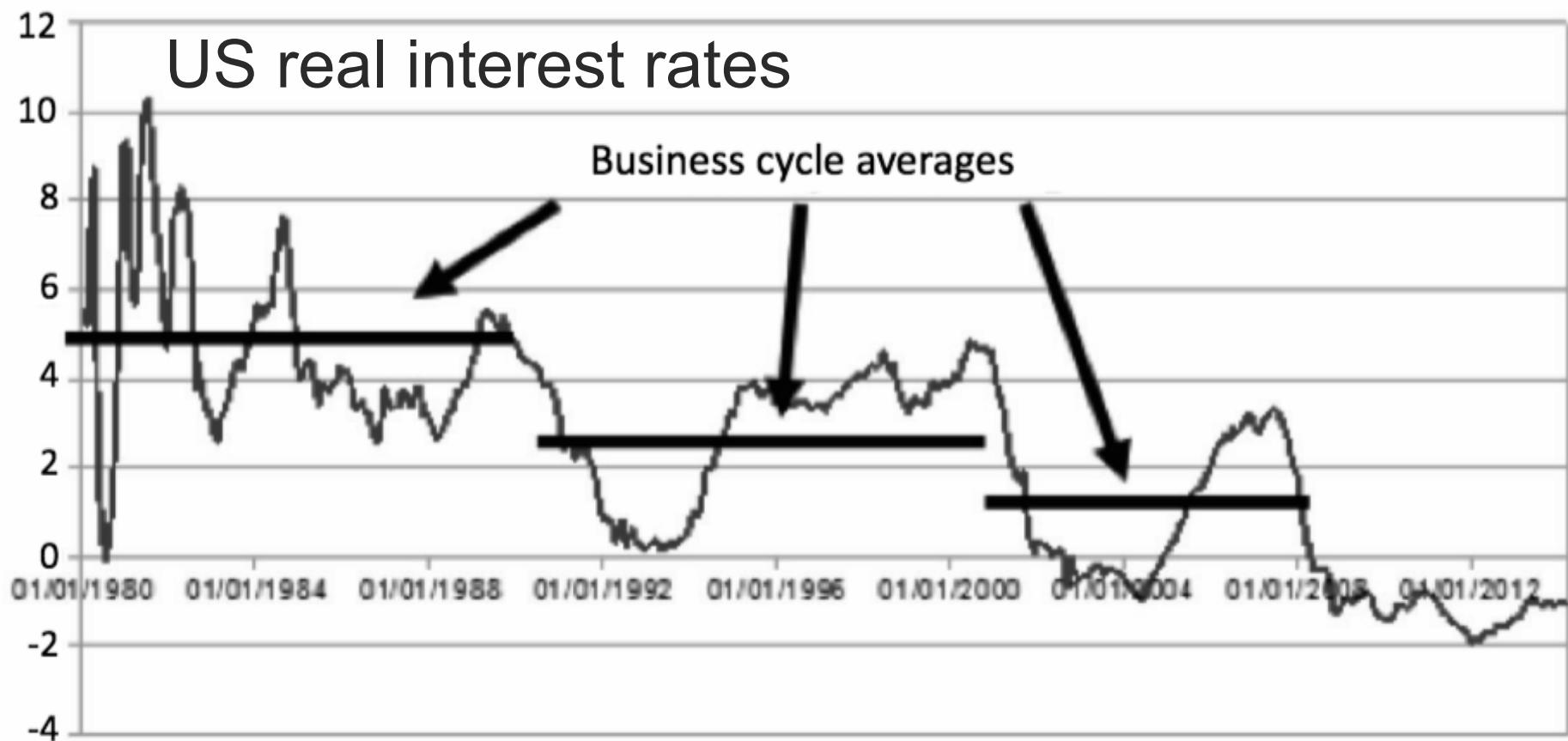


When low interest rates are not enough: secular stagnation



Summers on ‘secular stagnation’

- ‘Full employment real interest rate’ is falling (i.e., need lower and lower rates to make up for reluctance to invest)



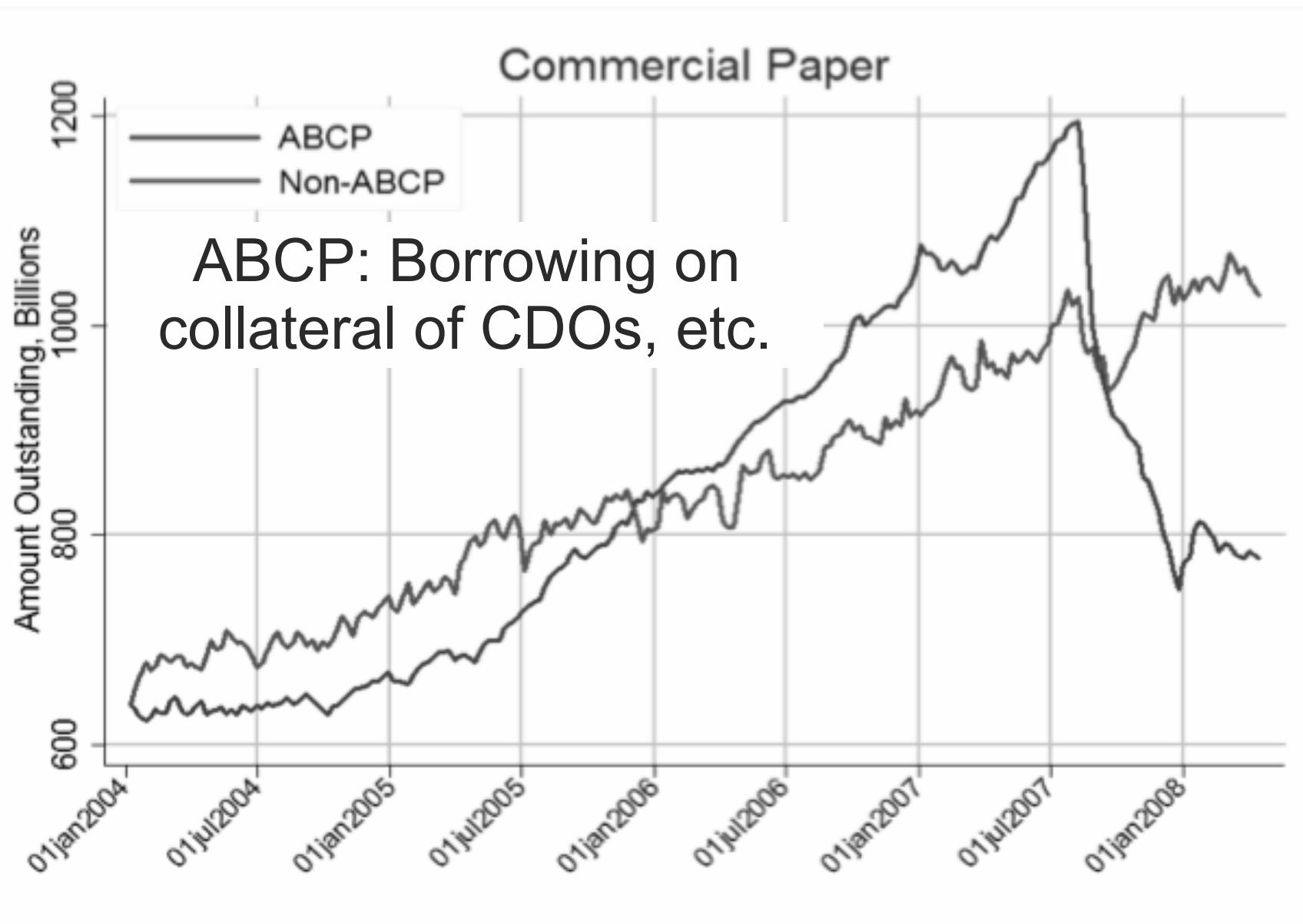
Source: Krugman in http://www.voxeu.org/sites/default/files/Vox_secular_stagnation.pdf

Summers on ‘secular stagnation’: why is it happening?

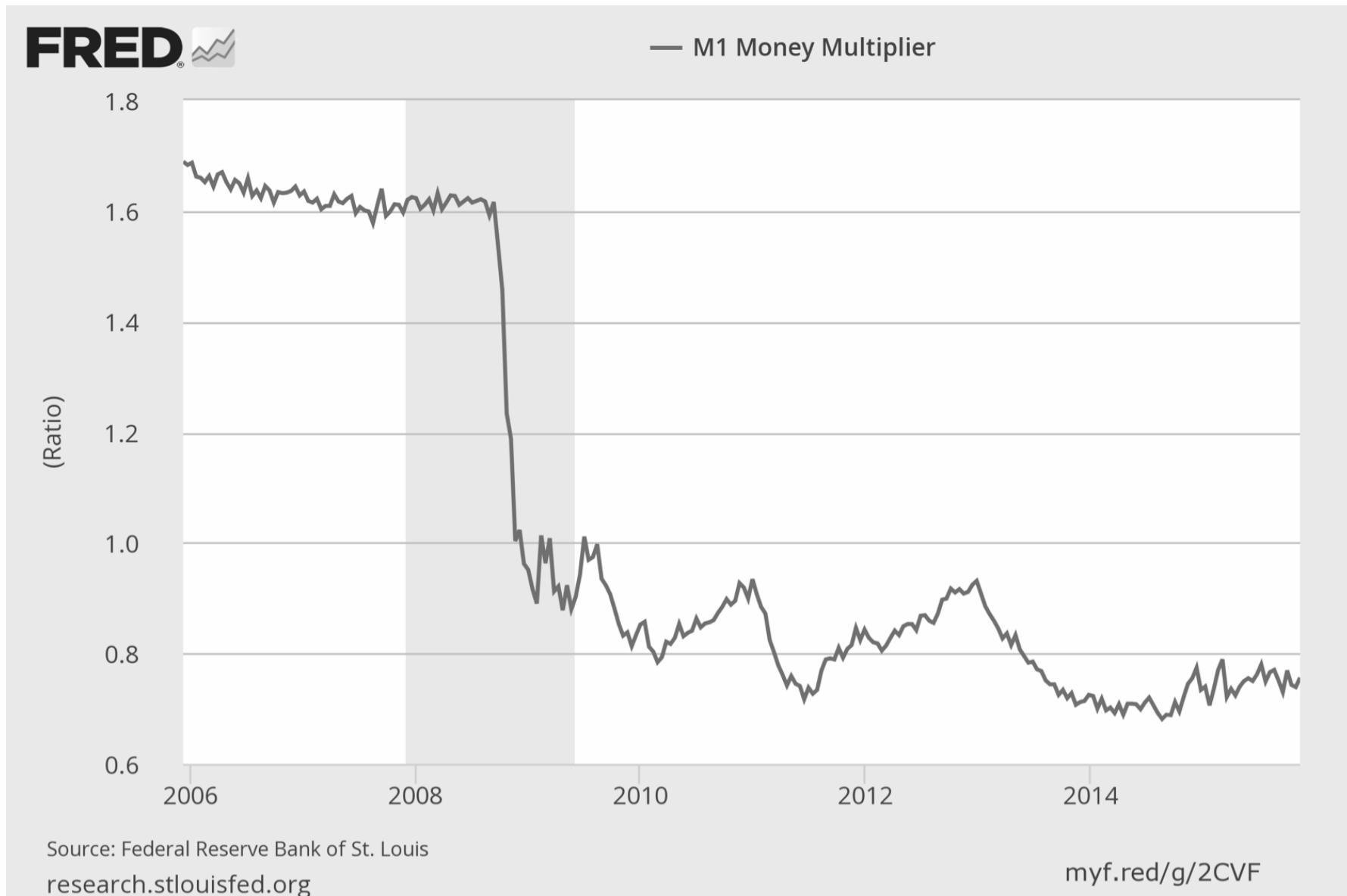
- Among other reasons: structural changes suggest no increased demand to make investments pay off
 - “Slower population and possibly technological growth means a reduction in the demand for new capital goods to equip new or more productive workers.”
 - “Rising inequality operates to raise the share of income going to those with a lower propensity to spend.”
 - “Closely related, a rising profit share operates to transfer income to those with a lower propensity to spend.”
- ‘Privatised Keynesianism’ and other ‘regime of accumulation’ arguments can be regarded as analyses of political *reaction* to secular stagnation

II. AFTER THE FINANCIAL CRISIS: THE ‘LIQUIDITY TRAP’ AND THE COLLAPSE OF GROWTH

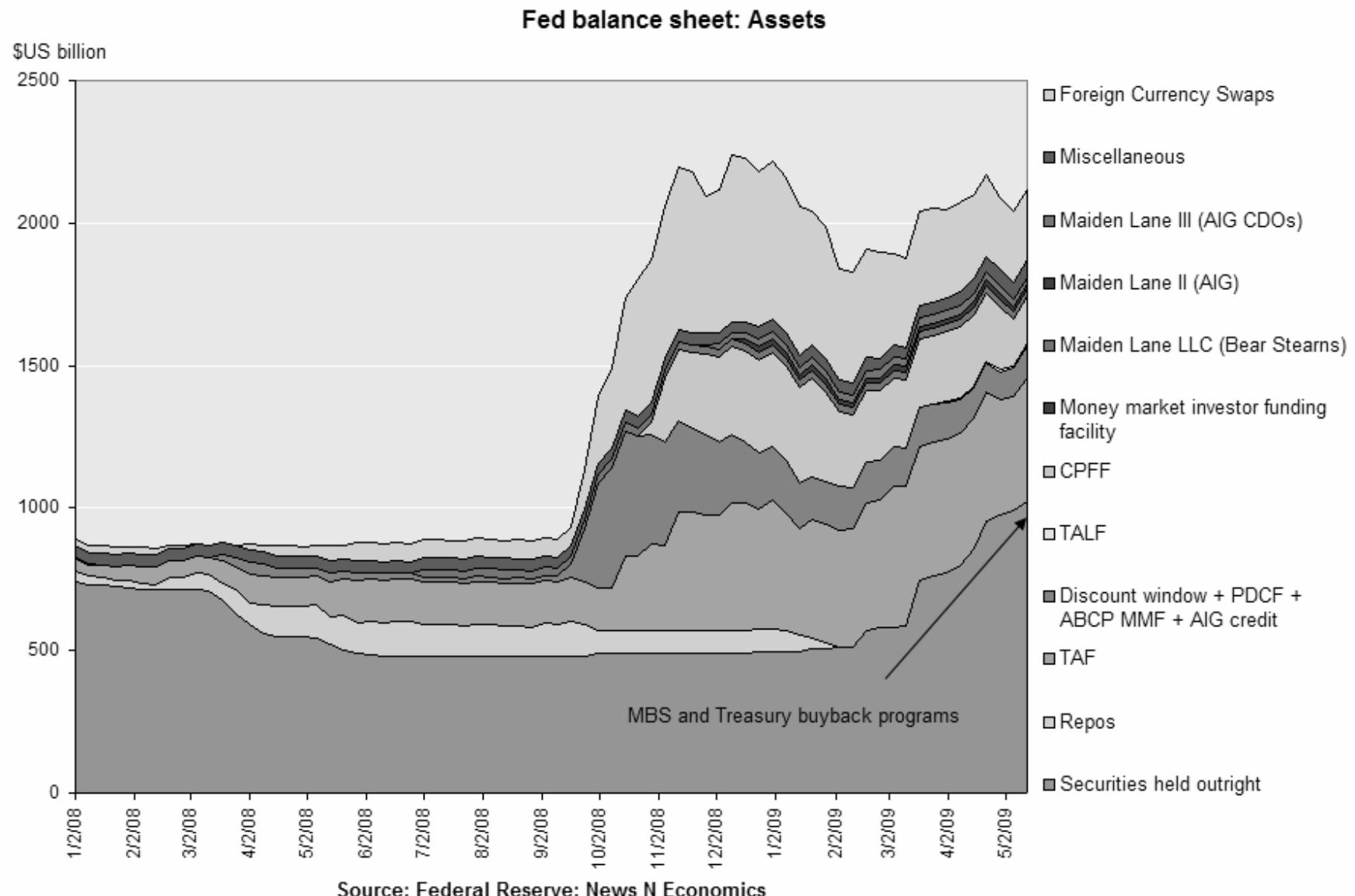
The 2008 crisis: lending collapses



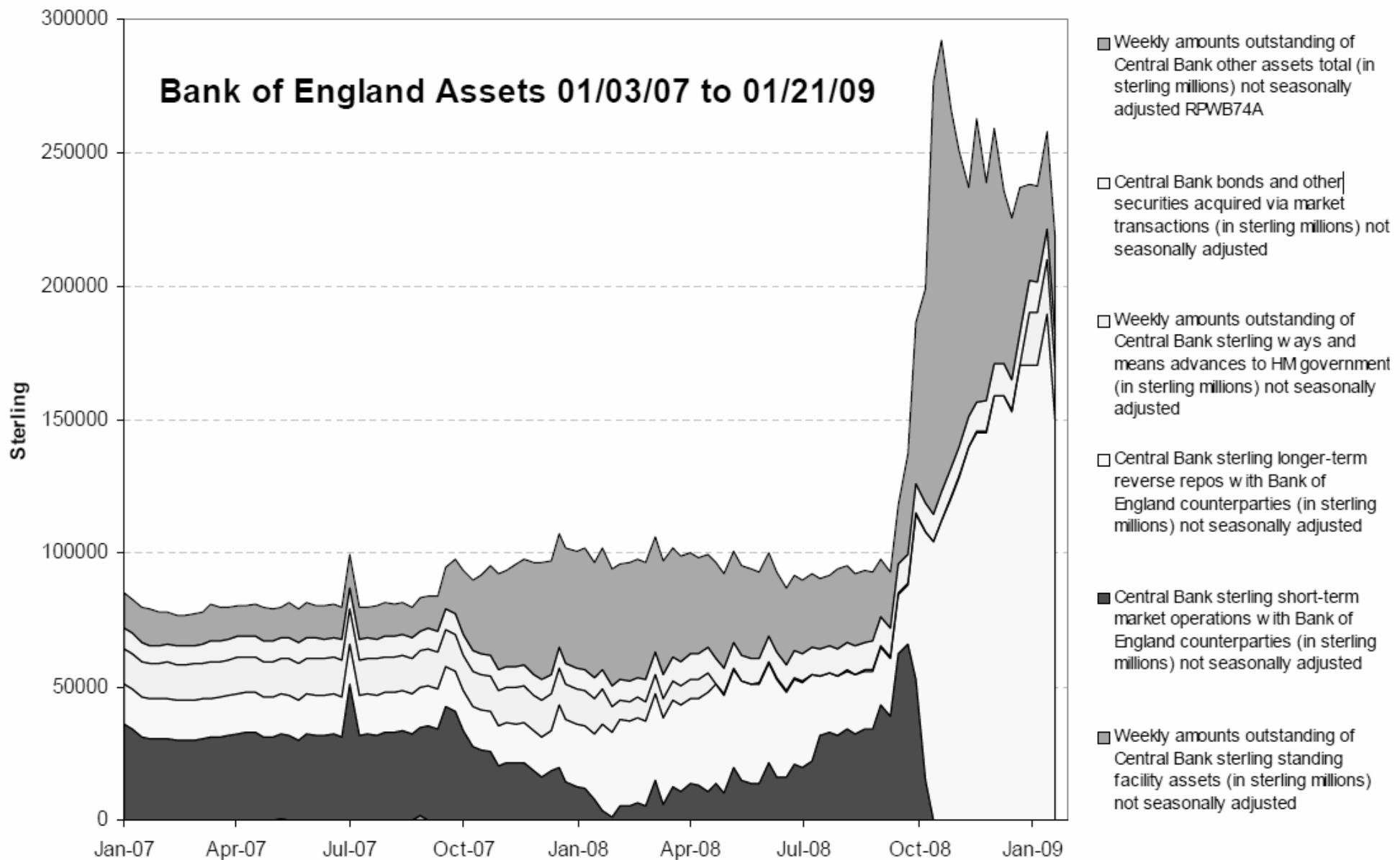
2008 crisis: money not multiplying



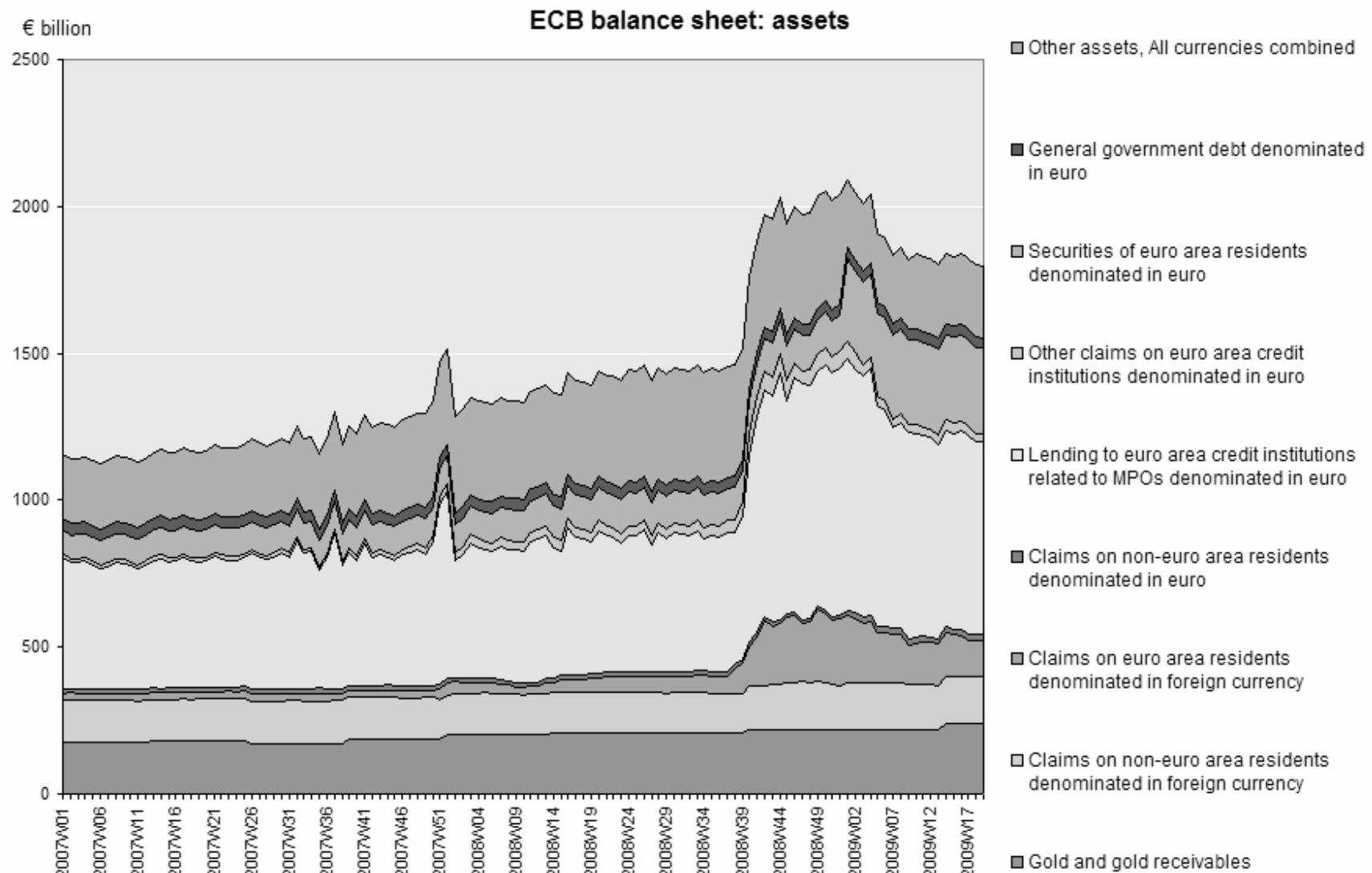
Central Banks replace private sector lending



Central Banks replace private sector lending



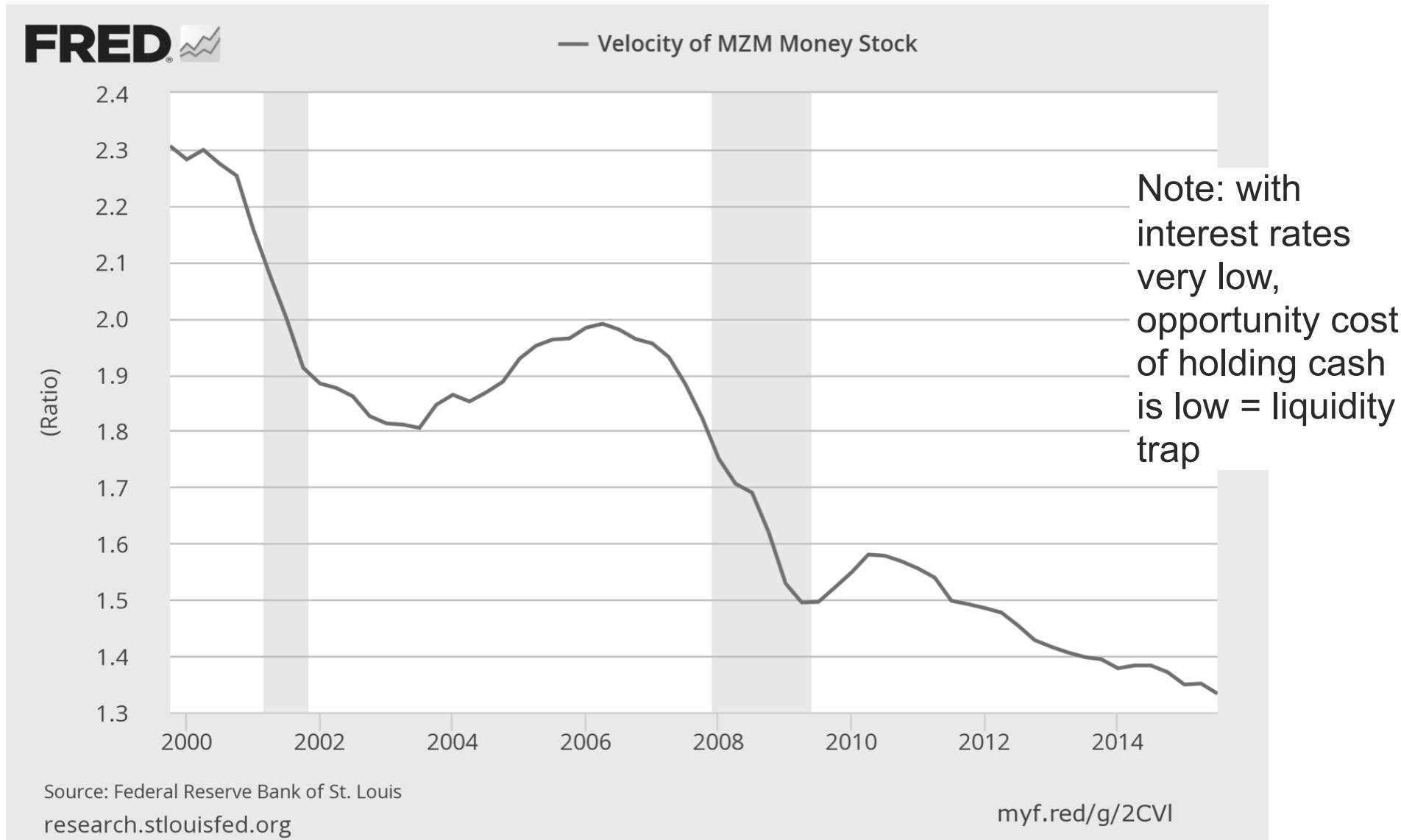
Central Banks replace private sector lending



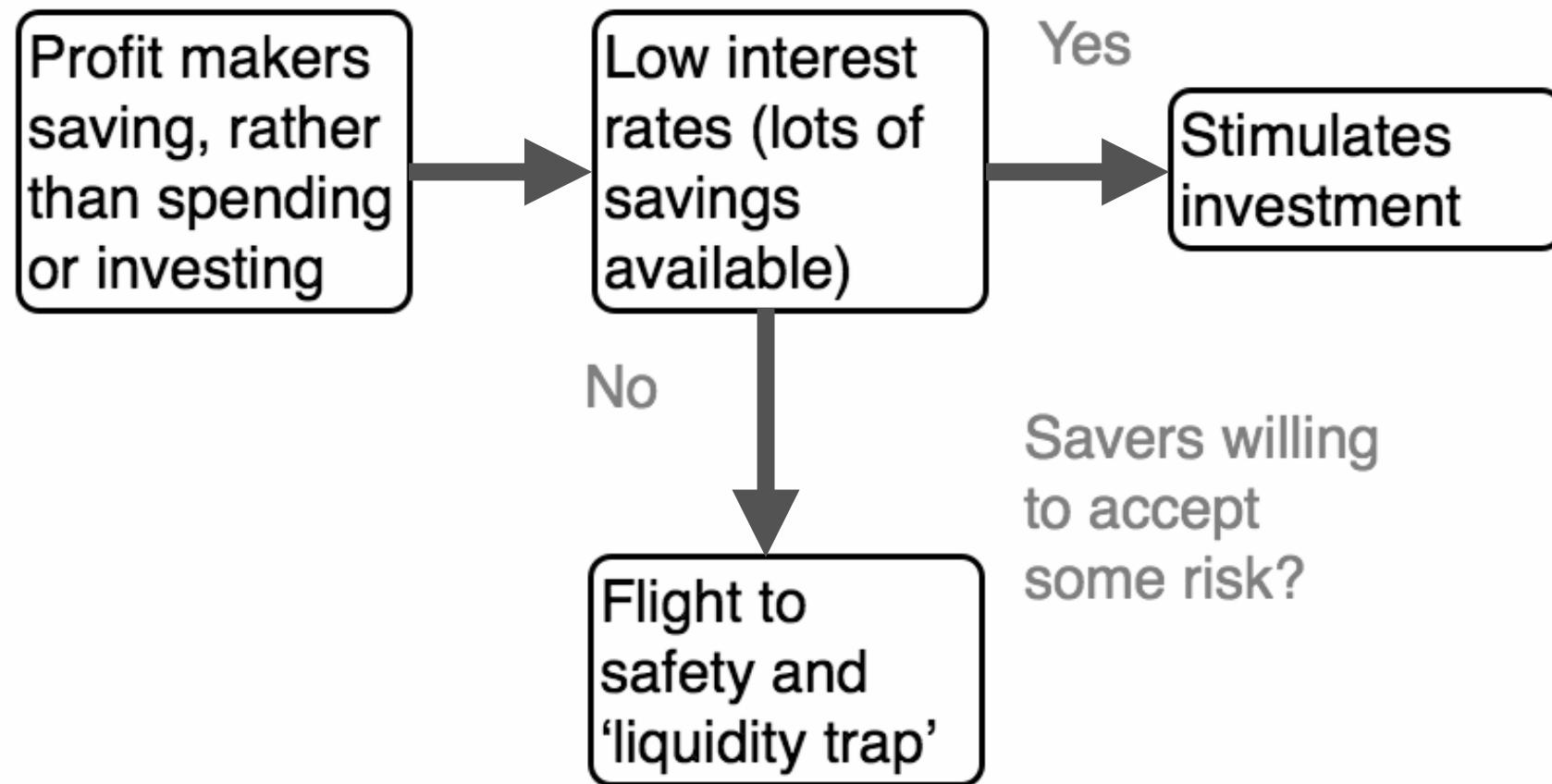
Source: European Central Bank; News N Economics

Eek! They're printing money! Inflation coming?

Remember $P = MV / Q$



The liquidity trap



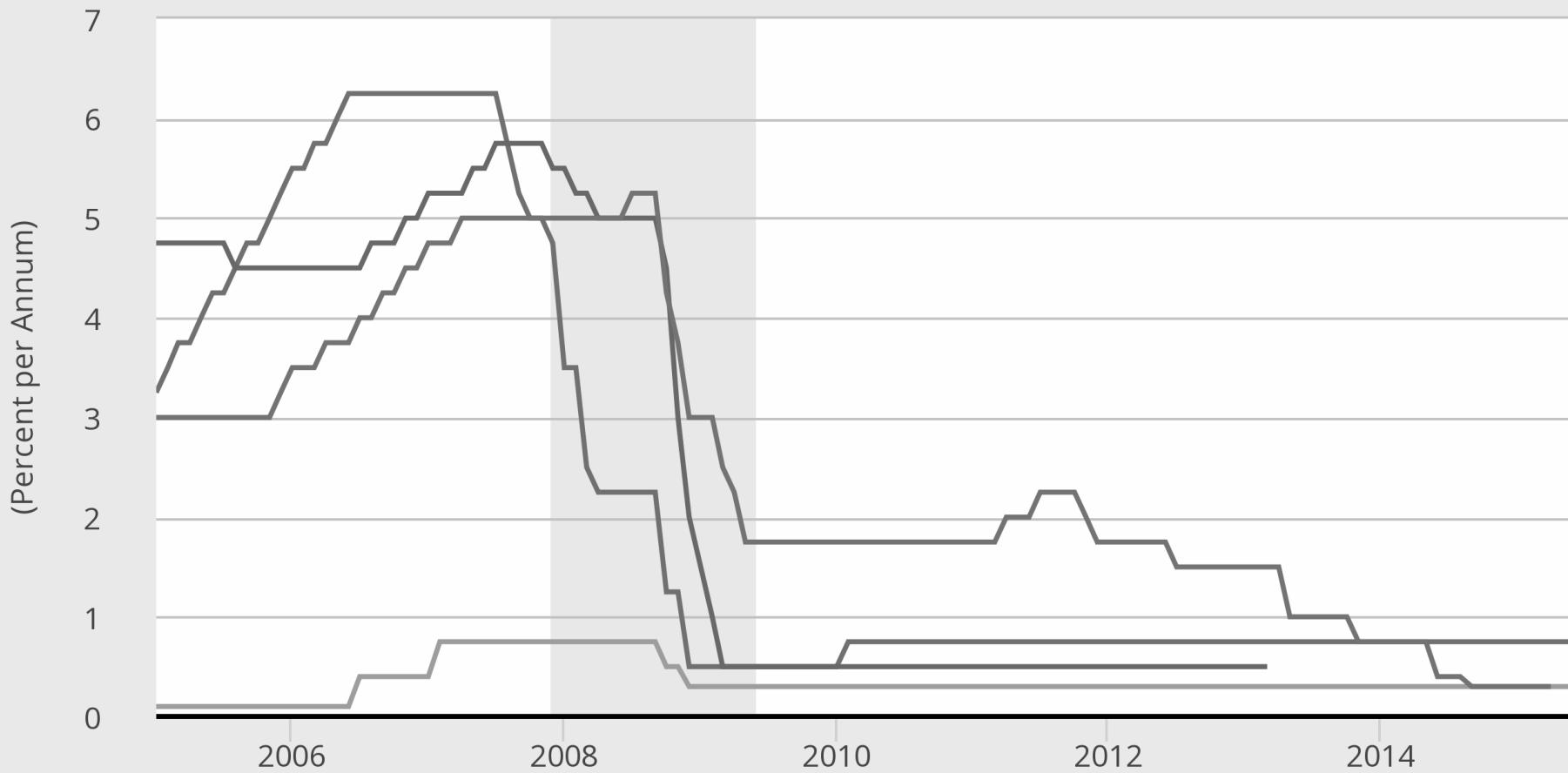
The ‘zero lower bound’

- Both the liquidity trap and secular stagnation imply that low interest rates don’t translate into investment
- But what about using the central bank to make interest rates *even lower*, to make investment relatively more attractive?
- The ‘zero lower bound’ means that interest rates *cannot* go (much) lower than zero

Arrival of the zero lower bound

FRED 

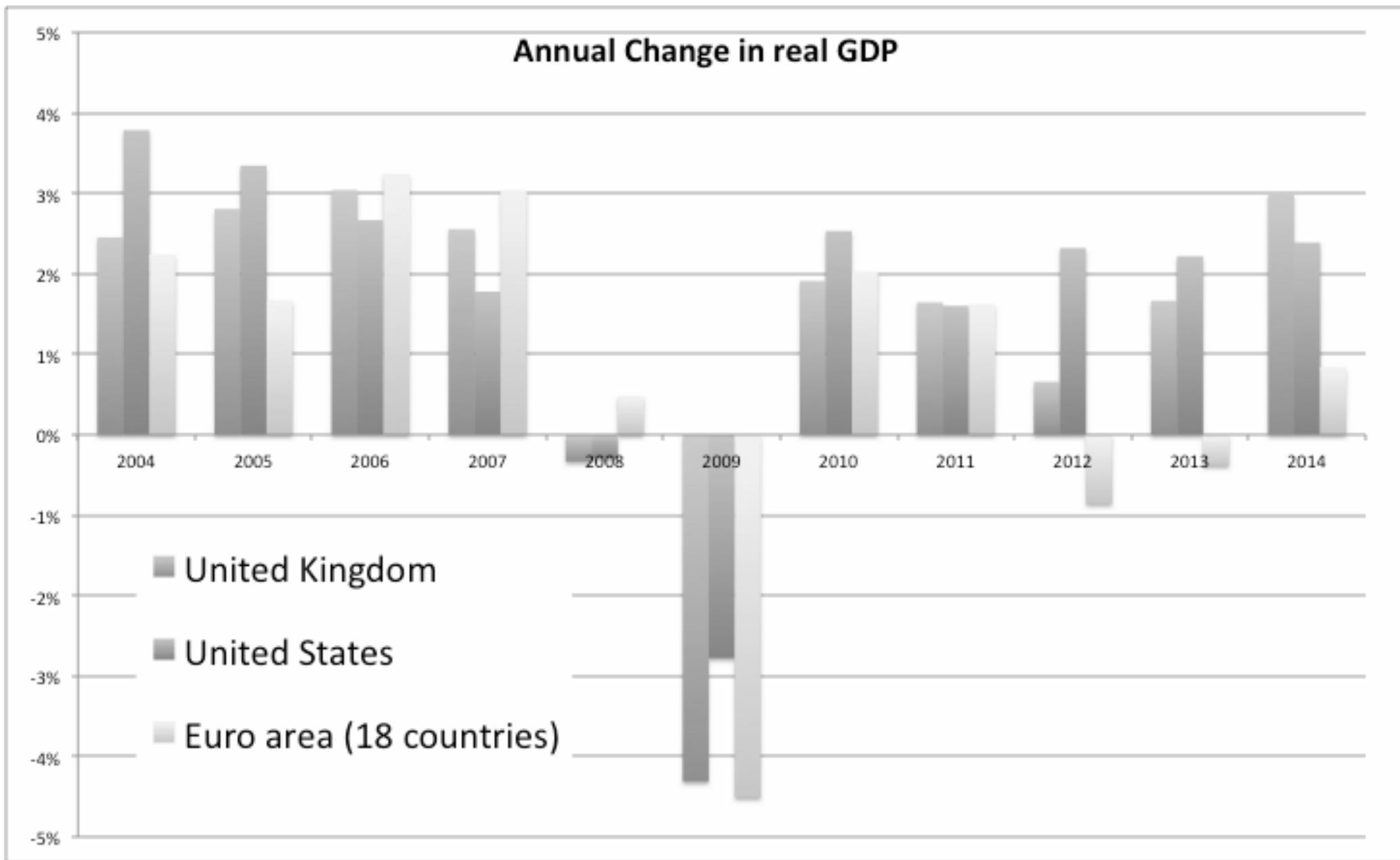
- Interest Rates, Discount Rate for United States©
- Interest Rates, Discount Rate for United Kingdom©
- Interest Rates, Discount Rate for Japan©
- Interest Rates, Discount Rate for Euro Area©



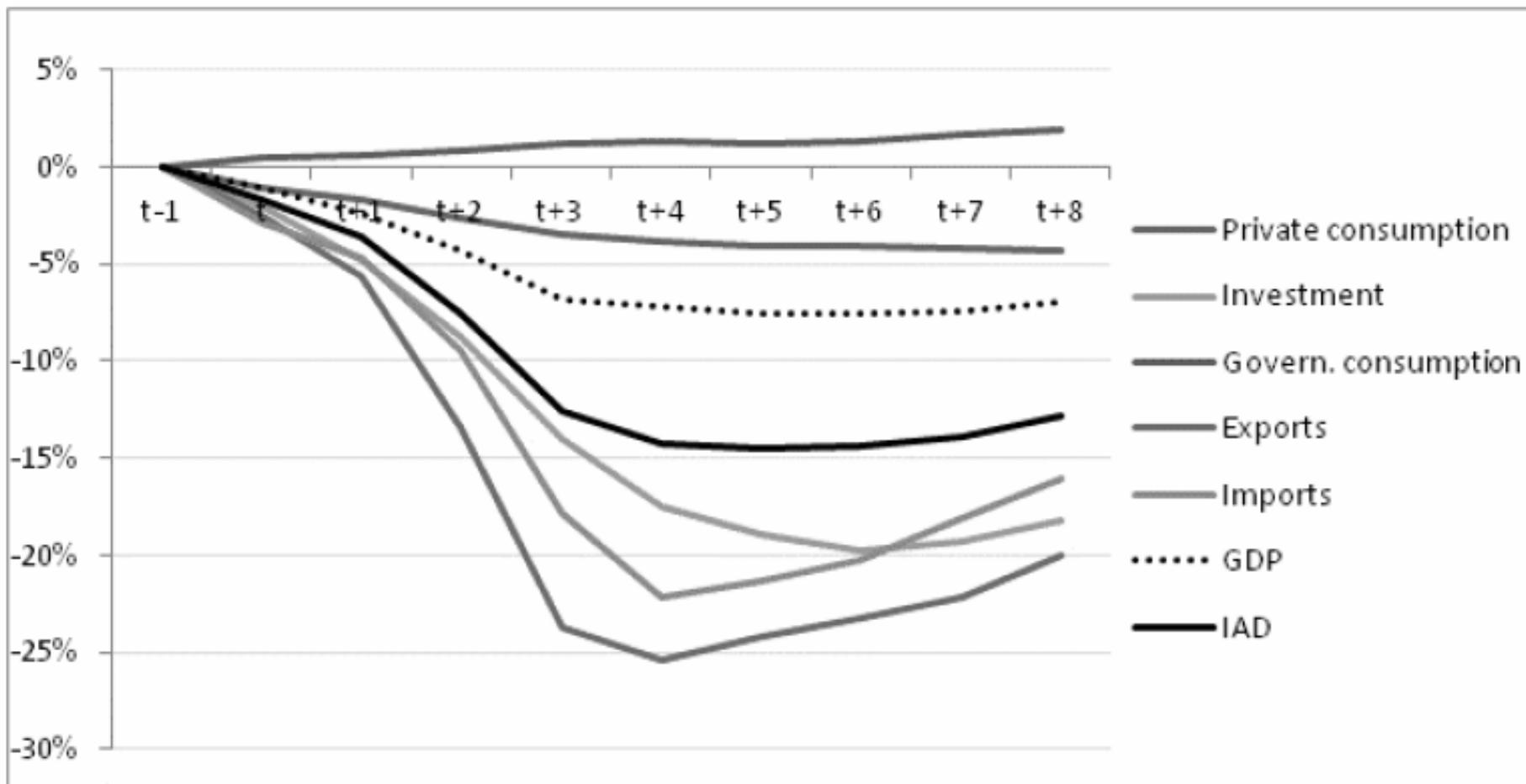
From financial crisis to the collapse in demand

- *Credit crunch*: Financial sector not lending, makes even ordinary business operations (trade credit) more difficult
- *Balance sheet effects*: Businesses tended to have accumulated a lot of debt in pre-crisis period (when credit was easy). They won't want to borrow (and banks won't want to lend to them) until their debt-to-equity ratio is lower.
- Applies to *consumer borrowing* as well
- Also, simple feedback effects (unemployed people don't buy anything -> more unemployed people; businesses not investing means no prospective sales -> business not investing, etc.)

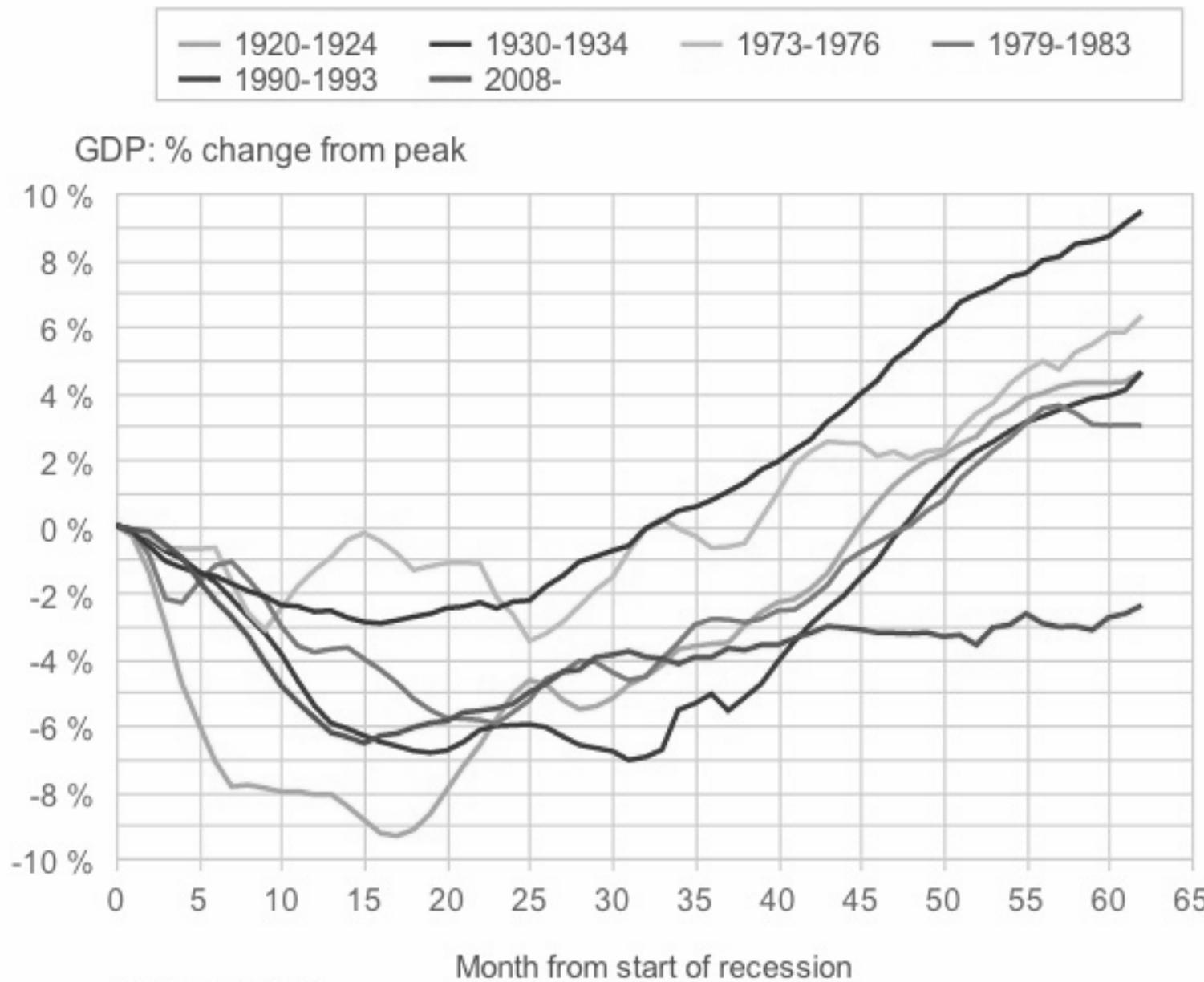
Annual Change in real GDP



Panel D: G7 - 2008-2009 recessions



How recessions compare

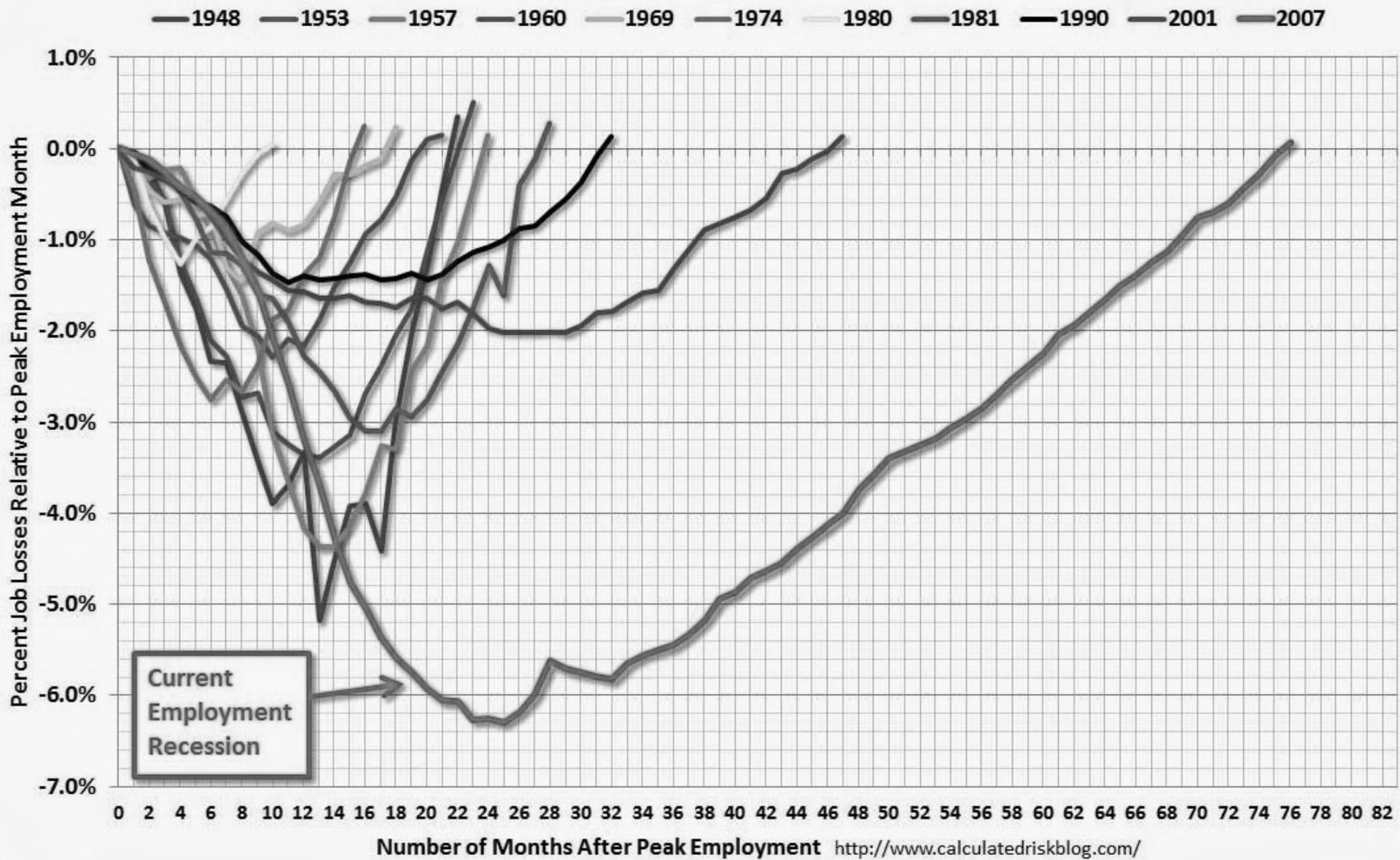


Source: NIESR

<http://www.bbc.co.uk/news/10613201>

United Kingdom

Percent Job Losses in Post WWII Recessions



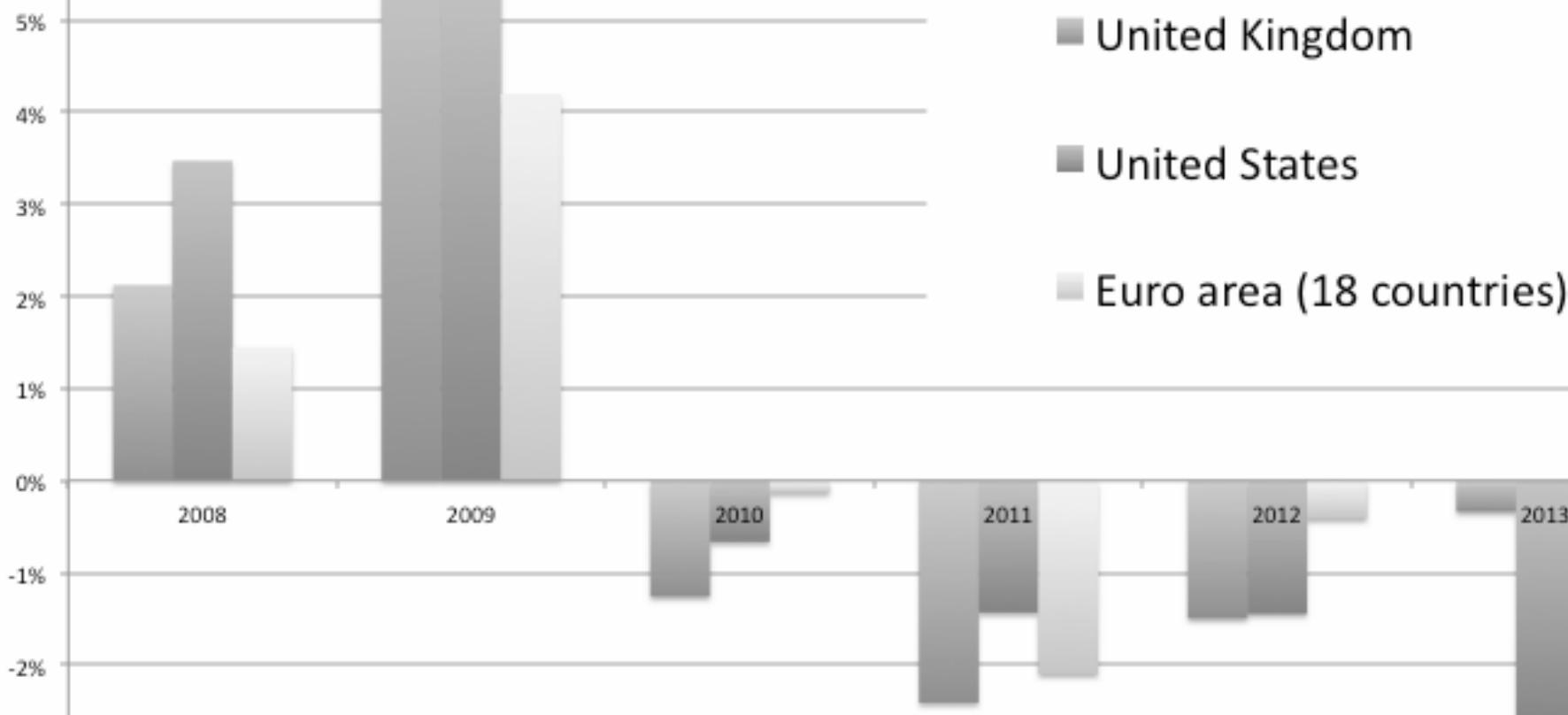
United States

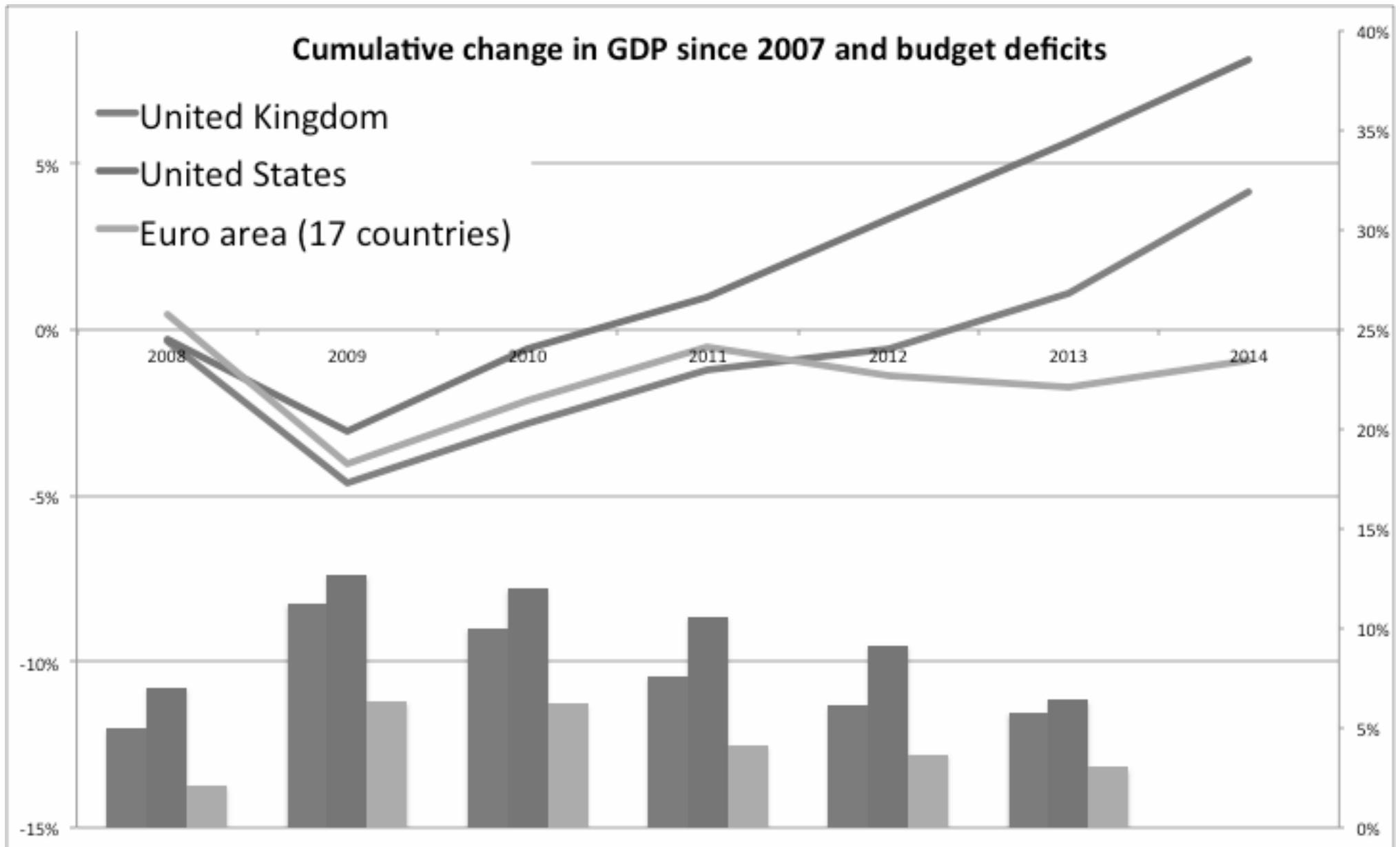
III. THE AUSTERITY MYSTERY

Forms of demand stimulus

- Automatic stabilisers
 - *Tax income* tends to go down in a recession
 - *Expenditure* tends to go up (unemployment insurance)
- Budget deficits increase
- Explicit stimulus: new policies to reduce tax income or increase spending

Annual change in budget deficit as share of GDP (all levels of government)





The really bad case for austerity

- The “Treasury View” -- government can only move spending around, not increase it
 - Grover Norquist: “The idea that if you take a dollar out of the economy and then — from somebody who earned it, either through debt, or through taxes — and give it to somebody who’s politically connected, that there are more dollars around, that if you stand on one side of the lake and put a bucket into the lake, and walk around to the other side in front of the TV cameras, pour the bucket back into the lake and announce you’re stimulating the lake to great depths. We just wasted \$800 billion on stimulus spending that added to debt, that killed jobs.”
 - The whole problem in a recession is that *money is not getting spent*. It’s not M that’s at issue, but MV

The slightly less, but still very bad case for austerity

- Can't run up national debt forever
- Prospect of future tax rises
 - Stifles business confidence
 - Consumers reduce spending in anticipation

The case for more stimulus

- Challenging the austerity case
 - Where's the signs of fears over size of deficits, at least in countries that print their own currencies?

	Budget balance, % of GDP 2010	Budget balance, % of GDP 2011	Outstanding debt %GDP, end 2009	10-year gov't bonds interest rate 1/Dec/10, %	10-year gov't bonds interest rate 28/Nov/ 11, %
United States	-9.0	-9.0	53.1	2.96	1.86
Japan	-7.5	-8.3	178	1.14	0.97
UK	-10.1	-8.8	75.1	3.47	2.14
France	-7.8	-5.8	60.8	3.24	3.67
Germany	-3.7	-1.0	43.8	2.77	2.05
Greece	-8.5	-9.1	125.7	11.85	29.4
Ireland	-32	-10.1	46	8.97	8.62
Spain	-9.7	-6.5	46.1	5.27	6.59
Portugal	-7.4	-6.7	81.1	6.73	10.8
Italy	-5.0	-4.0	106.6	4.5	7.29

Sources
OECD,
Economist

The case for more stimulus

- Challenging the austerity case
 - Where's the signs of fears over size of deficits, at least in countries that print their own currencies?
 - Austerity very likely 'self-defeating': allows potential of economy to decay, slows growth, making debt harder to pay back
- The positive case
 - *Accounting identities*: not possible for everyone to reduce their debt at once. If balance sheet effects important, then government needs to take on more debt to allow private sector balance sheet repair
 - In *liquidity trap*, monetary policy ineffective in translating low interest rates into demand. Government borrowing and spending overcomes this problem

The case for stimulus: ‘The Paradox of Thrift’

<u>What everybody else does</u>	
Borrow, spend, invest	Scrimp and save
Borrow, spend, invest	Economy grows and we all make money
Scrimp and save	No big deal: I was thriftier than I had to be
What I do	Argh! I’m broke and there’s no jobs/customers
Scrimp and save	My thrift was justified, but economy keeps getting worse

Self-fulfilling predictions: what I do depends on what I think everyone else will do

Demand stimulus vs. thrift

What demand stimulus does

What
I do

**Borrow,
spend, invest**

**Scrimp and
save**

What everybody else does

Borrow, spend, Scrimp and invest

Economy grows and we all make money

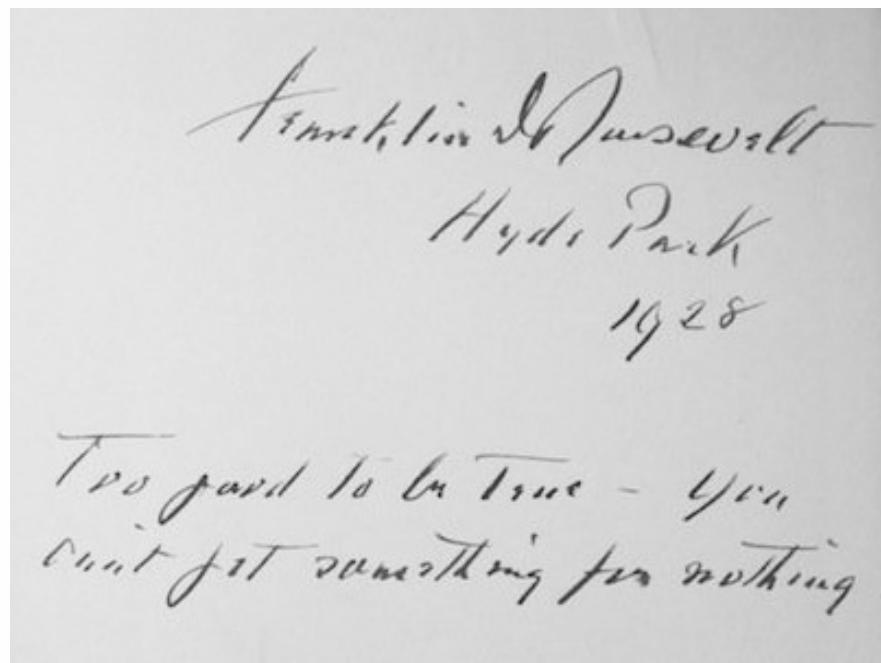
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Self-fulfilling predictions: what I do depends on what I think everyone else will do

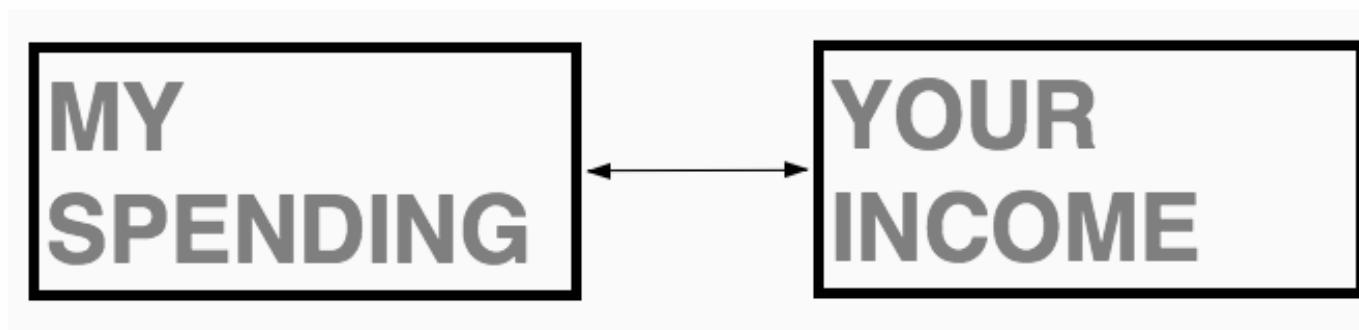
Something for nothing!



Keynes Writes FDR, 1933

In the field of domestic policy, I put in the forefront, for the reasons given above, **a large volume of Loan-expenditures under Government auspices.** It is beyond my province to choose particular objects of expenditure. But **preference should be given to those which can be made to mature quickly on a large scale, as for example the rehabilitation of the physical condition of the railroads.** **The object is to start the ball rolling. The United States is ready to roll towards prosperity, if a good hard shove can be given in the next six months.** Could not the energy and enthusiasm, which launched the N.I.R.A. in its early days, be put behind a campaign for accelerating capital expenditures, as wisely chosen as the pressure of circumstances permits? You can at least feel sure that the country will be better enriched by such projects than by the involuntary idleness of millions.

The case for stimulus: spending identities



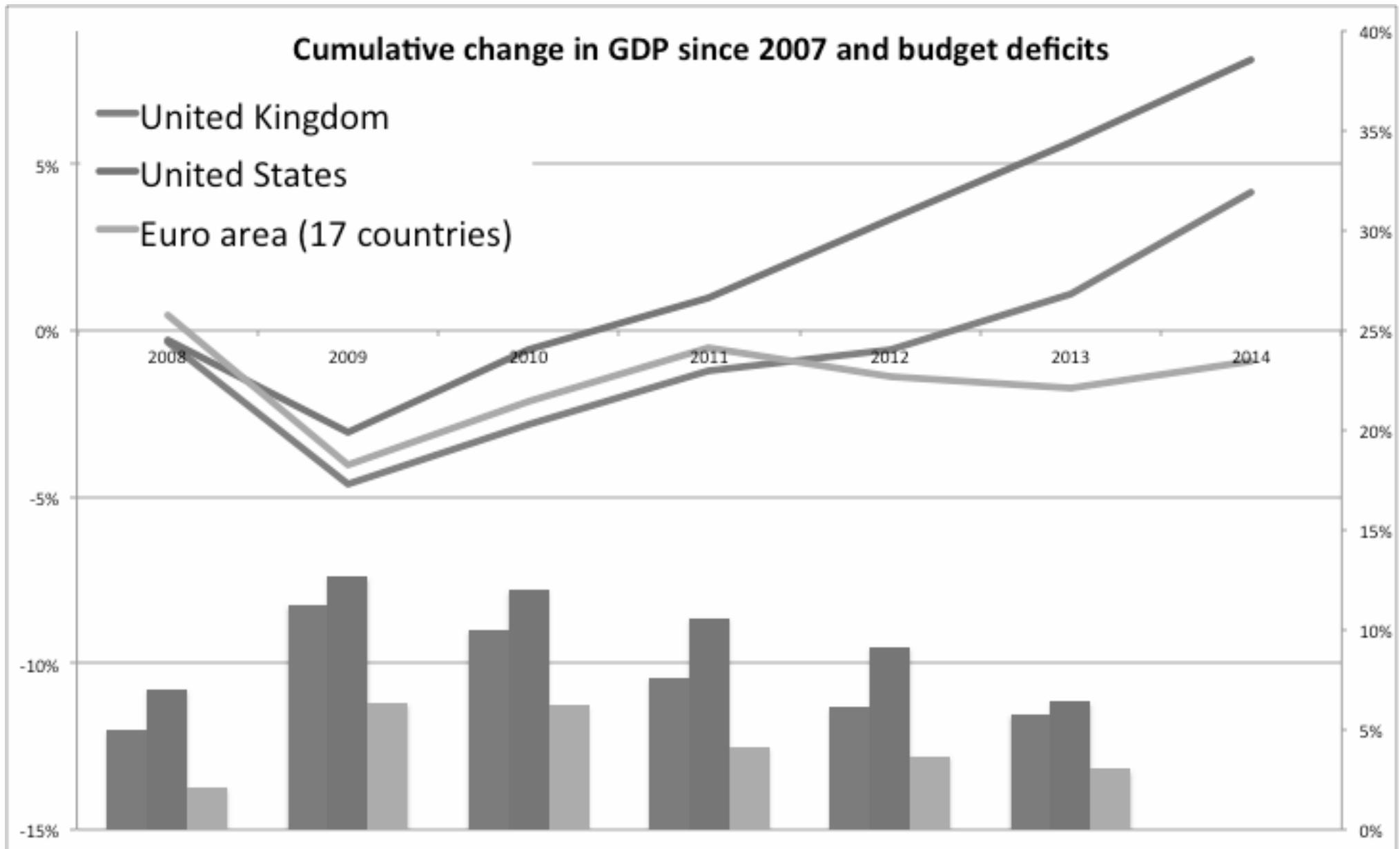
The political mystery

- Why isn't stimulus policy more popular?
 - Some have held that politicians love to spend money in search of votes -- why not do it now, when there's a credible economic justification?
 - The victims of austerity are concentrated and aware, not diffuse—why don't they effectively mobilise
- Three preliminary explanations
 - Blyth:
 - Power of ideas
 - Financial interests
 - My view: Positive feedback between veto points and the power of ideas in key jurisdictions of Eurozone and the US

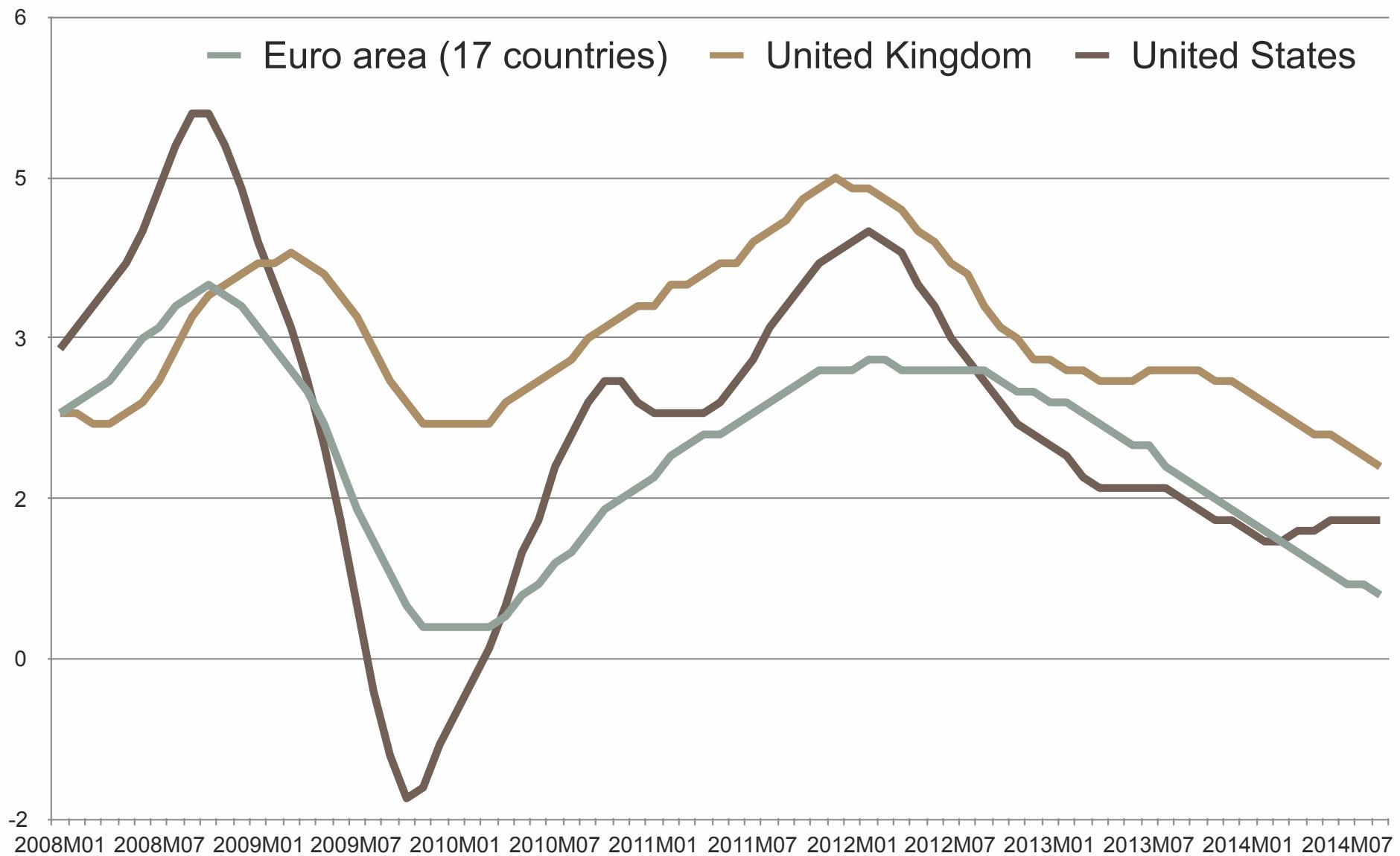
Additional possible explanations for austerity

- Kalecki: Business prefers a situation in which its confidence drives investment, as this gives it political influence
- Hard to convince people it works, because in individual country must rely on ‘counterfactual’ (without stimulus, things would have been even worse)
- International coordination problems (how to make surplus countries stimulate)
- Long-term decay of *explicitly theorised* demand stimulus as a tool of governance, propped up by implicit demand stimulus (privatised Keynesianism)
 - Reliance on central banks

POLITICS OF AUSTERITY IN PRACTICE: CRISIS IN THE EUROZONE

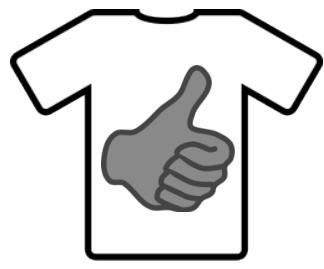


What happened? Inflation (12 mo avg)

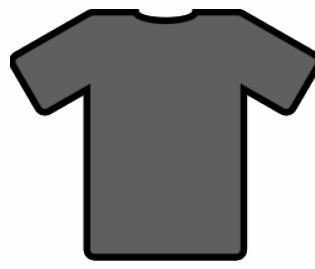


BEFORE THE CRISIS: COMMON CURRENCY AND UNCOMMON EFFECTS

Exchange rates and competitiveness



£1



Fr 110

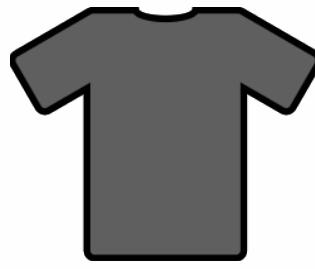


£1.10

**FRENCH GOODS
UNCOMPETITIVE**



£1



Fr 92



£0.92

DEFLATION



£1



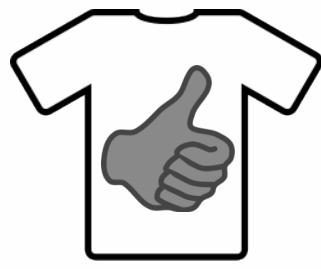
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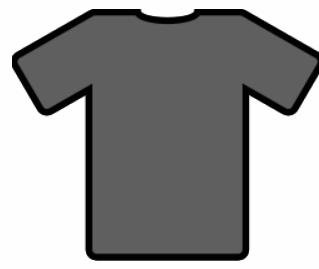
£0.92

DEVALUATION

120Fr/£



£1

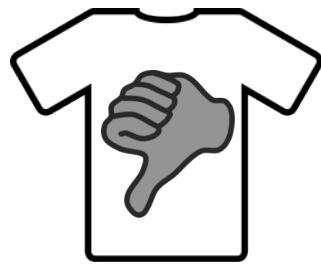


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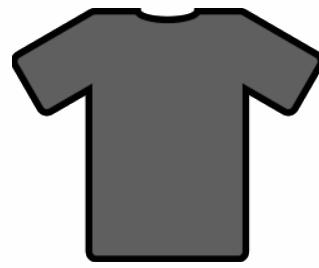


£1.10

**FRENCH GOODS
UNCOMPETITIVE**



£1



Fr92



£0.92

DEFLATION



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DEVALUATION



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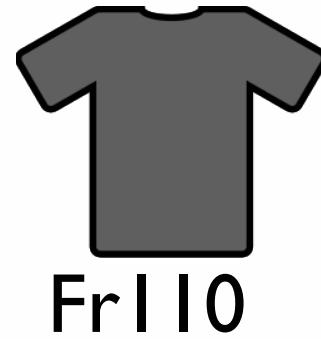
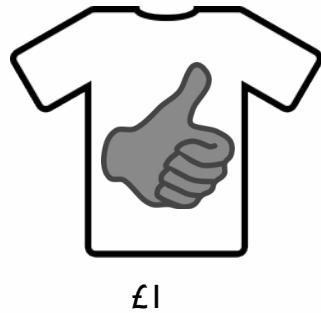


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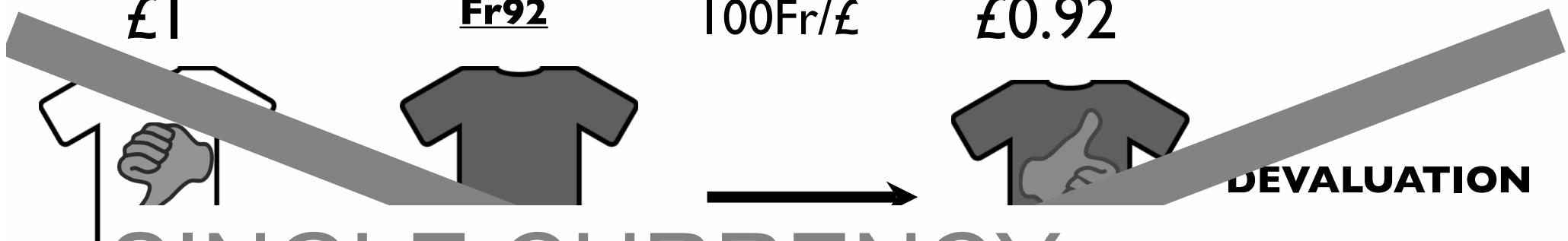
PROTECTION



**FRENCH GOODS
UNCOMPETITIVE**

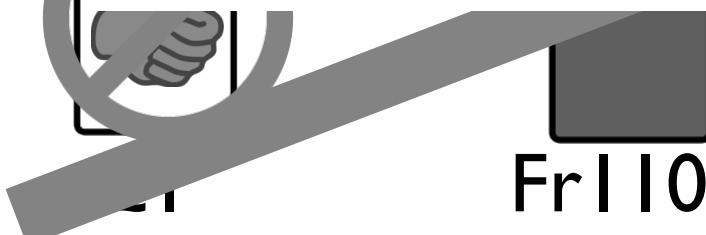


DEFLATION



SINGLE CURRENCY

AND EU FREE TRADE



PROTECTION

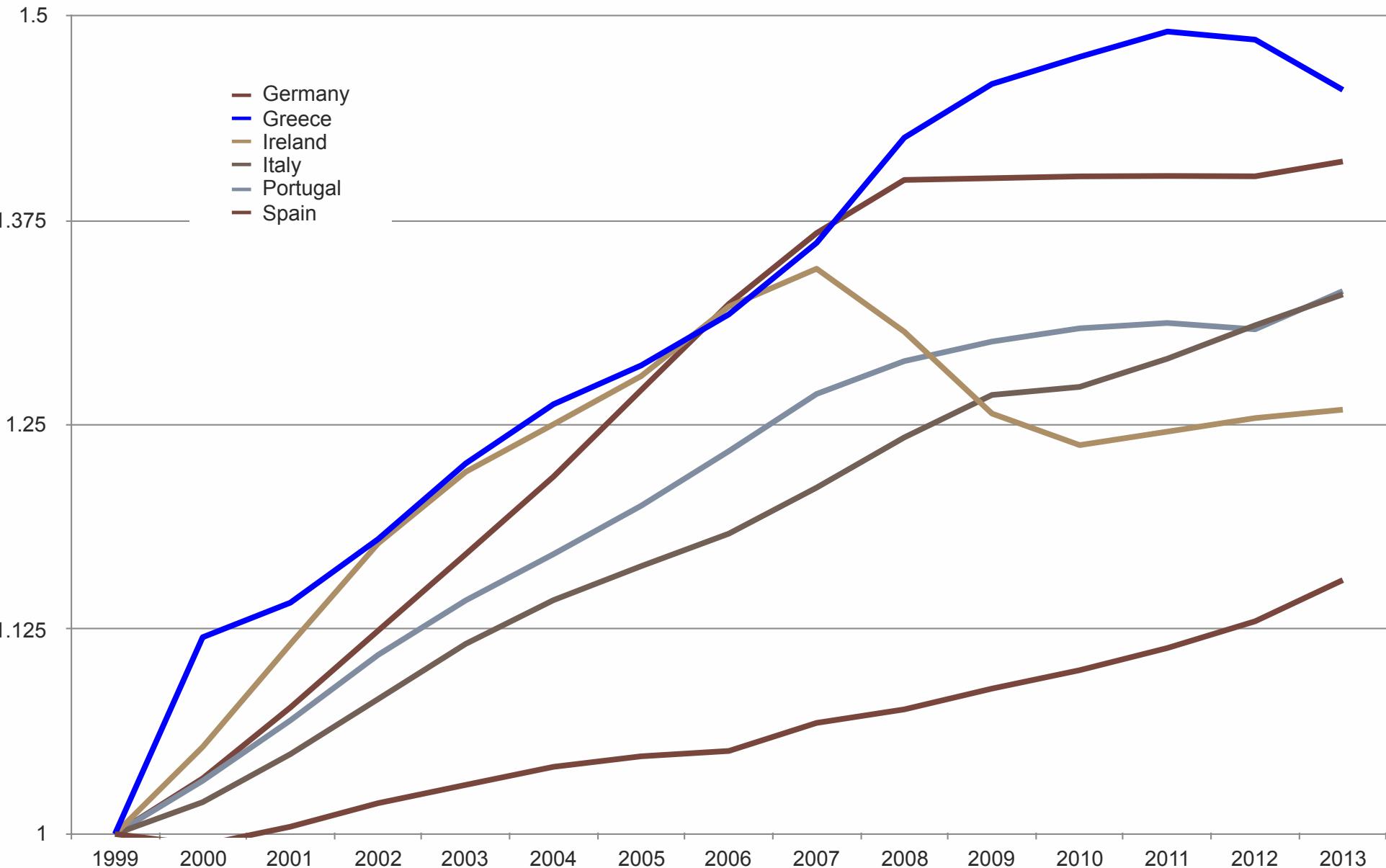
Inflation and competitiveness

- Note that if one country's price level rising faster than another's, its goods will become less competitive
- With fixed, or relatively inflexible, exchange rates, ability to hold inflation down key to maintaining competitiveness
- Deflation as a route to competitiveness is really hard!
 - Deflation tends to create downward economic spiral
 - Politically very difficult

Why the Eurozone?

- Before currency union, Germany heavily reliant on exports, low inflation rates to maintain competitiveness
- Other countries with higher inflation would regularly devalue to maintain competitiveness
- Single currency motivations multiple, but key ones
 - For Germany, eliminate competitive devaluation by key trade partners
 - For other European countries, elites hoped to have “credible commitment” to low inflation

Price index (HICP, 1999=1)

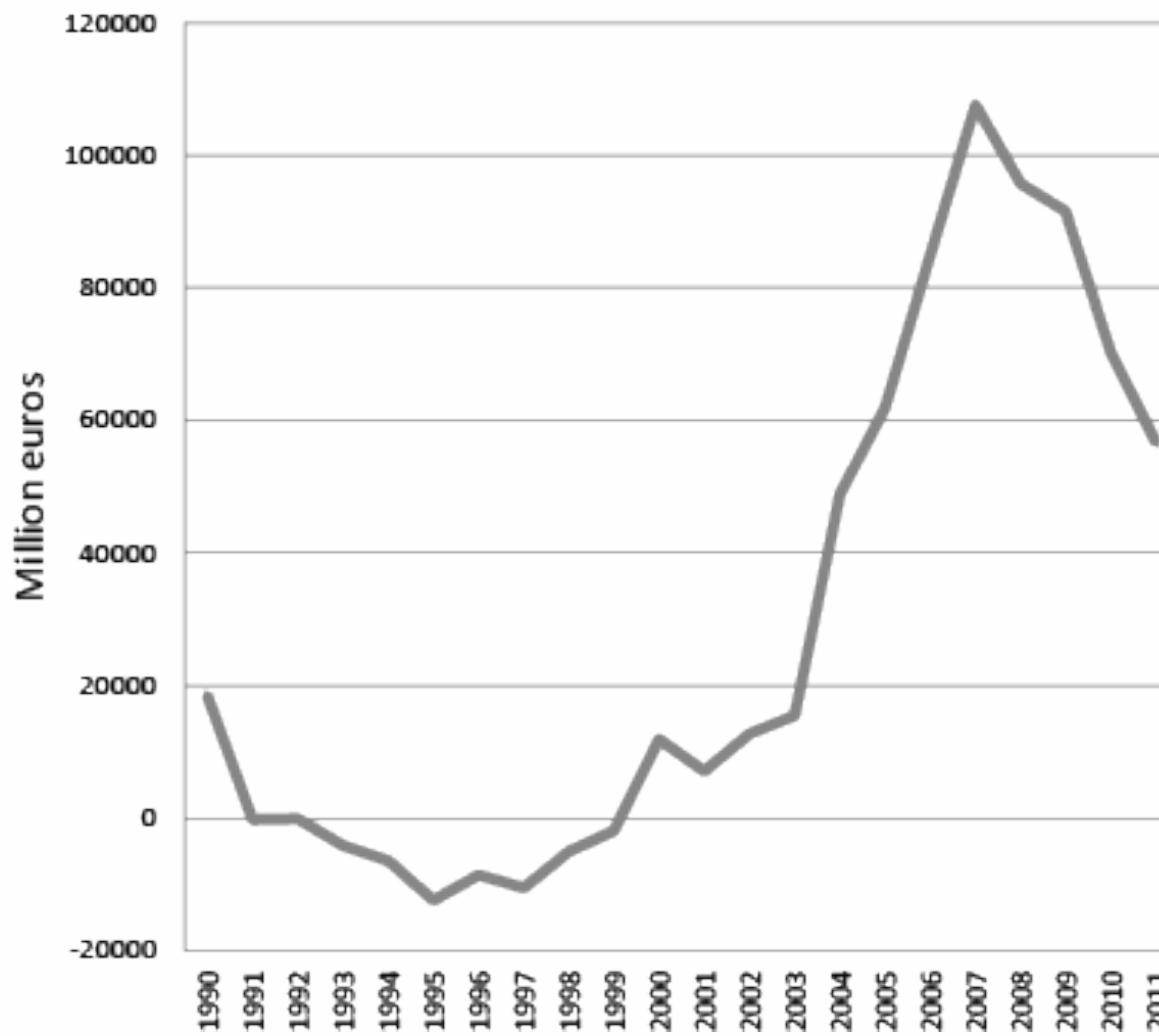


Boom-bust effects of differential inflation rates

- Multiple stimuli for investment & capital inflows in countries with above-average inflation
 - Real interest rates low, borrowing (including government borrowing) very attractive. THUS: eventual fiscal crisis in Greece
 - Low competitiveness, high purchasing power tends to fuel trade deficit, inflows to cover
 - One-way bets based on predicted inflation
 - THUS: housing booms in Ireland, Spain
- Note that process works in reverse in countries with lower inflation rates

Current account, Germany vis-a-vis the Eurozone

<http://www.voxeu.org/article/target2-scapegoat-german-errors>



Different varieties of capitalism?

- Hall:
 - ‘variations in the organisation of the European political economies generate[d] structural strains within EMU’
- Northern model:
 - Wage coordination enables wage moderation
 - Competitiveness does not depend on devaluation
 - Exports as key source of demand
- ‘Southern’ model:
 - Weak capacity for wage moderation
 - Competitiveness depends on devaluation
 - Domestic demand crucial

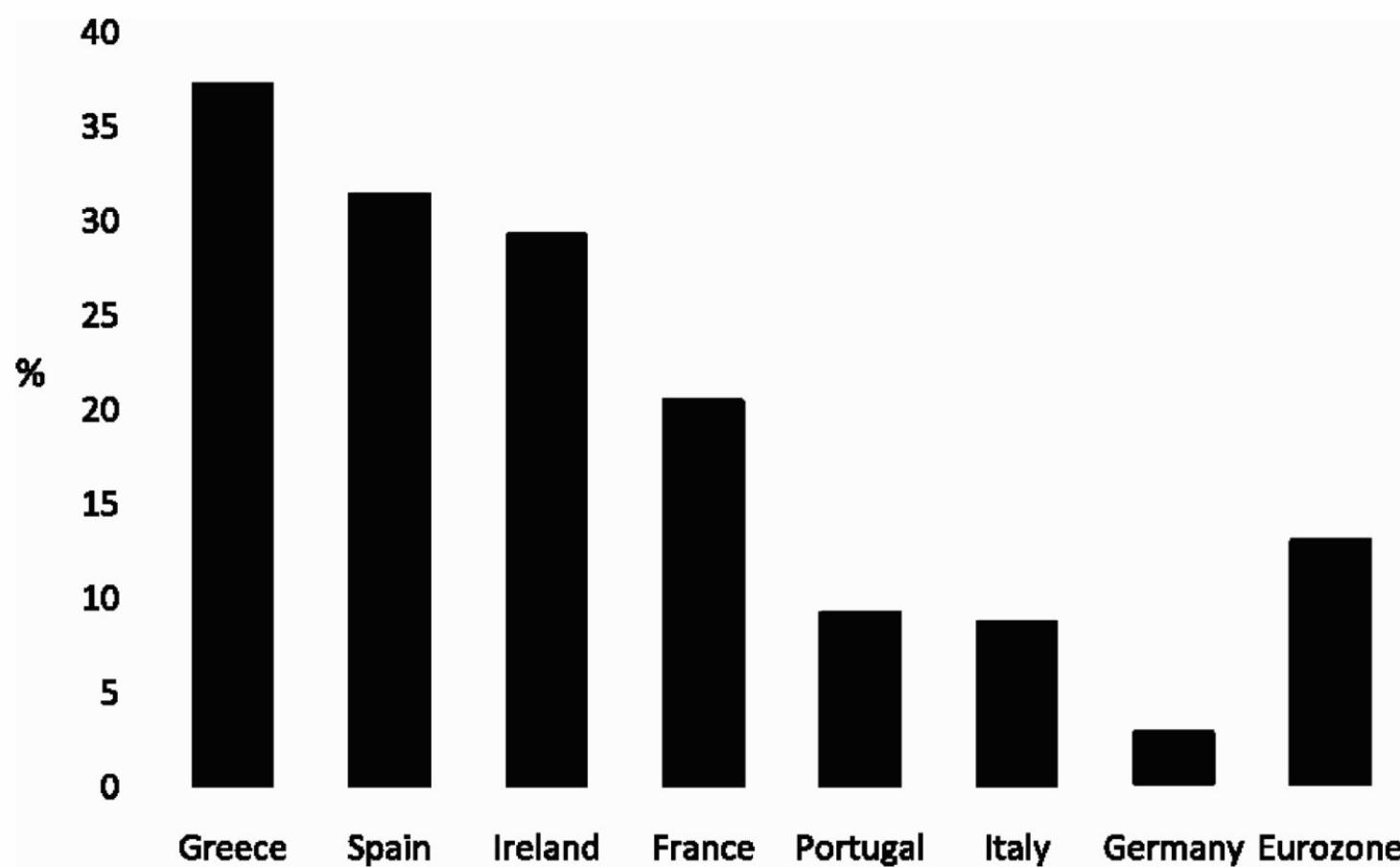
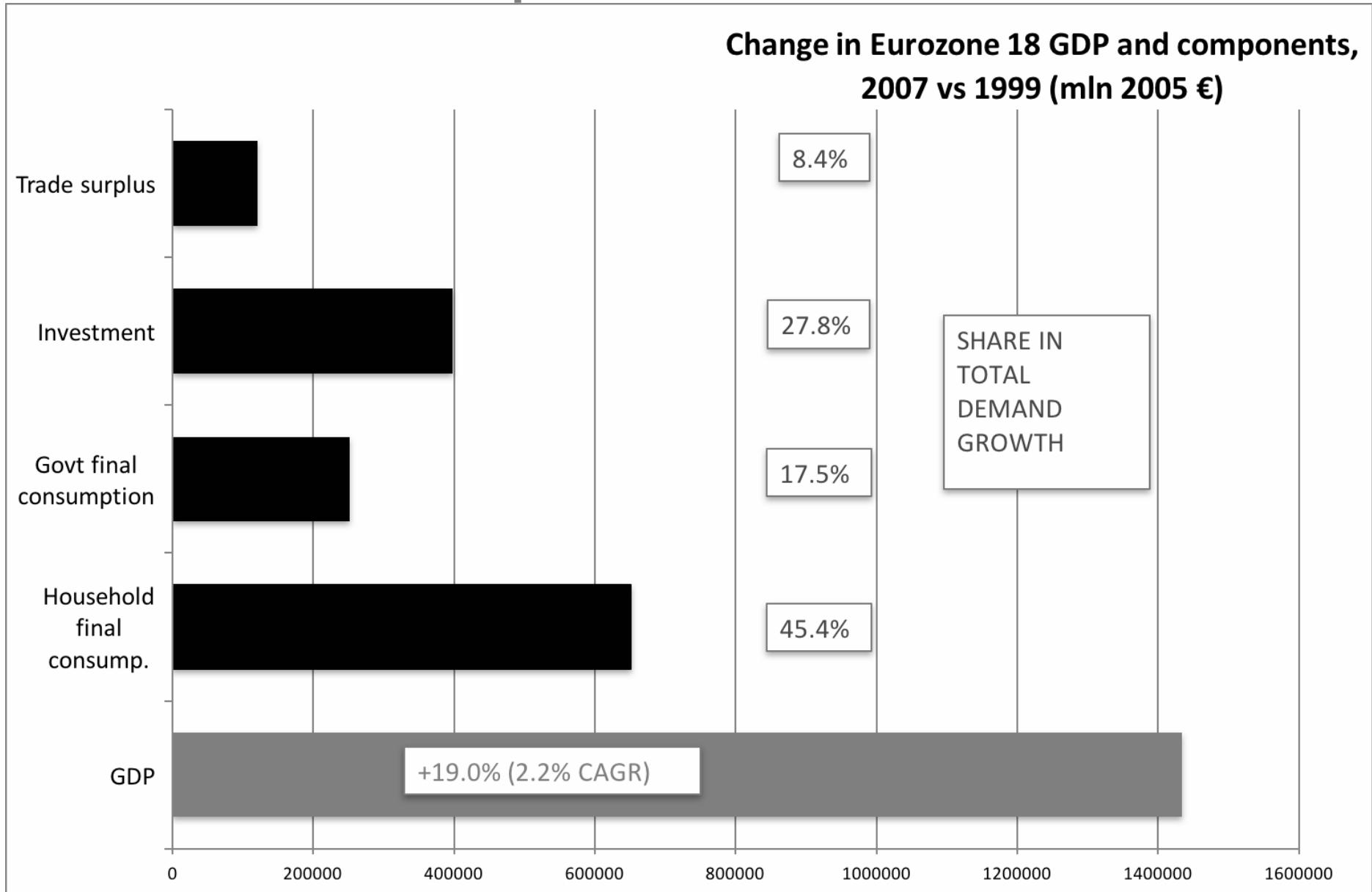
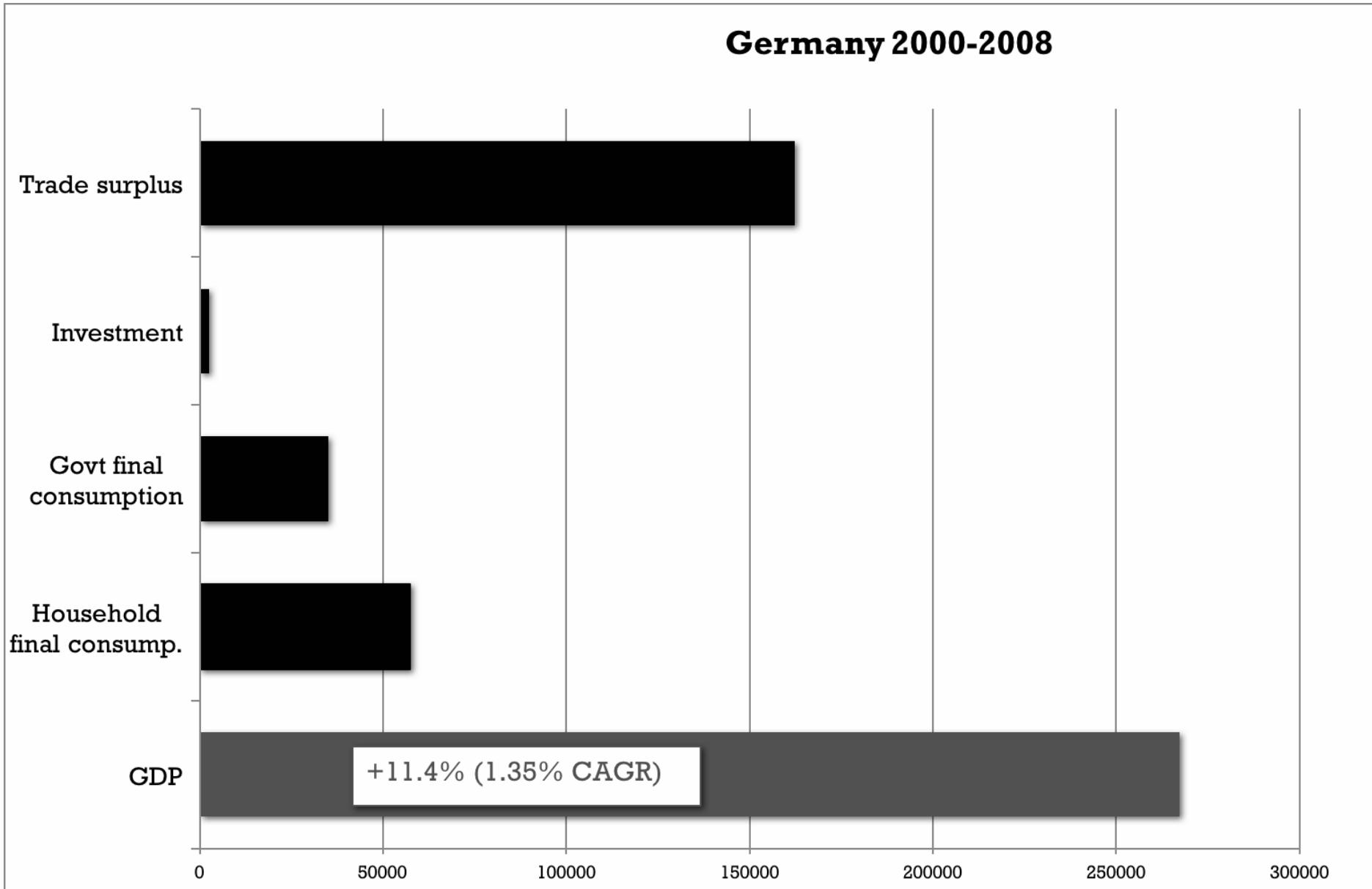


Figure 1 GROWTH IN DOMESTIC DEMAND, 1999–2009 (%)

The Eurozone's pre-crisis demand model



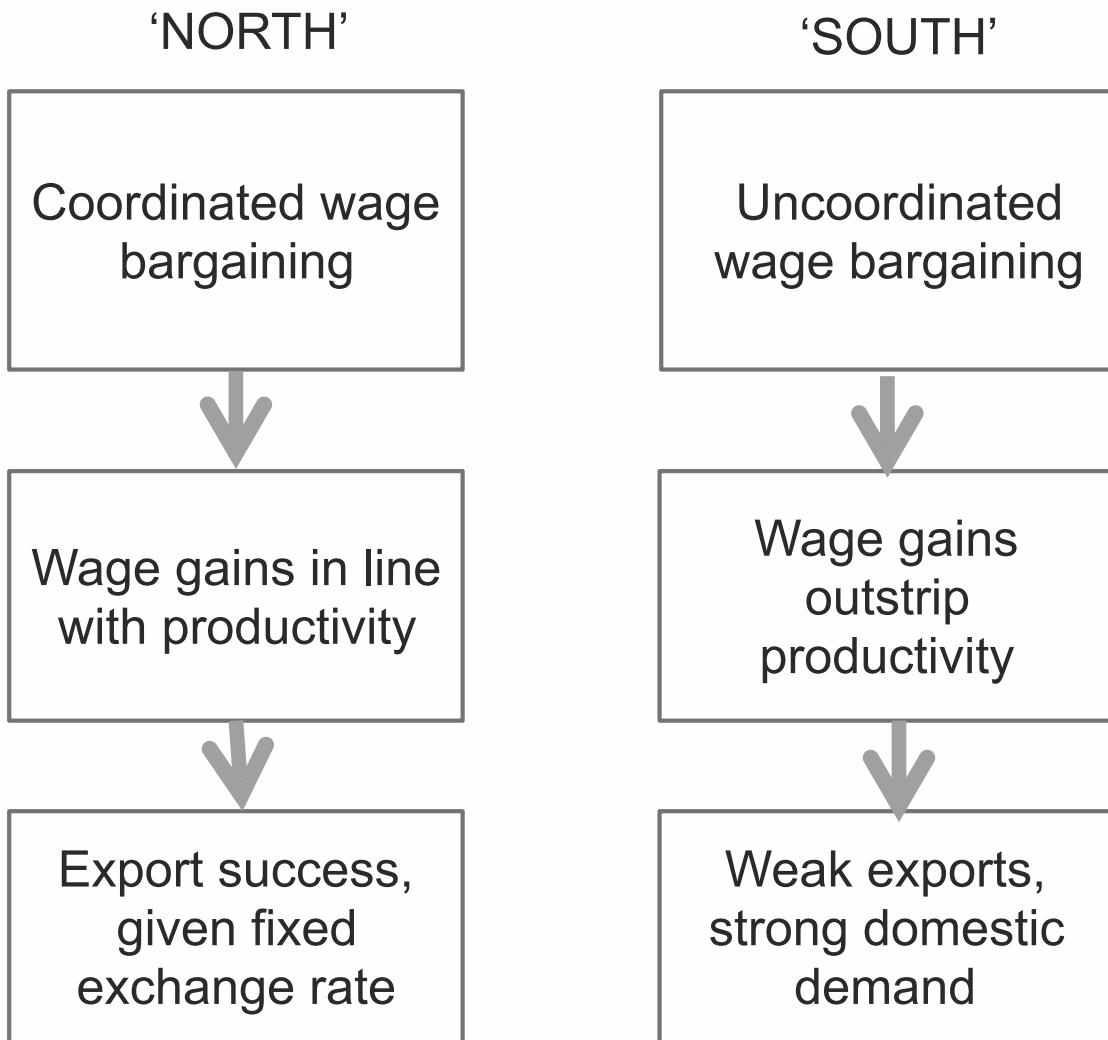
Germany 2000-2008



‘Process tracing’ Hall’s argument

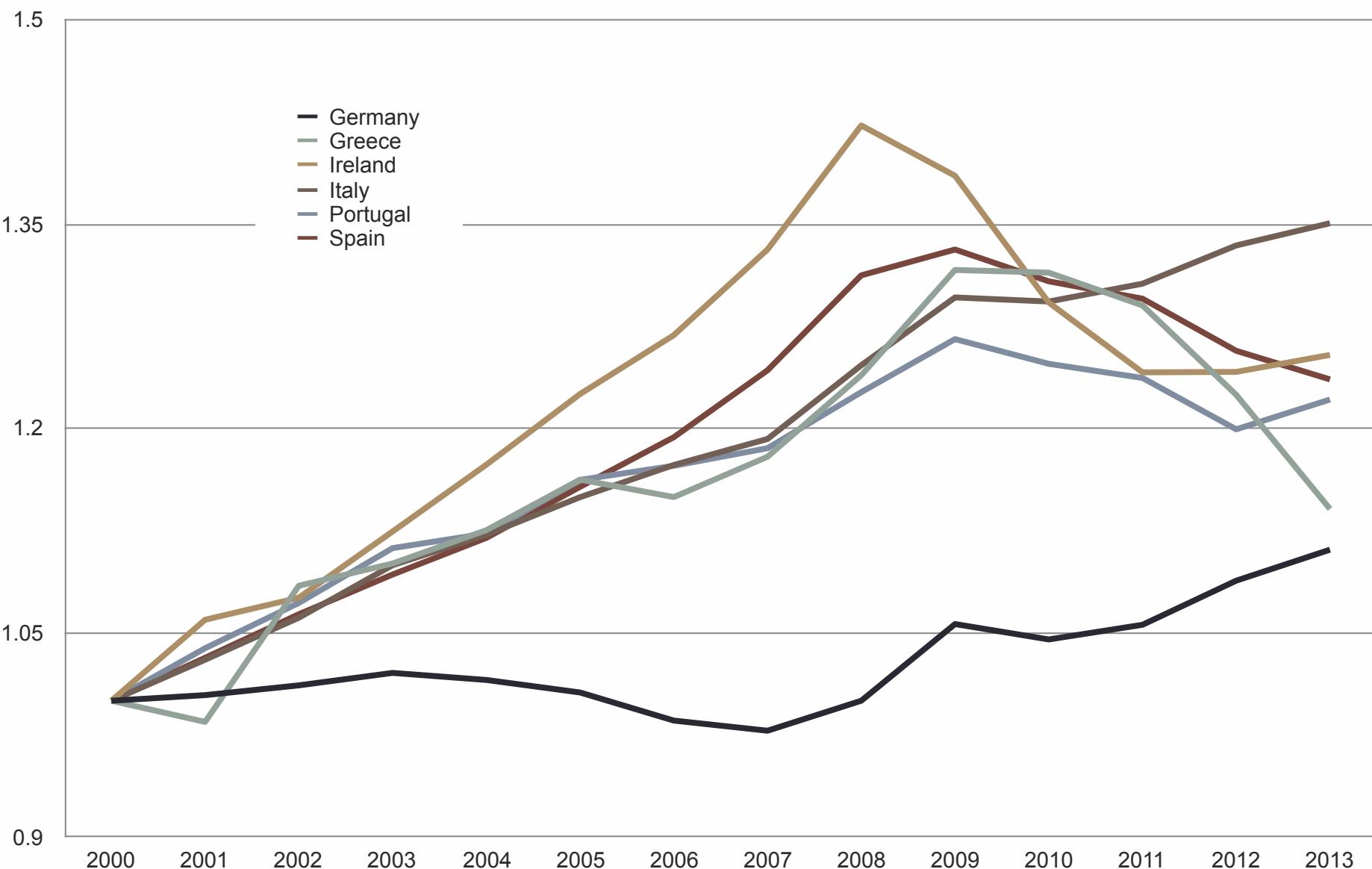
- Hall: “export-led growth strategies were not practicable in the context of the institutional structure of the southern European economies. In the absence of a trade union movement and employers' organisations structured so as to make sustained wage co-ordination possible, preventing the increase in unit labour costs that led to a deterioration in the trade balance would have required fiscal policies so austere that they would have stifled growth.”
- Unit labour costs: the share of labour costs in the price of output. The lower it is, the higher the productivity of labour

'Process tracing' Hall's argument

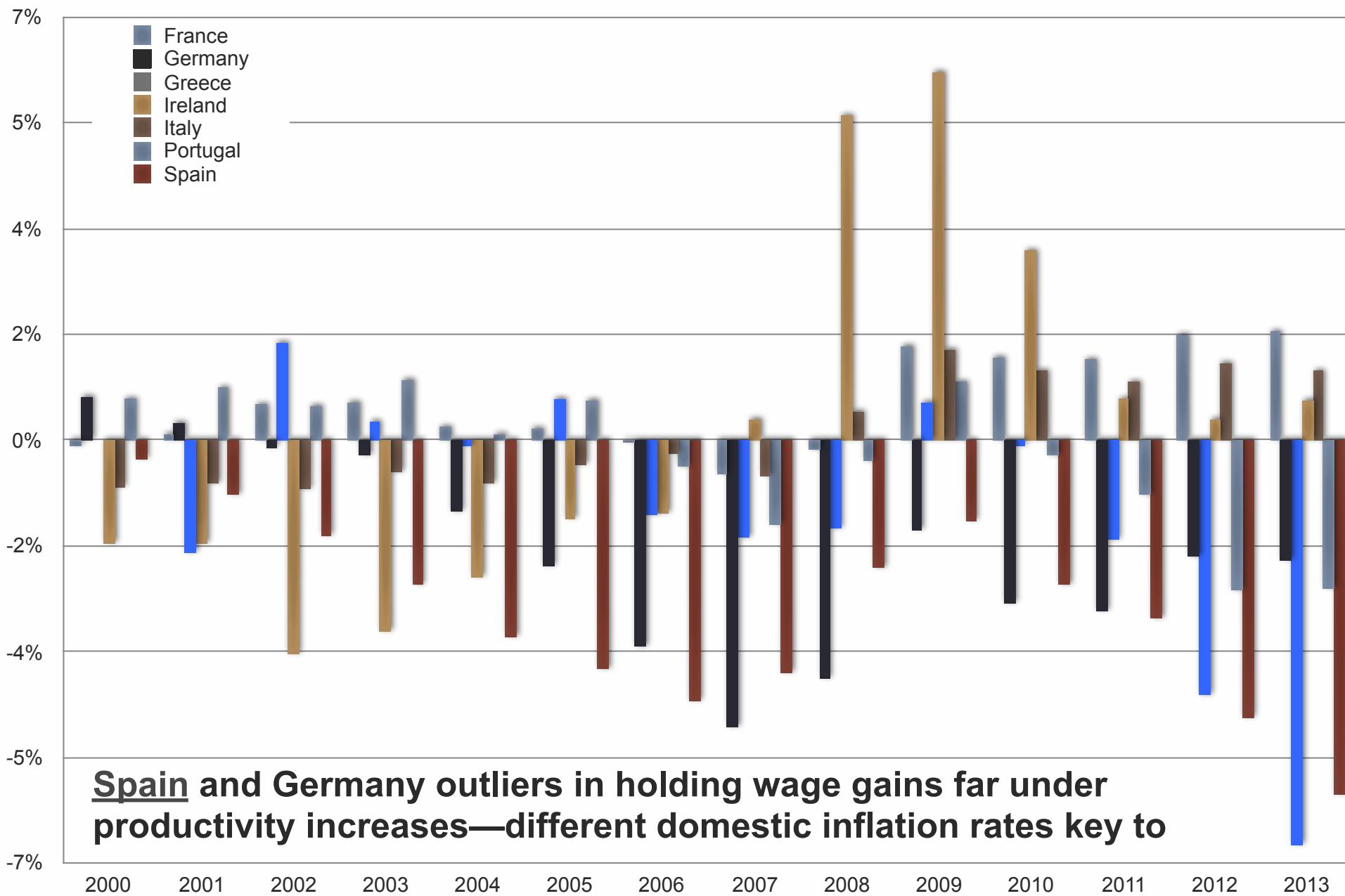


Nominal unit labour costs = unit labour costs * price index

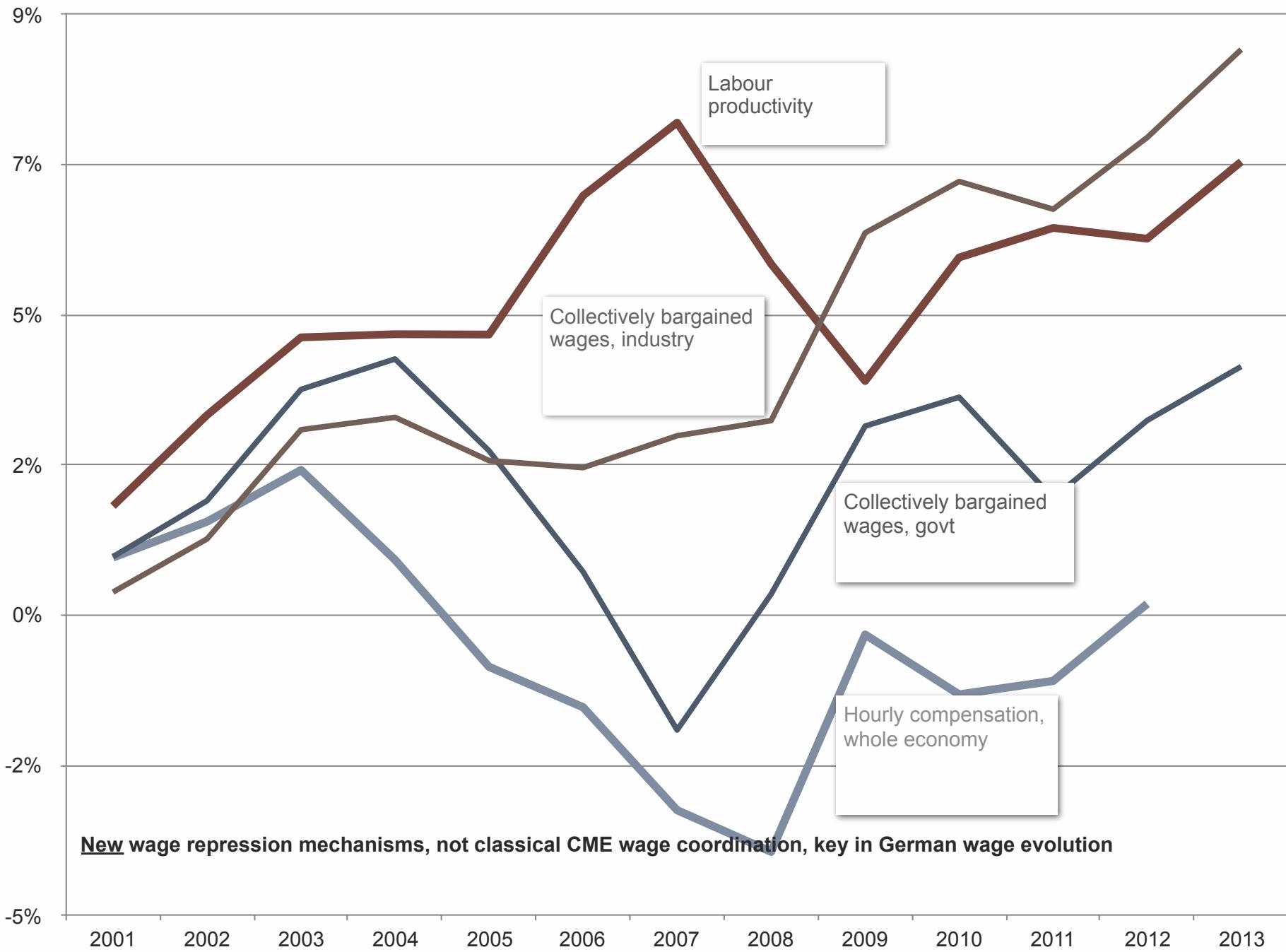
Nominal Unit Labour Costs, 2000=1



Cumulative change in labour costs as share of output since 1999



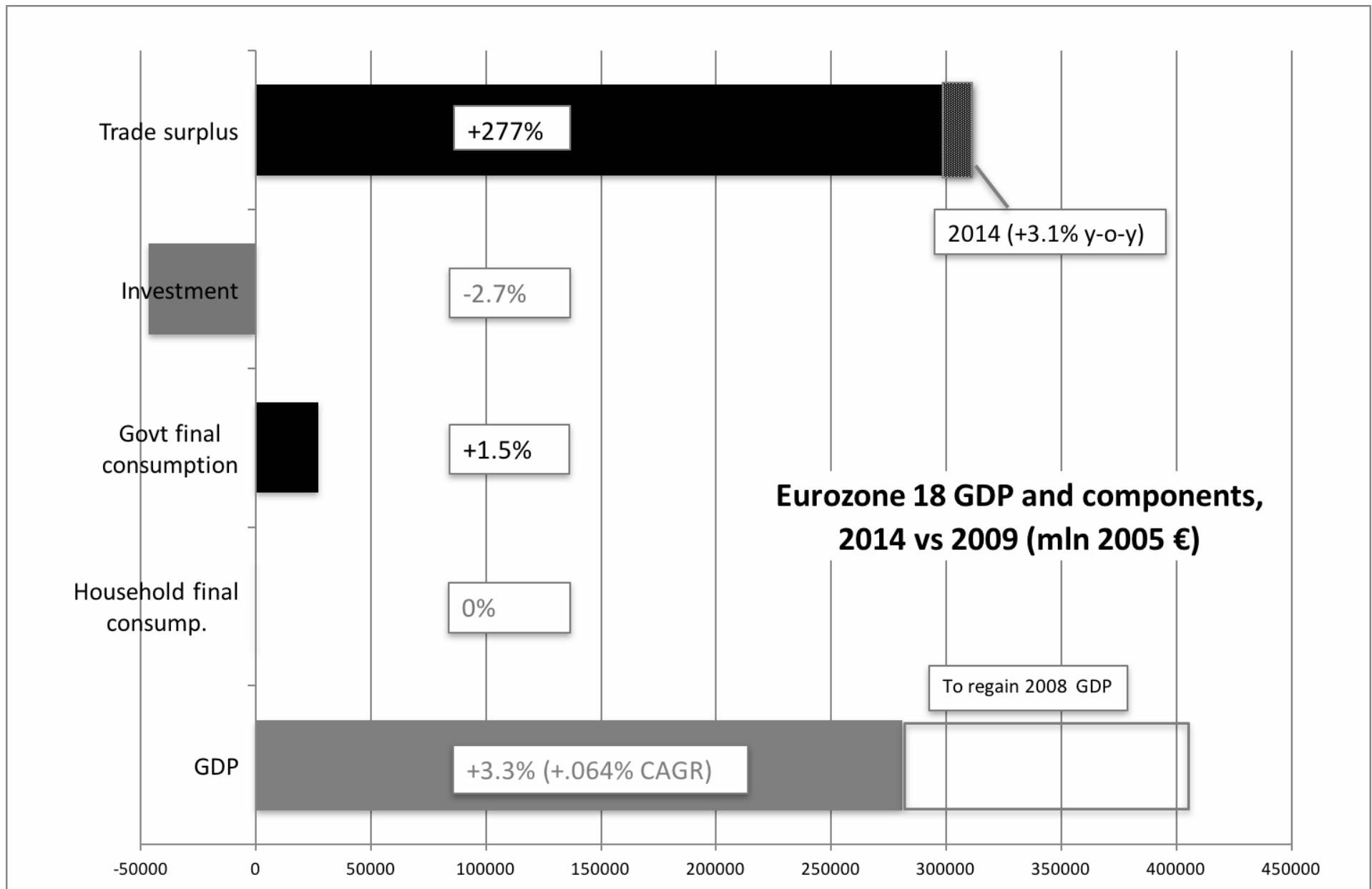
Productivity and hourly wages in Germany (real % change since 2000, HICP deflator)



AFTER THE FINANCIAL CRISIS: THE POLITICAL USE OF FISCAL CRISIS

The ECB emerges as a lender of last resort, but its price is austerity

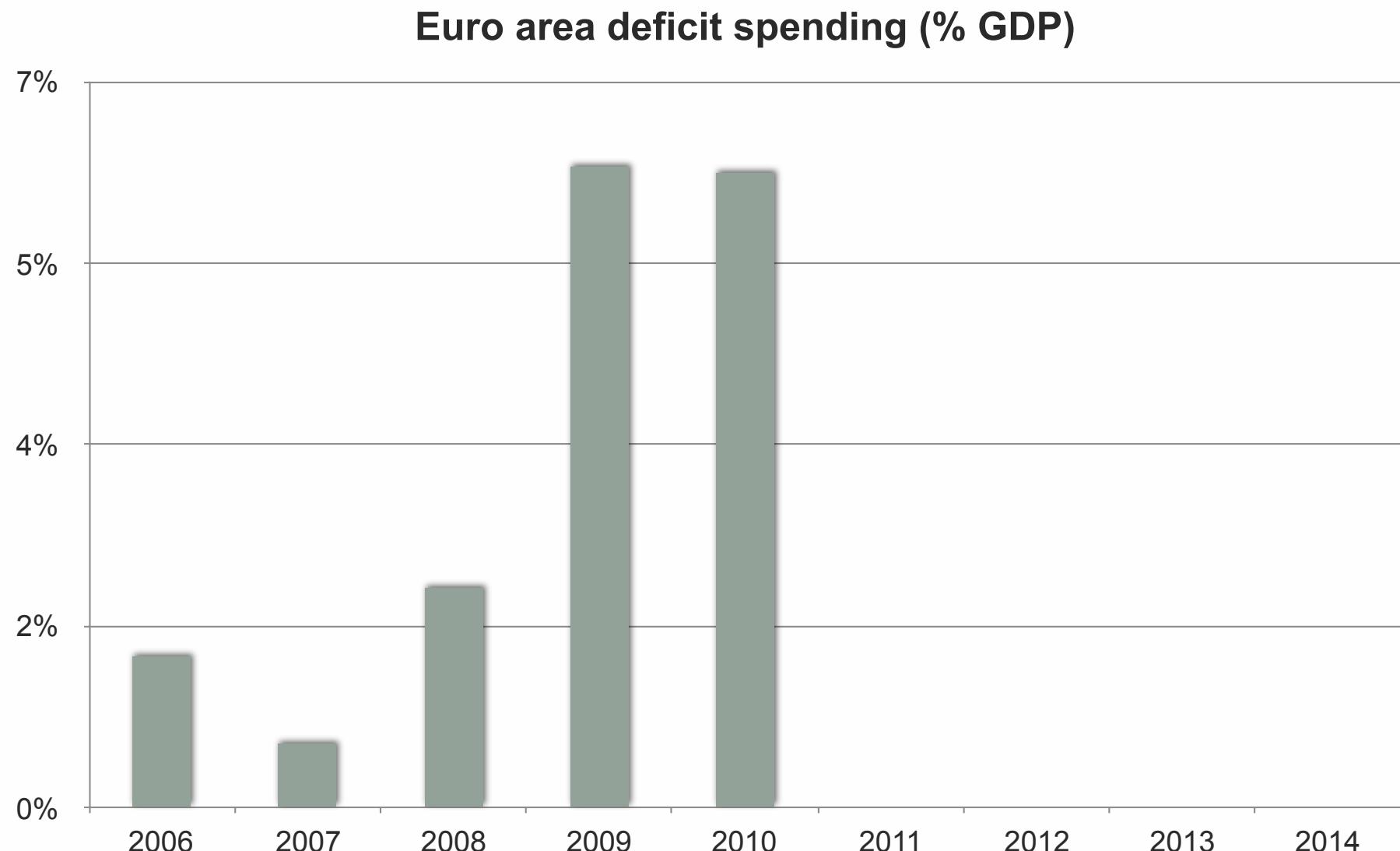
The Eurozone's post-crisis demand model



Roots of the post-crisis Eurozone demand model

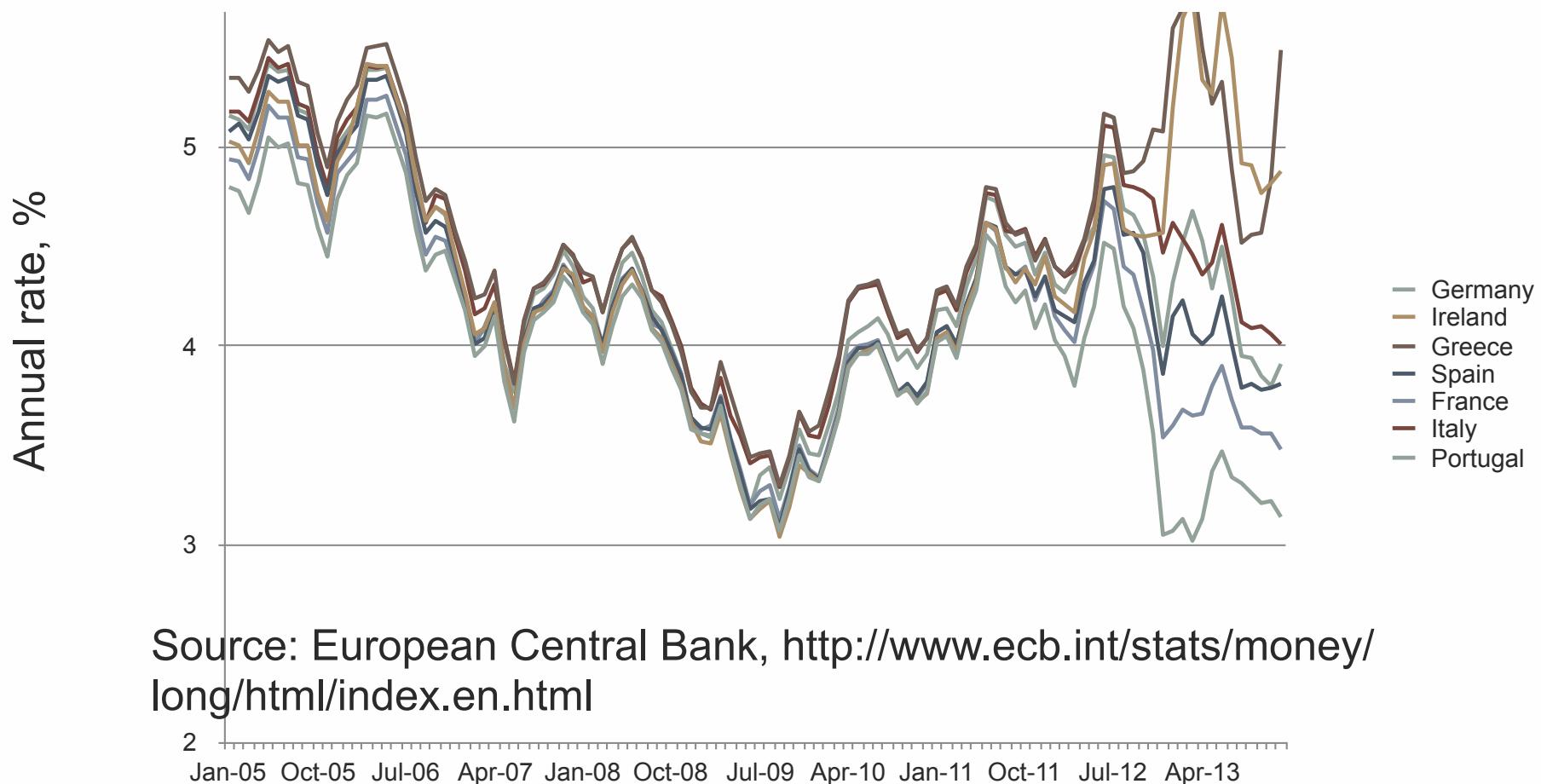
- Brussels-Frankfurt consensus (BFC) focused on
 - Micro-economic liberalisation (especially labour markets), ‘competitiveness’
 - Fiscal balance
- BFC involves *implicit demand model*
 - Stimulate *investment* and *exports* by ‘favourable business environment’ (lower labour costs, moves toward fiscal balance)
 - Requires sacrificing *consumer demand* and *fiscal stimulus*

How did BFC come to shape policy?



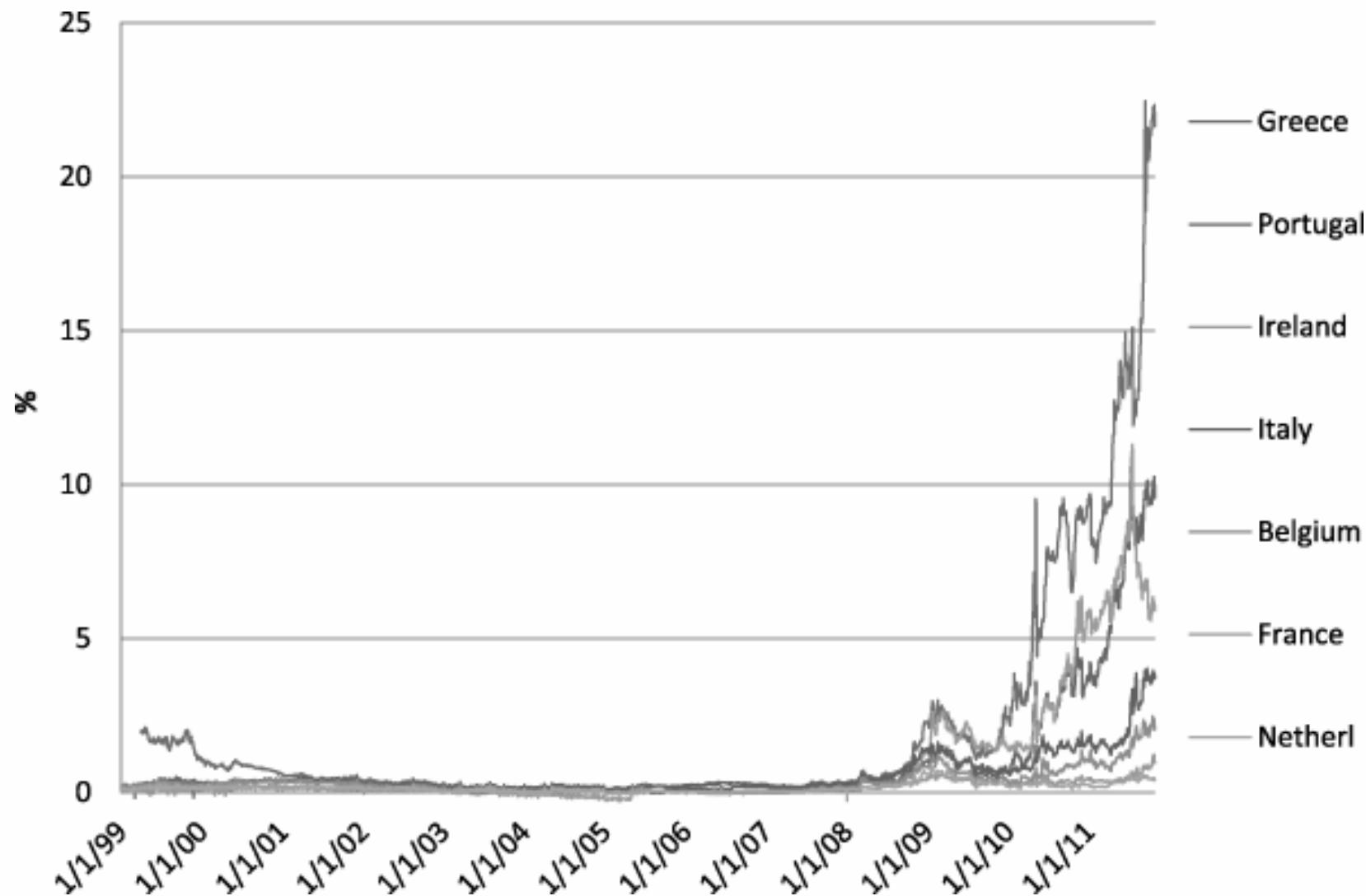
Interest rates on 10-yr gov't bonds

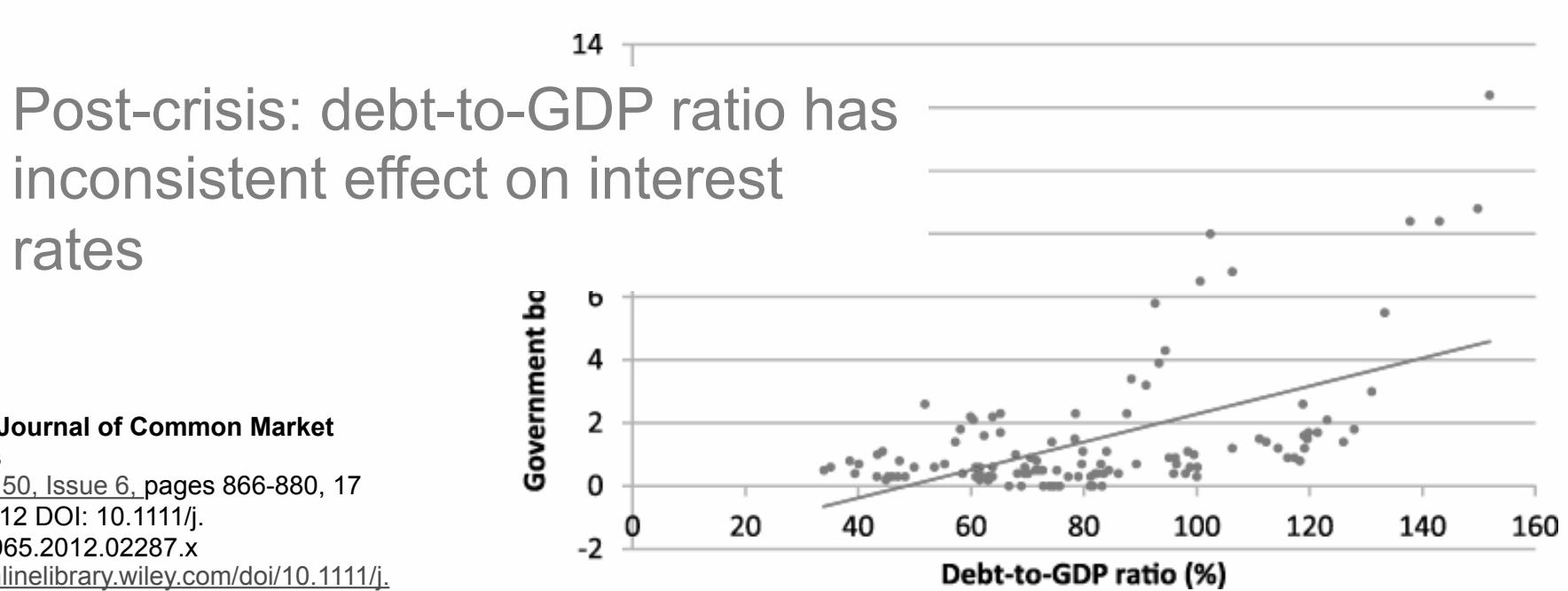
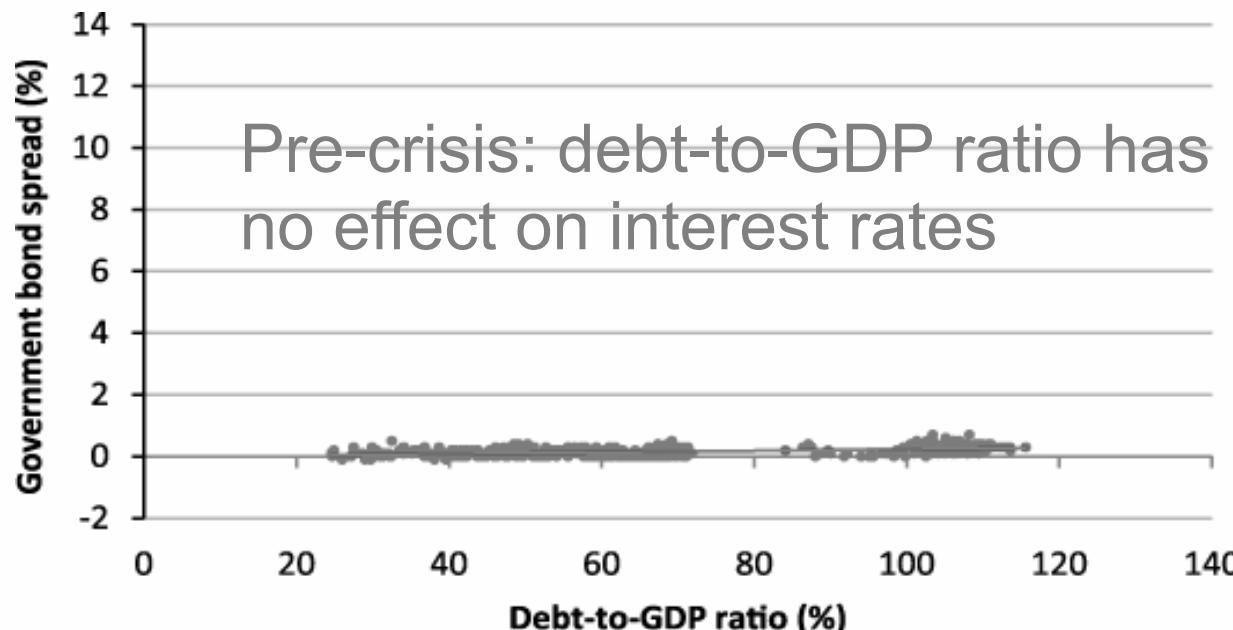
Euro leads to convergence in rates, persists until financial crisis



Source: European Central Bank, <http://www.ecb.int/stats/money/long/html/index.en.html>

Spreads on 10-year gov't debt





Self fulfilling prophecies on government bond

LENDER OF
LAST RESORT
(LOLR) ABLE
AND WILLING
TO BUY BONDS

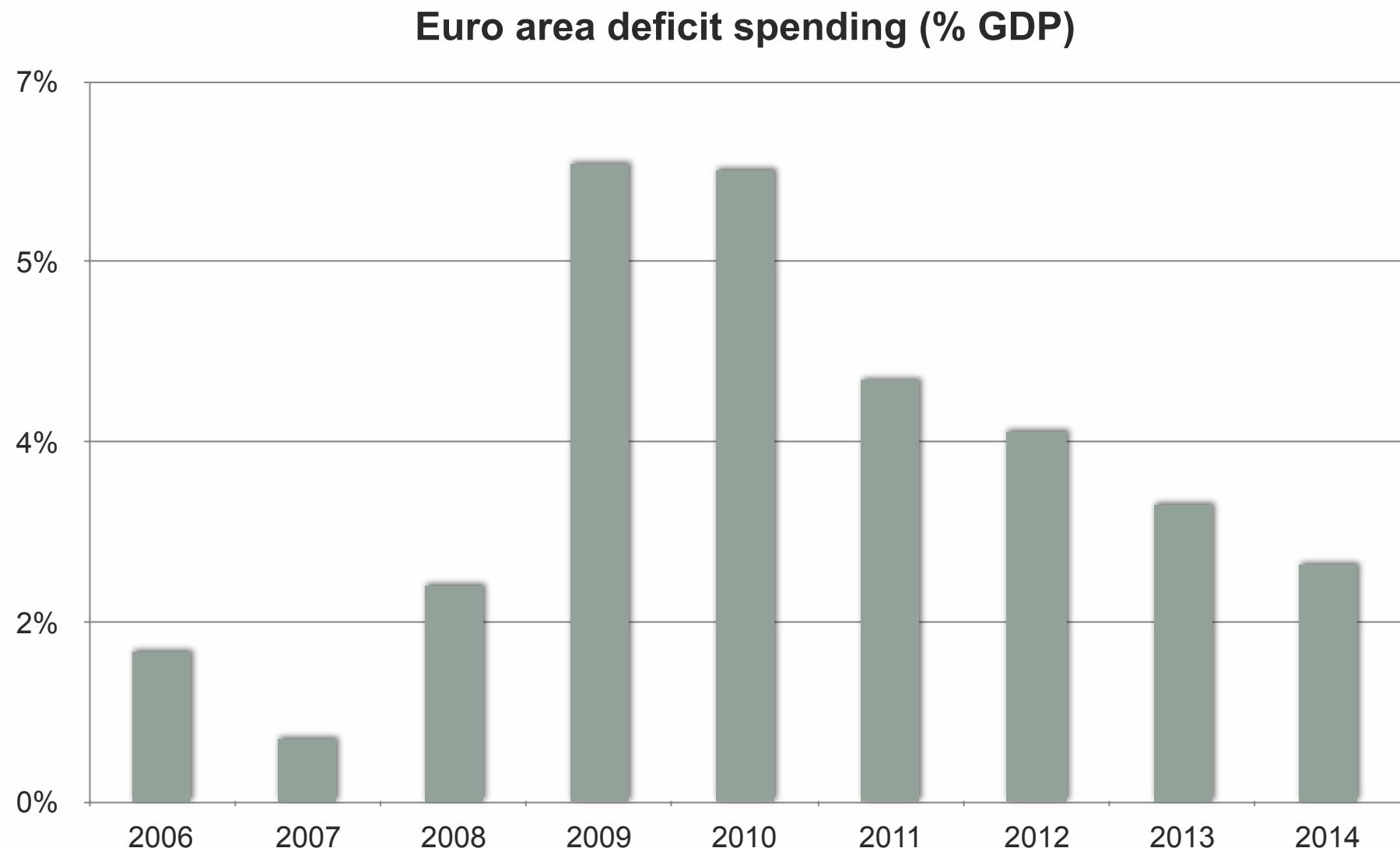
Other investors

	Buy/hold bonds	Sell bonds
One investor	Buy/hold bonds	Sell bonds
	Interest rate low, government can afford payments, no default	Interest rate high, government can't afford payments, default

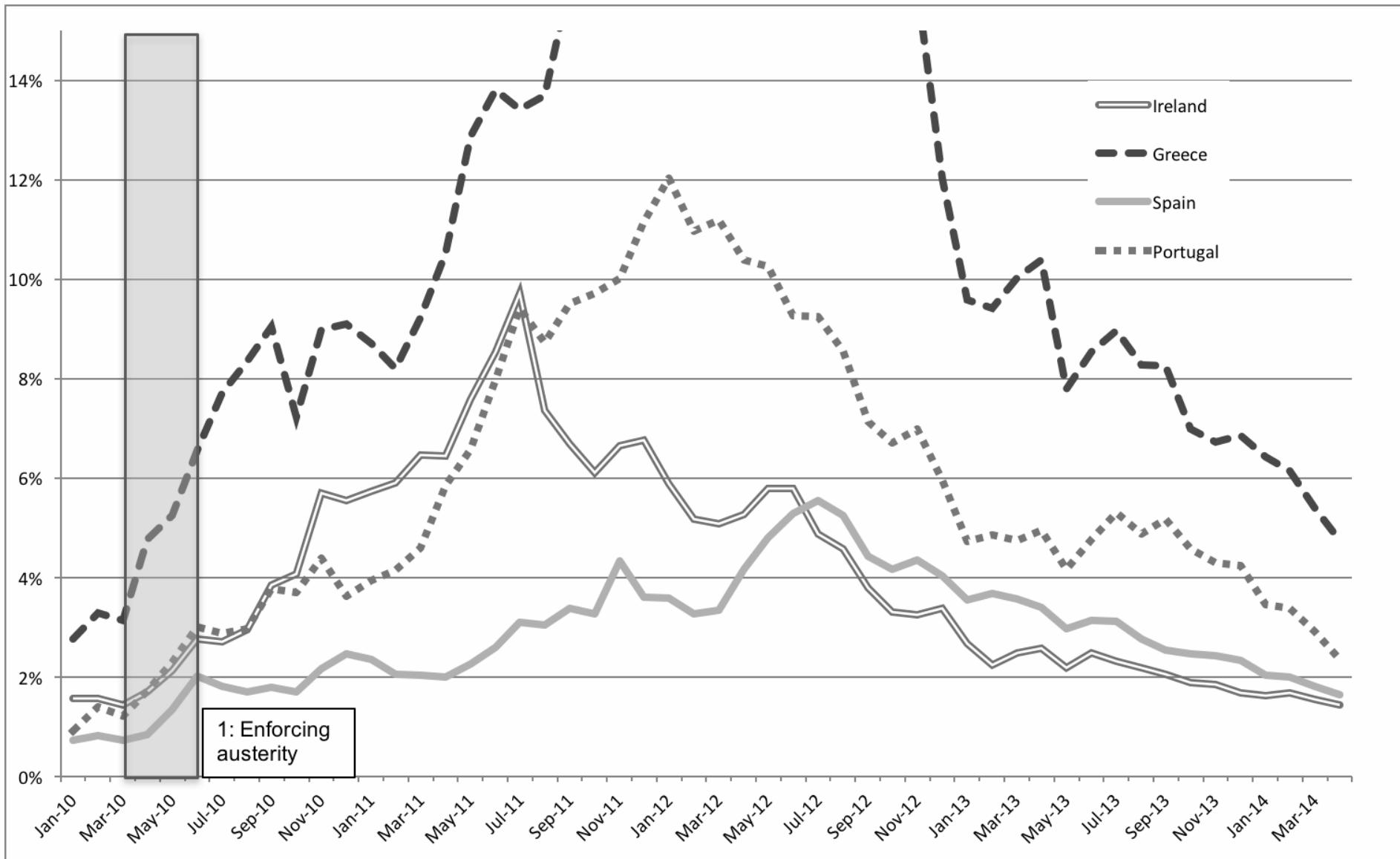
Weaponised market panic: lender of last resort makes political demands in return for calming markets

It is what the LOLR demands, *not* what markets demand, that drives policy outcomes

How did BFC come to shape policy?

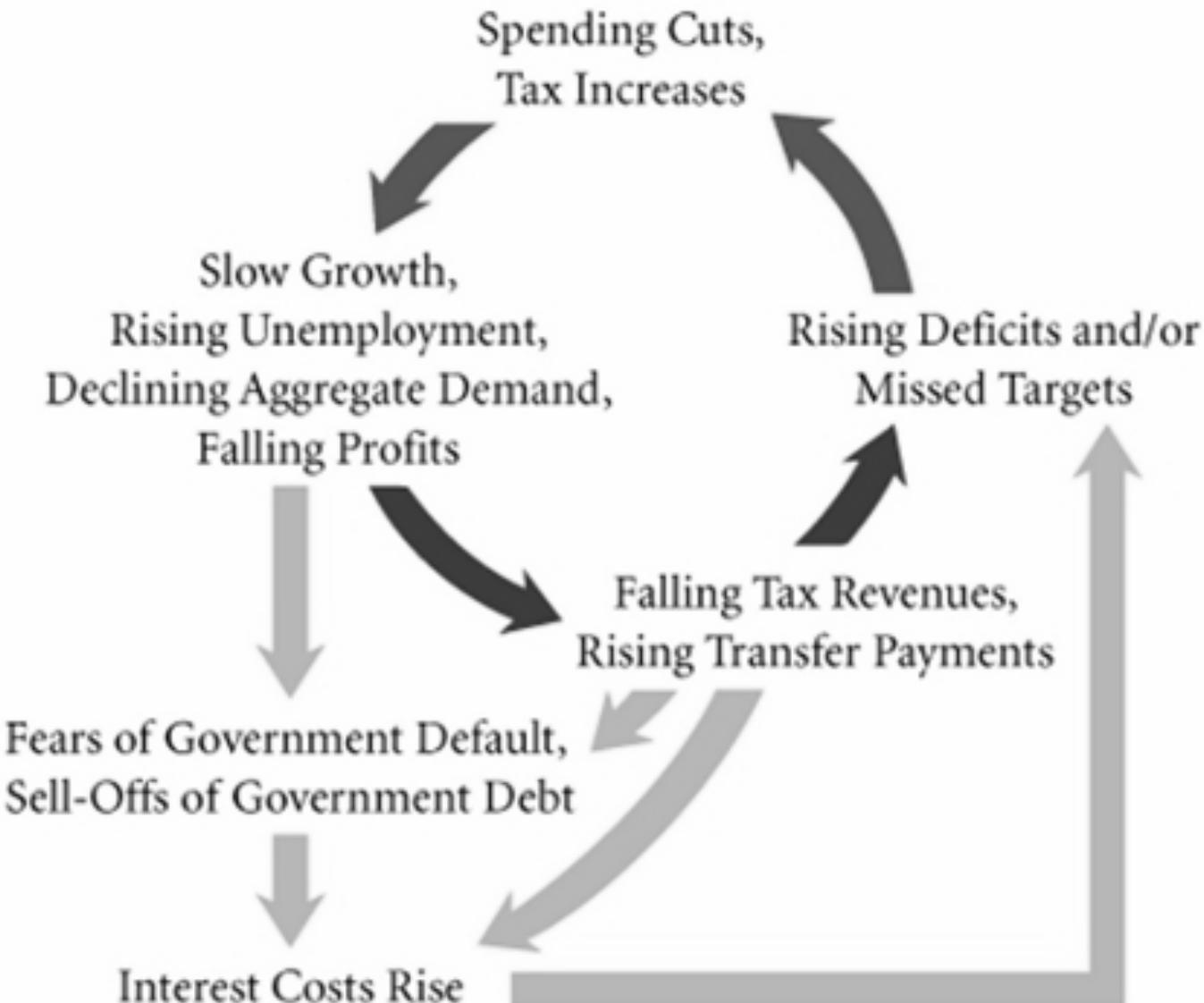


Bond prices and policy change

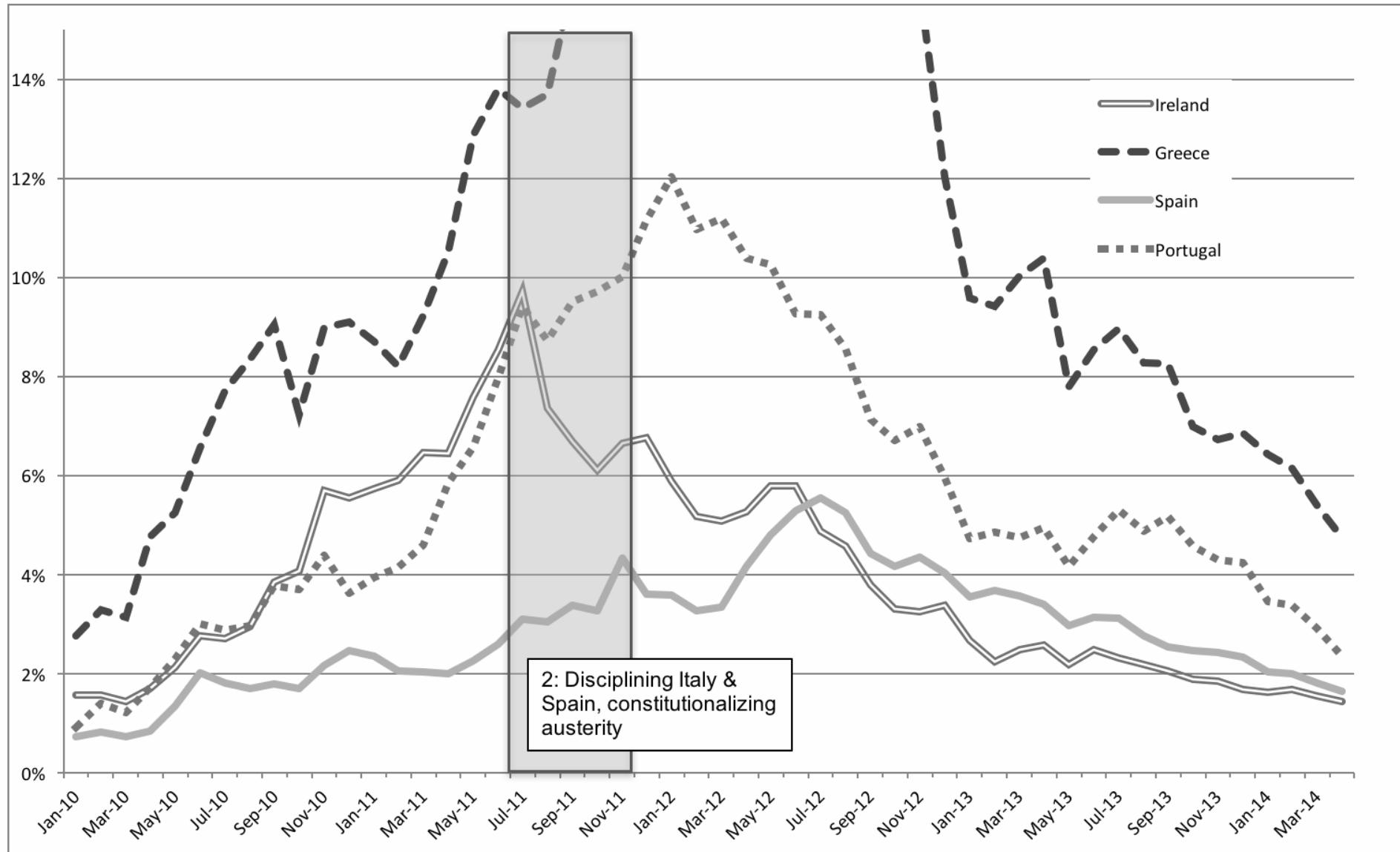


Self-defeating austerity?

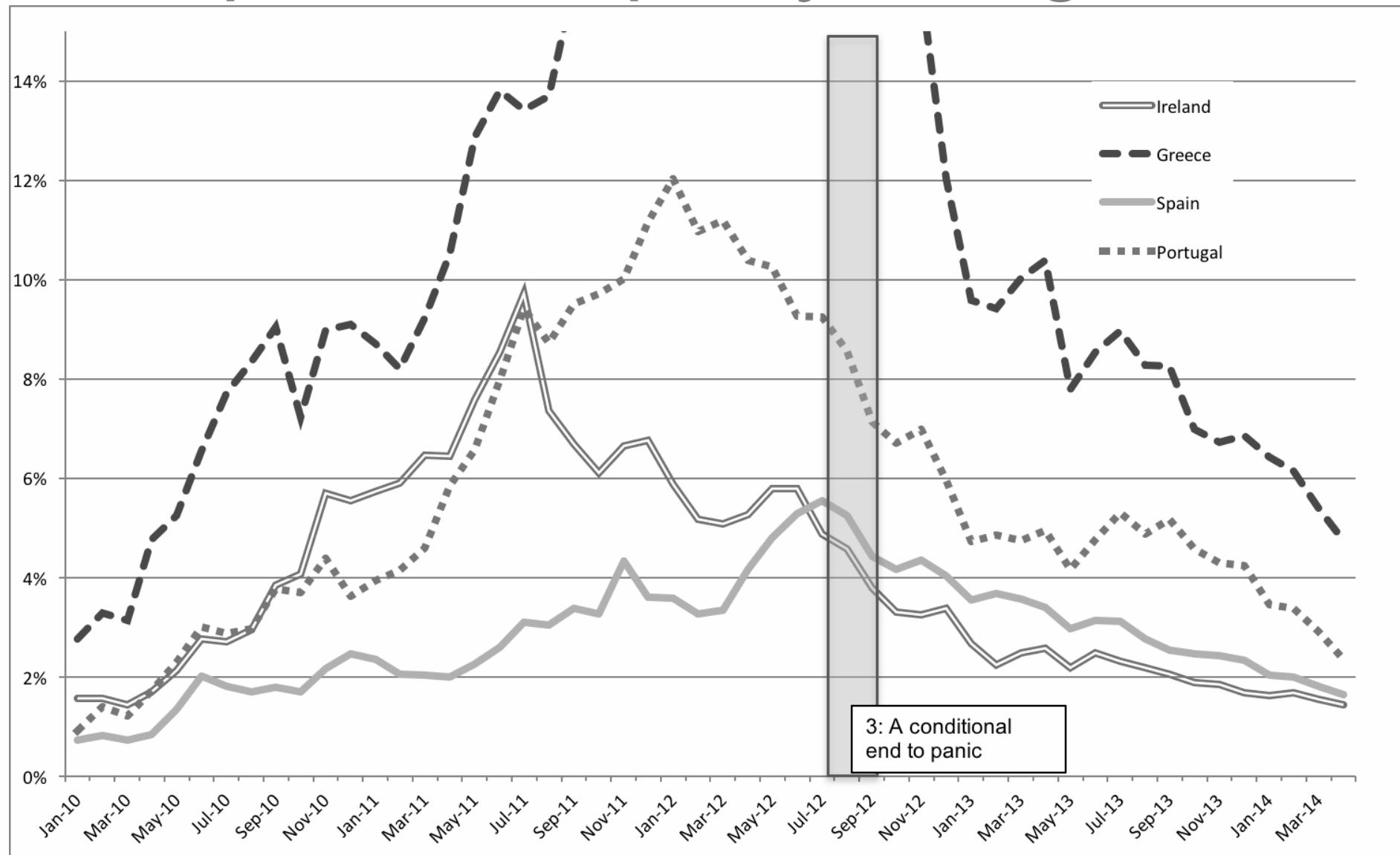
<http://blogs.lse.ac.uk/europpblog/2012/12/07/europe-fiscal-trap/>



Bond prices and policy change



Bond prices and policy change



Draghi: 'Whatever it takes' July 2012

Political mystery of austerity's victory

- Why isn't stimulus policy more popular?
 - Some have held that politicians love to spend money in search of votes -- why not do it now, when there's a credible economic justification?
 - The victims of austerity are concentrated and aware, not diffuse
- Possible explanations
 - Power of ideas
 - Financial interests
 - My view: In Eurozone, positive feedback between *veto points* and the power of ideas in key jurisdictions
 - How does the ECB *credibly* weaponise market panic?

Ordoliberalism

- German variety of neoliberalism, but sees state action as key to building markets
- Emphasises that state action should be bound by rules to ensure promotes rather than undermines markets
- Key influence on German negotiating position over EMU
 - Stability and Growth Pact
 - Independent central bank

Controversy over bond purchases

- Is it consistent with Eurozone treaties?
 - These forbid direct ECB purchases of government debt; some think this should be interpreted to forbid secondary market purchases as well
 - Treaties ECB only with price stability
 - Consistent German objections
- ‘Blunted incentives’ argument
 - “There’s also a risk that you mute the incentives that come from the market. Recent experience has shown that market interest rates do play a role in pushing governments towards reforms. You have seen that in the case of Italy quite clearly.” Jens Weidmann, Bundesbank, November 2011, <http://www.ft.com/cms/s/0/b3a2d19e-0de4-11e1-9d40-00144feabdc0.html#ixzz2EaYoFYPP>
- ‘Moral hazard’ argument

Why do Ordoliberalists get their way?



Chicken game



Veto points in the shadow of catastrophe

- Suppose that ‘status quo’ means going off a cliff (here: accelerating a feedback loop)
- Suppose there are two parties, each with a veto over changes from the status quo
- Chicken game structure
- Appearing credibly insane, as opposed to deliberating, gets you the most concessions (“brinksmanship”)

Two approaches to ethics (Max Weber's version)

- *Ethics of responsibility*: Do what will bring about the best consequences
- *Ethics of conviction*: Act in accordance with principles, come what may (“Fiat iustitia, et pereat mundus”: Let there be justice, though the world perish.)
- Politicians ought to be characterised by ethics of responsibility, bureaucrats by ethics of conviction (“I don't make the rules, I just apply them”)
→ Bureaucratic mindset dangerous in a politician

Bargaining and the two ethics

- Just like appearing credibly insane, appearing credibly wedded to immutable principles (ethics of conviction) increases bargaining power

Why do Ordoliberalists get their way?



Chicken game

Bargaining and the two ethics

- Just like appearing credibly insane, appearing credibly wedded to immutable principles (ethics of conviction) increases bargaining power
 - politicians with an ethics of conviction are going to have disproportionate success when inaction is disastrous and they control a veto point
 - “morality play” type ideas about the causes of the crisis have an ethics of conviction structure

Bargaining and the two ethics: examples



German constitution limits debt, mandate of ECB

“Nevertheless, the chancellor is playing a dangerous game. She wants all or nothing. She wants to get the whole package approved, or nothing at all. According to Merkel's plan, other European countries must adopt the **German culture of stability**. They must reform their labor markets, health systems, taxes and wages as well as reduce their debt levels. If they refuse, Merkel will refuse to provide German guarantees for bailout packages. To some leaders, that might seem to show a lack of solidarity. But, actually, (Merkel's approach) is very clever. **Berlin needs to exploit the pressure created by the crisis to push through the necessary reforms that will allow the monetary union to survive.**” <http://goo.gl/rllgf>



I think it's tempting not to negotiate with hostage-takers, unless the hostage gets harmed. Then people will question the wisdom of that strategy. In this case, the hostage was the American people and I was not willing to see them get harmed.

Moral hazard and credible commitment

- Moral hazard exists for me when I get the benefits and someone else bears the costs
- Credible commitment not to bail out failing firms, fiscal systems avoids creating moral hazard for them
 - “Automaticity” = ethics of conviction
 - But is automaticity *responsible*?
 - Moral hazard, or hazardous morality?



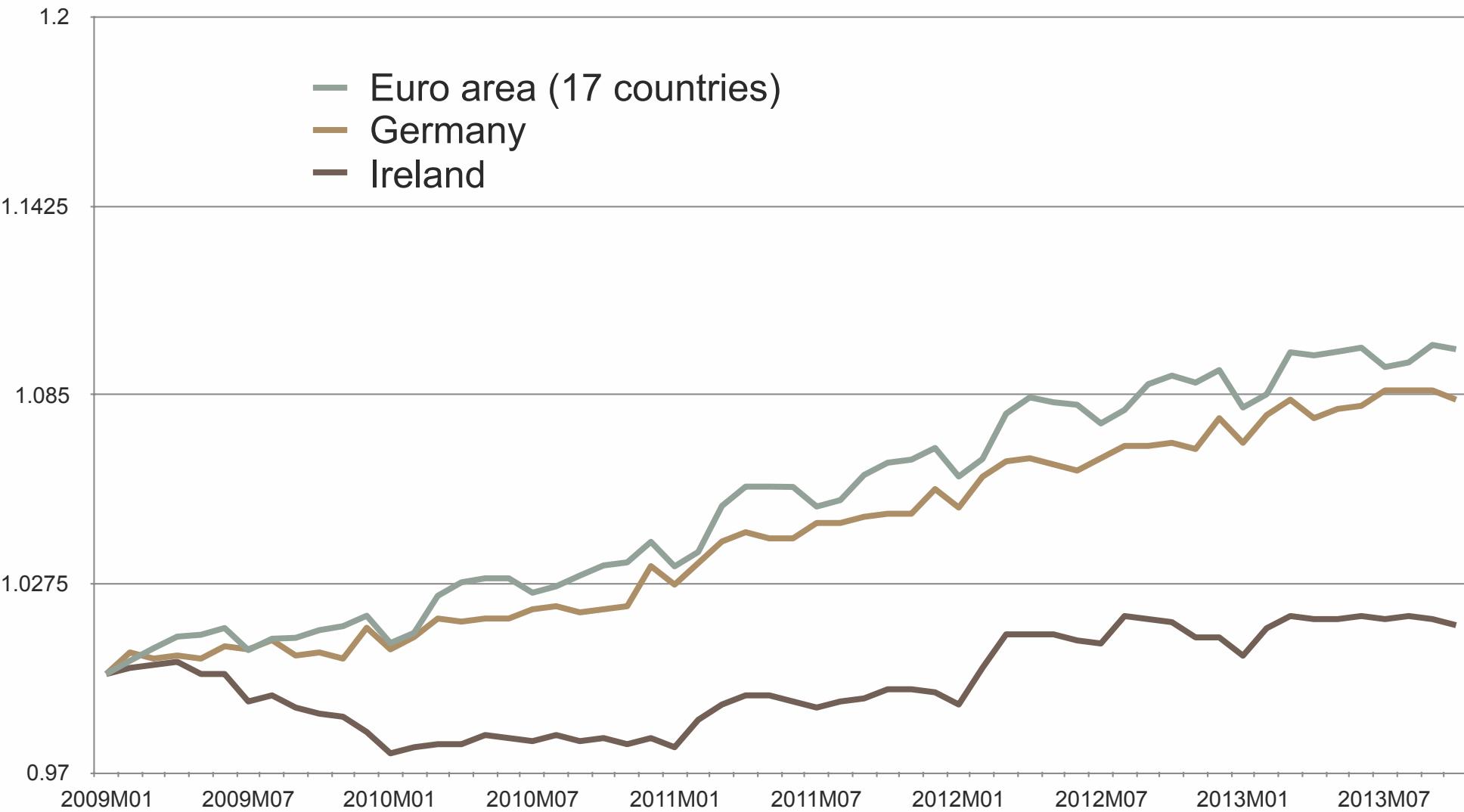
ECB ‘mission creep’ in the course of the crisis

- From the “hard money” side
 - De facto financing of government borrowing, supposed to be ruled out by Eurozone treaties
 - Covert intra-country transfers via government bond purchases, other forms of secured lending
- From the “soft money” side
 - Explicit and implicit conditionality of lending (lending only made if conditions on austerity met) turns ECB into unelected instrument of government
- More Europe or less?

Old Polanyian dilemma

- What can uncompetitive Eurozone countries do?
- Devalue
- ~~Trade protection~~
- Force nominal deflation
- Inflate, but more slowly than Germany?

Relative prices since the crisis



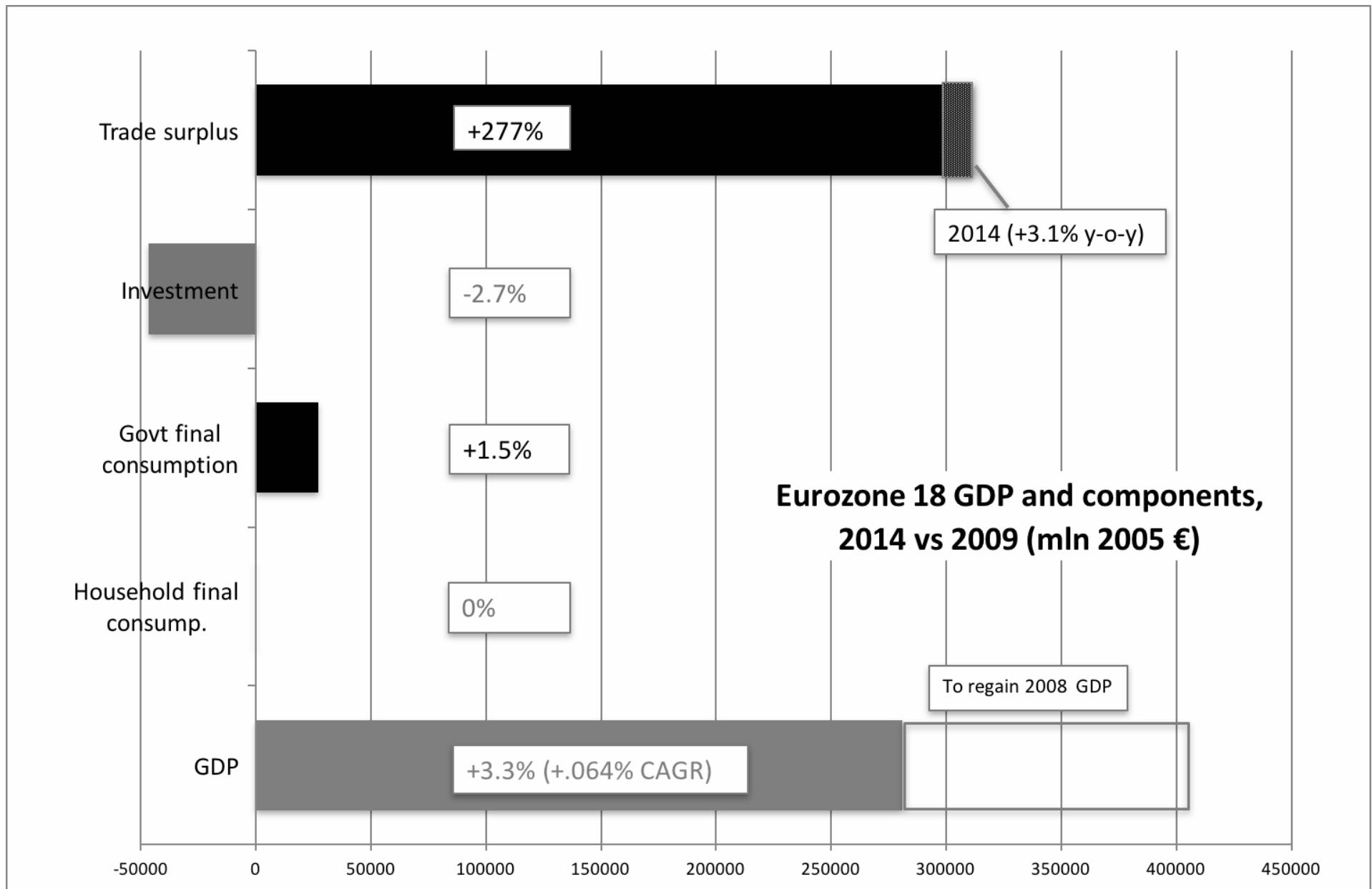
CONCLUSION

Politics of demand: summary

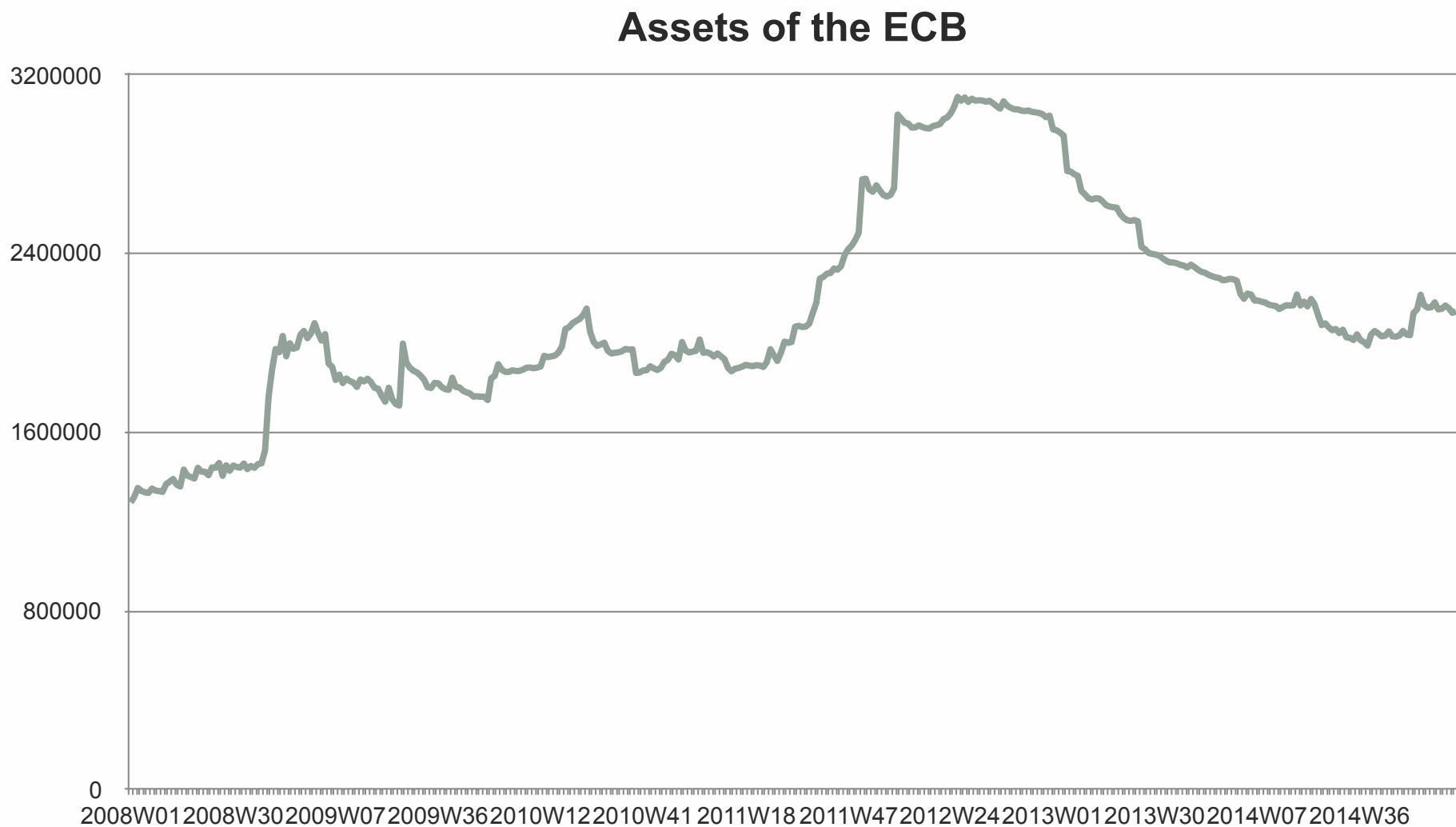
- Where does the ‘deficit spending’ come from?
 - Good times
 - Investment
 - Net exports
 - Consumers borrow more than they take in
 - Bad times
 - Government borrows more than it takes in
- After the financial crisis:
 - ‘Privatised Keynesianism’ hard to restart
 - Political barriers to government spending
 - ‘Secular stagnation’ makes investment hard to restart

APPENDIX: QUANTITATIVE EASING (QE) IN THE EUROZONE

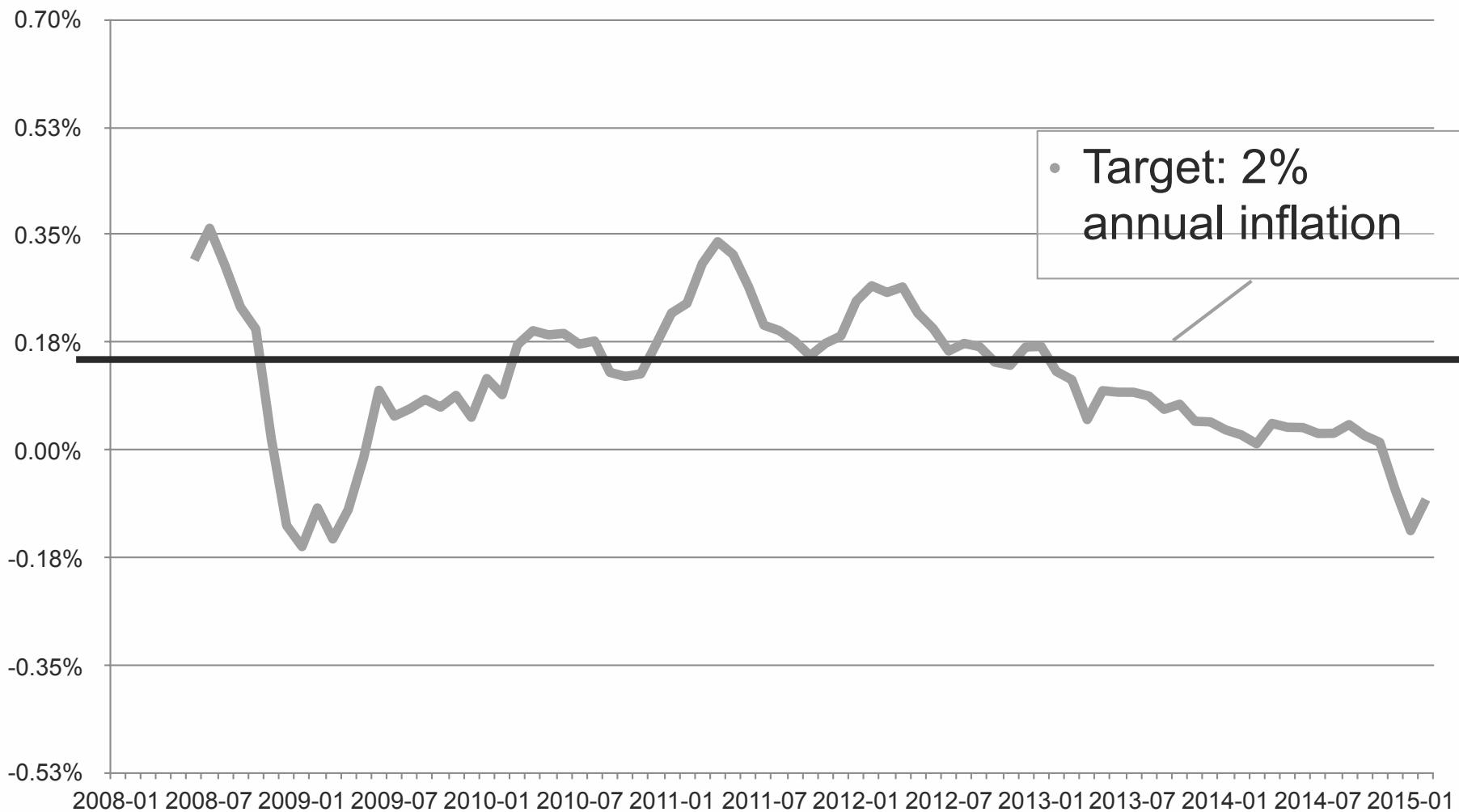
The BFC's implicit demand model doesn't work!



ECB can't give money away



Monthly change in consumer prices (6-month moving average)



Reacting to the model's failure

- Looser and looser monetary policy to stimulate investment and fight 'lowflation'
- By 2014, recognition that monetary policy has been 'pushing on a string'
 - Cheap money has no impact on the economy if no-one wishes to borrow and invest
 - TLTRO and other asset purchases, ultimately QE
 - Very mild relaxation of fiscal rules (slower austerity, not demand stimulus), coupled with continued liberalisation push

Will QE be effective? Possible mechanisms

- Exchange rate weakness (export stimulus)
- General expectations effect
- ‘Portfolio balance effect’
 - ECB buys safe assets, former owners invest in riskier ones, easing credit conditions and facilitating real-sector investment
- Indirect consumption stimulus
 - Rising asset prices and easier credit fuel consumption
 - **Likely was crucial to effectiveness of US QE, but unlikely to have this effect in Eurozone**

Conclusions on QE

- The Eurozone is presently wedded to an unworkable demand model
 - *Government consumption*: pressed by austerity
 - *Private consumption*: pressed by ‘competitiveness’ push, treating labour as a cost to business rather than business’ customers
 - *Investment*: not responding to efforts to create ‘favourable business climate’ nor to ultra-low interest rates
 - Leaving only *exports* as a success story – but this is not enough
- In this context, QE is unlikely to be very effective without a *political breakthrough* changing demand model
- This breakthrough is itself very unlikely