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Flexibility is out: now we see rigidity's virtues

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The economic paradigm developed during the boom years was based on the idea of flexibility. The economically successful countries were those which allowed flexibility in goods and labour markets. Rapid growth lay ahead of them if they permitted firms to hire and fire without restrictions; if wage contracts made it possible for firms to adjust wages up and down quickly to changing economic conditions. New growth models were developed by academic economists stressing the need for flexibility. International organizations chastised those countries with rigid labour and goods markets and urged them to introduce "structural reforms". The European Commission was mesmerized by the idea of flexibility and cooked up the Lisbon Agenda with the ambition of transforming the EU into a flexible economy. The great role model was the US which was seen to have a superior economic model thanks to its flexibility.

Today it becomes increasingly clear that flexibility may not be a quality at all, but a major handicap. Let's analyze why that is.

Since the outbreak of the financial crisis the world economy is increasingly gripped by debt deflation. The dynamics of debt deflation is well-known and has been described by Irving Fisher eighty years ago. Households and firms (including banks) faced with excessive debt have to sell assets. Asset prices decline leading to more intense solvency problems elsewhere in the system. Firms are forced to lay off workers and/or to reduce their wages. As a result, more households find it impossible to service their debt. Thus in a debt deflation dynamics the attempts of some to service their debts makes it more difficult for others to service their debts.

The source of the problem is the fact that the level of debt is a fixed nominal variable. The consumer who has to pay back a mortgage of $400,000 faces this rigid payback threat whatever the value of his assets or the value of his wage. Thus the problem of debt deflation is that there is one rigid variable (the value of the debt) while so much of the rest (asset values, wages, employment) is flexible. The more flexible these variables are the more hellish is the dynamics of debt deflation, and the more difficult it is to pull the economy out of this devilish dynamics.

It follows that the most flexible economies will suffer most from the debt deflation dynamics. In countries where firms can easily fire workers, or where they can cut their wages on a whim, these same workers will be hit stronger by the debt deflation dynamics. They will have to sell their houses and their other assets more quickly thereby threatening others (including banks) with bankruptcy.

When economies are hit by debt deflation they need circuit breakers. You guessed it; rigidities in wages, prices and employment contracts are such circuit breakers. They slow down the debt deflation dynamics allowing for a more orderly retreat. Workers do not immediately loose their jobs; their wages are not cut instantaneously, giving some respite in the orderly winding down of debt levels.

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Of course, these circuit breakers do not eliminate the debt deflation dynamics; they slow it down. There is one ultimate circuit breaker, however, that has the capacity to stop the dynamics. This is the social security system. “Rigid economies” have been chastised for having too generous social security systems. They pay their unemployed too much for too long. It now turns out that this ultimate source of rigidity is a great advantage. The workers that are laid off in the rigid countries will have higher unemployment benefits that will sustain consumption and reduce the fall in prices. The debt deflation dynamics hits a floor.

One may argue that since the unemployed in the rigid countries get paid better, the budget deficits in these countries will increase more than in the flexible countries. This is far from certain though. For sure, the governments of flexible countries will spend less on unemployment benefits, but to the extent that the debt deflation leads to a stronger decline in economic activity in these countries government revenues will decline more. As a result, budget deficits may actually increase more in the flexible countries.

The idea that flexibility is good and rigidity is bad continues to influence the minds of policymakers and analysts. Rating agencies, for example, continue to give a more favourable rating to the US and UK sovereign debt based on the notion that the greater flexibility of these countries gives them a better capacity to adjust to the crisis than rigid countries like Spain, Italy and Ireland. The opposite is true. Today rigidities in wages, employment and social security allow countries to better deal with the great rigidity that the fixed levels of debt impose on households and firms. We should cherish these rigidities today.