PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

POLICY BRIEF

16-14 The State of Advanced Economies and Related Policy Debates: A Fall 2016 Assessment

Olivier Blanchard
September 2016

Olivier Blanchard *is the C. Fred Bergsten Senior Fellow at the Peterson Institute for International Economics. He was the economic counselor and director of the Research Department of the International Monetary Fund. He remains Robert M. Solow Professor of Economics emeritus at MIT.* *He thanks Vivek Arora, Julien Acalin, Bill Cline, Jérémie Cohen-Setton, Joe Gagnon, and Jeromin Zettelmeyer for comments and suggestions.*

Perhaps the most striking macroeconomic fact about advanced economies today is how anemic demand remains in the face of zero interest rates.

In the wake of the global financial crisis, we had a plausible explanation why demand was persistently weak: Legacies of the crisis, from deleveraging by banks, to fiscal austerity by governments, to lasting anxiety by consumers and firms, could all explain why, despite low rates, demand remained depressed.

This explanation is steadily becoming less convincing. Banks have largely deleveraged, credit supply has loosened, fiscal consolidation has been largely put on hold, and the financial crisis is farther in the rearview mirror. Demand should have steadily strengthened. Yet, demand growth has remained low.

Why? The likely answer is that, as the legacies of the past have faded, the future has looked steadily bleaker. Forecasts of potential growth have been repeatedly revised down.[1] And consumers and firms—anticipating a gloomier future—are cutting back spending, leading to unusually low demand growth today.

This *Policy Brief* develops this theme in more detail and draws some policy implications. First a quick preview.

On productivity growth and the policy interest rate: Modal forecasts must be that both will indeed remain low. But both of these forecasts come with very large standard deviation bands. Growth could well turn out higher, so could interest rates.

On macroeconomic policies in general: Monetary policy still works. But it comes with increasing risk, and for that reason, it probably cannot be used much further. Fiscal policy, however, can. The key is taking measures that help growth and do not scare investors. These measures exist.

As the legacies of the past have faded, the future has looked steadily bleaker.... And consumers and firms—anticipating a gloomier future—are cutting back spending, leading to unusually low demand growth today.

Finally, structural reforms can improve both productivity growth and demand today, but counting on them to solve all problems would be unwise. One must be realistic about how much they can achieve.

On specific countries' macroeconomic policies: The United States, the Eurozone, and Japan are in very different economic places. But there is a strong argument that all three should accept and engineer higher inflation. The United States should do so as an insurance policy against recession;

1. Five-year-ahead International Monetary Fund (IMF) forecasts of growth have decreased from 2.4 percent in the fall of 2010 to 1.8 percent today for advanced economies as a whole and from 2.6 to 2 percent for the United States.

the Eurozone should do so to allow Southern countries to reestablish competitiveness and eventually recover; and Japan should do it to deal with its public debt.

Now to the more detailed analysis.

Productivity Growth. The argument above suggests that the decrease in expected productivity growth is the fundamental driver of current developments (in addition to an established trend of worsening demographics)—not just through supply but also via weak demand today.

How pessimistic should we actually be about future productivity growth? How much do we really know? My reading of the large amount of research triggered by this issue is that much uncertainty remains. My main takeaways are the following.[2]

...there is a strong argument that the United States, Eurozone, and Japan should accept and engineer higher inflation.

Looking at the last 10 years, productivity growth has truly decreased; it is not just measurement error. The catch-up process that had generated high productivity growth in Europe earlier has come to a standstill, even reversed. But, even at the technology frontier (i.e., in the United States), there is a clear slowdown. Innovation appears to continue roughly at the same rate, but diffusion (i.e., the use of innovations to improve actual processes and thus increase productivity), which was exceptionally high during the decade from the mid-1990s to the mid-2000s, is lagging. Interestingly, the best firms appear to continue to enjoy high productivity growth; firms that were less productive to start with appear to have slowed down relative to the frontier.

What does this tell us about the future? Unfortunately, not too much. The faster productivity growth of the 1995–2005 decade came as a surprise and went away also as a surprise. And this is not an isolated case. Correlations between productivity growth averages across time are low: For example, for the United States since the mid-1970s, the correlation of successive pairs of 5-year averages of total factor productivity growth is only 0.20.[3] In short, my best guess is that productivity growth will remain low, but that guess comes with a large distribution of outcomes around it, including some potential upside.

The Neutral Rate of Interest. The long downward trend in the neutral rate—the safe interest rate consistent with the economy remaining at potential output—since the mid-1980s is too heavy to be dismissed, and my best guess is that the rate will remain low for some time to come. But there is again much uncertainty and substantial upside.

First, some of the factors that explained the trend decline are turning around. The global savings glut is largely gone: The current account surplus of China has been cut in half, and the large current account surpluses of oil producers have turned into deficits. Demographic changes are leading to an increase in the proportion of retirees, who are more likely to dissave than to save. Second, if previous financial crises are any guide, the increase in "market risk aversion" will slowly fade away, leading to less demand for safety, and, by implication, a higher safe rate[4] (although financial regulation is moving financial sector demand the other way). Third, the diagnostic above suggests that low demand growth may reflect a temporary adjustment to expectations of lower potential growth: Consumers, expecting weaker income growth, may conclude they need to save more for a while; firms, expecting slower sales growth, may scrap some investment projects. Once the adjustment has taken place, demand will likely strengthen again, leading to a higher neutral rate. None of this is certain, although my bet is on a future neutral interest rate higher than currently implicit in market forecasts.

IMPLICATIONS FOR MACROECONOMIC POLICIES I

What do remaining output gaps, poor productivity growth prospects, low neutral rates, and large uncertainty about both productivity growth and neutral rates imply for macroeconomic policy today?

Start with **monetary policy**. In most countries, except perhaps the United States (more on this below), the output gap remains negative, suggesting a case for more expansionary monetary policy. But some argue asset purchases may have outlived their usefulness. I believe we may indeed be close to that point.

In contrast to conventional monetary policy, unconventional monetary policy (taken here to mean the purchases of longer-maturity or riskier assets) not only decreases rates but also increases risk, a point often made (too strongly) by the Bank for International Settlements.

To see why the two are linked, think of a central bank buying long-term bonds. Initially, it will buy them from

2. Baily and Montalbano (2016) provide a useful summary of the evidence for the United States.

3. Bureau of Labor Statistics, Historical Multifactor Productivity Measures, www.bls.gov/mfp/mprdload.htm#Historical Series.

4. I am always struck by how long it took for the equity premium to decline after the Great Depression. But it did decline, leading to a steadily higher safe rate. See Blanchard (1993).

investors who are largely indifferent to the specific maturity of the bonds they hold, and the purchases will increase the price of the bonds (decrease their yield) only a little. As the central bank buys more and more of the bonds, it will have to buy them from investors who care more and more about maturity and are more and more reluctant to sell: The resulting effect of purchases on the price will get bigger, and unconventional monetary policy will actually work better the more it is used. But the other effect of the policy is clear: The investors who sell these long-maturity bonds presumably held them to hedge against long-maturity liabilities. As they sell the bonds, they trade off a higher price for less hedging, more risk taking.

Another reason to worry is that unconventional monetary policy may squeeze the profits of banks; this is particularly the case for negative nominal rates, as banks may not be willing to pass the negative rates on to some of their depositors (although, so far, the evidence on bank profits does not show strong effects). If so, the direct positive effect of lower rates on demand may be more than offset by the negative effect of tighter bank credit supply. At some low enough rate, unconventional monetary policy will become counterproductive, not only increasing risk but also decreasing demand.[5] I do not believe that we are there, but, as we get closer to it, the more unconventional policy is used, the more likely it is to become counterproductive.

...the more unconventional monetary policy is used, the more likely it is to become counterproductive.

This puts the onus on **fiscal policy**. I believe there is plenty of room for fiscal policy to reduce output gaps where they exist and increase potential output.

First, fiscal space is better assessed by looking at interest payments on debt, rather than the level of debt itself. True, as discussed earlier, the neutral rate, and by implication the rate on government bonds, may well go up in the future, even more than the current yield curves suggest. But given how flat yield curves currently are, governments can lock in low long rates for more than a decade.[6]

Second, fiscal space is not a mechanical concept: It depends on how investors view additional spending and higher deficits. If they see it, for example, as promoting growth, they will react differently than if they see it as just an expansion of public bureaucracy. For example, if they see a debt-to-GDP ratio of, say, 100 percent as sustainable (which they appear to in most countries today), it is unlikely that they will change their mind if they see the state increase debt by, say, an extra 2 to 4 percent of GDP in order to strengthen public infrastructure. If done over a couple of years, this can substantially boost demand in the short run and increase potential output in the longer run.

Third, what is true for private investment is equally true for public investment: At lower rates of interest, it makes sense to increase investment. Given how fiscal austerity came largely at the expense of public investment, the case for more public investment, which was already strong in a number of countries including the United States, is now even stronger.

Fourth, given the existing output gap and the limits on monetary policy, there is a strong argument for increasing investment today rather than in the future, when the output gap has closed and higher interest rates may be needed to offset the increase in spending.

Finally, what about the much-trumpeted case for "**structural reforms**"? Lifting productivity growth would indeed solve many of the current macroeconomic woes faced by advanced economies. It would make the future more exciting, which would in turn increase demand and output today; it might increase the neutral rate and give more room for monetary policy. The main message, however, must be that one has to be realistic about what such reforms can accomplish.

Many of the reforms on the G-20 or OECD agendas are likely to have a one-off effect on the level of productivity and thus are unlikely to offset the observed decrease in productivity growth. Furthermore, many of those reforms have distribution effects, for both income and employment: They may take away rents (think taxi drivers who bought their medallions—city-issued licenses—and see their value vanish) or temporarily increase unemployment (think employment protection reforms).[7] Indeed, this is often the reason why they are so hard to pass and to get political support for. The temptation is to tell governments to push them through. However, in a context of increasing inequality and high unemployment, unless workers who are adversely affected in the process can truly be compensated,

5. The rate at which a further decrease in the rate becomes contractionary has been called the "reversal interest rate" by Markus Brunnermeier and Yann Koby, www.bis.org/events/confresearchnetwork1603/brunnermeier.pdf.

6. France, Belgium, and Italy have all sold 50-year bonds this year. See Marius Zaharia, "France sells 50-year bond as QE helps extend euro zone debt life," Reuters, April 12, 2016, http://uk.reuters.com/article/uk-eurozone-bonds-idUKKCN0X91XC?type=GCA-ForeignExchange.

7. See, for example, IMF (2016, chapter 3).

the tradeoff between the productivity effect and the distribution effects may not be worthwhile.

The focus should thus be on reforms that may lead to faster productivity growth, be they education, property rights, or the role of the state. This is, however, easier said than done. These reforms are much harder to define and implement, and their effects much more uncertain and longer term. In short, the advice must be: Choose structural reforms carefully, and do not count on miracles.

I believe there is plenty of room for fiscal policy to reduce output gaps where they exist and increase potential output.

IMPLICATIONS FOR MACROECONOMIC POLICIES II

The broad-brush remarks above did not distinguish between the different advanced economies. The specific issues vary from economy to economy— from the United States, to the Eurozone, to Japan.

The **United States** economy is operating close to its potential. Judging from the evolution of inflation, the unemployment rate is close to the natural rate, growth is roughly equal to potential growth, and the rate of inflation is close to target. Yet, the policy interest rate is still very close to zero. Precrisis, this would have led to an unambiguous recommendation for tighter monetary policy, in order to avoid overheating. The case is more open now, for at least two reasons.

The first, which may have been relevant in the past but is surely relevant now, is the potential presence of hysteresis. In ongoing work with Lawrence Summers, we confirm that the majority of recessions appear to trigger (or, at least, be associated with) a permanent loss in output relative to the prerecession trend, coming both from lower employment and lower productivity. After the long period of high unemployment the United States has suffered since 2008, there is a case for running the economy above potential for some time, bringing back into the labor force some of the workers who have dropped out, and undoing some of the loss in productivity due to the crisis.

The second is that letting the economy overheat would lead to a higher rate of inflation, something that may well be desirable. I and others have articulated elsewhere the general argument for a higher target of inflation. It is particularly relevant now. While the US recovery has been balanced, and the risk of a recession is not unusually high, it is nevertheless positive, on the order of 10 to 15 percent a year based on historical evidence. If and when a recession comes, a higher inflation rate and, by then, associated higher nominal rates would give more room for the Federal Reserve to decrease real rates.[8] Whether or not the Fed considers permanently changing its target, it may make sense to allow for more inflation for a while, as an insurance policy against the next downturn.[9]

Inflation is also a central issue for the **Eurozone**, but for somewhat different reasons. In contrast to the United States, most Eurozone members, except for Germany, still have a large output gap and high unemployment. Southern members suffer not only from weak internal demand but also from weak external demand.[10] A return to health requires not only stronger domestic demand but also a major improvement in competitiveness.

Fiscal policy can help strengthen domestic demand. Here, the earlier discussion is directly relevant. Even the very highly indebted countries have some fiscal space if they use it to take measures that help growth, from public investment to the additional financing required to implement some structural reforms. Even in Spain, Italy, or Portugal, investors are unlikely to change their mind about debt sustainability if the debt-to-GDP ratio increases by a few percent and the funds are credibly used to improve potential output. In this context, the Juncker Plan for investment in Europe, even doubled, is insufficient.

Fiscal rules can be improved to allow for such spending without compromising credibility. It may be time to reconsider an old but highly sensible proposal, the so-called golden rule of public finance. This rule has two parts: first separating a current account and a capital account for public accounting, and second, the possibility of financing part of capital account spending by debt, just as any private firm would do. Attempts to put such a rule into practice in the past have often failed because of cheating by governments on what constituted investment. This is no reason to give up, but it makes clear that the key to success here is a credible definition of what does and does not constitute invest-

8. See, for example, the discussion in the recent Geneva Report, *What Else Can Central Banks Do?* http://cepr.org/active/publications/books_reports/viewreport.php?cvno=P285.

9. My views on whether the Fed can weather the next recession are close to those of Larry Summers. See http://larrysummers.com/2016/09/06/the-feds-complacency-about-its-current-toolbox-is-unwarranted/.

10. Some of these countries no longer have a current account deficit. But this is more the result of depressed output than an improvement in competitiveness. If potential output returned at the same real exchange rate, the current account deficit would reappear.

ment. Independent commissions, at the national and euro levels, are essential to achieve such credibility.

Yet fiscal policy is only half the solution. The other is a needed improvement in competitiveness for Southern members. Here, higher Eurozone inflation is absolutely needed. With very low inflation in surplus countries, in particular Germany, reestablishing competitiveness requires deflation in deficit countries. Large deflation, however, means high real interest rates and further increases in real debt and leverage, with large adverse effects on internal demand; whatever gains are made on the external front are likely to be lost on the internal front. Limited deflation, on the other hand, implies an extremely long adjustment process, one with a high probability of political derailment. Thus, higher average Eurozone inflation is required. More bluntly, if the Euro average inflation is to be equal to 2 percent, and deficit countries are to have zero inflation, Germany in particular must allow its inflation to substantially exceed 2 percent and accept above-potential output and appreciation for some time. Anything less will jeopardize the future of the Eurozone.

Finally, turning to **Japan**, the country's macroeconomic performance is mediocre at best. But in contrast to the Eurozone, this does not reflect primarily a shortfall in demand. Unemployment is low, and growth is roughly equal to potential growth. Unfortunately, potential growth is nearly equal to zero, reflecting both low productivity growth and adverse demographics. The case for structural reforms is strong, but again, one should not expect miracles. Thus, one must assume that growth will remain low.

Given low growth, Japan's problem is not so much macroeconomic as it is fiscal: The ratio of debt to GDP, however measured, is very high and increasing. Of all advanced economies, Japan is the one with the most limited fiscal space. Even a small increase in interest rates on government bonds, due either to tighter monetary policy or to an increase in the risk premium required by investors (who will increasingly be foreign), would lead to an unsustainable debt explosion. If nothing is done, such an increase seems nearly inevitable. It is in this context that there is a strong case for a higher rate of inflation. A higher rate of inflation, coupled with low nominal rates, appears to be the only way to avoid a future debt explosion, and potentially chaotic debt restructuring down the line. By leading to more negative real interest rates, it would allow for a gradual reduction in debt to a level that is sustainable: in effect achieving smooth debt restructuring now to avoid chaotic restructuring later.

The issue is how to achieve such a rate of inflation. The best tool may not be monetary policy, which has proven to have limited effects on both activity and inflation expectations. It may be a coordinated increase in nominal wages and prices, a reverse "incomes policy," along the lines Adam Posen and I suggested last year[11] and the IMF is now suggesting as well (Arbatli et al. 2016).Working directly on wages and prices rather than indirectly through the effect of monetary policy on inflation expectations seems more likely to succeed than what has been tried so far.

To summarize: The current environment of low growth and low interest rates is a tough one and forces a reassessment of macroeconomic policies. The scope for monetary policy, which has carried much of the burden, is increasingly limited. The scope for fiscal policy is, however, wider and should be explored more aggressively. There is a case for higher inflation in the United States, the Eurozone, and Japan, but for three different reasons: In the United States, as insurance against the next recession; in the Eurozone, to allow periphery countries to improve competitiveness without deflation; and in Japan, to reduce the burden of debt.

11. See Olivier Blanchard and Adam S. Posen, "Japan's solution is to raise wages by 10%," Financial Times on The Exchange, December 2, 2015, http://blogs.ft.com/the-exchange/2015/12/02/japans-solution-is-to-raise-wages-by-10/.

REFERENCES

Arbatli, Elif, et al. 2016. *Reflating Japan: Time to Get Unconventional?* IMF Working Paper WP/16/157. Washington: International Monetary Fund. Available at www.imf.org/external/pubs/cat/longres.aspx?sk=44162.0.

Baily, Martin Neil, and Nicholas Montalbano. 2016. *Why is US productivity growth so slow? Possible explanations and policy responses.* Hutchins Center Working Paper 22 (September). Washington: Brookings Institution. Available at www.brookings.edu/wp-content/uploads/2016/09/wp22_baily-montalbano_final.pdf.

Blanchard, Olivier. 1993. Movements in the Equity Premium. *Brookings Papers on Economic Activity* 2: 1993. Washington: Brookings Institution. Available at www.brookings.edu/wp-content/uploads/1993/06/1993b_bpea_blanchard_shiller_siegel.pdf.

IMF (International Monetary Fund). 2016. *World Economic Outlook* (April). Washington.

This publication has been subjected to a prepublication peer review intended to ensure analytical quality. The views expressed are those of the author. This publication is part of the overall program of the Peterson Institute for International Economics, as endorsed by its Board of Directors, but it does not necessarily reflect the views of individual members of the Board or of the Institute's staff or management.

The Peterson Institute for International Economics is a private nonpartisan, nonprofit institution for rigorous, intellectually open, and indepth study and discussion of international economic policy. Its purpose is to identify and analyze important issues to make globalization beneficial and sustainable for the people of the United States and the world, and then to develop and communicate practical new approaches for dealing with them. Its work is funded by a highly diverse group of philanthropic foundations, private corporations, and interested individuals, as well as income on its capital fund. About 35 percent of the Institute's resources in its latest fiscal year were provided by contributors from outside the United States. A list of all financial supporters for the preceding six years is posted at https://piie.com/sites/default/files/supporters.pdf.