IESE Business School
University of Navarra

International Economic Overview

Year 27 / No. 6 / March 2014

Index

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Secular Stagnation of Ideas?

Summers' arguments, like summer breezes, are never as cool as they pretend to be

In recent months, the hot topic in macroeconomics has been the idea that industrialized economies are set for years of low growth. Last November, Larry Summers launched the debate with a speech at the IMF Economic Forum on "secular stagnation"[1].

Larry Summers launched a debate at the IMF Economic Forum about whether the U.S. and other advanced economies would stagnate due to a declining natural rate of interest.

In his remarks, Summers questioned if the U.S. and other advanced economies would suffer the fate of the Japanese economy, which is today only half the size economists in the 1990's predicted it would be by now.

The conjecture behind Summers' concerns about secular stagnation revolves around a declining natural rate of interest. He suggested that: "The short-term real interest rate that was consistent with full employment had fallen to negative 2 percent or negative 3 percent sometime in the middle of the last decade."

The decline in the "real interest rate that was consistent with full employment" – below normal levels experienced since the end of World War II, as Summers indicated – is supposedly due to both: (i) an increase in the global rate of saving ("global savings glut" is the jargon here) in surplus countries and even in G7 countries and (ii) a lack of investment opportunities (an "investment dearth") both in Asia and in the G7.

Suppose, as Summers suggests, that the real interest rate is negative 3 percent. Then if the economy has an inflation rate of 2 percent, the nominal interest rate would be negative 1 percent. But this cannot happen: nominal interest rates cannot be negative. Why? Because nobody will lend at a negative interest rate, since holding cash guarantees a rate of return of zero. Therefore, there is a zero lower bound in the nominal interest rate.

Because of this zero lower bound, the economy would find itself stuck in a non-market-clearing disequilibrium state, that is, it creates the situation where interest rates – which seem to be low – are not low enough to induce firms to invest.

Actually, this disequilibrium story is nothing new. Over half a century ago, classical economists were arguing that, in times of crisis, the investment/saving curves could cross at negative interest rates. And because of the zero lower bound in the nominal interest rate, the economy would find itself in a "liquidity trap"[2]. Classical economists argued that, in a world with flexible prices, this disequilibrium would be solved through a deflationary

[1] Here is the speech: http://www.youtube.com/watch?v=KYpVzBbQIX0
[2] See Don Patinkin's monograph "Price Flexibility and Full Employment." American Economic Review, 38, no. 3 (September 1948), pp. 543-64.

Economic recovery in the U.S. has been weak, according to Summers, because interest rates have not been low enough to drive a strong recovery.

The economy, according to Summers, needs bubbles just to achieve something near full employment. If the U.S. economy does not experience bubbles, it would have an ex-ante real rate of interest that is too high and, thus, it will stagnate.

Summers' statements imply that there should have been slack economic conditions and high unemployment in the U.S. in the years before the crisis. But it was just the opposite: the American economy was booming, especially in the real estate market.

process that would decrease savings (as real balances rise).

Summers and others argue that evidence of this secular stagnation is the performance of the G4 (U.K., U.S., Japan and Euro-area) economies since 2008, which has been far below its potential after the crisis.

This is the case even in the U.S., which is the G4 country that has experienced the strongest recovery. Indeed, since the end of the recession, American GDP growth has been too slow to close the gap between real GDP and potential GDP. Consequently, the longest and worst U.S. recession since the end of World War II has been marked by the weakest recovery in employment than any U.S. recession in that same period.

The big question is: why has the U.S. seen such a dismal recovery? Summers' speech recycles an old answer: There is a negative equilibrium real interest rate that, jointly with the zero lower bound on nominal interest rates, generates ex-ante real interest rates that are not low enough to drive a strong recovery.

More challengingly, Summers adds, the economy may need bubbles just to achieve something near full employment. The bubbles argument goes as follows: We tend to think that bubbles mean that monetary policy has consistently been too loose. But Summers asks: if the monetary policy was too expansionary, where is the inflation? We did not see any inflation during these economic booms.

According to Summers, the only way to reconcile bubbles with a lack of inflationary pressures is that we may need bubbles to reach near full employment. In other words, if the U.S. economy does not experience bubbles, it would have an ex-ante real rate of interest that is too high and, thus, it will stagnate. And this has been the case of the current bleak recovery.

Summers is not suggesting that policymakers should foster bubbles. This idea confuses prediction with recommendation. It is of course far better to support demand by supporting productive investment or highly valued consumption than by artificially inflating bubbles. On the other hand, it is only rational to recognize that low interest rates raise asset values and drive investors to take greater risks, making bubbles more likely. The risk of financial instability provides yet another reason why preempting structural stagnation is so profoundly important."

This is a neat argument, because it provides the justification for heavy government interventions, such as the Fed's quantitative easing and forward guidance, as policymakers try to respond to the secular decline. It can also be interpreted as a Keynes redux, which advocates that a world of adequate demand, supported by public investment, is preferable to a world of inadequate demand.

Of course, there are many problems with this secular stagnation hypothesis. First, as John Taylor has argued elsewhere[3], Summers' speech implies that there should have been slack economic conditions and high unemployment in the U.S. in the years before the crisis, even with very low nominal interest rates then.

But it was just the opposite. The American economy was booming, especially in the real estate market. The unemployment rate got as low as 4.4 percent – well below the normal. Inflation was rising, not falling; the annual inflation rate for the GDP deflator doubled to 3.4 percent from 1.7 percent from 2003 to 2005.

Moreover, it is not clear what the term "global savings glut" means. Does it mean that world savings was higher than it had been before? That is patently not true. In the past decade, global savings rates fell below what they were in the 1980s and 1990s. Does it means that savings relative to investment in some Asian and oil exporting countries was higher in the early 2000s than in the past? This view is more defensible.

Yet it is important to recall that current account balances are endogenous variables, determined by the interaction of saving and investment in different economies. So one can't say without further analysis whether the U.S. current account deficit was driven by excess supply of savings from East Asia or excess demand for savings from the U.S. The latter seems plausible, given the unsustainable fiscal policy followed by the U.S. government and deregulation in U.S. financial markets.

An alternative explanation of both the crisis and the slow recovery in the U.S. is that it is

1 "The Economic Hokum of 'Secular Stagnation,'" *Wall Street Journal*, Jan. 1, 2014
2 "Economic Progress and Declining Population Growth" Presidential Address at the American Economic Association. December 1938.

largely a result of policy errors on macro and regulatory policies. American firms appear to be reluctant to invest and hire, and the ratio of investment to GDP is still below normal. That is most likely explained by policy uncertainty and increased regulation. There is plenty of evidence for this, especially in comparison with the secular stagnation hypothesis.

So why has the reemergence of the secular stagnation hypothesis become such a hot topic in macroeconomics discussion? Summers is not saying anything new. Not even the expression "secular stagnation" is new. It was first used in the late 1930s by economists such as Alvin Hansen[4]. It is difficult to understand what the controversy is really all about. It appears that the economics profession suffers collective amnesia, repeating the same old controversies that have been previously resolved.

But the real danger with this sort of controversy is that it distracts us from the real issues. It biases the economic discussion toward fiscal and monetary policy, along with financial regulation. But very little discussion focused directly on an agenda for creating a supportive environment for private investment in physical and human capital. In sum, it is likely to lead to more bad government policy.

The real danger with this sort of controversy is that it distracts us from the real issues and could lead to bad government policy.

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Life in the Eurozone: A Blessing in Disguise from Karlsruhe

The debt crisis in the euro area has entered into a remission phase after Mario Draghi pronounced the magic words in July 2012 "the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

The statement was followed up in September of the same year with the novel OMT (Outright Monetary Transactions) operation, consisting of insuring peripheral European debt of maturity of less than three years. Progress in the reduction of debt spreads has been formidable.

The program of the European Central Bank has not spent a single euro buying bonds of peripheral countries; the threat of buying them has sufficed. Can the magic continue or will the market at some point try to test whether Mr. Draghi was bluffing? A crucial ingredient of the magic is that Mr. Draghi promised to do "whatever it takes." That is, he promised unlimited intervention in the markets in case of turbulence.

This is akin to Bagehot's recipe of providing unlimited liquidity support to a bank in trouble, provided that the bank is solvent. Just replace bank by country in the recipe of the founder of *The Economist*. The problem with the promise is that typically a central bank is backed by a Treasury with the power of taxation over its citizens. This is not the case in the eurozone, where there is no centralized fiscal power and the political structure is that of a loose confederation.

The ECB cannot monetize the debt of countries and there is debate over whether successful OMT is just part of the normal operation of monetary policy or may have fiscal implications if the ECB has to buy bonds of countries that later default. The German Constitutional Court (Karlsruhe) has stated that OMT is tantamount to debt monetization, in accordance with the opinion of the Bundesbank. However, it defers the final judgment to the European Court of Justice (ECJ). Furthermore, the court states that OMT may violate the German Constitution and leave the German taxpayer vulnerable. A declaration of incompatibility of OMT with the European Treaties would deal a fatal blow to the euro. There is good reason to think that it will not happen but the tension with Germany is evident. Germany defers the decision to a European institution making clear that the German Court, and the Bundesbank, are not thrilled by OMT and that to be acceptable the policy must be limited and have the approval of the Bundestag. So, the decision of the German Court is mixed news: Germany will not pull the carpet out from under the feet of Mr. Draghi, and defers to the good of Europe, but at the same time warns about a course of action subject to heavy criticism in Germany. The practical implication for the

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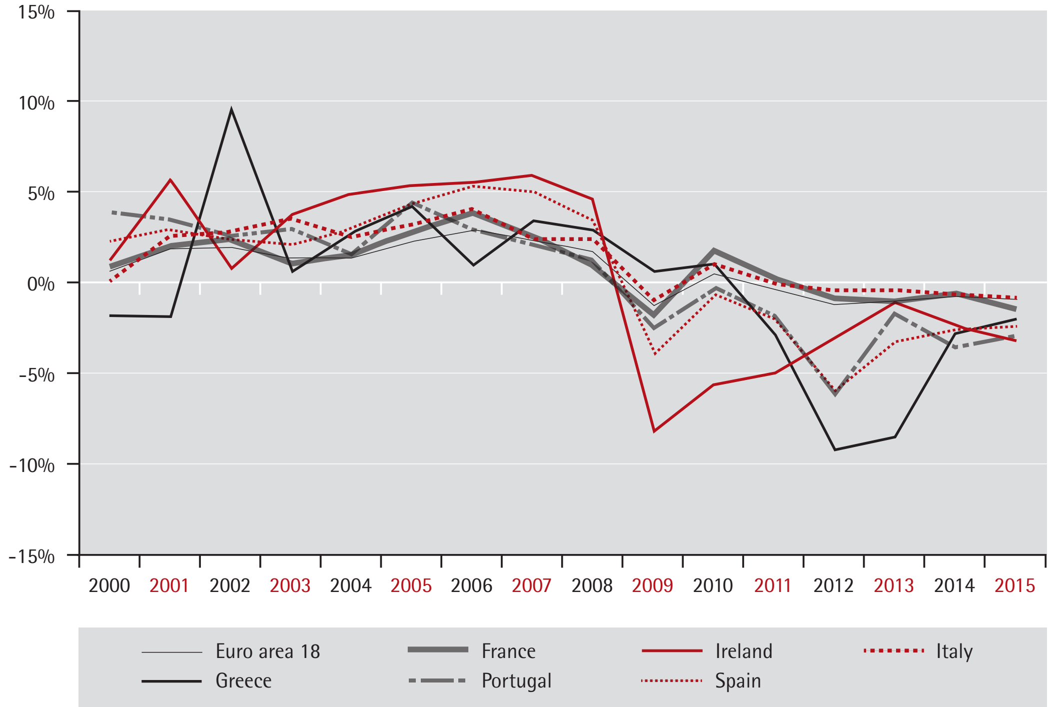
Figure 1. Relative Growth of Nominal Unit Labor Cost (%∆ Country – %∆ Germany)



ECB is that Mr. Draghi may think twice before responding massively to a problem in a peripheral economy. But, if this is the case, then Draghi's magic may fade and instability may come back.

The decision of Germany's Constitutional Court may be a blessing in disguise. The words of Draghi have had a balsamic effect on markets but at the same time may have had a relaxing effect on the reform agenda of the countries in the eurozone. The German Court, by reminding everyone that the euro is not a foregone conclusion, may enhance the incentives to reform.

A declaration of incompatibility of OMT with the European Treaties would deal a fatal blow to the euro. As such, there is good reason to think that it will not happen but the tension with Germany is evident.

It is well known that for a workable and systematic monetary union, large and increasing discrepancies in competitiveness are problematic. Indeed, the periphery has lost competitiveness with respect to Germany since the establishment of the euro.

These large discrepancies in competitiveness create balance of payments problems that surface when there is a sudden stop in capital flows, as exemplified in the financial crisis started in 2007 with the subprime mortgages. The tool of depreciation of the currency, which was used systematically by countries such as Italy and Spain to recover competitiveness, cannot be used in a currency union.

The German Court, by reminding everyone that the euro is not a foregone conclusion, may enhance the incentives to reform. Countries such as Spain and Italy have had to resort to painful internal devaluations to adjust.

Now those countries have to resort to painful internal devaluations to adjust. Unit labor costs can be diminished in relation to other countries by nominal increases, or outright decreases, of wages and other labor costs below the country average, or by productivity improvements with better organization of production and innovation. Massive unemployment, such as in Spain where it hovers around 26 percent, has worked in moderating wage increases and has increased productivity by the expeditious method of lowering dramatically the denominator in the wage bill over workers computation. But this is a brutal and unfair method. In fact, the periphery has managed in the recession to regain competitiveness with respect to Germany. Indeed, as a result of the crisis, the relative rates of growth of unit labor costs have been negative for the periphery in relation to Germany (see Figure 1).

A better antidote against country imbalances is to reform the economies so that productivity is increased and the distance between the core and periphery is made smaller. However, this is easier said than done and it takes time to design and implement.

Germany reformed its economy under Chancellor Schröder, but France has not reformed. Italy undertook relatively weak reforms under Mario Monti, and now we still have to see whether the new Prime Minister Matteo Renzi delivers. Greece, Portugal, Ireland and Spain, countries under European help programs during the crisis, have undertaken reforms subject to the pressure of the troika (Brussels, the IMF and the ECB). Carrying out reforms is not easy. The most important obstacle is political, and more specifically, the difficulty in compensating the potential losers in the process. Building a social consensus around reform and having political will are both crucial. This is a lesson from the successful reform programs in Scandinavian countries, such as Sweden and Finland. These countries managed to overcome deep crises in the 1990s, caused by systemic problems in the financial sector. These systematic problems were compounded with the fall of the Soviet Union.

The contrast with Southern Europe could not be greater – reforms are seen as an imposition of external powers synthesized in the troika. Society and politicians do not want reforms, despite claims to the contrary. Or, to be more specific, a large sector of society and politicians do not believe in reform. The problem then is that half-hearted reforms, which do not have the required social consensus, are implemented. And these may be easily rescinded when external pressure ceases to exist.

Let us take the case of Spain. The crisis was first denied by the government of President Rodriguez Zapatero. It was recognized in May 2010 because of heavy external pressure to act and due to the Greek sovereign debt crisis. Finally, a reform agenda was put on the table.

First, fiscal consolidation was carried out to avoid a default on Spanish debt. This was followed by labor reform, developed in two stages, and, more recently, pension reform. The reforms of the labor market and the pension systems go in the right direction but stop half way. The reforms do not attack the duality of the market in Spain with protected and unprotected workers, nor do they address the failure of active labor market policies.

Labor market duality is unfair and a drag on productivity, since firms are not interested in investing in the (temporary) workers and the (temporary) workers in return are not interested in investing in the firm either. Pension reform will help, but does not put public pensions on a sustainable path in Spain, given the expected evolution of demographics and productivity. Many other reforms are necessary and pending. Education is one of them, the present plan of the government may solve some problems and create others; R&D policy is in shambles as well as market competition and regulatory institutions (with the energy sector being a conspicuous example of bad regulation).[1] Despite all these shortcomings, Spain still fares better than Italy in terms of implementing a reform agenda.

In summary, the widespread resistance to reform is why the decision of the German Constitutional Court may be a blessing in disguise. It may help to maintain the tension necessary for reforms.

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[1] See the website SpanishReforms.com of the Public-Private Sector Research Center for coverage of the reform process in Spain from an international perspective.

The Future of Spain (2014 and Beyond)

The fourth quarter of 2013 has been a great quarter for the Spanish economy as far as its growth performance is concerned.

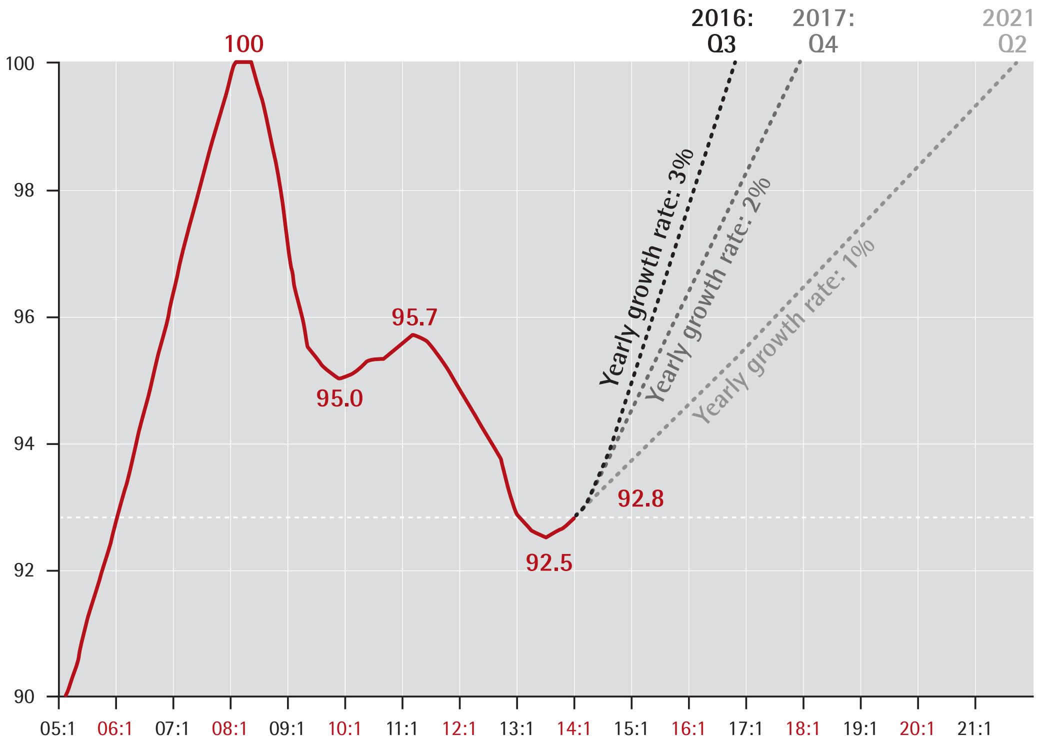
The annualized quarterly growth rate of real GDP was 1.2 percent and, when compared with the fourth quarter of 2012, it was -0.1 percent.

In Figure 1, we have plotted an index of Spanish real GDP and three fictional economic scenarios that depict its future values. In these scenarios, we have assumed that, from the first quarter of 2014 onwards, yearly growth rate will be constant at 1, 2 or 3 percent and we have calculated the quarter in which Spanish real GDP will return to its historical maximum.

It turns out that, if Spanish real GDP were to grow at an uninterrupted and constant rate of 1 percent, it would reach its historical maximum in the second quarter of 2021, 13.25 years after the recession began. If this growth

If Spanish real GDP were to grow at an uninterrupted and constant rate of 1 percent, it would reach its historical maximum in the second quarter of 2021, just more than 13 years after the recession began.

Figure 1. Index of Spanish Real GDP and Other Hypothetical Scenarios



First and foremost, Spanish growth will depend on any and all future reforms and policy measures which the present and future Spanish governments may take. Unfortunately, the reform plans of the current government are a carefully guarded secret, so are difficult to comment on.

Two elasticities will surely have an impact on Spain's future growth: the output elasticity of employment and the consumption elasticity of imports.

Since 2010, two labor market reforms have reduced statutory firing costs. This suggests that labor hoarding in Spain is most likely at an all-time low.

rate were to reach a constant value of 2 percent, Spanish real GDP would return to its historical maximum in the fourth quarter of 2017 and, if it were to reach 3 percent, in the third quarter of 2016. Nobody in Spain was even dreaming about 3 percent at the beginning of 2014, and we conjecture that many Spaniards would take anything between 1 and 2 percent gladly. If this were to happen, it would have taken Spain between 11 and 12 years to return to its maximum real GDP number. But, since the ride to growth will most likely turn out to be bumpy, Spanish real GDP may very well take further dips, delaying its return to the pre-recession level further.

Nobody knows what will happen in terms of Spain's future growth but, obviously, whatever ends up happening will depend on many factors, both domestic and foreign. First and foremost, Spanish growth will depend on any and all future reforms and policy measures which the present and future Spanish governments may take. Unfortunately, the reform plans of the current government are a carefully guarded secret and they are, therefore, hard to comment on. Secondly, Spanish growth will depend on the economic performance of the eurozone countries and of the rest of the world economy, and this, too, is a big unknown. That said, when we look into the crystal ball of the economic future of Spain, two elasticities emerge that will surely make a large difference for its future growth: the output elasticity of employment and the consumption elasticity of imports.

The output elasticity of employment

Traditionally, Spain has had short-lived recessions and very high firing costs. The optimal response to these two circumstances is to hoard labor. So much so, that a folk theorem much favored by many commentators and by the Spanish media claims that Spain only creates net employment when its GDP starts growing at 2 percent or more. It is hard for us to tell whether or not this was the case in the past. But we have reasons to think that this time it might very well be different.

The recession that started in the first quarter of 2008 has been the deepest and longest recession in the last 30 years. And since 2010, two labor market reforms have reduced statutory firing costs at least somewhat. These two changes suggest that labor hoarding in Spain is most likely at an all-time low. The firms that have survived the recession most probably have shed all their surplus labor by now, and have adjusted their labor force to a shrinking market. If this were the case, we might see net jobs being created with even minimal growth. If this is what ends up happening, job creation will accelerate the growth of private consumption, and the growth of consumption will accelerate the growth of GDP, helping make the growth process self-sustaining.

The consumption elasticity of imports

The second elasticity that will determine the size of the future growth of Spain is the consumption elasticity of imports. The return to growth of the Spanish economy so far has been based on the growth of net exports. And net exports have grown both because exports have grown and because imports have shrunk. In the wondrous decade, the Spanish consumption elasticity of imports was very high (between 1998 and 2008 private consumption grew by 45 percent and imports grew by 118 percent).

Since the GDP share of private consumption is approximately twice the size as the GDP share of imports, each percentage point of imports growth detracts from Spanish GDP growth half the amount added by each percentage point of consumption growth. This means that, between 1998 and 2008, the net contribution to growth of consumption plus imports was *negative*.

Clearly, the Spanish economic environment at the beginning of 2014 is very different from that of 2008. In the six years that have ensued, unit labor costs have fallen, and Spanish firms have become more competitive and they have displaced foreign firms in many export markets. But we still do not know whether this will be the case in the Spanish domestic market, once consumption growth returns in earnest.

If the Spanish consumption elasticity of imports remains high, the growth of imports will slow down GDP growth. If, in the new Spain, this elasticity is smaller, both consumption and net exports will become the engines for future Spanish GDP growth. Unfortunately, expenditure data from the third quarter of 2013 suggest that Spanish imports are growing strongly again. If consumption growth resumes in the next few quarters, we will know whether this early data signals that Spaniards are returning to their old spending habits, or whether the spending pattern of the new Spain will turn out to be friendlier to growth.

Javier Díaz-Giménez. Professor of Economics,
IESE Business School

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Selected Activities

ALUMNI

Glocal:Criminal Networks in the Global Economy: How Can We Fight Them?

Munich, March 18

Prof. Antonino Vaccaro

How do criminal organizations affect the economy? And how is the activity of a "normal firm" affected by criminal networks? Are criminal organizations local or global? What are the sectors that are more attractive for criminal networks? And what is the total amount of mafias' revenues around the world? How is it possible to prevent and fight the infiltration of criminal networks in your organization? This seminar will try to address these questions through the discussion of data and examples resulting from recent research projects conducted within the Center for Business in Society of IESE Business School and some consultancy experiences of the speaker.

Decision Making in an Uncertain World

Oslo, March 20

Prof. Franz Heukamp

Many executives say that the world has become less predictable and more complex. In this session we will review some of the sources of increased (perceived) uncertainty and the related global trends; and we will ask which decision marking tools and habits can help us to navigate and manage this new world.

Risk:Controversies and Impact on Investment Decisions London

London, March 20

Prof. Javier Estrada

Risk is an essential variable in investment decisions. That being said, there is ample disagreement about how to assess it and different investors perceive it in many different ways. In this session, we will discuss two issues: 1) The distinction between short-term risk and long-term risk; and 2) the impact that different measures of risk have on long-term investment decisions, particularly as far as saving for retirement is concerned.

Both issues will be illustrated with comprehensive evidence covering 19 countries over a 110-year period. In both cases, we will see that a portfolio or strategy can be more or less risky depending on the way an investor perceives risk. This implies that investors should focus on making investment decisions consistent with the way they will evaluate the risks.

Excellence in Business Leadership and Governance

Tokyo, March 24; Shanghai, March 25 and Hong Kong, March 27

Dean Jordi Canals

Business leaders still focus their attention too much on the short term and the vagaries of the economic cycle. Great and respected companies need to look at the long-term. Bad governance and leadership were some causes of the 2008 financial crisis and its effects. It is worthwhile to take time to look into what we can take away from the disaster for better business leadership and governance. In this session, we would like to discuss the following:

- How to better manage your business over the long-term
- How good governance helps a firm's long-term development
- How to define the role of CEO and board of directors for better corporate governance

The State of the World Economy

Geneva, March 27

Prof. Pedro Videla

In this session we will discuss the current situation and perspectives of the world economy in a year when most pundits are forecasting a global recovery. I will outline the main challenges of the current environment, contemplate potential developments, and discuss the main key leading indicators of economic activity in the current environment.

SHORT FOCUSED PROGRAMS

Driving Change Successfully

Barcelona, March 24-27

The program provides participants with an excellent opportunity to design and deliver a change program while experiencing the emotions that change brings to individuals and teams. It will provide participants with the opportunity to grow professionally and personally: professionally, by learning and applying a systematic change approach from creating the desired level of urgency in an organization to successfully embedding the change; and personally, whereby participants will engage in a process of self-awareness (understanding one's emotions), self-management (situational understanding) and emotional awareness (empathy, not sympathy).

Make Innovation Happen

Barcelona, April 8-10

Learn how to engage everyone in key innovation behaviors as part of their daily work, driving your company towards better business results. The program is based on Paddy Miller and Thomas Wedell-Wedellsborg's new book "Innovation as Usual: How to Help Your People Bring Great Ideas to Life," published by Harvard Business Review Press.

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