Seminar with Professor Steve Hanke and his Johns Hopkins students

I will divide my remarks in 3 headings :

1. The present policy mix ;
2. The importance of structural reforms ;
3. The impact of the absence of a proper international Monetary System.

I – The issue of the policy mix.

The art of macro-economic policies is to achieve a strong and balanced growth rate (i.e. combining the highest possible GDP compatible with least inflation).
This requires a proper combination ("mix") of :

- Fiscal,
- Monetary policy,
- And the right incentives to promote an increase in potential growth (supply side measures).

To cope with the existence of economic cycles, policies have to be adapted (stimulus in recession, contractionary monetary policy in case of overheating).

But the advanced countries have not been very good at managing the cycles over the past decades.

To simplify, one can observe the following episodes :

1. During the 60's, the advanced countries were running faster than what capacity should normally have allowed. Therefore, inflation started to emerge.
2. During the 70's, the fight against a soaring inflation became predominant and the high price increases in the 70's (double digit inflation) led to a policy mix where the slack (the room left between actual growth and potential) translated in higher unemployment.
3. In the mid 80's Central Banks became more independent and were proud of the "great moderation" in terms of inflation.

But the world economy got more and more dependent on borrowing. In other words, the actual growth rate (albeit more subdued than it had been in the 60's) was fueled by more and more leveraged financing (the rate of growth of financing was twice the economic rate of growth).

4. This "over financialisation" of the system was largely due to 2 factors :
   - Insufficient structural measures to boost productivity ,
   - Accommodative Monetary Policy (that ended up in asset bubbles).

This combination led, eventually, to the 2007-2008 crisis.

The last 10 years were caracterized by :
- Low – CPI – inflation (less than 2%),
- Sluggish growth,
- Extreme leverage and asset bubbles which are the harbingers of future financial crises.

5. After the pandemics that struck in the spring of 2020, a new shock on growth emanated followed the lockdown imposed by governments to mitigate health problems.

This has led to a severe hit on growth (the US economy contracted by -3,5% in real terms in 2020).

And this time, the reaction of the policy mix <u>has been particularly strong</u>, notably in the US.

- <u>Monetary Policy</u> has been extremely accommodative :

  - Large buying of securities by the Fed and the European Central Bank,
  - Interest rates close to zero,

- <u>And fiscal Policy</u> has literally exploded.

The 900 Billion $ fiscal plan of end 2020 (equivalent to 4,5% of GDP) is being supplemented by the 1900 Billion of the Biden Plan (9% of GDP).

How can we assess this policy ?

- In 2021 the US would grow by +5% ;
- It is an ambitious plan that errs on the “safe” side of the equation : i.e. : “Do as much as possible, and even more” ;
- If one adds the overhang of “forced” savings that accumulated during the pandemics, which, in part, will be run down for consumption purposes, one can expect a significant overheating in the latter part of 2021 and in 2022 with a – perhaps temporary – rebound in inflation, which the markets are anticipating.

The determination of the exact inflationary impact of this present policy mix is a difficult exercise.

Indeed the “output gap” that expresses the slack in the economy is hard to measure (it depends on models used – to build a potential growth calculation) and on the choice of the right multiplier coefficients to gauge the final impact on demand of fiscal measures.

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So, we are about to live a new episode of the bumpy history of our policy mix as it can be observed over half a century : what if inflation were to re-emerge after 20 years of moderation ?

<u>II – The insufficiencies of structural reforms.</u>

Let me explain this subject that is at the heart of all economic issues.

Over the last two or three decades, stimulating demand has been the name of the game.

But this has been to the detriment of supplyside economic reforms.

When we consider the output gap we tend to equate unused capacity to unemployment, while we should be looking also at the other ways (than reducing unemployment) of boosting productive opportunities.

Among those ways, <u>productivity gains and investment have been, too often, the neglected orphans</u>.

Actually, global productive investment has declined by 3 percentage points of GDP over the last 10 years while the need for investment is rising and this in spite of very low interest rates.

So we should focus on all factors that influence production such as : demography, competition, labor/market flexibility, fight against excessive bureaucratic complexity and inefficiency, reducing obstacles to new entrants on the markets, not protecting zombie companies that only survive because of low interest rates …

We must understand that all policies that contribute to shaping an efficient eco-system are thus crucial. If they are neglected, reasonably good employment could well coexist with economic inefficiency and poor productivity, which therefore would entail long term economic decline.

Therefore, if we want – as we should – to eliminate the negative output gap, we have to look at supply side factors as well as demand related ones. Fostering the potential growth element is as crucial as stimulating demand.

If you look at Japan – which is a caricatural example of the lack of structural measures, what do you see ?

A very rapid ageing of the population accompanied by a fall in birth rates. This ends up in a shrinking labor market.

And to face that situation, instead of opening Japan to reasonable immigration (which would be a powerful way to revive the labour markets), the Government has engaged in a policy of no immigration and of abundant liquidity creation accompanied by zero interest rates.

This liquidity has not seeped into the real economy nor has it been invested in capital equipment (because of the economic stagnation linked to demography). It has been hoarded and kept in liquid riskless placements (Treasury bonds). Who would invest in risky assets with no return ?

The result of this very accommodative monetary and fiscal policy in Japan has been :

- Huge increases in the BOJ balance sheet (120% of GDP – 3 times US : US = 40%),
- Large public deficits : public debt = 260%/GDP (world record),
- And no growth,
- But the weakening of the financial system is apparent : zero interest rates cannot ensure a minimum margin for financial institutions and investors.

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My point can be summed up as follows :

Structural issues can only be solved by structural measures : simpler regulations, immigration policy, birth rate incentives, fiscal incentives to invest, …

But the problem is this one :

The following diagnosis has been made :

« Keynesian stimulus will repair the sluggish global demand and unlock the savings glut ».

But the diagnosis as well as the medication proposed are both, in my view, misconceived :

- First in a long term perspective, it is not so much the lack of consumer demand that is the problem, but the lack of investment and of productivity gains.
- Second, throwing more money at these structural issues is of no help. It pushes up leverage, but does not end up in more investment (because the absence of remuneration on risky capital investments encourages savers to keep their money in liquid forms).

<u>So my conclusion is simple.</u>

- Structural problems call for structural solutions ;
- The mistake is to believe that the sluggish global demand can be corrected by monetary and fiscal stimulus ;
- The “secular decline” is more the result of structural weakness (ageing) or of globalization than a conjonctural lack of demand ;
- The savings glut is in part the result of monetary policy and pushes households to save more (0 interest rates foster liquidity hoarding) ;
- Zero interest rates are a disincentive for structural reforms (since Governments can raise billions at no cost).

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III – The absence of a proper international monetary system compounds the macro economic issues.

1. The Bretton Woods system was, in fact, a source of macro economic discipline.

Exchange rates were fixed to the dollar. If the 1% corridor around the $ was exceeded, a country had to ask permission to the IMF to devalue.

Therefore, macro economic behavior had to be restored (Fund conditionality).

2. The system broke down in 1971-73.

When the US abandoned the gold convertibility of the $ because of their deficits (Vietnam war, Welfare State) and the accumulation of dollars by foreign Central Banks, the US gold reserves were not enough to ensure the convertibility of the dollar.

The result was : exchange rates are free to float.

And the way out was : “borrow” nationally and don’t mind about the exchange rate.

3. Since the 70’s.

The system has been replaced by more and more leverage …. And the crises flourish.

But we see now that the exchange rate has become a fear or a threat for all countries.

Risk of “beggar your neighbor” and trade wars.

We need a form of discipline.

Jacques de Larosière