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Secular stagnation risk for EU and Japan

By Willem Buiter

But US, emerging markets and UK are not suffering this malaise

Larry Summers has argued that the short-term real interest rate consistent with full employment fell to minus 2 or 3 per cent sometime in the middle of the last decade. This was due to an ex-ante global saving glut, possibly reinforced by a weakening in ex-ante investment demand. Because currency has a riskless zero nominal interest rate, nominal interest rates on other financial instruments cannot fall much below zero.

With output significantly below potential since the start of 2008, the expected inflation required to achieve a significantly negative real interest rate with the nominal rate at zero has not been forthcoming, despite aggressive policy easing by the world's leading central banks. The resulting unemployment is self-perpetuating. Human capital formation suffers: today's high actual unemployment rate becomes tomorrow's high natural unemployment rate.

Is this view correct and are bolder policies needed to boost demand? Most of humanity lives in the emerging markets that account for 45 per cent of the world's gross domestic product. Although lower than in 2010 and 2011, EM growth is likely to be around 4.6 per cent this year. Citi's recent annual longer-term forecast sees real EM growth of around 5 per cent for the next five years: hardly secular stagnation.

The US has had a mediocre year because of premature and badly designed fiscal austerity that may have knocked about 1.5 per cent off 2013 GDP growth. But a repeat of this self-inflicted pain is unlikely.

We see US growth just below 3 per cent in 2014 and just above it in 2015 and 2016. Moreover, the risk is mainly on the upside, because private investment could be stronger than expected: hardly secular stagnation.

The UK is likely to grow at more than 3 per cent during 2014 and 2015, although this is largely driven by a break from fiscal austerity and by residential construction and household demand, boosted by rising house prices. This house price boom is partly due to demand from the world's scared rich, looking for bolt holes in London, and partly to misguided policies making it possible for first-time buyers to once again obtain 95 per cent loan-to-value-ratio mortgages.

Three years from now, with Bank Rate back at 3 per cent and rising, foreclosures and evictions will be headline news again. Learning has not occurred in Westminster, but secular stagnation this is not.

Stimulus required

Japan is attempting to exit 15 years of deflation and stagnation, but the Bank of Japan will have to do more, and a larger temporary fiscal stimulus will be required to offset the sales tax increases scheduled for 2014 and 2015. Much more must be done to increase labour supply and boost productivity in the service sectors if higher potential output growth is to materialise. Japan remains at risk of secular stagnation making a comeback.

The main candidate for secular stagnation is the euro area. Significant recovery is unlikely there until impaired sovereigns and banks have deleveraged significantly and the European Central Bank reverses its recent asymmetric reinterpretation of its price stability mandate and tackles the material risk of further disinflation and even of deflation.

Boosting demand

How can a sufficient further reduction in the short-term real interest rates and a boost to demand be achieved? Not by a sustained debt-financed fiscal stimulus. Either the markets will rebel or governments will face an ugly additional debt burden when real interest rates recover. This will be an unfortunate accompaniment to the entitlement-spending explosion that will soon hit ageing societies.

The zero lower bound on nominal interest rates could be eliminated by abolishing currency, taxing currency or eliminating the fixed exchange rate between currency and bank reserves held with the central bank, but central bank conservatism prevents this.

The only other sure way to ward off secular stagnation is a sustained (but not indefinite) fiscal stimulus funded through base money issuance – helicopter money. The Bank of Japan is playing its part, as is the Fed, albeit at a diminishing rate now that tapering has started. The Bank of England will have to do this again when further fiscal tightening becomes unavoidable.

The ECB, however, appears to believe that the right policy in the face of below-potential growth, below-target inflation and likely further disinflation is to shrink the balance sheet of the eurosystem – by 26 per cent since mid-2012.

After setting the deposit rate below zero, aggressive monetised balance sheet expansion through outright purchases of private and sovereign debt and through long-term fixed-rate repos at rates very close to zero, are required if the euro area is to avoid secular stagnation.

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