Larry Summers crystallized an important question in a recent speech: Has the world economy entered a period of “secular stagnation”? The slow recovery in the United States since the financial crisis is his starting point and he argues that secular stagnation could also retrospectively explain features of previous decades, such as low inflation. Professor Summers had picked up an old term first coined by Alvin Hanson (1939), in his Presidential Address of the American Economic Association in 1938. Back then, Hanson focussed on the importance of (public) investment expenditure to achieve full employment. His argument was that for such investment to happen, the economy needs new inventions, the discovery of new territory and new resources, and finally, population growth.

Summers’ argument is centered on the fact that inflation rates have been falling for the past two decades and have often been lower than expected. Is a permanent fall in the equilibrium real interest rates needed to achieve full employment? Olivier Blanchard (2013) argued that it is advisable to have higher inflation rates in normal times as this makes it possible to drive down nominal interest rates more substantially so that real interest rates fall even further in crisis times. Krugman (2013) goes one step further, and even argues that the new normal may be a permanent liquidity trap, so it would therefore not be advisable to have low inflation rates in the eurozone and the inflation rate should be increased.

So how can we summarize the situation today in the eurozone and what policy measures can be envisaged to improve the situation? I would identify three fundamental issues facing the eurozone currently.

The first issue is a lack of aggregate demand and a corresponding fall in inflation rates. The economic recovery in the eurozone has been weak and recent data show that it may slide back into a full recession again. Correspondingly, unemployment remains very high, in particular for the young. In addition, inflation rates have been falling since late 2011, and forward-looking indicators now suggest that inflation expectations have become disanchored from the close-but-below 2 percent goal.

The second important issue is the combination of significant divergences in unit labor cost with the build-up of large levels of debt, in both the private and public sector in the eurozone periphery. The gap in unit labor costs that has opened between Italy and Germany since the beginning of the euro amounts to more than 20 percent, while the gap between France and Germany is similarly around 20 percent. At the same time, debt to GDP ratios have increased prior to the crisis mostly in the private sector while since the beginning of the crisis, high deficits have added to a substantial increase in public debt to GDP ratios, for example by more than 60 percent of GDP in Spain.

The third problem is the remaining uncertainty around the state of the banking system as well as doubts about the profitability of the system. While the European Central Bank’s (ECB) asset quality review (AQR) and stress test should remove uncertainty, the assessment by the IMF is quite clear that more restructuring may be pending. Non-performing loans remain high in a number of countries.

It is against these three central issues that any policy response for the eurozone has to be formulated.
Partial proposals aimed at addressing only some of the above problems are unlikely to deliver results that will satisfactorily create stable and robust growth and new employment opportunities. The solution must be found in the current context of a monetary union operating without a fiscal union, and thus there are limits on what monetary policy is allowed to do. Dealing with the problems of the eurozone therefore goes beyond the risk of secular stagnation. In fact, some of the fundamental issues may not be solvable without further steps towards fiscal union.

**Three Central Policy Measures to Deal with Stagnation in the Euro Area**

First, policies need to be designed to address the demand shortage. U.S.-based Keynesians typically suggest that eurozone periphery countries should increase their deficits in response to the recession. However, this argument fails to acknowledge that debt levels have already increased substantially due to high deficits and that in a monetary union, sub-federal debt is inherently less stable. In fact, the eurozone has already used substantial fiscal resources to lessen the impact of the shock. Unless one is willing to accept the ECB as an unconditional lender of last resort, a policy recommendation to increase periphery deficits could quickly lead to renewed market stress with very harmful consequences for financial stability, which would in turn deteriorate the economic situation substantially. While one can argue that the ECB should automatically act as a lender of last resort to governments and buy governments bonds without conditions even in countries under stress, the legality of this arrangement is heatedly debated. While one could argue that the ECB should automatically act as a lender of last resort to governments and buy governments bonds without conditions even in countries under stress, the legality of this arrangement is heatedly debated. While one would argue that the Outright Monetary Transactions (OMT) program is economically justified and legal, it certainly cannot be misread as an automatic policy to buy debt under all conditions. In fact, only a clear political consensus on the sustainability of debt in the context of a European Stability Mechanism (ESM) program would allow the activation of bond purchases from distressed countries.

Consequently, the best way to increase eurozone demand will be by a combination of more fiscal measures in countries with strong fiscal positions and a build-up of a eurozone fiscal capacity, together with more aggressive monetary policy. Germany in particular could use its fiscal space to increase borrowing to fund public investment as well as reduce taxes on low-income households. A eurozone fiscal capacity could be built up by using existing instruments, such as the European Investment Bank (EIB), much more forcefully, for example by increasing the EIB’s leverage. Such European funds could be used to fund European investment projects as well as to support national budgets where public investment has been cut substantially recently. Monetary policy could be more aggressive by buying more bonds issued by the EIB, asset-backed securities, covered bonds as well as corporate bonds.

Second, bold measures are needed to address the substantial unit labor cost divergence and substantial debt overhang. The empirical literature is clear that countries with high unit labor costs will find it difficult to attract new and productive industry, especially if their tax levels are high. The debt overhang in the private sector in some periphery countries is holding back new investments and can lead to a negative feedback-loop between corporate debt and a weak banking system, as has been seen in Japan. At the same time, it needs to be made clear that unit labor costs require an adjustment in both the deficit and the surplus countries in order to be politically feasible and economically effective. I would therefore advocate for bold structural reforms such as increases in annual working hours and increases in retirement ages to address the unit labor cost problem in the deficit countries. In the surplus countries, reforms that open up professions and lead to the creation of new industries are paramount in order to achieve adjustment. The introduction of minimum wages is a riskier policy measure, but the public sector and its wage-setting can be part of the answer to support rebalancing. To deal with the high private debt levels, restructuring and reorganization in the banking system are important. One should
also consider reviewing insolvency regimes and restructuring frameworks for the corporate and household sector, as has recently been argued by the IMF’s legal counsel Sean Hagan. Policies such as non-recourse loans for mortgages have greatly helped to reduce the debt overhang in the household sector of the U.S.

Third, the remaining banking sector problems need to be addressed. It is obvious that the ECB needs to be ambitious in its stress tests and AQR. The way the exercise has been designed largely prevents the deleveraging pressure to result in a reduction in lending. Rather, the logic of the exercise should lead to deleveraging through strengthening the capital base, and there is some evidence of such an increase having happened in the eurozone banking system. An important question is about the right interplay between monetary policies and the ongoing bank restructuring process. Some of the ECB’s recent measures, such as the TLTRO (targeted longer-term refinancing operations) measure may delay some bank restructuring while adding little to ease monetary conditions. It would be useful to reconsider the balance between active management of the balance sheet of the ECB through unconventional measures and the policies directly aimed at supporting liquidity in the banking system.

This overall mix of policies should deliver results in terms of addressing the underlying weaknesses of the eurozone and revitalizing growth. While a lot can be done within the framework of the current institutions, this policy mix also points to the need to upgrade the European policy framework and move towards the creation of a eurozone fiscal capacity.

Some have argued that the eurozone needs a change in its inflation target to overcome the crisis and to be better equipped to deal with secular stagnation. However, I fail to see how an increase in the inflation target can be achieved in normal times without generating significant risks to the economy. One of the important features of the pre-crisis global economy was that inflation rates were falling despite loose monetary policy and arguably overly optimistic asset markets. In fact, more demand generated by monetary policy prior to the crisis would have led to even more substantial distortions in the asset markets and in the real economy. This could have triggered an even more substantial crisis than the one we are seeing currently. Perhaps more important than this rather theoretical consideration of normal times is an assessment of a potential change in the inflation target within the current situation. A change in the inflation target by the ECB from 2 to 4 percent, for example, would undermine the credibility of the ECB in many respects. On the one hand, it would undermine trust in the institution by all those who have relied on the ECB to keep inflation at close but below 2 percent. On the other hand, even now the ECB’s credibility is endangered by the fall of inflation expectations below 2 percent. Market participants fear that the ECB will not be able to push inflation up to the target level with its existing policy instruments. Instead of changing the target, the ECB would therefore be well advised to deliver bolder policies to convince markets that it is serious about achieving its current target.

To summarize, like Hansen, I believe in the importance of the structural factors that actually provide the conditions for new investment opportunities. Fundamentally, we need to know why the equilibrium interest rate has been falling globally and why the global economy has entered “secular stagnation”. Is it global demographics? Is it the lack of good investment opportunities? Certainly, these challenges need to be addressed. Also the eurozone needs to see more substantial structural policy actions to increase its long-term growth potential and to tackle the very substantial divergences between the different member states of the eurozone.

But macroeconomic policies will also have to play a larger role. One of the big problems in the eurozone has been the weakness in public investment in the last few years, in contrast to the U.S., where public investment actually increased. More European level investment in European public goods such as new and better energy and digital networks should also
be undertaken. But the EU will also need a boost in domestic investment at the member state level. Monetary policy needs to be bolder and arguably the ECB has the instruments available. Overall, President Draghi’s Jackson Hole speech points the way in the right direction. The euro area needs bolder fiscal and structural policies, and the ECB must also play its part.

References


Endnotes

1. This article is based in part on commentary published by the author on August 19, 2014, titled "Monetary Policy Cannot Solve Secular Stagnation Alone." It is available at www.bruegel.org

2. Krugman (2013b)


5. Ruscher and Wolff (2012)
