The Recovery. State of play, challenges, and risks.

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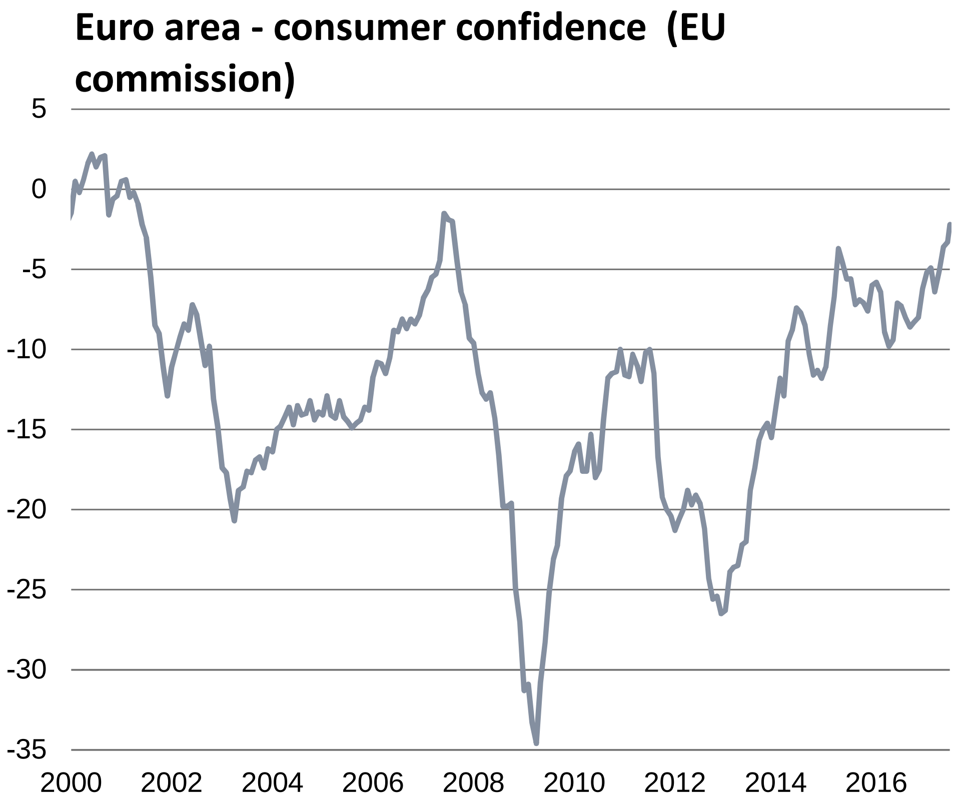
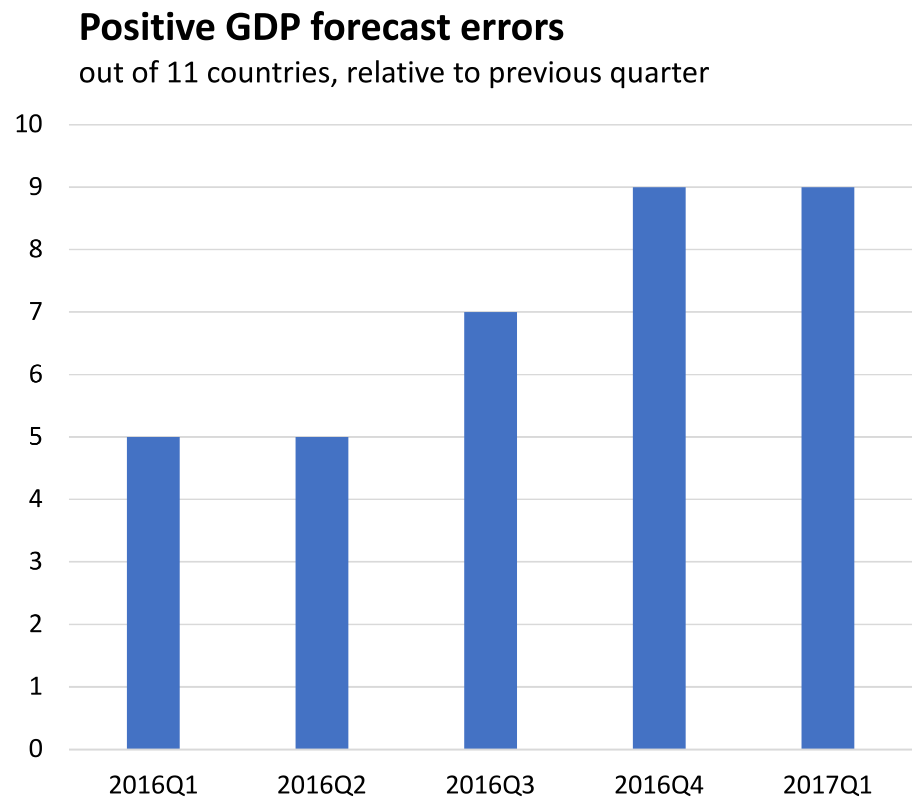
Recovery is solid and wide



Sources : EC, PIIE



Sources : Consensus Forecast, PIIE

The structure of the talk.

The story: 3 low-frequency forces:

- Fading legacies from the crisis. But still high public and private debt.
- Secular stagnation. Low potential growth, low safe interest rate, but a lot of uncertainty about both.
- Inequality, unhappiness, and the rise of populism.

→ A potentially dangerous combination.

- Short run policy challenges. Smooth landing.
- Medium run risks. Recession? Fiscal crises?

(Warning: Much too quick, pick and choose. Will show how much we/I do not know.)

1. Legacies from the (acute phases of the) financial and euro crises

- High private debt (largely from before the crisis)
- High public debt (largely from during the crisis)

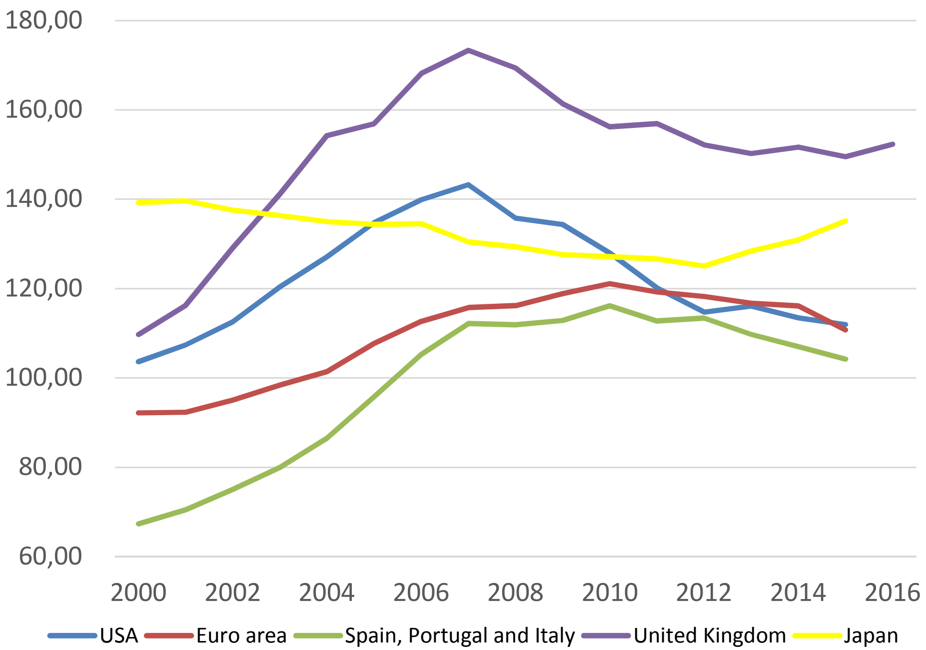
- Why high debt matters? Asymmetry debtors/creditors
- Initial adjustment: Fiscal consolidation, deleverage, private saving
  - Dominated 2010-2014. Largely over.
- After the initial adjustment, still much higher debt
  - Interest and growth sensitivity. Still very relevant

- Countries most exposed
  - Japan: At potential, but with extremely high debt
  - Euro periphery: Far from potential, with high debt

Increases in private and public debt

Household debt level

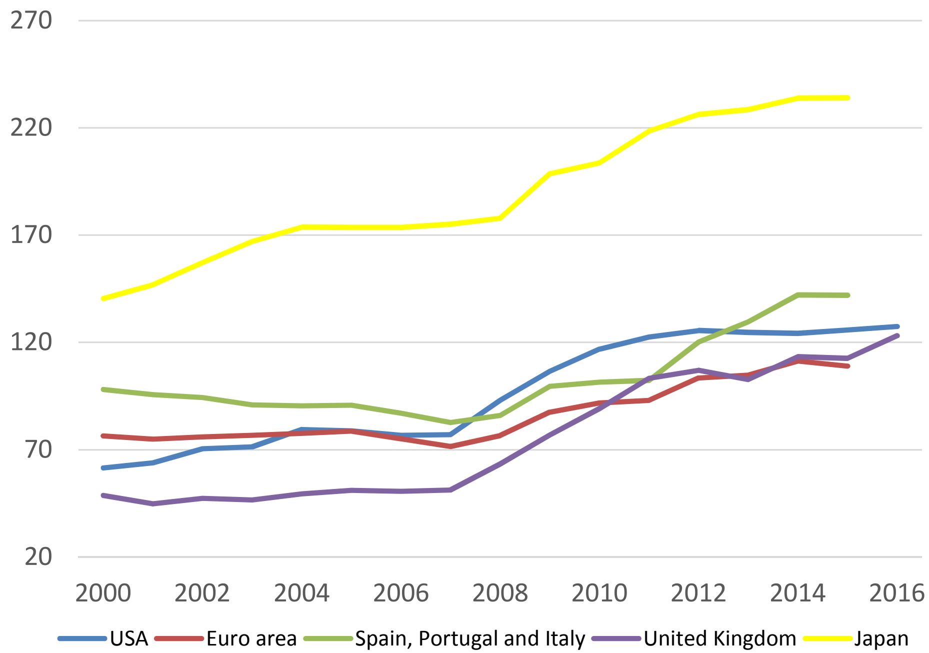
% of disposable income



Source: OECD

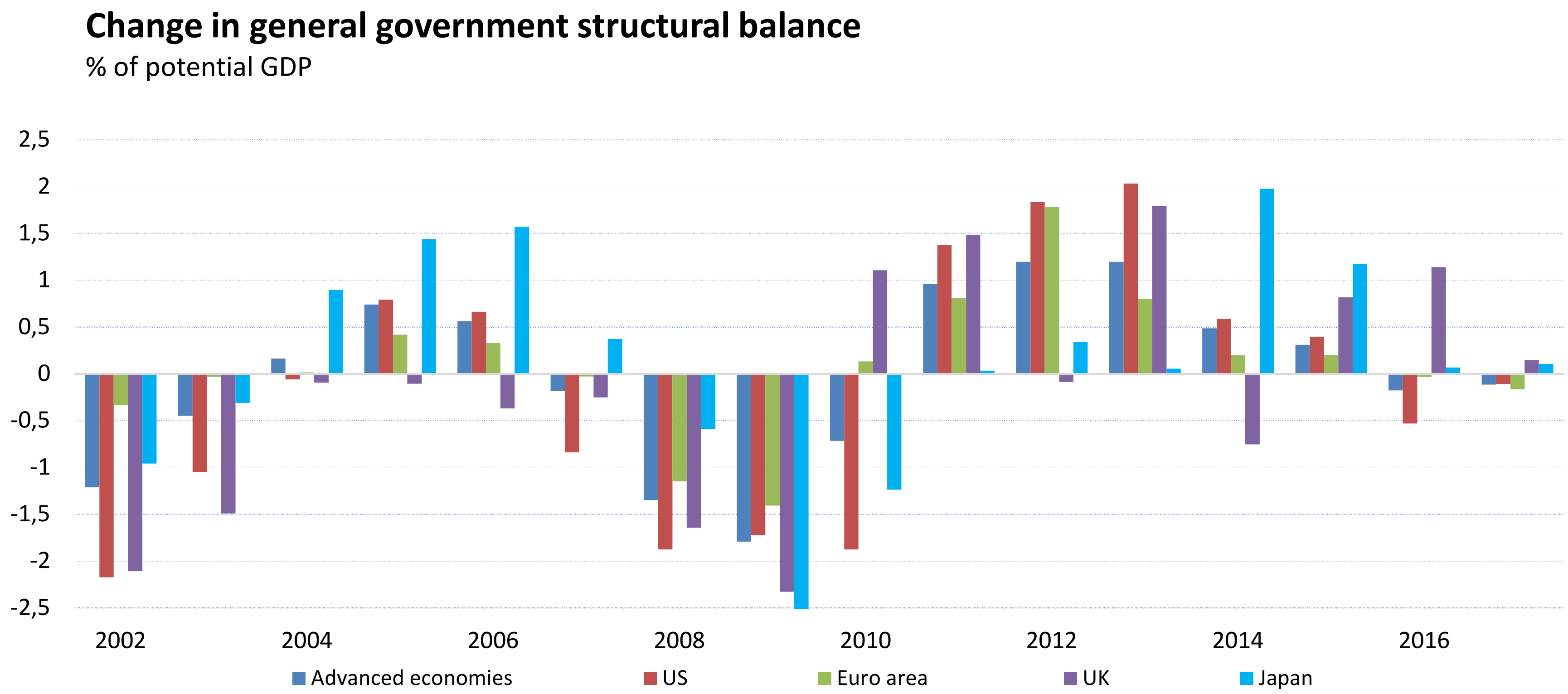
Government debt level

% of GDP



Source: OECD

The end of fiscal austerity

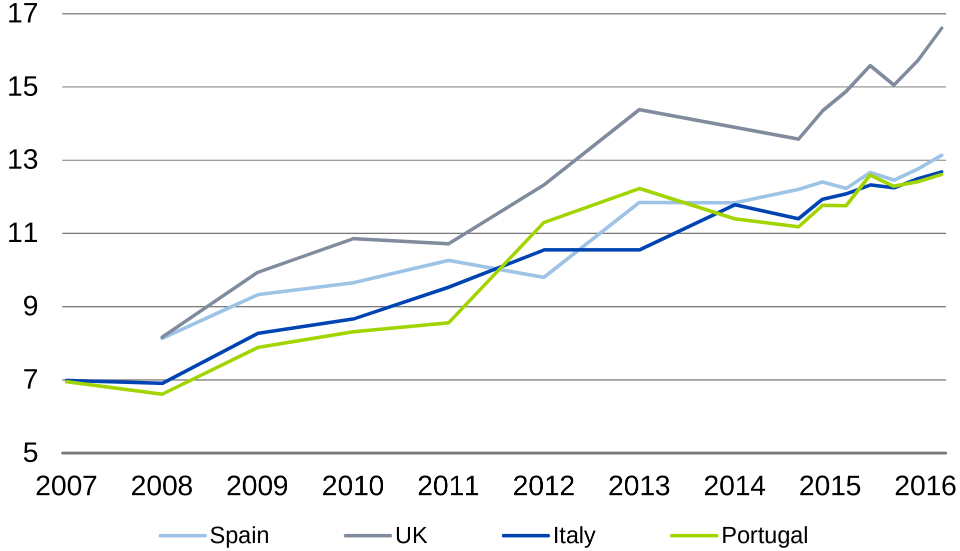


Source: IMF WEO, *April* 2017

Looking at banks

Tier 1 capital ratios by country - all banks

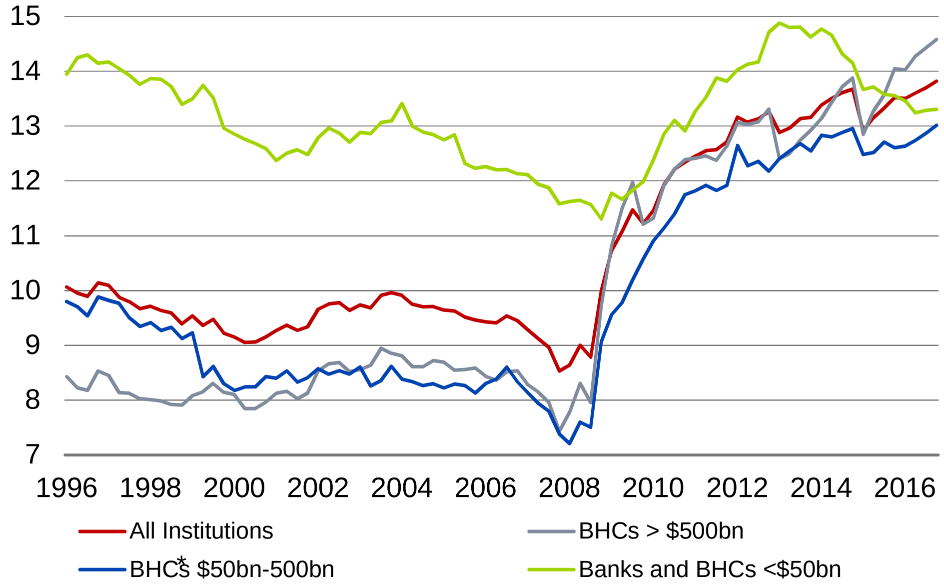
in % of risk weighted assets



Sources : ECB, PIIE

Tier 1 capital ratios United States

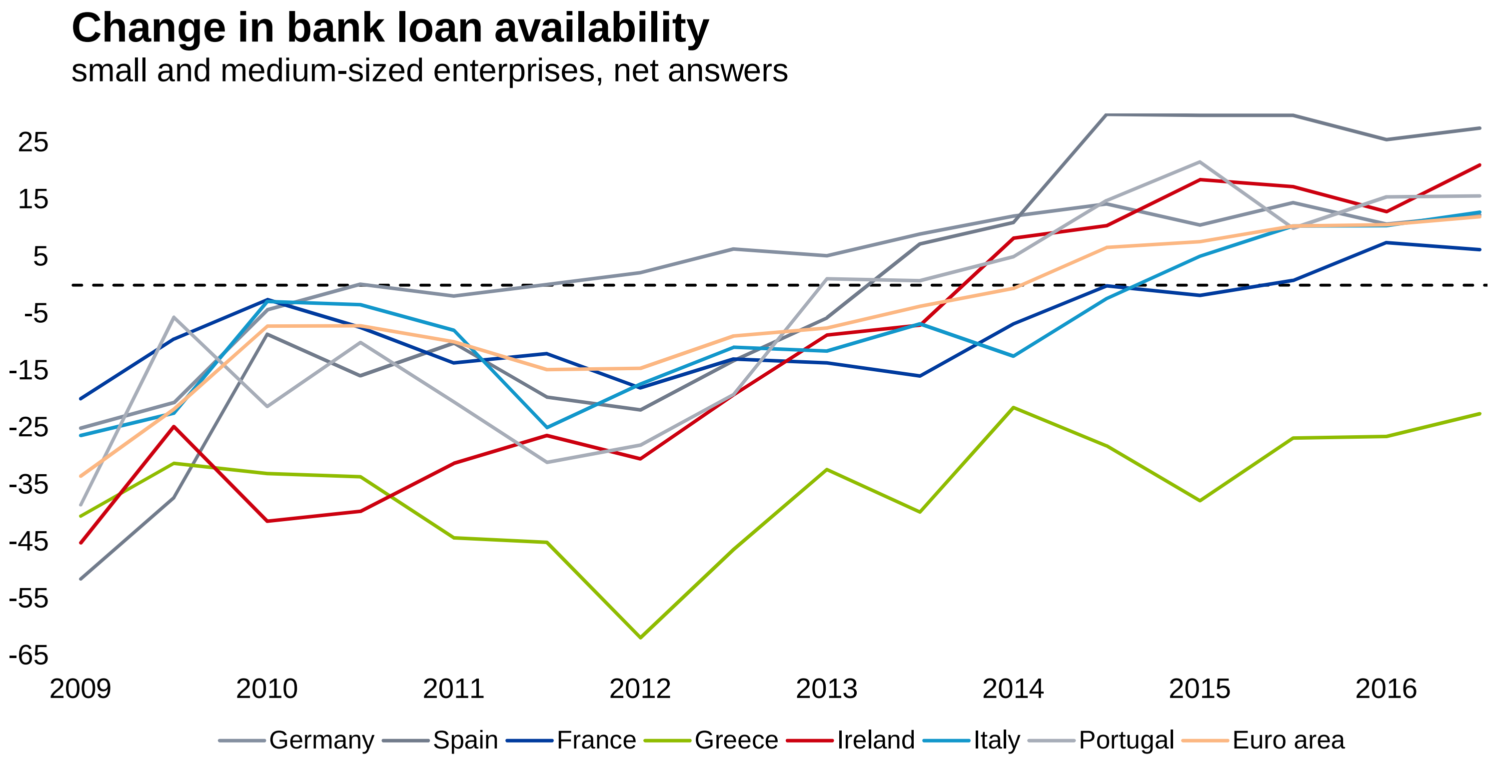
in % of risk-weighted assets



*Bank holding corporations

Sources : NY Fed, PIIE

Increase in credit supply



Sources : ECB SAFE Survey, PIIE

2. Secular stagnation?
Growth rates and interest rates

Two evolutions dating back to before the crisis:

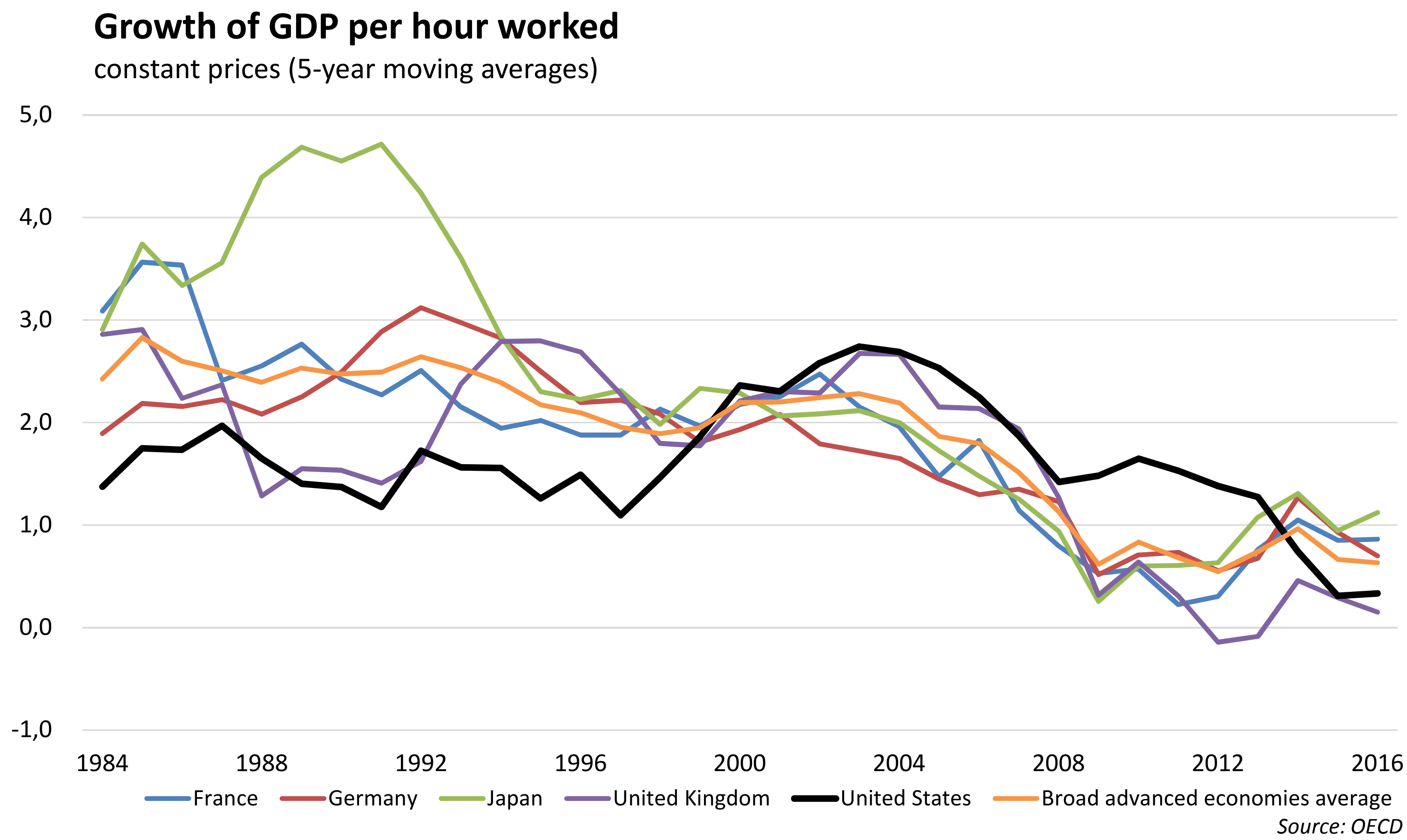
- Decreasing productivity growth (and, by implication) potential output growth rates

  (Secular stagnation interpretation 1.)

- Decreasing safe real interest rate

  (Secular stagnation interpretation 2. Hansen/Summers)

Decrease of productivity growth



How worried should we be about low productivity growth?

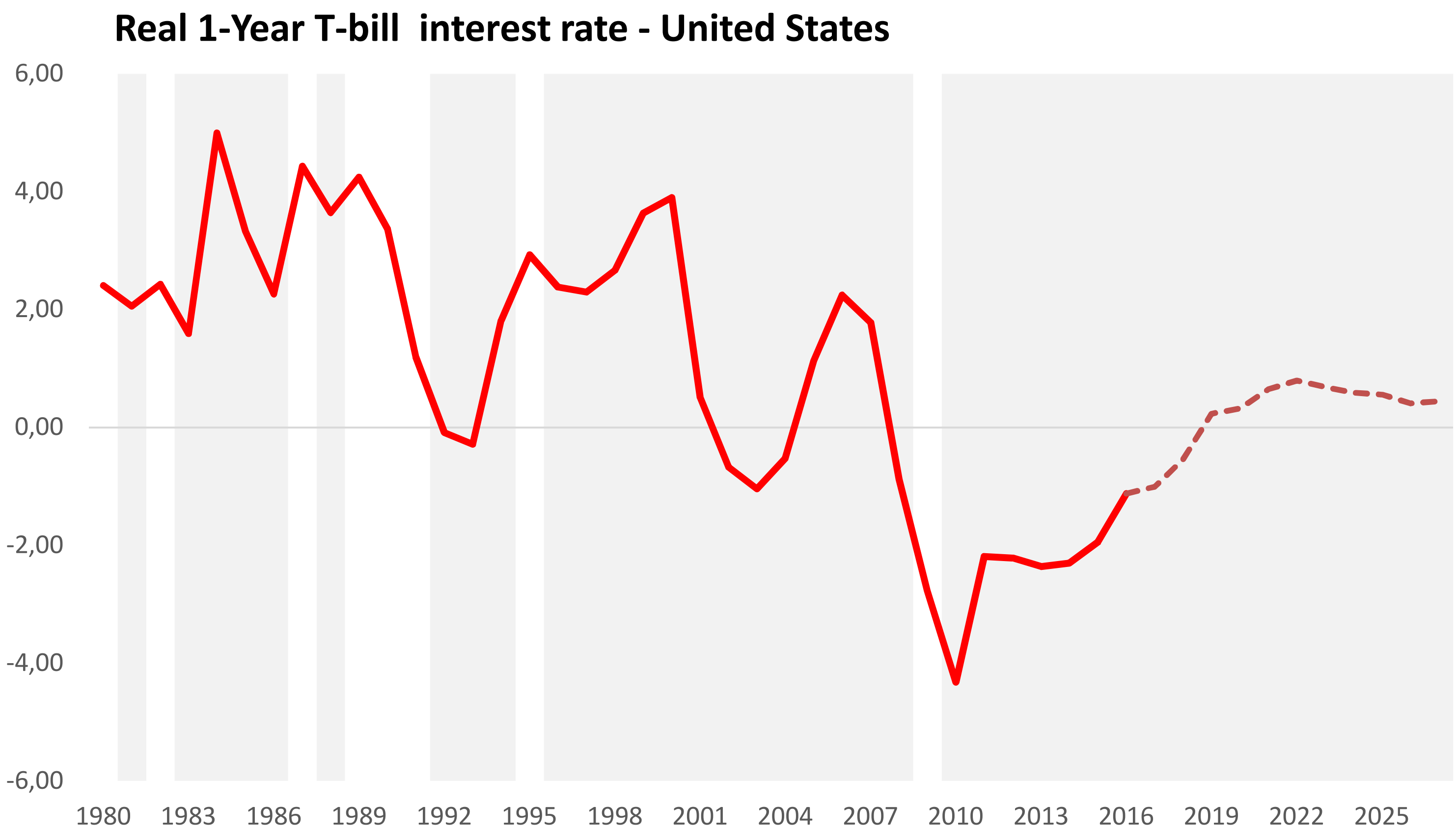
- Measurement error. A very serious issue.
  - Quality adjustment for existing goods. IT, Healthcare
  - Treatment of new goods. Example of statins (Feldstein)
  - Surely a large downward bias.
  - Has the bias increased? Lit says no. I am more skeptical.

- Serial correlation.
  - At the frontier, productivity growth comes in bursts
  - Low correlation across decades

- Innovations (as opposed to implementation)
  - Continuing at a high pace.

Bottom line: Baseline: low productivity growth.
But very large uncertainty, mostly on the up side.

Decreasing safe real interest rate



Sources: FRB, Haver, CBO Forecasts

Will the safe rate remain very low?

- Decrease clearly pre-dates the crisis

  (but after a steady increase from WWII to the early 1980s)

- Appears to reflect mostly an increase in the risk/liquidity premium

  (rather than a decrease in the rate of return on capital)

- Poor understanding of the reasons why.

- Same bottom line as for productivity growth:

  Baseline: low rate
  But very large uncertainty, both ways

3. Inequality, populism, and political risks.

Political surprises. Brexit, US elections, shifts towards populism,

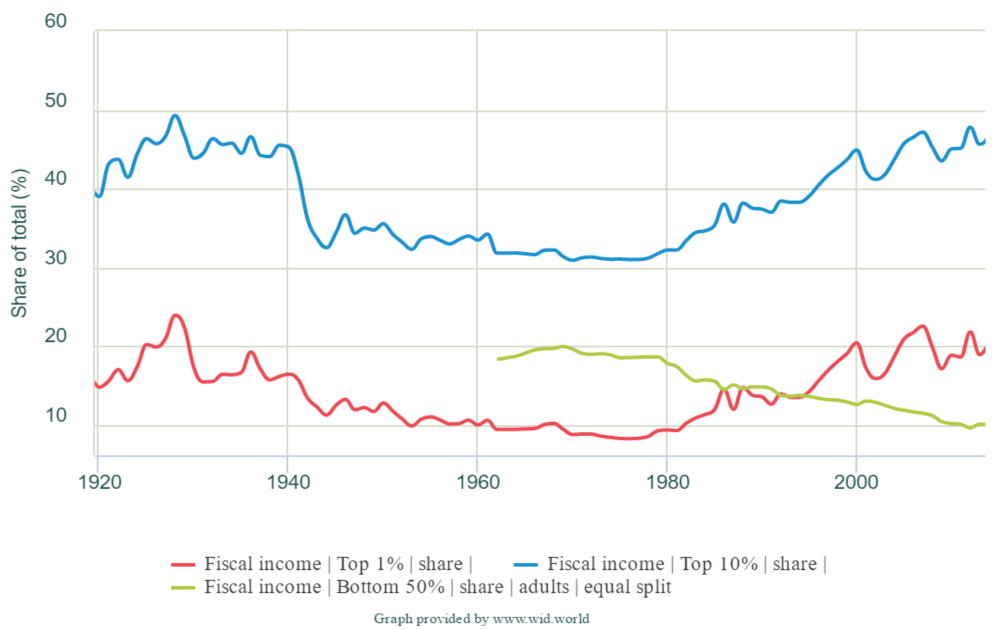
Sources: Inequality? In part, but a complicated story

United States versus France.

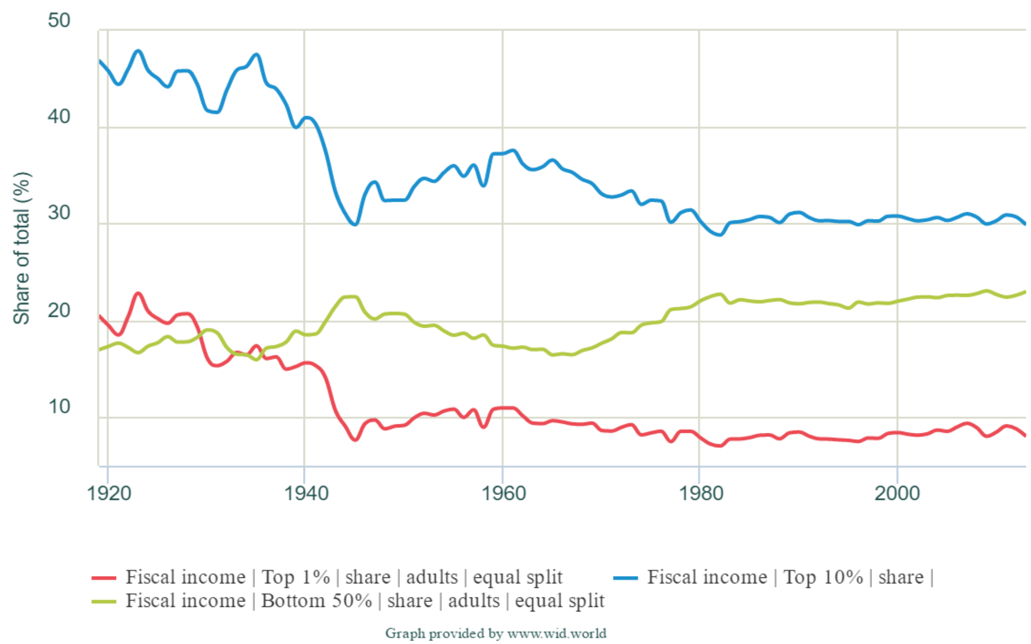
Implications?

- The Trump incarnation. Non standard. Pro-business, incoherence, checks and balances
- The risk of more traditional (Latin American) populism elsewhere?

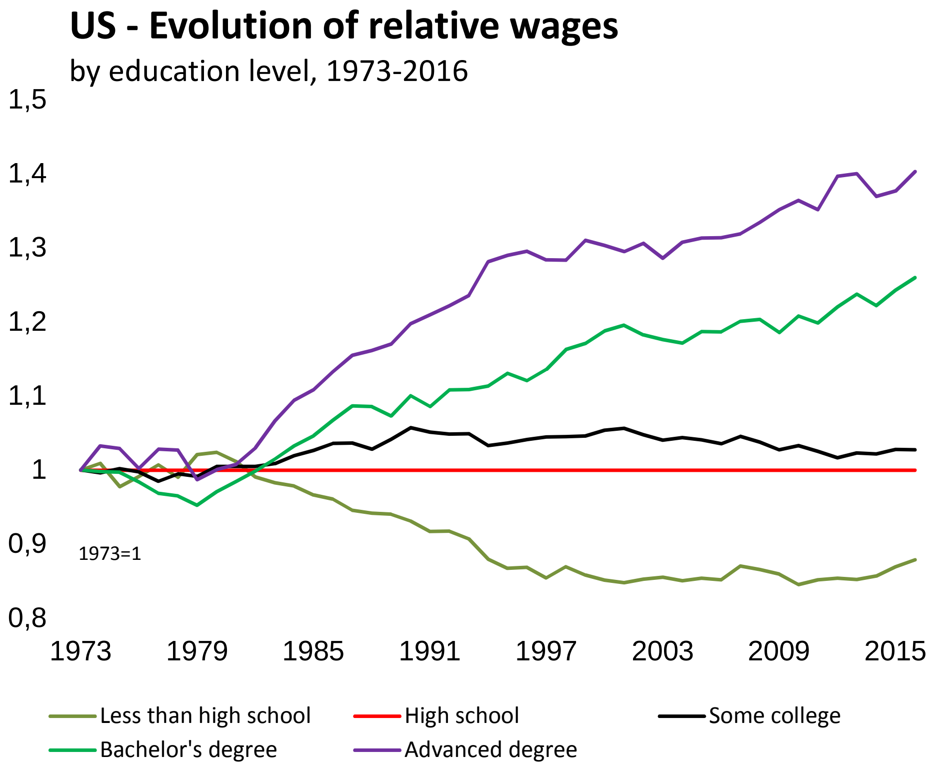
Income inequality in the USA, 1920-2015

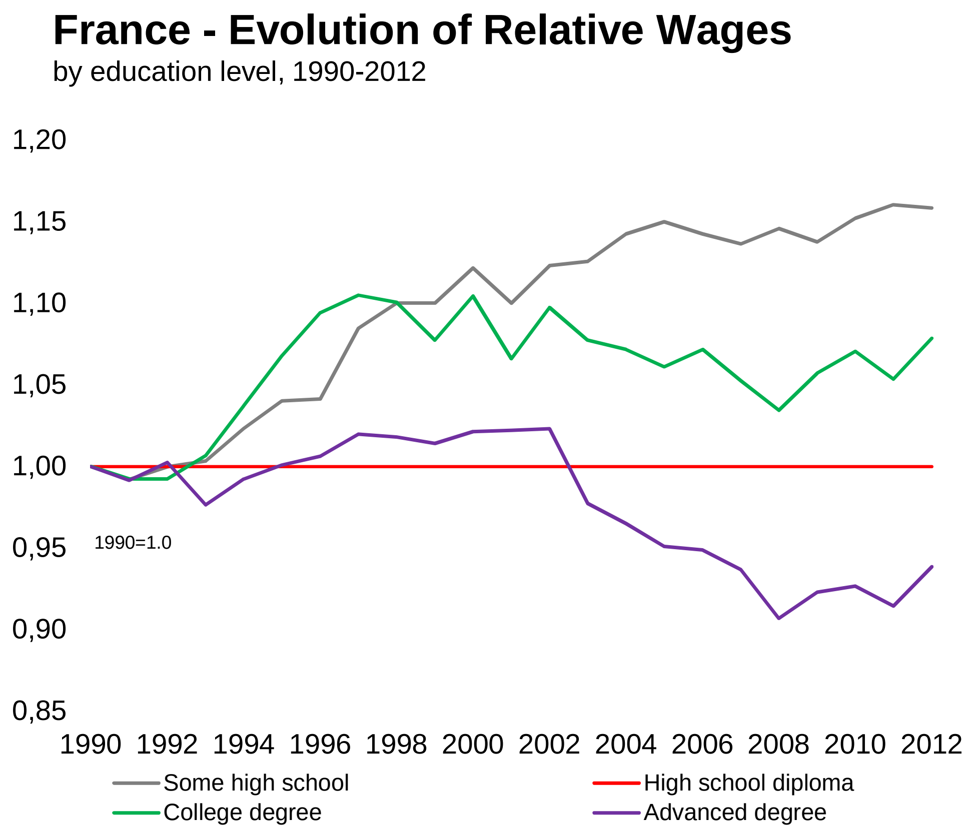


Income inequality in France, 1920-2013



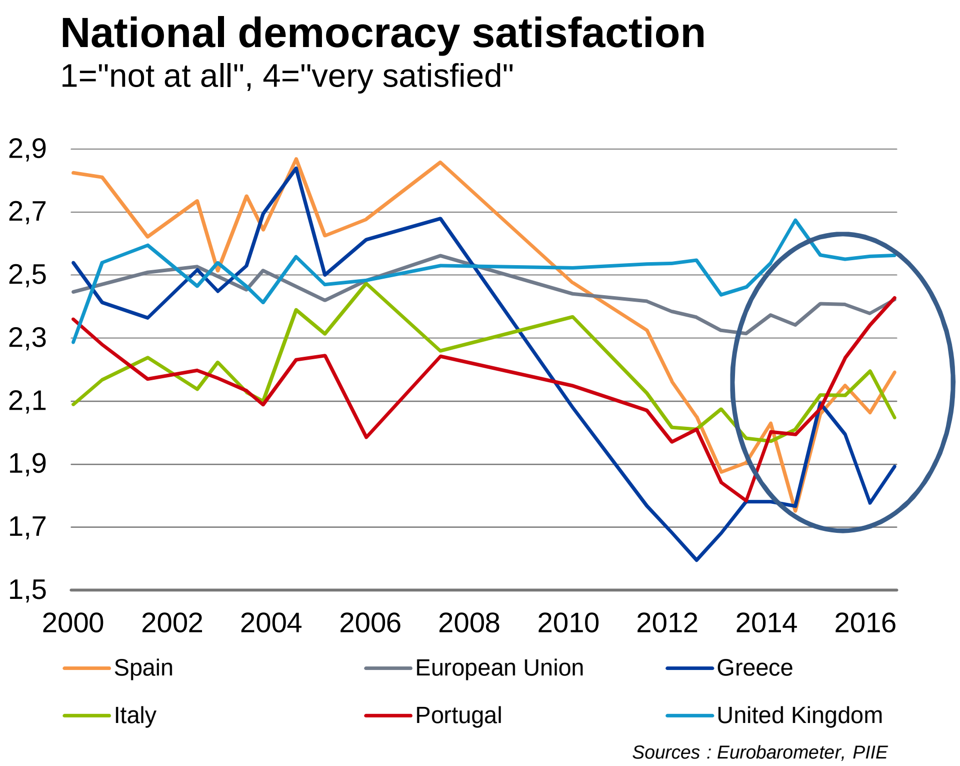
The evolution of relative wages: United States versus France





Source: Economic Policy Institute, PIIE

Dissatisfaction with the democratic process



- Answer to the question: On the whole, are you very satisfied, satisfied, not satisfied, not at all with the way democracy works (in your country)?
- Note the effect of recent growth in Portugal and Spain (red and orange).

4. Short run policy challenges.

(I shall go fast, although this is the main preoccupation of central banks and financial markets at this point)

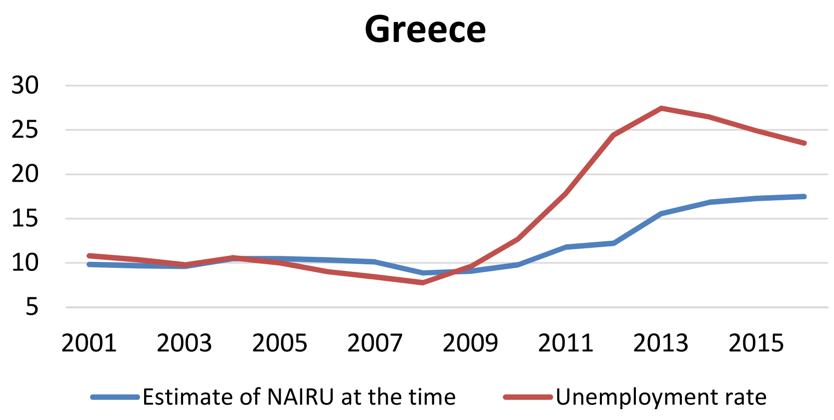
Achieving soft landing.

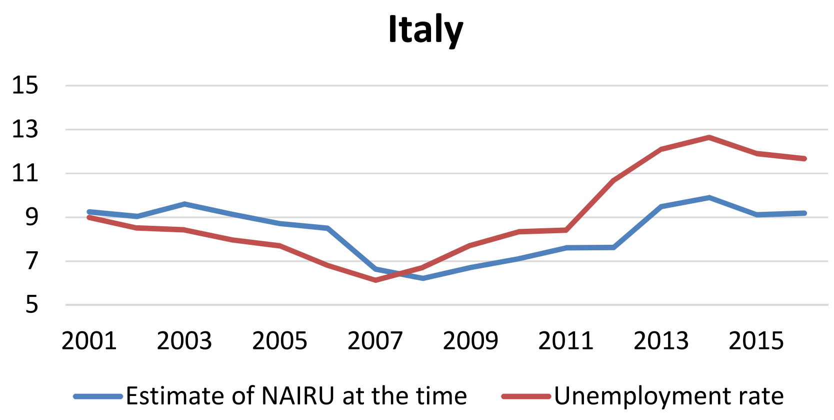
Challenges:

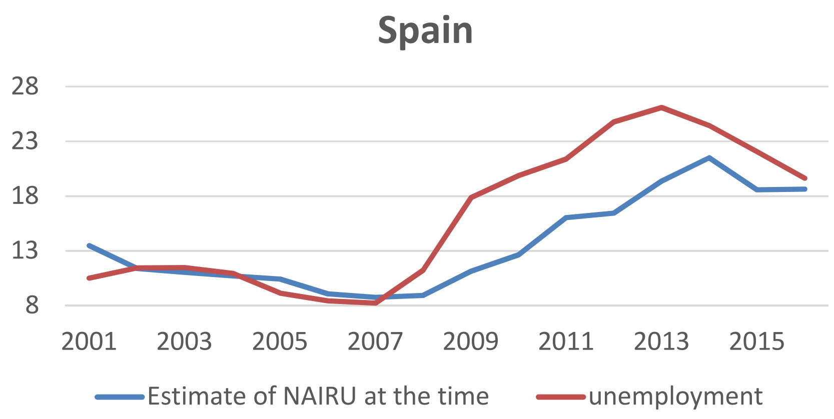
- Where is the landing pad (potential output, natural rate) ?
- Inflation as a signal? The mutations of the Phillips curve

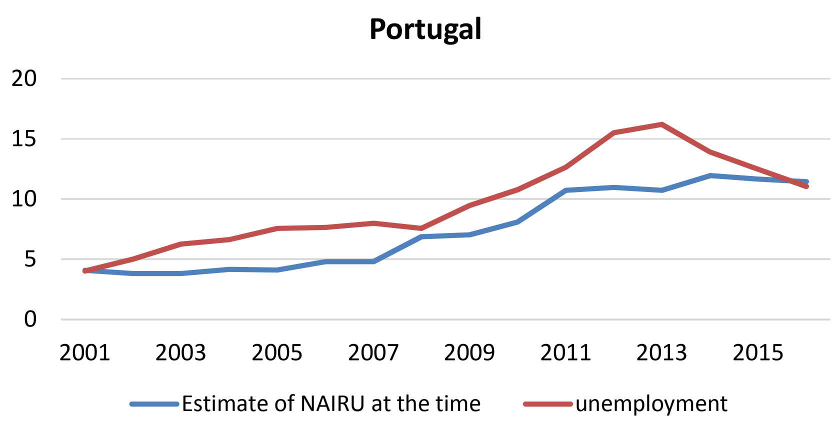
- ''Looking at inflation in the eye''? Lags in monetary policy
- Policy rate increase versus balance sheet reduction.

The natural unemployment rate as a moving target









Sources: OECD, PIIE

5. Short and medium run risks? I. Recession

If there was to be a recession soon, would policy makers have the tools to counteract it?

Fiscal space? More than you think.

Over US recessions since 1970, excluding the 2008-9 recession

Increase in debt until debt stabilization: 3.3%.

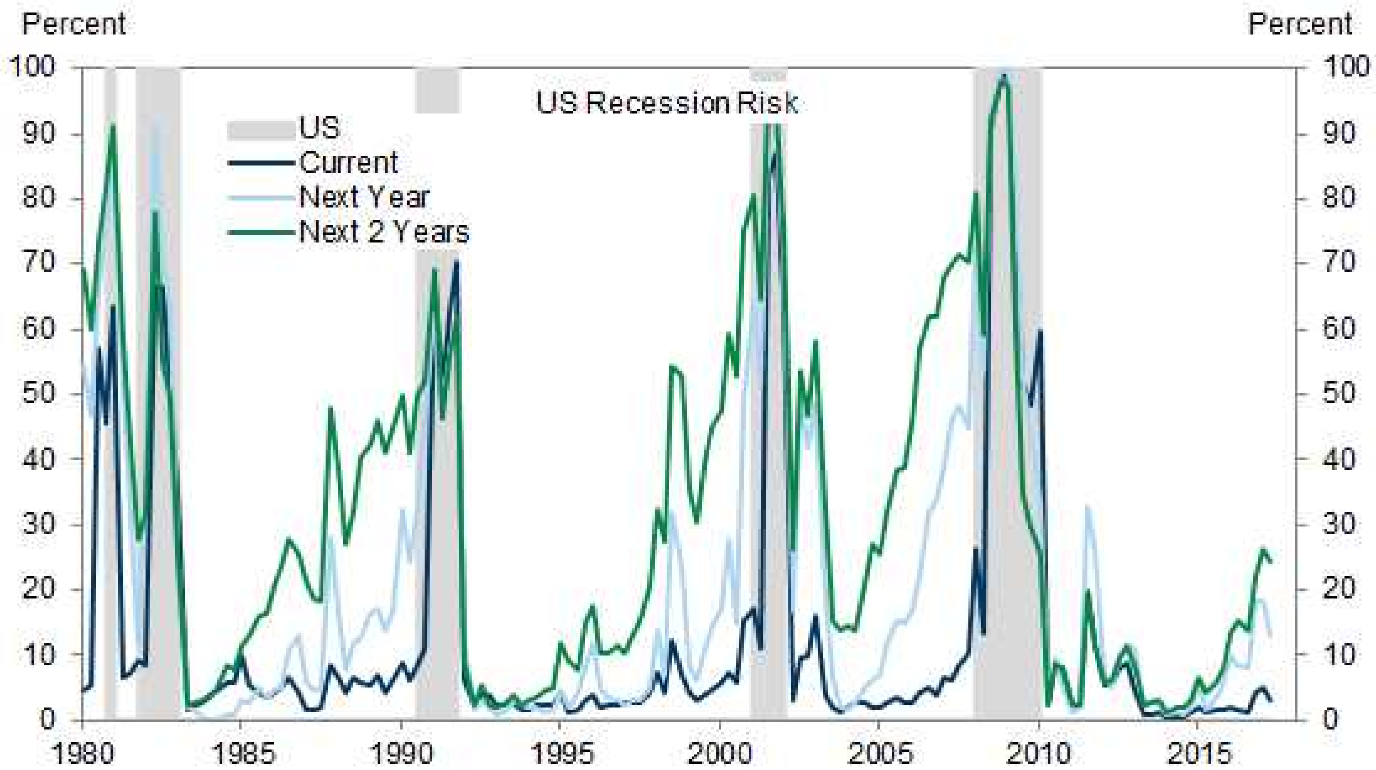
Would it be larger today? Probably, but still manageable.

Monetary policy space? More than we used to think

QE and long rates: 100 bp on long rate: 300 bp on short rate

Negative rates more feasible than we thought.

US recession risk (Goldman Sachs)



Sources Goldman Sachs

5. Short and medium run risks? II. Fiscal crises?

- Debt dynamics. $\Delta(D/Y) = (r\text{-}g)\,(D/Y) - (\text{primary balance}/Y)$

  Start from high D/Y, low r, low g (and risk of populism)
  What if r increases?
  Benign: Increase in g, increase in r.
  Dangerous: increase in r, no increase in g
  either because the policy rate increases
  or because spread over policy rate increases
- For example:
  - Increase in g in Euro zone, and thus increase in Euro policy rate. But no increase in g in Italy.
  - Foreign investors having doubt about Japanese debt sustainability, increase in spread.
  - Risk of a populist government being elected in Italy and increase in spreads.

How dangerous?

- Simple computation: D/Y = 100%. Δ(r-g) = 300 bp. → 3% additional deficit

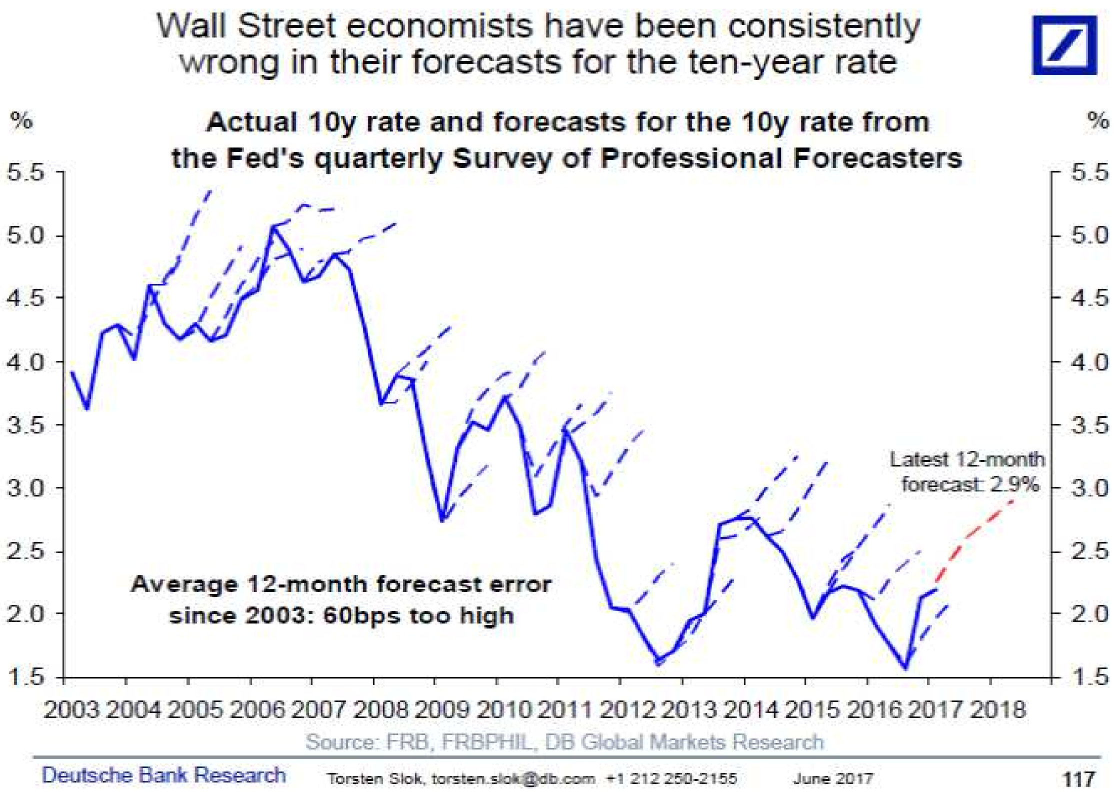
- Misleading computation however: Maturity structure matters
  Large increase in long maturity debt since low rates
  So initial effect of interest rate increase is limited.
  For example, Japan 30% of gdp rollover in first year, Italy 10%

- Gives time to time (and to fiscal adjustment)

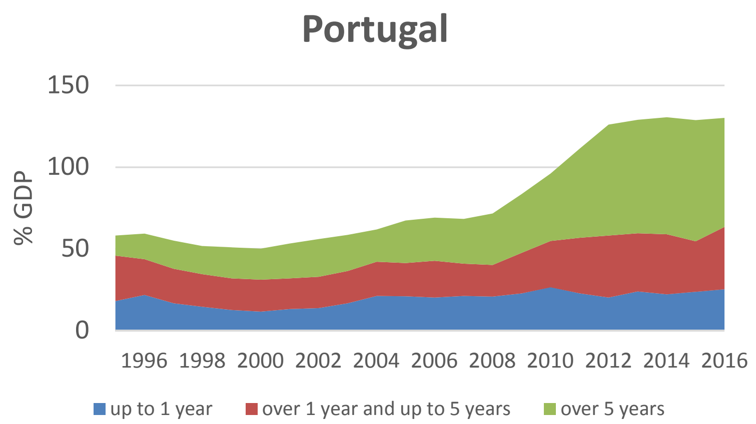
  - If given time, can countries eventually make it? Japan? (150% net debt, 4% primary deficit, close to zero potential growth). Hard to see how, without inflation

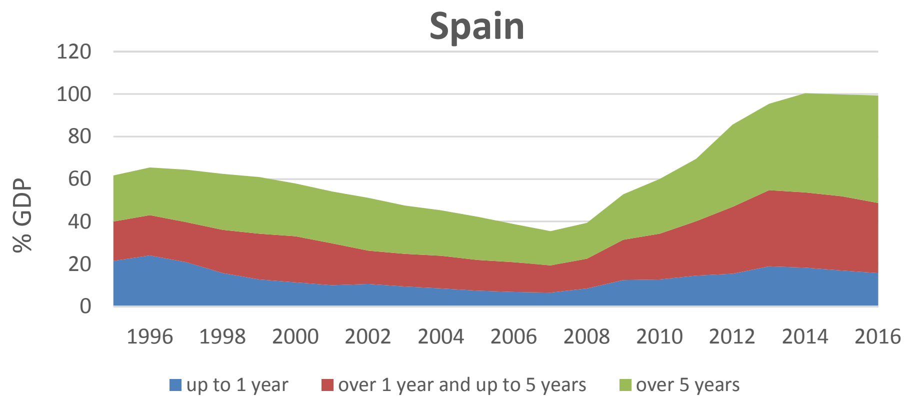
  - Other countries with high debt ratios? Probably, with some risk of fiscal dominance (not in Euro), and inflation.

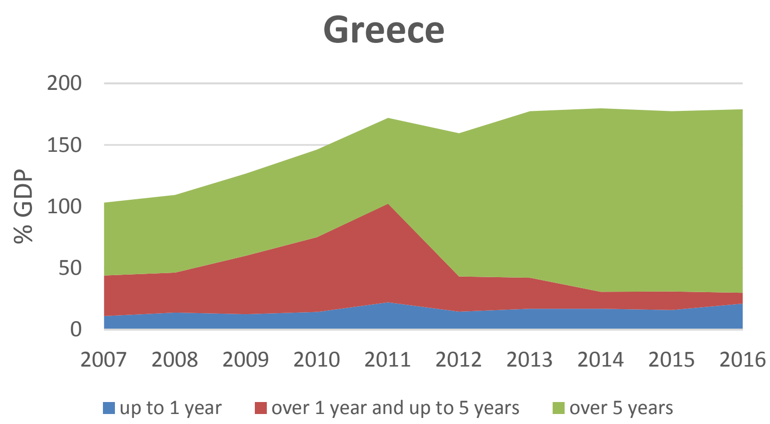
Will rates increase?
Humility: Forecasts of the 10-year rate…

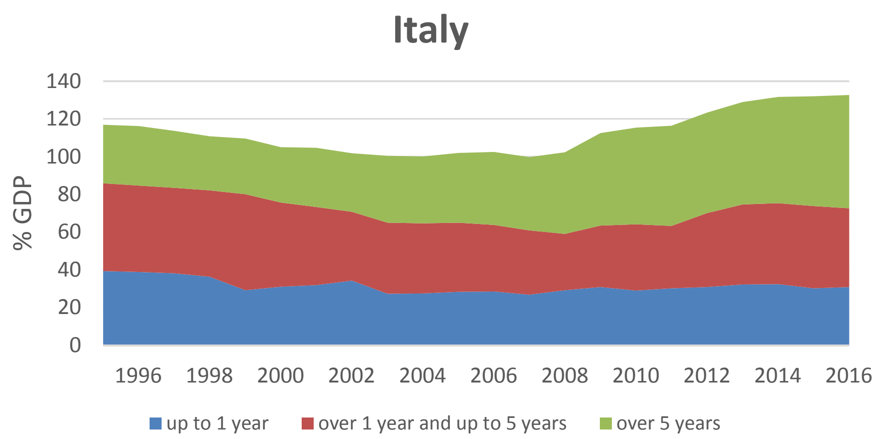


The increase in public debt maturity



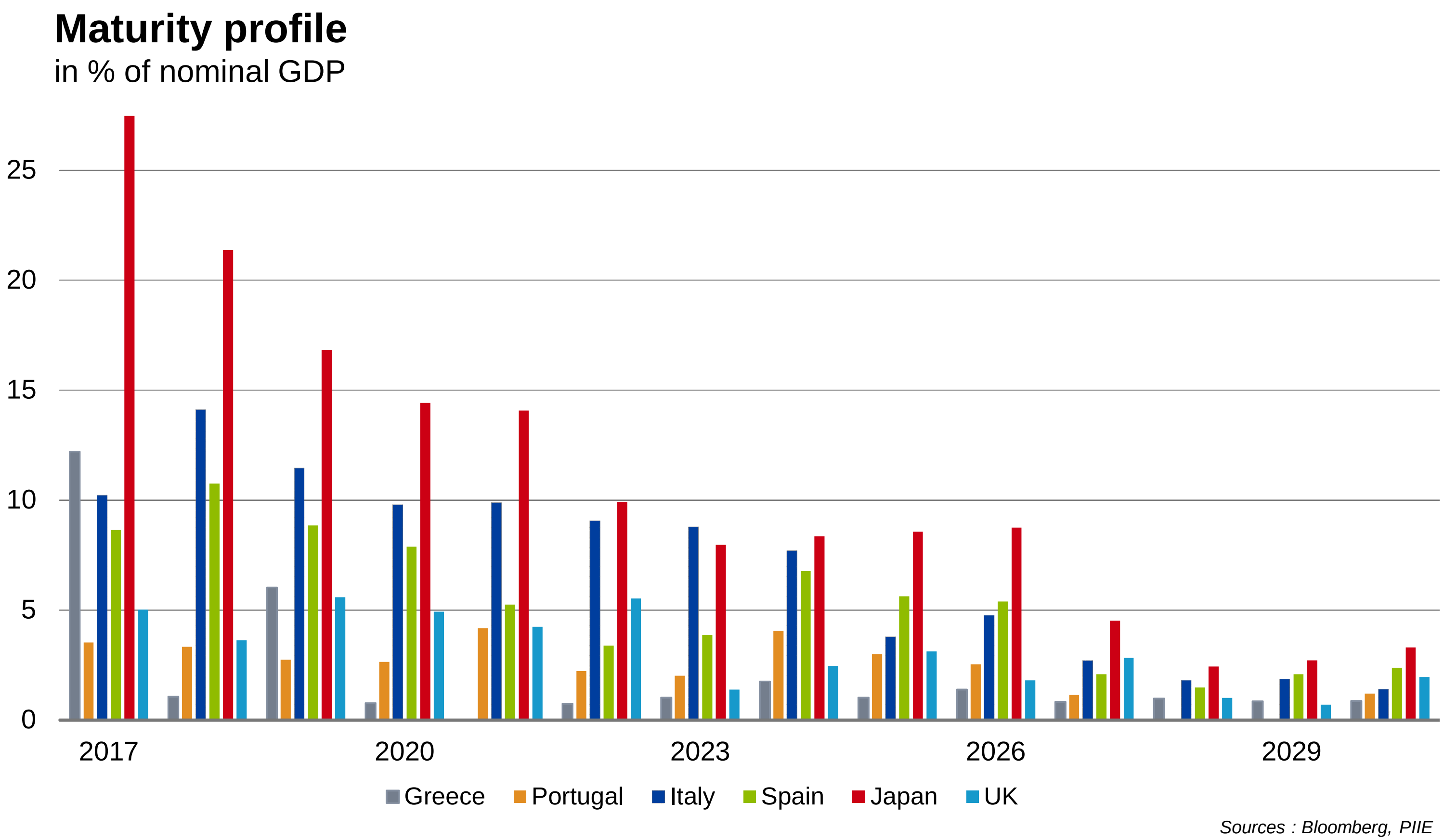






Sources: ECB, PIIE

The maturity profile of public debt



Conclusions

Calm before the storm?

- Recovery strong and wide.
- In the short run, issue is soft landing. Now in the US and Japan, still far away in Euro zone
- High debt. Low g, low r in the baseline. But substantial uncertainty about both
- Medium run risks? Recession risks and policy space?   Fiscal crises?