What Ails Europe and the United States?

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I'm delighted to have the opportunity to speak to you while being surrounded here in Luzern and on this boat by such beautiful nature. We Norwegians think of ourselves as experts on scenery. It would be hard even for us to match the beauty of this place!

Usually, in my speeches, I touch upon several interesting countries on various continents. But as I have only 20 minutes for this dinner speech, I decided to concentrate on Europe, especially the euro area, and the United States. Much of what I've seen in the world since 2008 I've found natural to interpret in the light of the theory underlying the time-inconsistency of optimal government policy. I didn't use to focus on that, but starting with a speech in late 2008, that has been a main organizing theme for me.

Something I find interesting is how different in nature the situations in different parts of the world are. That applies also to countries in the eurozone in contrast with the United States. Let's start with the euro area. I have to warn you – I have some shocking pictures to show you!

But first, let's get a sense of the bigger picture for Europe. In Figure 1, real GDP per capita is plotted for eight nations. (Out of modesty, I decided not to include Norway.) Until 1990 or so, countries such as Spain, Greece, and Ireland are hovering near the bottom. But then, starting in the early 1990s, Ireland takes off. In less than 10 years it surpasses Denmark, Germany, U.K., and France. Surely an important factor was the Irish government's decision on a policy of explicitly committing to their (reasonably low) levels of tax rates, especially for capital taxation, for the next 20 years, making it an attractive place for investment by domestic and foreign companies alike. (The fact that many of the new factories and office buildings were owned by foreigners means that the growth in real GNP is not quite as impressive. But presumably most of their employees were still Irish.) Unfortunately, as we all know, the story had an unhappy ending. Eventually, growth became debt-driven to an extent that by 2008, when the financial crisis hit, major banks faced insolvency. The government then made the terrible, in my opinion, decision to bail them out, at incredible cost to tax payers. This ending, however, to my mind doesn't take away from the success of the 1990s — a great example of policy consistency and removal of uncertainty about future taxes for the lifetime of a typical factory. Of course, if one were to guarantee the banks, as Ireland implicitly did, the government can be blamed for not putting in place an appropriate regulatory environment from the very beginning.

Since the failure of Greece, one often hears mentioned as potential additional problem nations Italy, Spain, and Portugal. Let's get a sense of their backgrounds in terms of the main driving forces for sustainable growth: innovative activity and technological progress, as reflected in, say, total factor productivity (TFP) and, after appropriate capital accumulation to go with it, in labor productivity. In Figures 2 and 3 I show those two data series for each of the three nations. In each of the plots, the average growth from 1960 to 1990 is indicated as a straight line and extended to the present. The shocking thing is that, for all three countries, both TFP and labor productivity are more or less flat since

the early 1990s! One might have suspected that the slowdown in these nations was partly a consequence of them having been tempted to take advantage of the low interest rates after joining the euro area and "live the good life." While there may be something to that, these charts show that these nations' problems are much more deep-seated and appear to date back to well before the euro. I'd be inclined to conclude that the attention to the problems that many ascribe to the euro are only a "red herring" which, if anything, has distracted from dealing with more fundamental underlying structural problems. Until these nations figure out how to make their respective curves in Figures 2 and 3 turn back to significant positive slopes, sustainable growth will be lacking.

For comparison, I include the plots also for Ireland, a nation sometimes mentioned in the same breath with these other three countries. TFP displays an impressive pick-up in the 1990s, but then flattens out. Eventually, so does labor productivity. Ireland surely has its problems, but at least from a productivity standpoint, the situation looks much less dire than for the other three nations, as the flattening started much later and from a substantially higher level. These labor-productivity numbers suggest that those of Ireland currently are on the order of 40-50 percent higher than those for the other three countries.

Turning to the United States, Figure 4 plots real GDP per capita post WWII. The straight line represents average growth 1947-2007 and is extended to the present. There are of course ups and downs about that straight line – what we call business cycles – but it does an amazing job in accounting for the long-run growth over these 60 years. The startling part, as further emphasized in Figure 5, which "blows up" the most recent time frame of Figure 4, is how far below the trendline the economy fell in 2008 and after – by on the order of 12 percent. And worse, unlike prior recoveries, which were typically quite rapid, so far there's not been any sign of moving back towards the old trend. On the contrary, the two curves are still diverging more than four years on.

Of course there are several factors contributing to the severity of this recession. One thing is remarkable: Unlike past recessions, the severe decline happened without an initial slowing of productivity. Another aspect has got some attention: The decline in consumption was relatively small by recession standards. The recession is largely investment driven.

As Zarazaga and I (2012) show, a large portion of the recession can be accounted for as follows. Around 2008, the growth in the debt/GDP ratio, partly because of stimulus packages, partly for other reasons, started to generate attention in the press and elsewhere. Indeed, even before the financial crisis, the U.S. debt had been projected to rise substantially, largely as a consequence of the "baby boomers" retiring in large numbers. The Bush tax-reduction law of 2001 already called for taxes to go back up starting Jan. 1, 2011. (As it turned out, this increase was postponed until 2013.) Suppose capital owners in 2008 were struck by the sentiment that taxes would rise in the future in order to keep the debt from growing further. Suppose, to be specific in our model experiment, they thought this tax increase would last for ten years, starting in 2013. The insight from the time-inconsistency literature would suggest that the tax increase would fall on capital income. Our experiment, using a standard neoclassical growth model calibrated to the U.S. economy through 2007, accounts for most of the decline in investment, about half of the decline in labor input, and it is the only explanation we're aware of that is consistent with consumption not falling much. Moreover, the experiment indicates it would take a long time to

move back to the vicinity of the old trend. Interestingly, if we modify the experiment to make all of the tax increase fall on labor income instead of capital income, then it doesn't account at all for what has happened over these past five years.

Considering most of you are central bankers, I'm sure you pay a lot of attention to the goings on at the Federal Reserve. In a recent op-ed, this is how Marty Feldstein explained what they're trying to do: Through their QEs, they're aiming to prop up the stock market so that people will feel wealthier and increase their consumption. As a consequence, the economy as a whole will grow faster. If that's really their thinking, that's insane! How could that policy possibly be associated with long-lasting growth if it does not translate into substantially increased investment, which so far evidently it hasn't? And what about the uncertainty as to what will happen when, at some uncertain point in the future, the Fed will start to unwind the huge positions they've taken in the debt market? What if, in the meantime, medium-to-long-term interest rates were to start rising, for example because of approaching good times with associated rising real interest rates, or because of an increase in the inflation premium in nominal rates as a consequence of higher inflation expectations? The point is, there's a lot of uncertainty about monetary policy for the next couple of years. Such uncertainty is not welcome for private-economy decision makers. Many things have the potential to go wrong. Ultimately, if bad things happen, the Fed's credibility would suffer and there likely would be pressure to curtail the Fed's independence. That would really be bad! One success story of the time-inconsistency literature is the emphasis in many parts of the world on the importance of independent central banks (unfortunately with no real counterpart in the fiscal arena).

[In response to a question about low interest rates associated with the QEs, I contended that it's not obvious the QEs per se have had much of an effect on the interest rates, and certainly not on the economy as a whole. Typically, low interest rates are not the key factor associated with booms – on the contrary, real interest rates, at least, generally have been procyclical. The dominant factor has to be the private economy being confident enough in future productivity and profitability (after taxes!) to expand their capacities to produce. It's hard to see how the Fed's actions associated with the QEs could have done anything to shore up such confidence for the future.]

Where the euro zone is similar to the United States is in terms of lack of policy consistency, that is, lack of clarity about future policy, which is so essential for the private-economy forward-looking decisions required for sustainable growth. Such lack of clarity surfaced soon after the Greek crisis hit. Policy makers would try something – that didn't work – then try something else – that didn't work either – and so on. Is there any sense of clarity about what they will do over the next three-to-five years, say? I should think not. How can they expect the business environment to improve, then?

One of the issues with which they're grappling is what to do about the banking sector. If the small- to medium-sized companies on whom well-functioning economies rely to engage in much of a nation's innovative activity, development of new products, and so on, if they're having a hard time getting the financing needed to put their ideas to fruition, then the economy won't do well. As an illustration of how important that issue may be, I'd like to end with a comparison of two nations – Chile and Mexico – in a banking crisis and the results of the different measures they took. [This comparison is taken from a

study by Bergoeing, Kehoe, Kehoe, and Soto (2007), as summarized in Fernandez de Cordoba and Kehoe (2009).]

In 1981-82, both countries found themselves facing a financial crisis as a result of rising world interest rates and low prices for their main export products – copper in the case of Chile and petroleum in the case of Mexico. In Chile, banks accounting for half of the nation's deposits were illiquid. The government stepped in, decided which banks were viable for the long run, let those they deemed not to be go under, and within a couple of years reprivatized the solvent ones. With appropriate adjustment of regulations, credit started flowing to worthwhile projects. As you can see in Figure 6, the initial cost in 1982 and 1983 was dramatic (a decline in real GDP of about 20 percent), but then the economy started growing and has since been the fastest-growing country in Latin America.

In Mexico, the banks weren't reprivatized until the early 1990s. In an effort to keep employment and investment from falling too much, government officials decided which companies (typically large ones) would get credit, while other companies got no credit. If you believe that government bureaucrats are the ones who best know which are the most productive projects, you probably also believe in Santa Claus! (I believe China suffers from a similar problem, leading to a lot of waste of resources, but that's another story.) Until the mid-1990s, Mexico experienced no growth.

So with those words to this group of bankers about the importance of a well-functioning banking sector, I note that I have exceeded my allotted amount of time. Thank you for listening, and skål!

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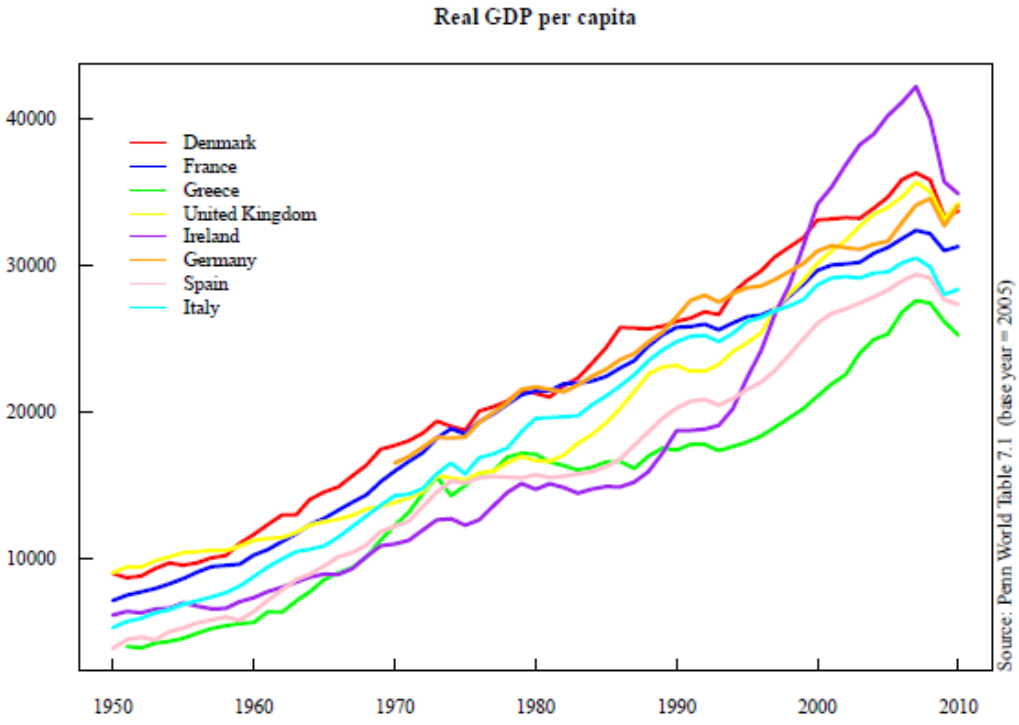

Figure 1: Real GDP per capita for eight European Countries

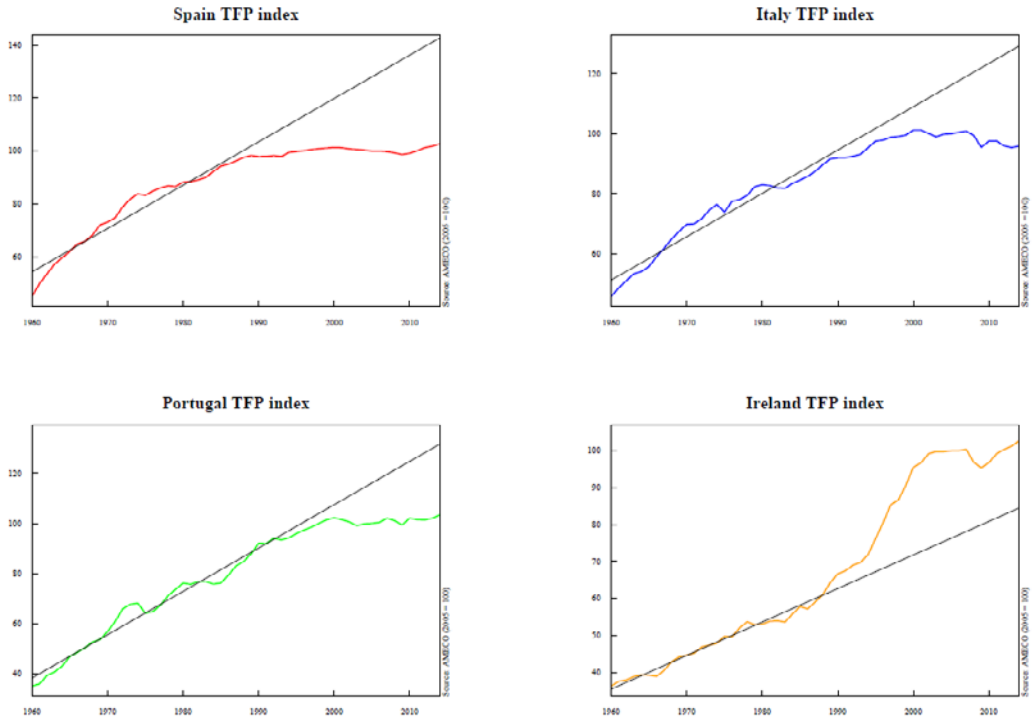

Figure 2: Total Factor Productivity for Spain, Italy, Portugal, Ireland

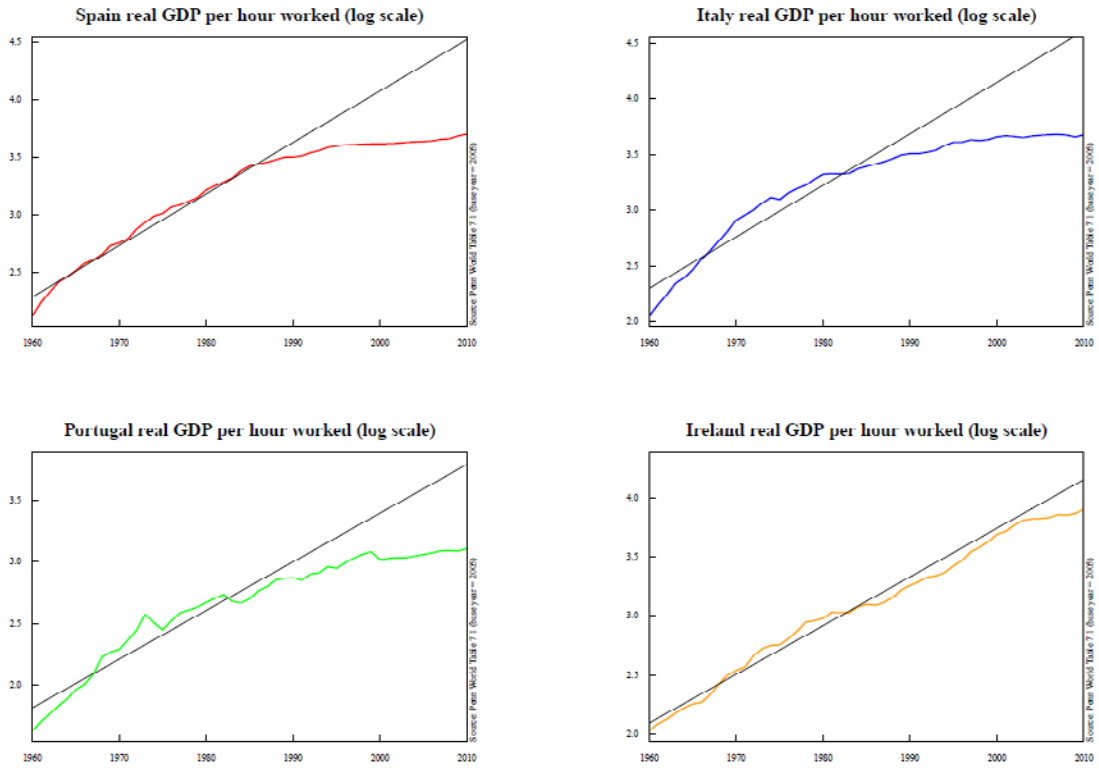

Figure 3: Labor Productivity for Spain, Italy, Portugal, Ireland

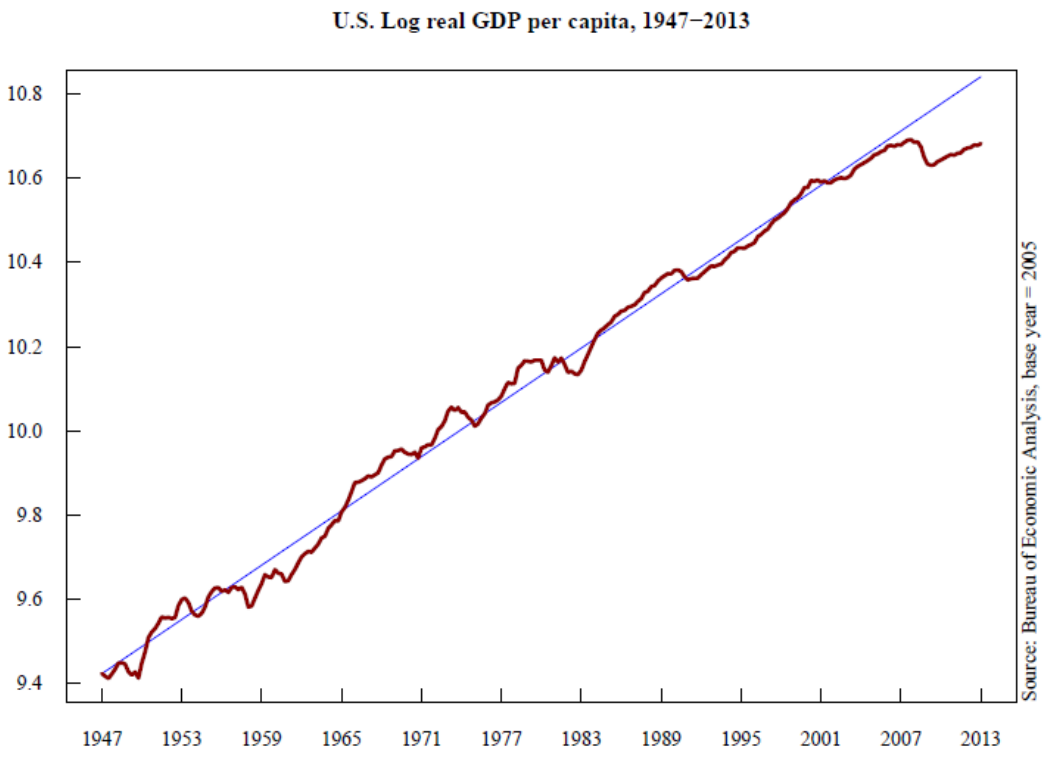

Figure 4: U.S. log Real GDP per capita, 1947-2013

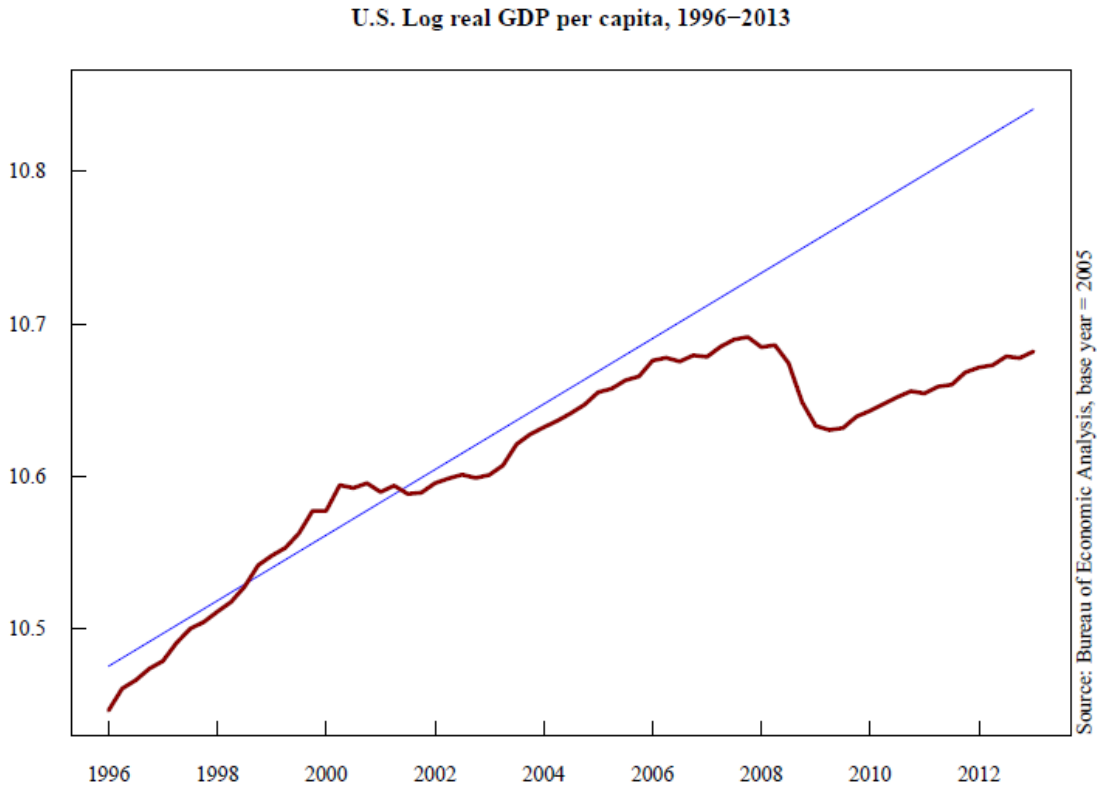

Figure 5: U.S. log Real GDP per capita, 1996-2013

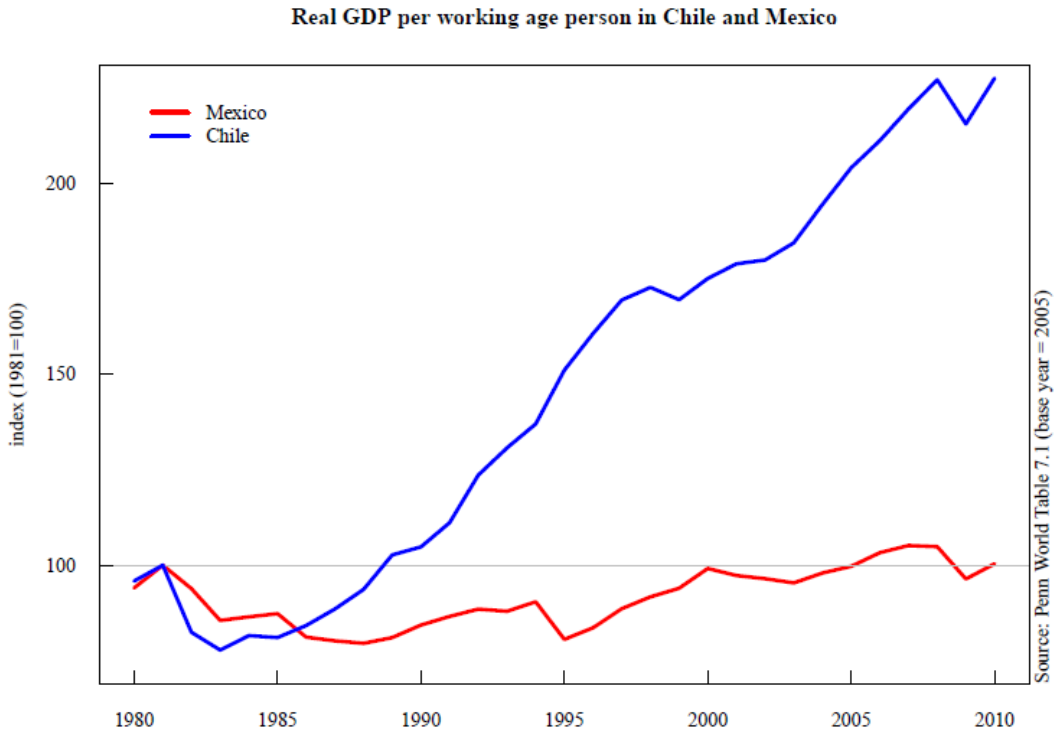

Figure 6: Real GDP per working age person in Chile and Mexico