Jürgen Stark: Is the global economy headed for a lost decade? A European perspective

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the National Association for Business Economics (NABE) Economic Policy Conference "The New Normal? Policy Choices after the Great Recession", Arlington, 8 March 2010.

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Introduction

Ladies and gentlemen

It is a pleasure for me to participate in this year's NABE Economic Policy Conference and an honour to be invited to debate the policy challenges facing the global economy in the aftermath of the most severe financial crisis since the Great Depression. Defining what "the new norm" of the post-crisis economic environment should be is challenging; although the global economy has recently embarked upon a recovery path, substantial fragilities remain and the outlook is still fraught with significant risks. For policy-makers, our key challenge now is to internalise the lessons of the crisis and to address its causes through long overdue reforms. The aim should be to prevent similar phenomena re-emerging and to create the conditions for sustainable and balanced long-term economic growth.

In my speech today, I will tackle three issues. I will start with an overview of the drivers and shortcomings of the pre-crisis global growth model. I will then move on to discuss what the obstacles to global growth might be in future and what features the "new norm" should have if growth is to be sustainable. Finally, I will take stock of the reform agenda for achieving strong, balanced growth and a resilient financial system.

The pre-crisis global growth model: drivers and shortcomings

It is undeniable that in the 15 years leading up to the crisis, the world economy achieved exceptionally high growth, combined with low levels of inflation and financial market volatility. Between the early 1990s and 2007, global economic growth averaged 3.7% per annum, while the volume of world trade expanded at an average pace of 7.1%. Global growth prior to the crisis was driven by several factors.

First, globalisation led to increased trade openness and a larger global labour supply. Key in this process was the integration of emerging Asia and the former COMECON countries into the world economy during the 1990s, which led to a significant expansion in the global workforce. The larger labour supply reduced production costs at the aggregate level and increased the comparative advantage in particular of Asian economies.

A number of countries benefited from this environment by pursuing export-led development strategies. In the case of emerging Asia, these strategies were supported by managed exchange rate policies that directly or indirectly targeted the US dollar. As a result, emerging Asian economies ran persistent current account surpluses and accumulated vast foreign exchange reserves.

Another feature was the debt-fuelled consumption booms experienced in a number of advanced economies. These booms were underpinned by positive wealth effects stemming from the appreciation of housing and financial assets. In addition, favourable credit conditions allowed consumption to be financed through a substantial rise in household indebtedness. The resulting shortfall in national savings meant that the large trade surpluses of emerging Asia were mirrored by deficits in the United States and certain other advanced economies.

Finally, growth was supported by a benign financial environment and a prolonged period of "easy credit". This phenomenon was related to a general process of deregulation and inappropriate regulation of the financial innovations that had taken place since the early 1980s. The securitisation of assets is one example of such innovations, which allowed the financial sector to offer credit at a lower cost than it had previously. Favourable financing conditions were further amplified by accommodative macroeconomic policies, abundant global liquidity and subdued financial market volatility.

Nonetheless, the financial crisis has forcefully demonstrated that the constellation of the recent past was fragile. With hindsight, it can now be seen that some of the factors driving growth in the past also sowed the seeds for the crisis. So why did the global growth model prove to be unsustainable?

One striking feature of the high global growth rates was the reliance on large and unsustainable global imbalances. In principle, current account imbalances can be desirable, if they channel funds across the world to their most productive use. But in the years prior to the crisis imbalances were a symptom of economic distortions: in some countries asset price bubbles developed and household debt levels rose beyond sustainable levels. Eventually, the rise in the household debt burden resulted in an acceleration of defaults on mortgage and consumer loans, which undermined the stability of the financial system.

In other countries – for example, in emerging Asia – which held the value of their currencies at artificially low levels to support their export-oriented growth strategies, the vast accumulation of foreign exchange reserves had potentially high opportunity costs. These managed exchange rate regimes may also have contributed to hampering necessary domestic adjustments and distorting the allocation of resources towards export-oriented industries.

As regards the financial system, there was a general under-pricing of risk, reflecting the apparently benign macroeconomic environment. This was exacerbated by the development of increasingly complex financial products, which made it difficult for investors to assess the quality of the underlying assets. A deterioration of credit standards – due to ill-designed compensation schemes for loan managers – went hand in hand with growth in the leverage employed by financial institutions, which increasingly relied on short-term funding.

Admittedly, the crisis was not only the result of market failures, but also of policy and supervisory failures. The institutional framework failed to keep pace with financial innovation. At the same time, insufficient coordination at the global level allowed financial institutions to engage in regulatory arbitrage.

The world economy after the crisis and the reform challenges

These are the facts. The question to be addressed now relates to the features that are likely to characterise the world economy after the crisis. Are there any important risks or potential obstacles to growth going forward?

For one thing, it is natural to assume that there will be a more permanent retrenchment by consumers in countries which experienced debt-fuelled consumption booms. Households in the United States, and also in a number of other countries, are unlikely to return to their past spending patterns. Massive losses in the value of financial and real estate assets mean that current debt levels are not sustainable and will require higher personal saving rates, which will depress consumption in the years to come. Retrenchment by consumers has already begun, but the wealth destroyed over the last few years may take a long time to rebuild.

On the supply side, economic growth may be dampened in future as the financial crisis is likely to reduce the level and growth rate of potential output. This may occur through depressed capital accumulation, with investment held back by a higher cost of capital and credit restrictions. The financial crisis may also adversely impact productivity and labour markets. Differing growth patterns are likely to lead to structural shifts in the global economy, both from “West” to “East” and at the national level. A major risk is that structural frictions might impede the necessary adjustments and lead to higher unemployment in the longer run.

The dire state of public finances represents another challenge, as many countries find themselves with unsustainable fiscal positions. Fiscal imbalances tend to fuel market concerns over a country’s ability to service its debt and to meet its future repayment obligations and risk imposing upward pressure on medium and long-term interest rates. This increases the cost of financing for everyone and poses a risk for future economic stability and growth. Internal studies at the ECB have found that in euro area countries an increase of 100 basis points in government bond spreads (vis-à-vis Germany) is associated with an average increase of 10 to 20 basis points in the cost of corporate bond financing. Moreover, high levels of public deficit and debt place an additional burden on the conduct of monetary policy. The substantial widening of long-term government bond spreads in many parts of the world has recently demonstrated that financial markets are keen to distinguish between countries on the basis of their creditworthiness. This mechanism now appears to be a more forceful disciplinary device for fiscal authorities than before the crisis. A return to sound and sustainable fiscal positions is a key responsibility that has yet to be addressed. Otherwise there is a rising risk that the financial and economic crisis will be followed or exacerbated by a sovereign debt crisis.

Having considered the obstacles likely to hamper global growth prospects, let me take the opportunity to share my views on what features the global growth model should have, if it is to be sustainable.

First, we need to reconfirm our commitment to medium-term, stability-oriented macroeconomic policies. As before, these policies should be focused on maintaining fiscal sustainability, price stability and financial stability, which should help limit boom and bust cycles in the future.

We need sound fiscal policies supported by credible fiscal rules. In Europe, the Stability and Growth Pact provides a rule-based framework based on reference ratios for fiscal deficits and public debt in terms of GDP. Looking ahead, the main priority will be to devise credible exit strategies to correct large fiscal imbalances and to demonstrate commitment to fiscal consolidation.

As regards monetary policy, this is best conducted when a central bank has a clear and unambiguous mandate, a clear objective and a medium term orientation. Central banks’ independence is paramount for achieving their mandates and monetary policy should be kept immune from political interference.

The role of asset prices in the conduct of monetary policy deserves mention. A long series of booms and busts over the last four decades has demonstrated that asset price developments can pose serious threats to macroeconomic and price stability and therefore central banks cannot simply ignore them. In this respect, it appears that a comprehensive monetary policy strategy, which also gives prominence to money and credit developments, might be better able to “lean against the wind” of financial exuberance. Central banks should be equipped with a broad-based analytical framework in which such developments are monitored and analysed in detail. At the ECB, this framework is provided by the monetary analysis, the second pillar of our monetary policy strategy.

Demand in the global economy also needs to be better balanced geographically. There is a broad consensus that national saving in the United States and other deficit countries needs to increase. This can be achieved through a strong commitment to fiscal consolidation, in conjunction with increased household saving. However, a rebalancing also requires stronger domestic demand elsewhere. This will require reforms in emerging Asian economies, most notably in China, to boost domestic demand, by developing financial systems, and by increasing spending on social safety nets to reduce households’ precautionary saving.

Greater exchange rate flexibility in some countries is a further necessary step towards achieving more balanced global growth.

Finally, governments need to intensify structural reforms in order to enhance the growth potential of their economies and their capacity to generate jobs. This is particularly relevant in the case of the euro area, given its relatively balanced current-account position and limited role in global imbalances. In the longer run, growth will depend, among other things, on the amount of innovation and the degree of market flexibility. Key challenges for Europe are boosting productivity and innovation and removing existing labour and product market rigidities. These objectives have been at the core of the political agenda since the launch of the Lisbon Strategy in March 2000.

The policy-makers' task of addressing the reform challenges is not easy, yet a broad set of measures is already taking shape at the global level. Following the crisis, the G20 has emerged as the premier forum for international cooperation. At recent G20 meetings, a framework for sustainable and balanced growth has been agreed upon and preparations for its implementation are under way. Key features of this framework should be:

- A medium to long-term orientation;
- Refraining from calls for macroeconomic fine-tuning;
- Commitment to stability-oriented macroeconomic policies;
- Achieving a more balanced pattern of global growth.

A sound and robust financial system is needed to strengthen the resilience of the global economy. The existing institutional framework for ensuring financial stability needs to be improved and supervision and regulation enhanced. A number of reform initiatives have been undertaken in this respect, their key aspects being:

- Strengthening capital standards and mitigating pro-cyclicality;
- Reforming compensation practices to avoid incentives for excessive risk-taking;
- Addressing cross-border regulation of systemically important financial institutions;
- The need for a ''holistic" approach to regulation, which should extend to the shadow banking system.

To this end, a timely finalisation of the Basel Committee's proposals on capital and liquidity regulations is critical to strengthen the resilience of the banking sector.

Initiatives to safeguard financial stability are being coordinated at the global level by the Financial Stability Board (FSB). At the European level, a new body, the European Systemic Risk Board, is expected to contribute to the global effort to enhance system-wide risk assessment and develop a consistent macro-prudential framework. The establishment of the European Systemic Risk Board will give the ECB a more prominent role in macro-prudential supervision, quite separate from its monetary policy responsibilities.

The initiatives undertaken at the global and European level should address the transparency and risk-taking behaviour of financial institutions, and thus be consistent with general principles such as: i) correct risk-taking incentives and avoid moral hazard; ii) minimise distortion in the banking sector; iii) ensure a global level-playing field. We must ensure that governments remain vigilant on safeguarding financial stability and financial market participants accountable for their decisions. In this context, I believe we should avoid creating new incentives for moral hazard for instance by creating an "emergency fund" for banks financed or co-financed by taxpayers' money.

Is the global economy headed for a lost decade?

Given the challenging reform agenda and the possible obstacles to global growth that I have outlined earlier, what are the chances of the global economy heading for a lost decade?

I feel that there is a widely shared view today that global activity and trade are unlikely to exhibit the same strength in the years ahead as in the past decade. Indeed, returning to pre-crisis economic activity levels is likely to take time.

On the one hand, some emerging economies, notably in Asia, have not experienced declines in output, yet still remain dependent upon advanced economies for future growth. Evidence of decoupling is at best mixed and export oriented strategies in those countries still prevail.

On the other hand, advanced economies may be faced with the prospect of a protracted period of sluggish growth, given that the financial crisis is likely to have adversely affected their growth potential. According to a recent OECD study, financial crises in OECD countries are estimated to lower potential output by 1.5 to 2.4 percent on average, while the magnitude of this effect might be significantly larger in the case of a severe crisis. If history is any guide, we should also take note of IMF studies which have found that, in advanced economies, recessions associated with financial crises tend to be unusually severe and long lasting, with output taking, on average, three years to recover to its pre-crisis peak. Studies by Reinhart and Rogoff have provided further evidence in this direction. Similarly, globally synchronised recessions are often long and deep and are generally followed by weak recoveries.

In addition, the risk of global stagflation should not be underestimated. The emergence of a multi-speed recovery, with developing economies leading the way, might put upward pressure on commodity prices at a time when labour markets are weak and the recovery still fragile.

Let me also provide some thoughts on a debate that was recently raised by the IMF as to whether central banks should err on the lax side and aim at higher inflation rates in order to minimise the likelihood of deflation. While I do see the temptation for governments to ask for higher inflation in order to monetise the dramatic build-up of public debt, let us not forget that it serves to expropriate the income and wealth of the general public to the benefit of those who have lived beyond their means. I can only reject the idea of raising inflation rates permanently. I would not like to imagine the consequences if, on top of the current financial fragilities and in an environment of high public debt, the general public were to lose trust in the purchasing power of money. There is no evidence whatsoever to support that deviating from price stability and aiming at an inflation rate of 4% would enhance economic prosperity or growth. On the contrary, a considerable body of empirical research finds that the Phillips curve has a negative bent in the long run: inflation and inflation volatility penalise capital formation and thus detract from the economy's growth potential.

Finally, given the uncertainties enshrouding the post-crisis economic environment, it is worth recalling the lessons of Japan's "lost decade". One lesson is that the financial system needs to be repaired first, before a durable economic recovery can be initiated. Another lesson is that reforms should not be delayed. And finally, in the absence of these reforms, the recovery may be slow, fragile and prone to reversals. If they are not addressed, then problems stemming from structural deficiencies are bound to reappear.

Concluding remarks

In a nutshell, the past global growth model proved unsustainable. The lessons from this and previous crises suggest that failure to address long overdue reform challenges promptly might result in a "lost decade" for the global economy. These reform challenges include:

- achieving a balanced global growth trajectory;
- implementing stability-oriented macroeconomic policies;

- carrying out structural reforms;
- putting in place more flexible exchange rate arrangements;
- appropriate financial sector regulation and oversight.

Only partial progress has been made so far, and the distortions that led to global imbalances are still present. If reform challenges are not met, there is a major risk that global economic activity will remain subdued, high public debt will become more persistent and unemployment will remain high.

It is therefore crucial to make headway with our reform agenda, while taking care to ensure that our response to the crisis does not sow the seeds for renewed economic imbalances and financial excesses.

Thank you for your attention.