

François Villeroy de Galhau: Secular stagnation and growth measurement

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Secular stagnation and growth measurement conference, organized by the Bank of France, Paris, 16 January 2017.

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Accompanying [slides](#)

Ladies and Gentlemen [slide 1],

I am very pleased to welcome you all to Paris, for this conference on “secular stagnation and growth measurement”. We should always be cautious when using expressions as categorical as “secular stagnation”, and which describe the long term: Alvin Hansen, who coined it in 1938 with his famous “full recovery or stagnation”, lived long enough – until 1975 – to see thirty years of almost full recovery, instead of stagnation. Nevertheless, this risk, popularized again recently by Larry Summers, is a matter of concern for central bankers. Why? Because a persistent slowdown in trend output growth could make the economy more vulnerable to shocks that push the natural interest rate below the effective lower bound. Whether secular or lasting for many years, very slow growth and inflation also challenge the efficacy of conventional monetary policy tools. They can affect the sustainability of public and private debt. And beyond central banking concerns, they can also alter the functioning of our social models. Let me just clarify that I will not speak about monetary policy today, as we are in our “silent period” before the Governing Council meeting. Allow me to say simply that some of the more recent comments about a “come back of inflation”, which would allegedly put the Governing Council under strain, seem greatly exaggerated.

So, where do we stand? The slowdown in per capita growth in advanced economies can actually be traced back to the 1970s [slide 2]. It worsened in several stages, the latest starting in the mid-2000s, after the ICT revolution and before the Great Recession. The issue is that this prolonged slowdown raises questions about future potential growth, largely due to uncertainty about productivity trends. To assess the risks, I would like to elaborate on the three hypotheses that form the basis for today’s conference [slide 3]: first, are we simply underestimating growth? Second, is the slowdown a demand phenomenon? Third, is it a persistent phenomenon due to a slowdown in the pace of innovation?

1. Are we underestimating growth?

New technologies usually lead to a mismeasurement of output. National accounts indeed have a hard time taking into account improvements in product quality and product entry or exit. As a result, they tend to overestimate inflation and underestimate output. For instance, there is currently an issue with IT hardware, as output of these products is inadequately recognised, even in the US.

But the growing share of digital computing technologies in economic activity raises new specific challenges, both on a conceptual and practical level [slide 4]. Let me take the example of travel services. On a conceptual level, digitalization is blurring the frontier between the market and informal economy, and leading to the development of “C to C” services; for example, many of us now directly buy our holidays on-line. This disintermediation of services has been accompanied by a significant improvement in their quantity and quality. Yet, travel services are now in large part ‘home production’, and the measured market value added of travel agency services is declining. On a practical level, with the rise of digitalization, new kinds of services can be imported, notably through e-trade, and the location of activities is less easy to determine. Moreover, the fact that

these services are not standardized and evolve quickly makes it more difficult to estimate the deflator for service output in national accounting.

The concern over output mismeasurement is therefore serious. Yet mismeasurement alone cannot explain all of the slowdown, as it did not suddenly appear in the mid-2000s.

2. Is it also a demand phenomenon? I am very much inclined to say it is.

Negative demand shocks are particularly pernicious when interest rates are already low, as there is limited room to spur demand by cutting interest rates. In central banking jargon, we say that short-term interest rates cannot be reduced to the “natural rate”, which is the level where demand equates to potential output and inflation is stabilized. Faced with these constraints, major central banks have implemented an array of non-conventional measures, including forward guidance and QE, in order to help stimulate demand by lowering long-term interest rates further.

So why is demand proving so slow to pick up in spite of these highly stimulatory measures? [slide 5] **Wage-setting mechanisms** are likely to play a role. Insufficient attention has been given to this, due to differences between countries and the fact that it is a micro-level issue. The muted reaction of wages to stimulatory measures and to a tense labour market is particularly puzzling in Germany. On the contrary, real wages in France have been relatively dynamic, despite a deteriorated labour market, leading to further competitiveness losses. This reflects in part the minimum wage and the associated automatic revaluation rules. And yet wage setting is an important issue not just for employment, competitiveness and growth, but also for monetary policy. Wages are a determinant of cost inflation, whereas wage negotiation is likely to take into account the central bank inflation target – over the medium run, wages should in theory increase at the rate of productivity growth plus the inflation objective. What is more, wage setting policies could improve coordination in the euro area, as relative wages could contribute to the correction of imbalances. Although this issue attracts less attention than fiscal policy in the public debate, there would be merit in exploring it further in each country, including in France, and in the euro area as a whole. In that respect, Jens Weidmann’s call for significant pay rises in Germany in 2014 was a courageous and welcome move.

Deleveraging is another factor that can act as a drag on demand. A significant deleveraging process took place after the recent financial crisis – among households, firms and also governments. Household debt declined the most in those countries where it had grown the most, such as the United States or Spain. Corporates reduced their net debt positions to insulate their balance sheets from the crisis. And, to make sure that debt remained sustainable, governments had to reduce their deficits from the very high levels reached during the Great Recession of 2009. Unfortunately, fiscal consolidation policies were not sufficiently coordinated in the euro area. While deleveraging might be individually desirable for over-indebted groups, if all agents scale down their debts simultaneously, aggregate demand inevitably slows.

Turning to more structural factors, **demographic trends** and **productivity** can also weigh on demand through their impact on savings. What are the determinants of savings in the long run? According to economic theory, people save more when the rate of the economic growth slows, either because fewer people are in work or because the productivity of each worker decelerates. Several factors are likely to reduce the growth rate of the working age population and increase the average age of workers: the gradual exit of baby boomers from the workforce, the one child policy in China and the decline of fertility rates in the OECD. This can also weigh on productivity as older workers may have a harder time adapting to new technologies. Another important demographic factor is increasing longevity which would also, for a given retirement age, increase savings.

Lastly, **inequalities** – both on a global level and within countries – can also affect demand [slide 6]. Growing income inequality within countries – even if it remains significantly lower in

continental Europe – implies reduced relative spending power for low-income households, which have a high propensity to consume. More inclusive societies with fewer unemployed and more even income distribution would most likely result in more dynamic demand.

3. Are we witnessing a permanent slowdown in the pace of technological progress?

The debate between techno-pessimists and techno-optimists over the future pace of innovation is well-known. It resulted from the slowdown in productivity and in the contribution of ICT to growth in the mid-2000s, even before the Great Recession. For the United States, there was a downward break in the productivity trend as early as 2006.

In fact, the diffusion of technology can suffer from two types of lag: a time-lag, but also a space-lag. Time-lags refer to the delay in incorporating innovations efficiently into the production process, as the required structural adaptation of the economy and learning processes can take decades. What stage of diffusion are we at for ICTs? Have structures in individual firms evolved sufficiently to allow them to reap the full benefits of ICTs? I very much doubt it given the usual time lags observed in the diffusion of past technologies and the differences in productivity levels between firms. The second type of lag, space-lags, refers to the uneven diffusion of technology across firms. Frontier firms usually enjoy stronger rates of productivity growth than imitators in the same sector. In France, the productivity growth of frontier firms has remained steady – or even increased – throughout the slowdown [slide 7]. This may reflect winner-takes-all phenomena. For example, in the digital economy, due to network externalities, one firm with a marginal comparative advantage can seize the whole market and benefit from the low marginal cost of production of additional units of its product. However, these phenomena may be specific to ICT-producing sectors. Productivity growth in frontier firms mostly reflects the actual pace of technological advance and supports techno-optimists views.

I've shared with you a few thoughts on these three promising hypotheses. To conclude, let me share with you what I see as priorities in order to exit the low growth trap and prevent the risk of secular stagnation. We must obviously accelerate domestic reforms in order to foster innovation and an entrepreneurial spirit. But at the European level, we need to tackle the persistent “investment crunch” which followed the financial crisis. Thus, we first need a “Financing and Investment Union” in Europe to steer abundant savings into investment and provide adequate financing for innovation. We also need, as a second step, a collective economic strategy in the euro area, which could be backed up with a euro area “Finance Minister”: growth and employment will be stronger in Europe if we combine more structural reforms where they are needed – such as in France and Italy – and more fiscal and/or wage support in those countries with room for manoeuvre – such as Germany. On that note, I wish you very fruitful discussions throughout this conference and I shall now leave the floor to the first session on measurement issues. Thank you for your attention.