Peter Praet: Is secular stagnation the new economic reality?

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, for the policy panel entitled "How to deal with potential secular stagnation?" at the Secular Stagnation and Growth Measurement Conference, Bank of France, Paris, 16 January 2017.

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The term "secular stagnation" was coined by Alvin Hansen before World War II.[1]

Among the driving factors of the slowdown he predicted were limited population growth and lack of innovation. A decade or so later, we had the baby boom and one of the strongest economic expansion the world has ever experienced – in French, "Les Trente Glorieuses" started. This experience should certainly invite all of us to ***be prudent with the concept of "secular stagnation"***. Let's not forget that a similar panel ten years ago would have been discussing "the Great Moderation".

Over the past 10 years, ***euro area growth has been particularly weak, with the level of GDP only having surpassed its pre-crisis peak level in the third quarter of 2015***. Short-term growth prospects were periodically revised downwards, and recent estimates of euro area potential growth are approximately 1%, compared to 1.5%-2% in the pre-crisis period.

These developments have raised the question of ***whether this low growth environment is in fact the new economic reality***. Central to this debate is whether the slow growth can be attributed to cyclical – and hence ultimately transitory – factors related to the financial crisis, longer-term structural factors, or a combination of both, whereby cyclical factors have over time turned into permanent factors, for example via hysteresis effects.

Longer-term structural factors have certainly been at play in the euro area. ***The decline in potential output growth*** pre-dates the financial crises, in fact going back to the mid-1990s, and reflects a long-term slowdown in the growth of total factor productivity. This decline ***went largely unnoticed***. To some extent this oversight can be explained by the fact that in the decade leading up to the crisis the overall macroeconomic environment had been stable. Remember our debates during the Great Moderation and all the good reasons that were put forward to explain macroeconomic stability!

Today we can look back at this period and see the ***expectation gaps*** that we could not clearly identify in real-time. In various parts of the euro area, firms', households' and governments' future income expectations had become disconnected from underlying growth, leading to an accumulation of excess debt. Those over-optimistic expectations were in turn reinforced by this renewed, yet complacent sense of economic prosperity.

So when the cycle did finally turn in 2008, several euro area countries were confronted with ***pronounced "balance sheet recessions"***: downturns created by the need for both private and public sectors to deleverage. This has produced a set of circumstances – a protracted slump – that are observationally equivalent to those that one would associate with secular stagnation. But it is important that we distinguish this from the longer-term slowdown in potential output, since it remains ultimately a cyclical phenomenon and hence amenable to different policy tools.

So how should policymakers respond to this mix of challenges? To be effective, the policy response should be ***comprehensive, consistent, well-sequenced and incentive-compatible***. Monetary, fiscal, structural and macro-prudential policies all have a role to play. With such a policy mix, I see no reason why we cannot lift both actual growth and trend growth back to more satisfactory levels.

Given the distance-to-frontier of many euro area economies, there is significant scope for a productivity catch-up with the right supply-side policies. And insofar as demand-side policies support the cyclical recovery, and thereby address the headwinds created by protracted balance sheet adjustments, they can prevent further damage being done to the productive side of the economy through hysteresis effects. In this sense, secular stagnation is not predestined, but is a possible outcome of bad macroeconomic policies.

In fulfilling its role in this comprehensive response, monetary policy is confronted with three key challenges. These challenges are related to measurement uncertainty, policy instruments and its relationship with other policy areas.

First, ***measurement uncertainty***. In theory, monetary policy should track the equilibrium real interest rate. The equilibrium real interest rate can be viewed as the interest rate consistent with saving and investment being in balance and output being at potential, with neither upward nor downward pressure on inflation. In practice, however, the equilibrium real interest rate is an elusive concept, or more precisely an unobservable variable – like the output gap – whose estimates are subject to significant uncertainty.

ECB staff estimates of the equilibrium real interest rate point to a significant decline over the past 10 years, even into negative territory. At face value, such estimates are consistent with the secular stagnation hypothesis. But as policymakers, can we really base our actions on such an intangible variable? My answer is no. This is why the ECB has always followed a comprehensive monetary policy strategy, based on two pillars, and has in practice always looked at a broad range of indicators to assess its monetary policy stance.

Second, ***policy instruments***. Proponents of the secular stagnation hypothesis typically argue that a low equilibrium real interest rate makes monetary policy ineffective, since interest rates cannot fall low enough to absorb the excess of saving over investment. And though several central banks have shown the zero lower bound is not, in fact, a constraint to the interest rate instrument, there is an effective lower bound on interest rates, which is probably not too far from zero.

So does that mean central banks have reached the limit of their actions? Again my answer is no. Instead we have used non-standard measures to flatten the term structure of interest rates and lower financing costs in the economy directly. And the ongoing economic recovery is testament to their effectiveness. What this shows is that theoretical constraints can be lifted in practice, because the economy is much more complex than models can capture.

Third, the ***relationship of monetary policy with other policy areas***. This is the thorniest issue. There is always a risk for a central bank of becoming the only game in town, even though large parts of the growth challenge are clearly beyond its remit. The drivers of long-term growth are innovation, technology diffusion, which is to say, productivity growth. To manage this risk, central banks should always staunchly stick to their mandate. This is the only way for them to do their part effectively while ensuring that the overall policy response remains comprehensive, consistent, well-sequenced and incentives-compatible.

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[1] This is the full text of remarks delivered in an abridged form in Paris on 16 January 2017.