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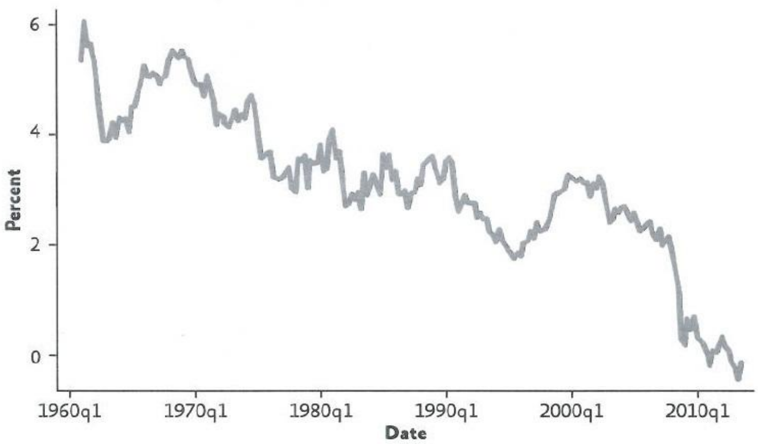
Daniel Daianu is a former Minister of Finance of Romania, has been a member of the European Parliament, is a member of the Board of the Central Bank of Romania, and is Professor of Economics. As I have mentioned, the wealth of experience of angular vision and so forth, having the Minister of Finance and a Professor of Economics knowing what the Central Bank is doing is certainly a big privilege.

Daniel DAIANU

"Secular stagnation" and an age of ultra low interest rates? When the financial cycle meets "secular stagnation"

While the financial crisis plays a major role in the current economic malaise, *secular stagnation* (Summers) has to be judged in terms of a long run decline in productivity, demographics, technological change, rising income iequality, etc. OCDE studies (Rawdanowiccz et. Al) show that potential growth in the EU slowed down from cca 2.5% in the late 1990s to 2% during 2005-2007, while trend growth in the 1970s and 1980s was around 5% on average. An analogous evolution can be ascribed to the US economy, too, over that period of time (see also Gordon). The impact of the financial crisis is also significant: estimates are that the Great Recession has brought GDP potential growth below 1,5% in the EU for the next 5-10 years (OECD and Economic Commission numbers). Low, ultra-low interest rates come into the picture in this context as they juxtapose dynamics of saving and investment over the longer term (William and Laubach, figure 1, quoted by Summers) which are also shaped by the financial crisis. Tehnological optimism (robots, IT) vs. pessimism is also an issue for contention. And finally and not least, what is the role played by debt overhang (Rogoff), of big debts in the public and private sector? Balancesheet recession (Koo) is to be highlighted in this context.

Figure 1: evolution of real interest rates (William and Laubach, 2003)



Estimate for the real interest rate by Laubach and Williams (2003)

Source: Summers (2014)

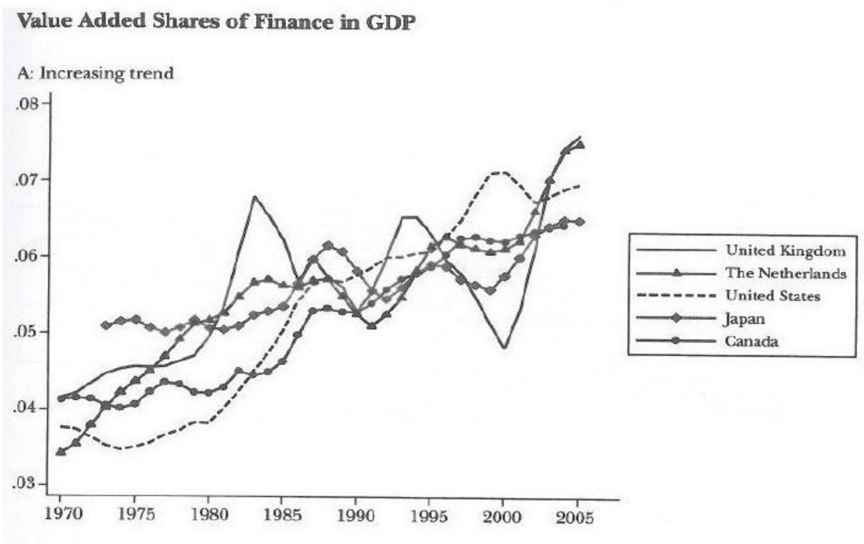
Competing narratives try to explain the current economic malaise, among which:

- deregulation of financial markets;
- lax monetary policies: a long cycle of boom and bust in the advanced economies (The Great Moderation), which was littered with episodes of possible major tremors, that were prevented by central bank intervention (ex: the LTCM crisis and the indirect FED intervention)
- structural tendencies, including the *glut of savings* (Bernanke, 2005) and the scarcity of safe assets (Caballero)

These narratives can be brought to a common denominator. Arguably, a “drifted” financial cycle has been at work in the global economy during the past two decades. This drifted cycle is reflected by *oversize finance* (Pagano et.al), rising debt overhang and huge fragilities in highly inter-connected markets. The Great Moderation years hid a huge resource misallocation (Jaime Caruana, 2014), which shows up in “debt overhang” and a “balance-sheet recession”.

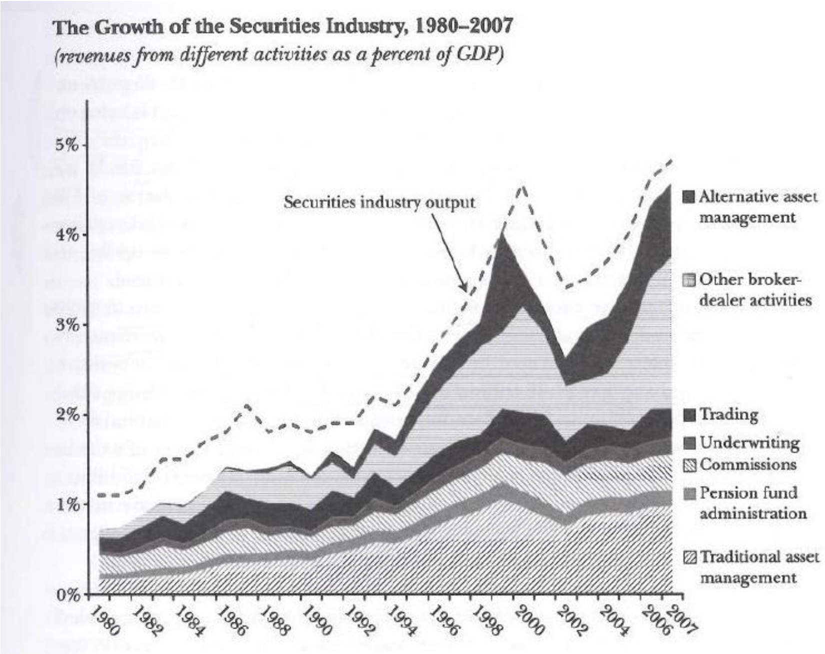
Finance deregulation has played a major role in derailing the financial cycle. Key moments were 1986, 1998, 2000 (the Big Bang in the UK and the promotion of the so called “light touch regulation;” the repeal of the Glass Steagal act and the Commodity Futures Modernization Act in the US, etc). As Greenwod and Scharfstein) show, finance has grown enormously during the last three decades. In 2006, finance contributed 8.3% to US GDP,compared to 4.9% in 1980 and 2.8% in 1950 (p.1); the financial share of GDP increased at a faster rate since 1980 (13 basis points of GDP per annum) than it did in the prior 30 years (7 basis points of GDP per annum).

Figure 2: Value added of finance in GDP



Source: Phillipon and Reshef, 2013, p.81

Figure 3: Growth of securities industry 1980-2007



Source: Greenwood and Scharfstein, 2013, p.9

AN AGE OF ULTRA-LOW INTEREST RATES?

Demographic and productivity trends, globalization, the financial crisis, overburdening debts, income distribution, new technologies, growing uncertainties, all these have impacted strongly on investment and saving. More specifically,

- Increased saving relates to demographics, income distribution, uncertain revenues, etc.

- the crisis has dented investment appetite, a natural reaction if one considers exuberance and bad investment choices in pre-crisis years; heightened uncertainties are reducing overall risk appetite --as Minsky remarked, uncertainty is fundamental for understanding economic cycles ;

- Over-indebtedness (‘debt overhang’) generates a slowdown of economic activity, a balance-sheet recession (via deleveraging) as Richard Koo noticed for Japan ever since the early 1990s;

- Productivity growth diminished in the US as well as in other economies over the past decades, which made Gordon, Summers and others to suggest that we have, quite likely, entered a period of lasting stagnation. Such an assumption may seem strange if it is juxtaposed to the thesis of an incoming new Industrial Revolution, but it is not implausible when new technologies eliminate more than create jobs;

- Decreasing inflation after large emerging economies entered global competition; an import of disinflation has occurred, from China in particular. The current crisis was a shock in itself that combined effects on both supply and demand sides. The decline in commodity prices (i.e. oil) speeded the fall of inflation.

The factors mentioned above suggest that the equilibrium interest rate (in Knut Wicksell"s' sense), at which there is full resource utilization, has fallen significantly in industrial economies. This is also seen in the trends of long-term real interest rates and yields on 10-year bonds (King and Low, 2014; Rachel and Smith, 2015). In the context of a chronic under-use of resources, with intense hysteresis taking place (depreciation of idle capacities, of human capital), real policy rates would need to turn negative. If inflation is very low (even negative), central banks would be forced to take policy rates below zero (hitting the zero-bound). Finally, the financial and economic crisis, the decline in economic activity and potential GDP, fuel governments' propensity for intervening in a drive to prop-up their economies. As a matter of fact, there is a worldwide competition via competitive devaluation.

Monetary policy in a depressed economy

The US economy - by size and depth the nearest to a closed economy model – has witnessed a steady decrease of real interest rates over the past decades, from 4-5 percent toward almost zero at present (Williams and Laubach, 2003; King and Low, 2014;Summers, 2014; Haldane, 2015; Williams 2016, etc.). In the global economy, which may be viewed as a closed one, real equilibrium interest rates had also fallen steadily over the past three decades (Figures 4 and 5; figure 5 mentions factors that moved global saving and global investment.

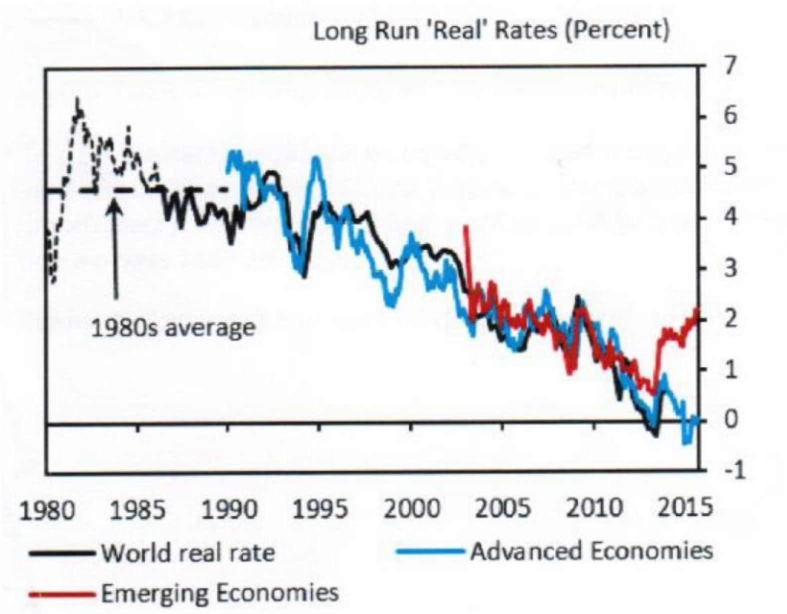
Lawrence Summers argues that the equilibrium rate, which allows full capacity utilization, is negative at present (2014, 2016). But a legitimate question is posed by the pretty low unemployment rate in the US currently.

If the severe unemployment case is dismissed, how does it come that inflation does not pick up? And why are inflation expectations persistently so low? It may be that, as James Bullard argues, there is need for another narrative. The latter should be centered on a Fisher equation ($i = ir + \pi$ (exp)), where (i) is the nominal interest rate, (ir) is the real rate, and (exp π) is expected inflation; the line of reasoning is that, under conditions of persistent low inflation, and when output and unemployment gaps almost disappear, the Taylor's rule turns into a Fisher equation . Bullard suggests that since the real rate is determined by markets, the "pegging'' of policy rates can be put in relation with persistently low inflation expectations. It may be that markets take their cues from resilient low policy rates. But, would this policy rate pegging and its impact on inflation expectations imply that policy rates need to climb again in order to move inflation expectations upwards? This would fit into BIS'view that policy rates need to move upwards to combat new speculative bubbles. I

Two key issues emerge: a/ whether negative equilibrium interest rates are justified, and b/ whether negative policy rates are effective? If resource allocation were adequate, the equilibrium rate should not be below zero. It is economic common sense to think so. But there is a different story when resources are grossly misallocated and structural conditions are unfavorable. During massive and chronic under-use of resources intense hysteresis may take place. Such circumstances may erode not only the value of current resources, but potential GDP too. Therefore, there are arguments for policy intervention to exit the state of considerable under-use of resources and to avoid deflation, debt-deflation. If such arguments (the ECB's current stance now, for example) are accepted, the issue that needs to be clarified is what kind of a policy mix should be used in the context of non-standard measures (such as those adopted by various central banks and which have entailed side effects (among which speculative bubbles and the impact on non-banks' financial balance-sheets).

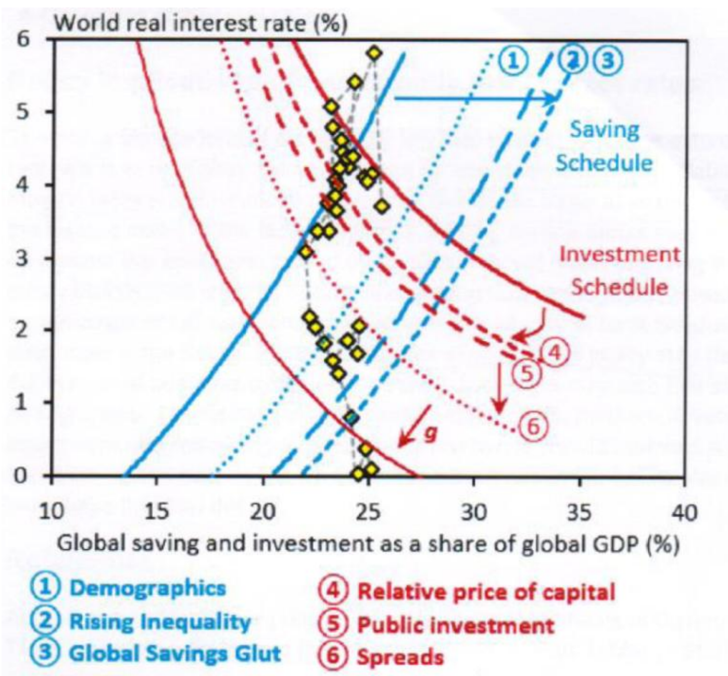
Another important question is linked with resource misallocation and heightened bad distributional effects (Stiglitz, 2016) when policy rates are very low. Summers, in his secular stagnation argument, says that there is a trade-off between the need to boost output and financial stability, while monetary base expansion is fueling the search for yields and new speculative bubbles (2014). Therefore, he calls for increased resort to fiscal tools (see also DeLong and Summers (2012)

Figure 4: the fall of real rates in the world (1980-2015)



Source: Rachel and Smith, who quote King and Low (2014), Consensus Economics, IMF, Datastream

Figure. 5: shifts in saving and investment schedules in the world ecnomy (1989-2015)



Source: Rachel si Smith, 2015

Massive capital movements complicate the picture.. Let us just take into account not only the savings glut in the global economy following past decades' development in China (where savings account for almost half of household income) and Asians and East Europeans' low wages in a global competition which favored disinflation and deflation pressures. Moreover, the euro-area, which is highly divided in terms of competitiveness (North and South division) is showing a current account surplus of cca. 3 percent of GDP currently, which is also putting pressure on the global investment and saving balance.

Emerging economies

Small and large emerging economies are trapped in this highly complicated and uncertain environment and bear the fallout from speculative capital flows. Countries with large budget and external deficits, high external debt, are more vulnerable and prone to balance of payment crises. The fall in commodity prices is also hitting hard countries which rely on basic commodity exports.

High liquidity and, yet, *sudden stop* threats

Fresh financial market turmoil cannot be automatically prevented via lower real interest rates and an expansion of high-powered money in the global economy; markets may freeze again and balance of payment crises may occur if large macroeconomic imbalances operate. Unconventional shocks can also frighten markets. Real rates were actually low even in the pre-crisis years. The global financial system is rife with vulnerabilities, not least because of a higher degree of interconnectedness, high leverage, and sophisticated financial instruments. In spite of more severe capital and liquidity requirements, of a new regulatory and supervision regime, transmission mechanisms continue to be precarious and sudden stops may emerge in areas of capital (money) markets, triggering contagion. This poses a tremendous challenge for governments and central banks, the latter having exhausted much of their ammunition.

The still fragile financial system is mirrored by developments across shadow banking, by systemic risks which evolve in capital markets. One should not rule out that the lender-of-last-resort function would be called upon for such markets too.

Final remarks

- structural trends, oversize finance, and a drifted financial cycle have provided the conditions for the eruption of the financial crisis;

- the slowdown of the global economy was obvious before the eruption of the financial crisis;

- structural factors have changed the propensity for investment and saving . Against this background, real interest rates have turned much lower since long;

- over-indebtedness is a huge burden; it may be softer in the US where capital markets are well developed, whereas the EU relies heavily on banks, with their overloaded balance-sheets. Deleveraging is a lengthy process;

- when inflation is so low, central banks may need negative policy rates to produce negative real rates –this is a big novelty in today's world;

- income inequalities create tensions in society; this is fueling populist and protectionist movements in both developed and emerging economies;

- can new technologies bring in a new upswing? It is not impossible, but it is time consuming given that debts are high, the financial sector is still fragile, and there are numerous tail events, big uncertainties. Moreover, new technologies may destroy more than crerate jobs, at least in the short and medium run;

- global economic conditions are extremely unusual (the New Normal), fueling great confusion and uncertainties;

- limits of cognitive models are increasingly clear and policies are navigating unchartered waters; but we can take comfort that a generalized Great Depression was avoided, at least until now.

We need to bank on the reinvigorating force of the entrepreneurial spirit and pragmatic policies (some would call them non-standard). There may be a recovery underway, be it a very slow one.

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Jean-Claude TRICHET

Thank you very, very much indeed, Daniel.

We are fascinated by the concentration that Professor Daianu was operating, and I guess that you will have a lot of questions on much of what was just mentioned, including of course today’s challenges, so thank you so much.

Can I ask you whether it would be the privilege of the panel to have a copy of your slides?

Daniel DAIANU

They are available, and I have another one as well on FinTech and financial markets but in my second intervention I will deal with that.

Jean-Claude TRICHET

Thank you very much indeed.