OLIVIER BLANCHARD

Former President of the American Economic Association, former Chief Economist of the IMF

Gabriel FELBERMAYR

I would like to start with Olivier Blanchard, to give us his views on the transatlantic economy, United States and Europe, where we have funny times really, for an economist; we have ultra low interest rates, we have full employment in many countries, in the US for example, Germany, Japan, essentially, and we have almost no inflation, and the big question is, how can we explain that? Is it going to last? What are governments to do about that?

Olivier BLANCHARD

Thank you for the excessively kind and optimistic remarks. It is a pleasure to be back, I always enjoy this meeting, I came last year, and I enjoyed it.

I thought that I would focus my remarks on macroeconomics; rather than geopolitics at least in the first round, and this reflects my comparative advantage. I will focus on the high income economies, as you indicated, as others on the panel are much more competent than me to talk about the rest of the world. I want to focus on what I see as two fundamental forces shaping the economy of advanced economies and, by implication, the world economy.

The first one really does not have much to do with geopolitics, although it is global, and it is the advent of extremely low interest rates, which I think is more than a technical issue. I think it is really a regime change, which is going to have profound implications for policy, and the way policy is made in the next decade or so. The first thing to say is, interest rates are amazingly low; as you know the yield curve, the structure of interest rates looking forward, for the Eurozone is negative for 25 years, which has never been seen before, similar in Japan, and not terribly far from this in the US; this is a global phenomenon and there is every indication that it is going to stay. Some people say, 'Well, tomorrow morning, rates will go up again', but if you look, this is something that really started in the mid 80s and has steadily, taken place over time, and the factors behind are probably there to stay, so I think we have to think of a world in which we are going to be exposed to very low interest rates.

Why is this important beyond macroeconomics, beyond just the narrow aspect? It is because it has implications for monetary and fiscal policy. Monetary policy has been the instrument that governments have used over the last 40-50 years to try to maintain the economy at full employment or something close, but we have come to the end of what monetary policy can do. You saw it in the discussions that took place in the Eurozone two weeks ago; there is an increasing notion that central banks have done everything they can, and therefore, monetary policy cannot be used much further. The main instrument that governments have had to, basically, counter fluctuations is not working, and so the question is, what else do we have? Fortunately, what makes things really bad for monetary policy makes things really good for fiscal policy: the cost of borrowing and the economic cost of deficits are very low, therefore there is more fiscal policy space. The big issue is that, from the policy point of view, monetary policy and fiscal policy are conducted in very different ways; the second process being more political and more complex, and I think that the issue we are going to face is whether fiscal policy is going to be used correctly, and there is a risk that it will not be. This shift from monetary to fiscal policy is not the only implication of low rates. There are implications for inequality, for example, if you are a saver and you rely on bonds as your income, you are in trouble, and this has political implications. That was the first force I wanted to talk about. It is not related to China, although China's saving has played a role in the low rates, but it is really something we must think about.

The second force that I want to talk about is this nexus between inequality, populism, and protectionism, which gets us closer to issues related to China. The facts on inequality are really striking. Inequality, measured in all kinds of ways, had decreased until the 1980s in most advanced economies, and it has turned around to different degrees; in the US, obscenely so; in France, actually, not very much, but the perception of people is that inequality matters a lot and therefore, even in France, it is a major issue, and this is going to bring a number of push backs, reactions, which may be tractable or intractable. It is going to lead to a push back in terms of capital taxation; I think we must be ready for a world in which wealth is going to be taxed more heavily, rich corporations are going to be taxed more heavily, and this may happen smoothly or not. The OECD just came out with a plan to have corporate taxation organised at the global level, which is progress. More generally, capital is not going to have it easy, and that has both economic and political implications.

The final one I want to focus on is the protectionism aspect, the trade wars, which clearly is not only triggered by inequality, but is part of a general reaction against the way things have been running, and here I want to make several points. The first one is, the mechanical effects of tariffs, is actually, from a macroeconomic point of view, not a big deal; when tariffs are put in, you have changes in relative prices but they do not do a whole lot. In a typical country, exports go down, but imports go down as well, which means more comes from domestic production. So you have foreign demand decreases, domestic demand increases; reallocation of resources is costly, but not catastrophic. If we agreed to increase tariffs, once and for all, I would not like it, but it would not be the end of the world and it will not create a recession.

What is far more worrisome, in the short-run, is the induced effect on investment, which comes, not so much from the tariffs but, from the uncertainty which has come with the trade wars with international relations. If you do not know whether there is going to be a tariff on Country X or on Good Y, and you have to decide where to build a plant, you, basically, wait. Now, from your point of view, waiting three months or six months is not a big issue, but when, many firms do this, you can have a collapse of investment due to the option value of waiting. It can be very costly, which is what we are beginning to see to different degrees. We have seen it; it took a while to happen in the UK with Brexit, but it is happening, basically, firms are just waiting; waiting for the next elections in the US, waiting for various things. In the short term, this is something that worries me.

In the long run there are big effects from trade wars and tariffs; we are seeing global trade decrease and, really, what we are seeing, in effect, is deglobalization. Not only because of tariffs, but security issues; you may not want to import refrigerators if they have some embedded component which allows some foreign country to know what is in your fridge, we may ban imports of fridges. So we may see a drastic decrease in trade. Carbon taxation is not going to help; it will become more costly to have goods travel large distances. Political uncertainty may make you want to deal with suppliers in countries close to you rather than in Asia, for example. I think all this may well happen, and this has major implications; in the short-term, I am not sure.

I will finish with what people ask me these days, which is, 'Well, are we going to have a recession?'. I think I have implicitly given my answer, which is we are probably going to get an effect on investment, which then may lead to pessimism and consumption going down, so it could happen. I do not think this will be the case in the US because we have an administration who seems quite indifferent to spending, and therefore, my guess is that, if needed, we shall see a fiscal expansion. I am more worried about Europe, where fiscal has many more strings attached, and I am not sure they will do the right thing; my guess is there will be a slowdown but probably not a recession, but there is a clear downside risk that things turn out worse.

Gabriel FELBERMAYR

Thank you very much. Talking about Germany, at the Kiel Institute we believe that we are in a recession; the third quarter in Germany had negative growth, the second quarter too, so technically speaking, we are in a recession in Germany already, and that, of course, is a drag on the entire Eurozone and EU economies.

I have seen that Naoki Tanaka wants to jump in, and why not? I have my order, but I am flexible, and seeing how eager you are to comment, please, go ahead.

Naoki TANAKA

May I comment on the effectiveness of monetary policy which Professor Blanchard presented?

Japanification of monetary phenomena are now spreading in the world, in Europe and North America. When we see the [inaudible] interest rate, I am reminded that John Hicks spoke about an almost zero natural rate of interest. Mr. Hicks mentioned the bad harvest in Ireland in the 19th century, when farmers did not want to borrow money in order to sow seeds, which is the phenomena where the natural interest rate is almost zero. Monetary policy did not work at that time, and this is the situation we now observe, and in this situation fiscal expenditure will be very important if we face a very deep recession, and this month the Japanese government has raised the consumption tax rate to face the next very difficult situation. In the very near future, monetary policy will not work in developed countries so other measures should be considered if we must face the very difficult situation of the management of demand. That is my understanding.

Gabriel FELBERMAYR

Thank you, Naoki. I think there is quite some consensus here, at least between the two of you, that fiscal policy has more to do, and certainly in Europe.