The Stamp Memorial Lecture 2017 hosted by the Department of Economics and the Centre for Macroeconomics

The State of Advanced Economies: forces, interactions and uncertainties

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State of the Advanced Economies: Forces, Interactions, Uncertainties

Stamp Lecture, LSE

Olivier Blanchard
Three main forces at work

1. Legacies from the financial/euro crises.
   Fading, but unevenly across countries

2. Lower current and prospective productivity growth.
   Important even in the short run.
   Demand effects fading.

3. Political uncertainty, and shades of populism.
   Translating into macro uncertainty?

   • Interactions: A better but still mediocre baseline

   • Uncertainties. A highly uncertain baseline.
1. Legacies from the (acute phases of the) financial and euro crises

- High private debt (largely from before the crisis)
- High public debt (largely from during the crisis)

- Why high debt matters. Asymmetry debtors/creditors
- Initial adjustment: Fiscal consolidation, deleverage, private saving
  - Dominated 2010-2014. Largely over.
- After the initial adjustment
  - Interest and growth sensitivity. Still very relevant

- Countries most exposed
  - Japan: At potential, but with extremely high debt
  - Euro periphery. Far from potential, with high debt
Household debt level (% disposable income)

USA
Euro area
Spain, Portugal and Italy
United Kingdom

Source: OECD
Government debt level (% GDP)

Source: OECD
Change of general government structural balance (Percent of potential GDP)

Source: IMF WEO, October 2016
2. Lower productivity growth

Very low during the crisis. Not very surprising.

But also very low since then, despite recovery: Unusual.

True for nearly all advanced economies *

Magnitude of revisions in potential growth: Substantial

CBO US estimates. * More than 1% decline since 2002
About 0.5% decline since 2012.
Growth of GDP per hour worked, constant prices
5-year moving averages

Broad advanced country average (unweighted)  France  Germany  Japan  UK  US
Long run potential growth
(CBO forecast)

Source: Congressional Budget Office
Could it be measurement error?

- IT sector badly measured, especially software. But
  Still small sector.
  Also, more IT produced abroad. No effect on US productivity

- A lot of measurement problems in intermediate goods.
  Does not matter for overall productivity.

- A lot of improvement in quality of leisure.
  Not part of market economy. Not measured in GDP

- But what about health care, transportation?

- Probably understates the level, but unlikely to explain the decrease since
  the crisis.

- What if growth were in fact higher? Perceptions matter. Would
  populism be as successful?
What about future productivity growth?

- Innovation continues apace. (although becoming more expensive)
- At the frontier, productivity growth comes in bursts. 1995-2005.
  - Low correlation from decade to decade

The meta discussion:

- The end of major discoveries: Gordon, *
- The era of technological breakthroughs
- Robots, and the end of work. Perceptions and reality.

Why does all this matter today? Anticipation effects:

- Weak demand in anticipation of a mediocre future
- Explains why we have had weak demand growth despite zero rates
- If no further bad news, demand should/will recover partly.
3. Inequality, populism, and political risks.

Political surprises. Brexit, US elections, shifts towards populism,

Sources: Inequality? In part, but a complicated story
United States versus France. * *

Implications?

• The Trump incarnation. Non standard. Pro-business, checks and balances
• The risk of more traditional populism elsewhere?
Income inequality in the USA, 1920-2015

Income inequality in France, 1920-2013

Graph provided by www.xd-world
Income inequality in the United Kingdom, 1918-2012
The evolution of relative wages: United States versus France

US: Evolution of Relative Wages, by Education Level, 1973-2012

France: Evolution of Relative Wages, by Education Level, 1990-2012
Evolution of relative wages in the UK

Percentage hourly pay gap to employees with GCSE or equivalent level of education, age 22 to 64

Source: Office for National Statistics, Earnings by Qualification
Macro implications of Trump policies. Uncertainty

Fiscal policy. Administration versus Congress
   Infrastructure, tax cuts versus deficit hawks
   Corporate tax cuts and some deregulation
   Best guess: Some increase in deficits

Monetary policy. Two levels of uncertainty.
   Reaction function of the Fed to deficits?
   Governance at the Fed? Hawks versus doves

Trade policy. Trade wars or symbolic wars?
   Trade war tools. Old: Tariffs
     New: Dislocation of global supply chains

Big issue: Effect of uncertainty per se? *
Economic Policy and Financial uncertainties

Sources: Policyuncertainty.com, Haver analytics

- News_Based_Policy_Uncert_Index
- Global EPU Index with PPP-adjusted GDP Weights
- VIX
Putting it together. Baseline

• Slow fading of financial crisis legacies
  Debt ratios will decrease very slowly
  But they are not constraining demand

• If no further downward revisions of medium term growth
  End of short term demand adjustment

• Trump fiscal expansion, cum higher uncertainty.

• Medium term: Remaining low potential growth.

All imply:
  Stronger demand growth in advanced economies in 2017-2018
  Increase in interest rates. More so in US
Growth rates (current and IMF forecast)

Source: IMF WEO, October 2016
Putting it together. (Two) Risks.

In a high debt (D) environment, what is crucial is the joint movements in growth (g), and the real interest rate (r).

The risk of stronger demand, and higher interest rates.
   Interaction with high public debt
      Danger in Euro periphery
      Danger in Japan

The risk of stronger productivity growth
   Likely to come with interest rates also.
   If g, r move together, roughly neutral for debt ratios
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