

Deutsche Asset Management | Frankfurt, 20 June 2017
Global Investor Seminar 2017

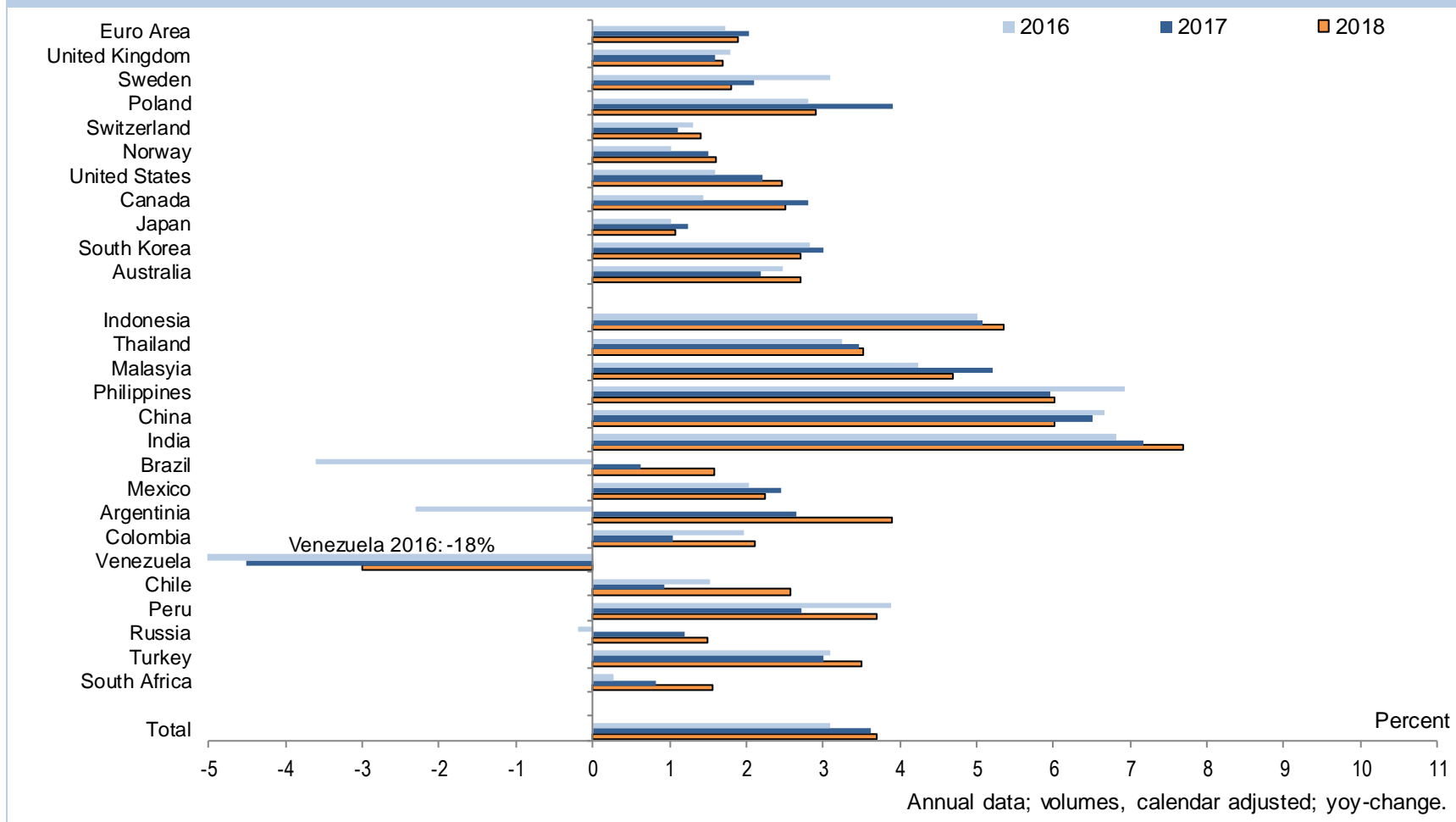
Policy Response to Slow Growth and Structural Change

Stefan Kooths
Forecasting Center



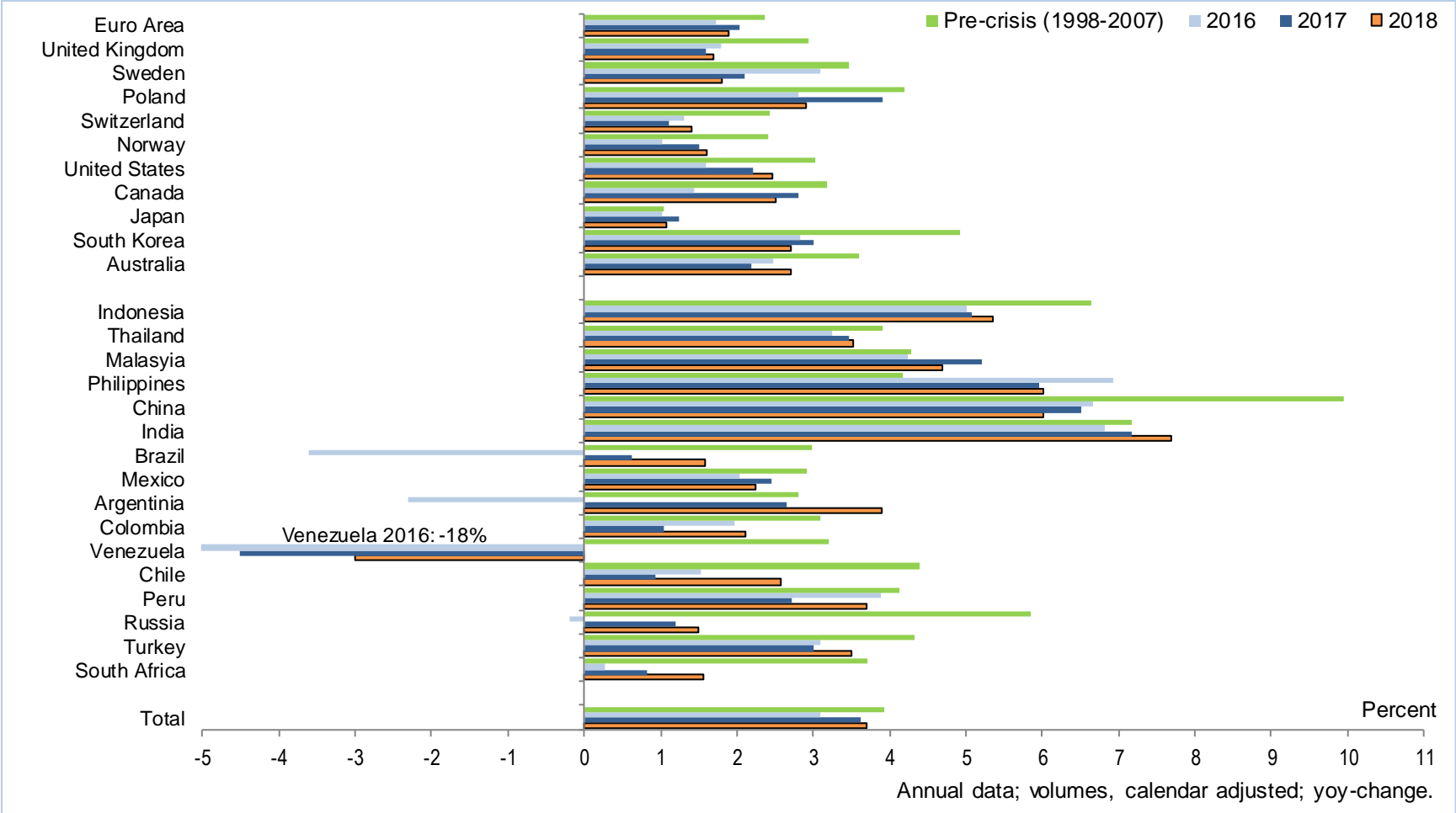
Global growth gaining momentum ...

Gross Domestic Product in Advanced and Emerging Economies



... but falls short of pre-crisis rates

Gross Domestic Product in Advanced and Emerging Economies



■ Structural Reforms

- » Even more important as economies are aging ...
- » ... but remain unpopular

**Structural
reforms**

■ Monetary policy

- » Did (more than) enough
- » Increasing negative side-effects

**Monetary
policy**

■ Fiscal policy

- » Back on stage? „Keynes put“?
- » Sustainability issues

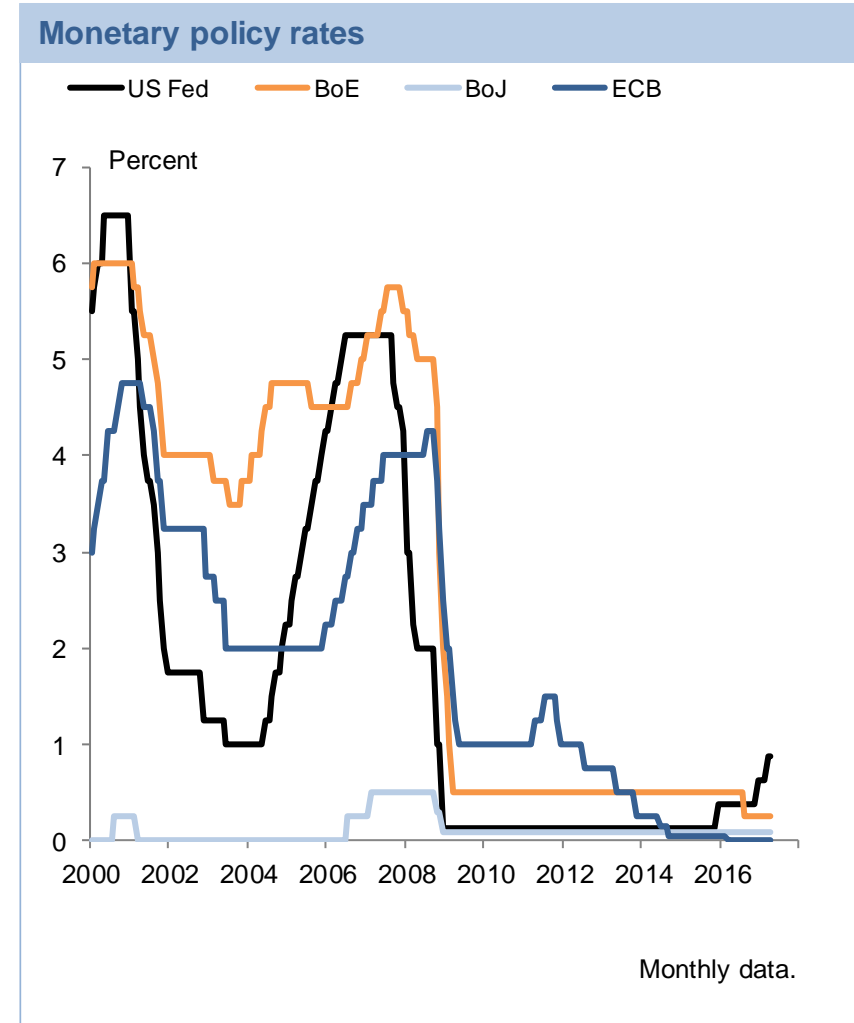
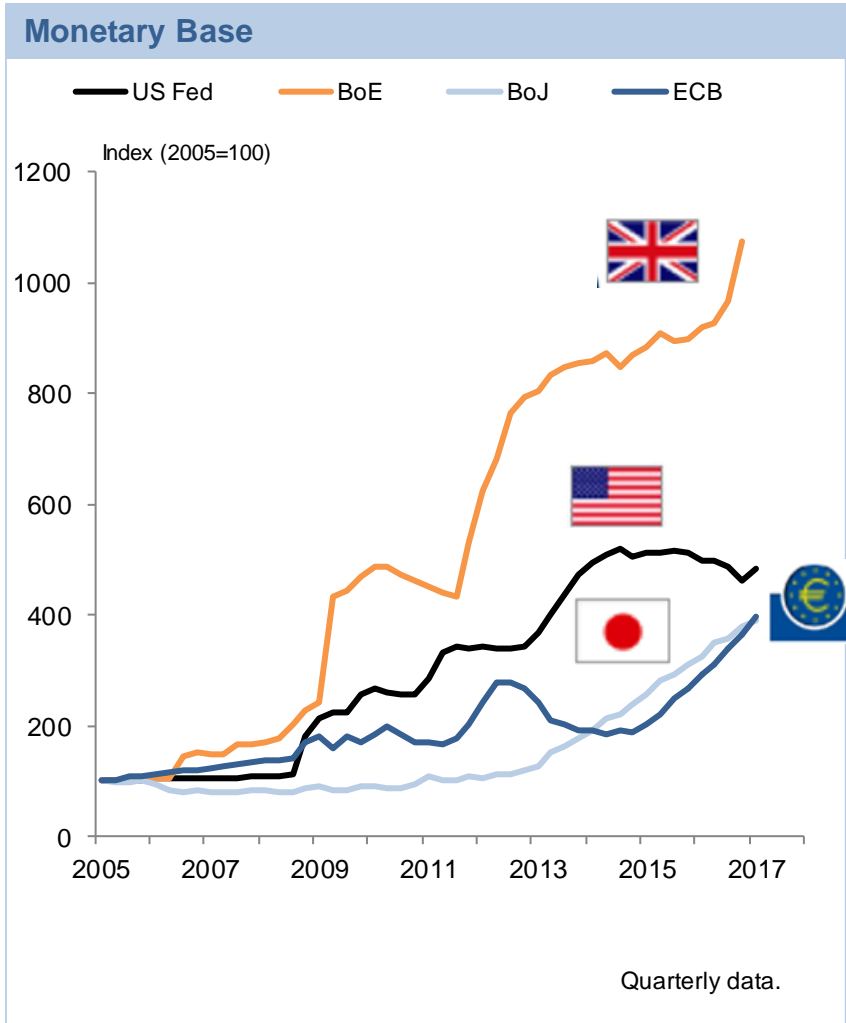
**Fiscal
policy**

■ Neo-protectionism

- » Beggar-thy-neighbor gains momentum
- » Popular, but destructive

**Neo-
protectionism**

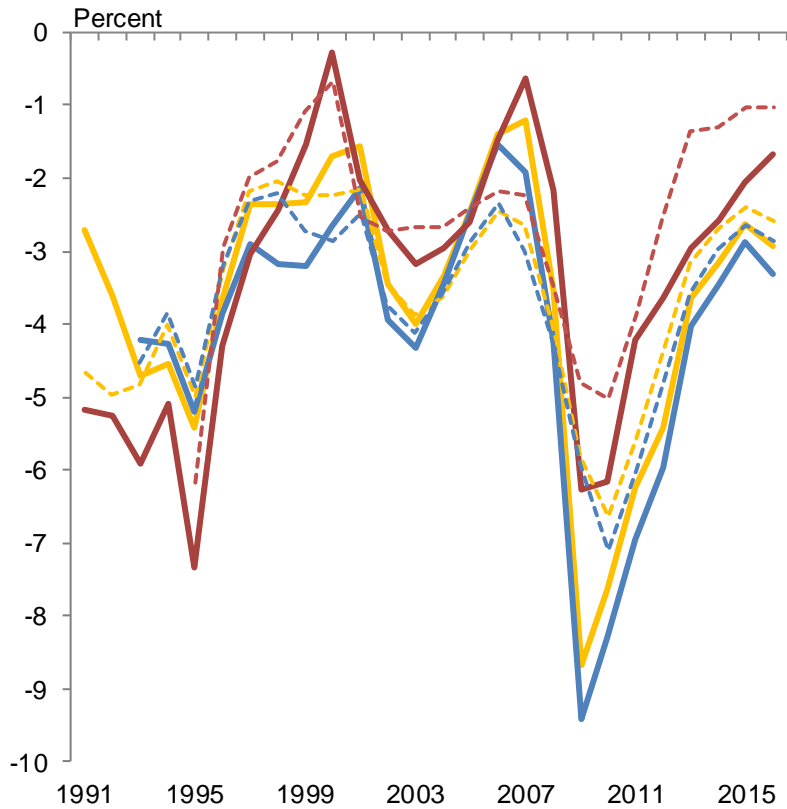
Monetary policy hits limits ...



... as does fiscal policy

Net Public Lending

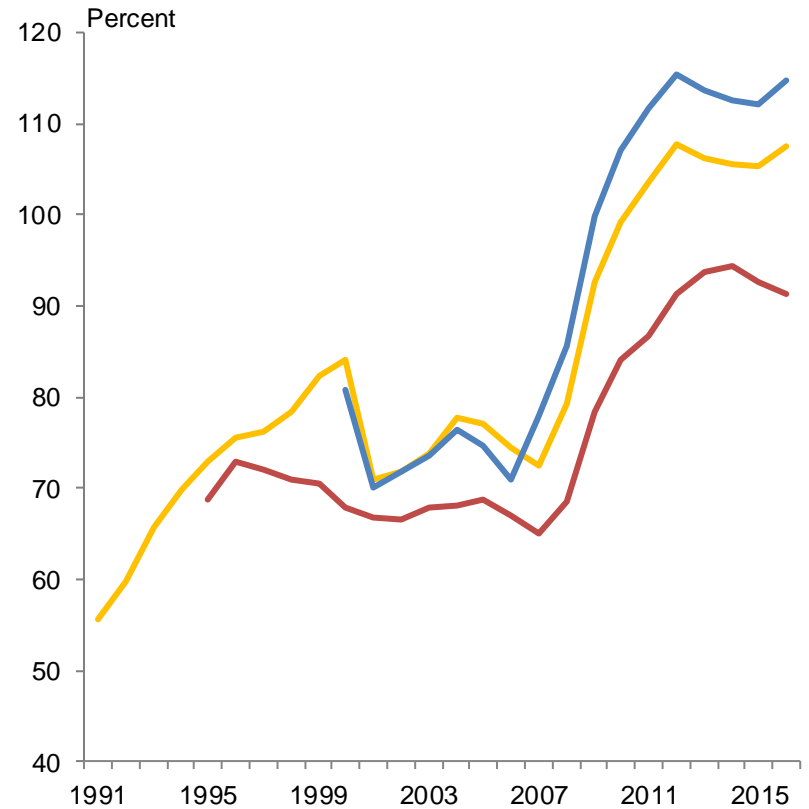
Advanced Economies G20 EMU



Annual Data. In relation to nominal GDP; Dotted lines: Cyclically adjusted.
Source: IMF, Fiscal Monitor.

Gross Government Debt

Advanced Economies G20 EMU

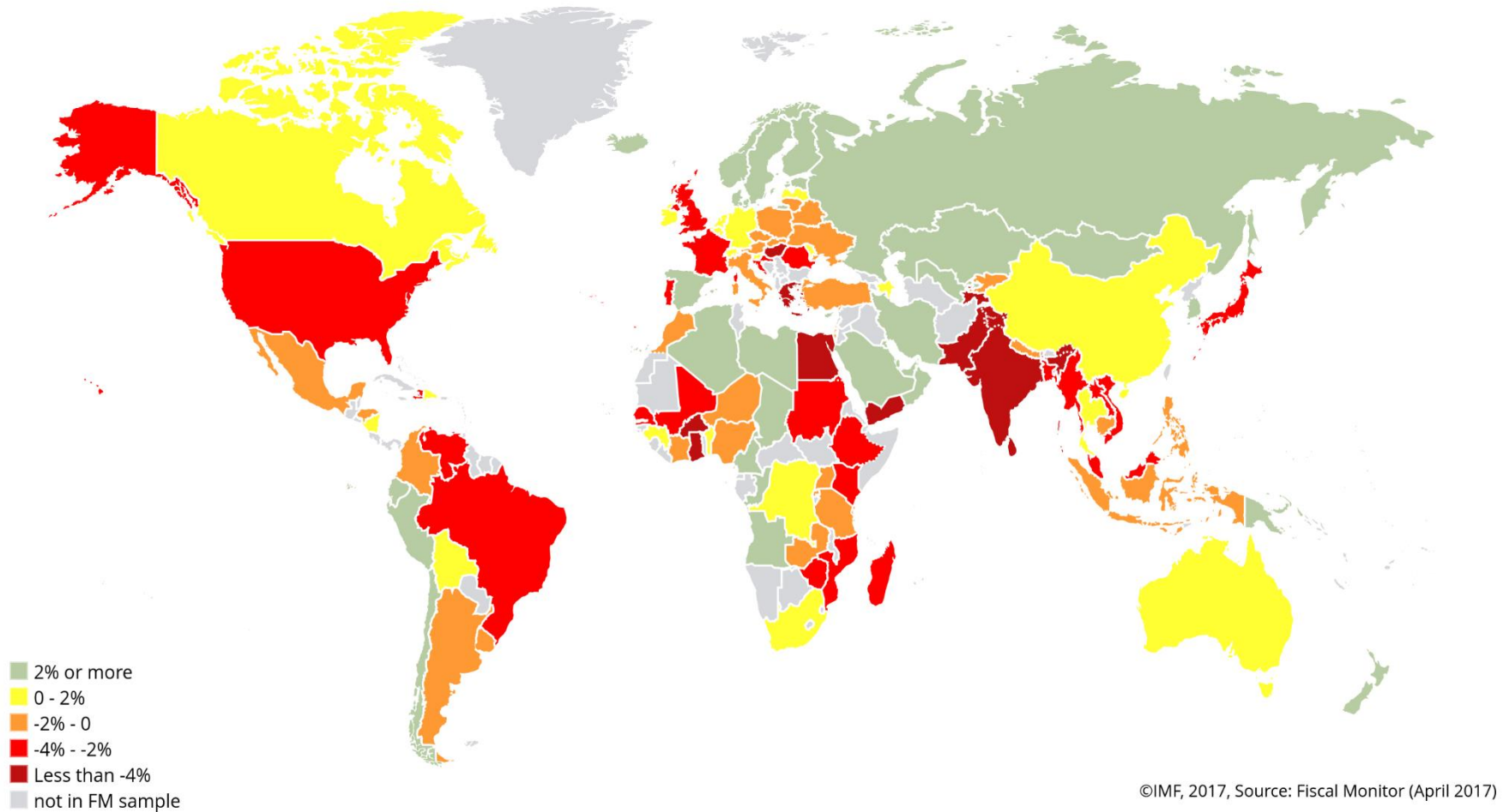


Annual Data. In relation to nominal GDP.
Source: IMF, Fiscal Monitor.

Fiscal stance 2007 (pre-crisis)

IMF DataMapper

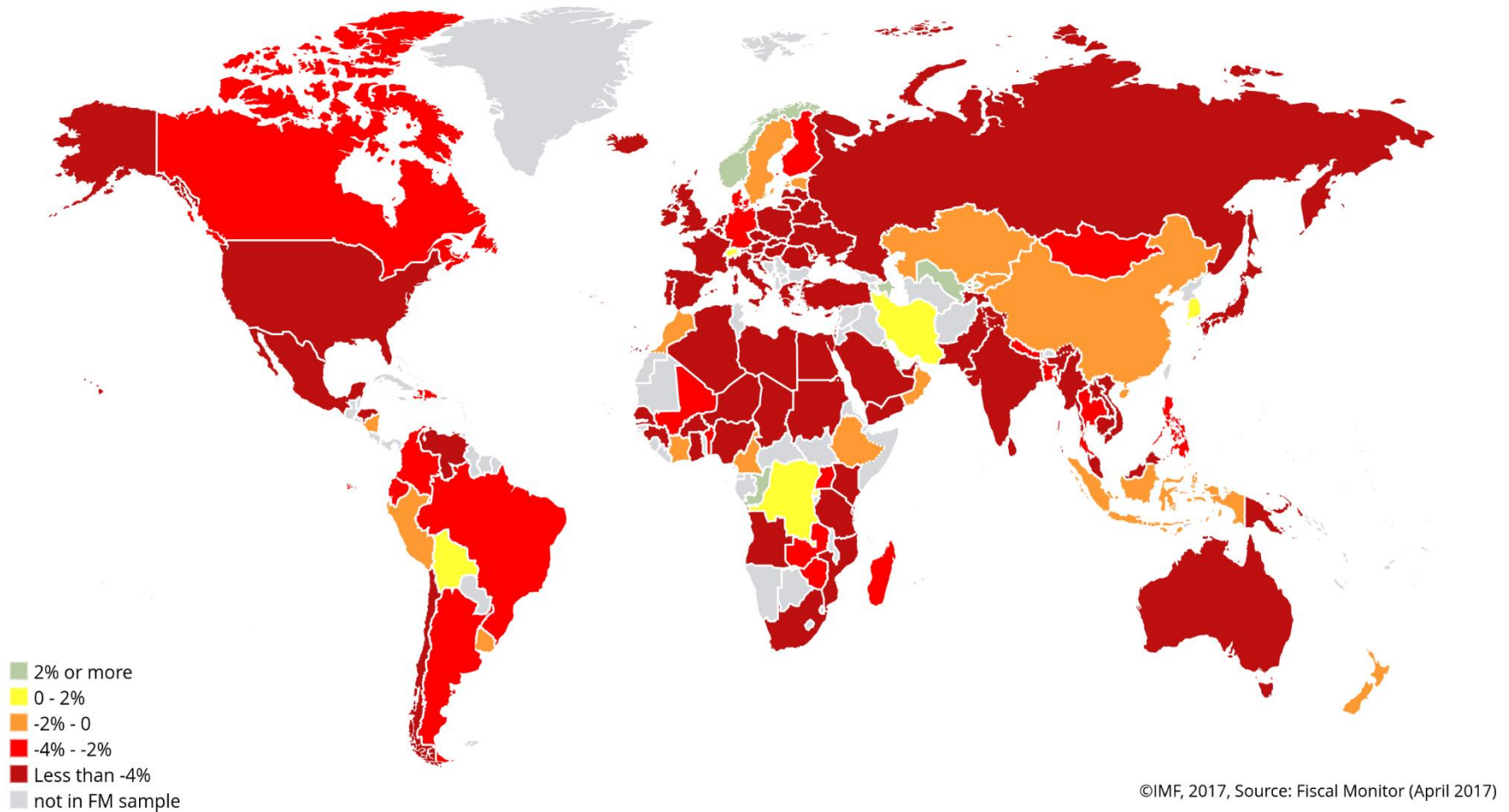
Net lending/borrowing (also referred as overall balance) (% of GDP, 2007)



Fiscal stance 2009 (in crisis)

IMF DataMapper

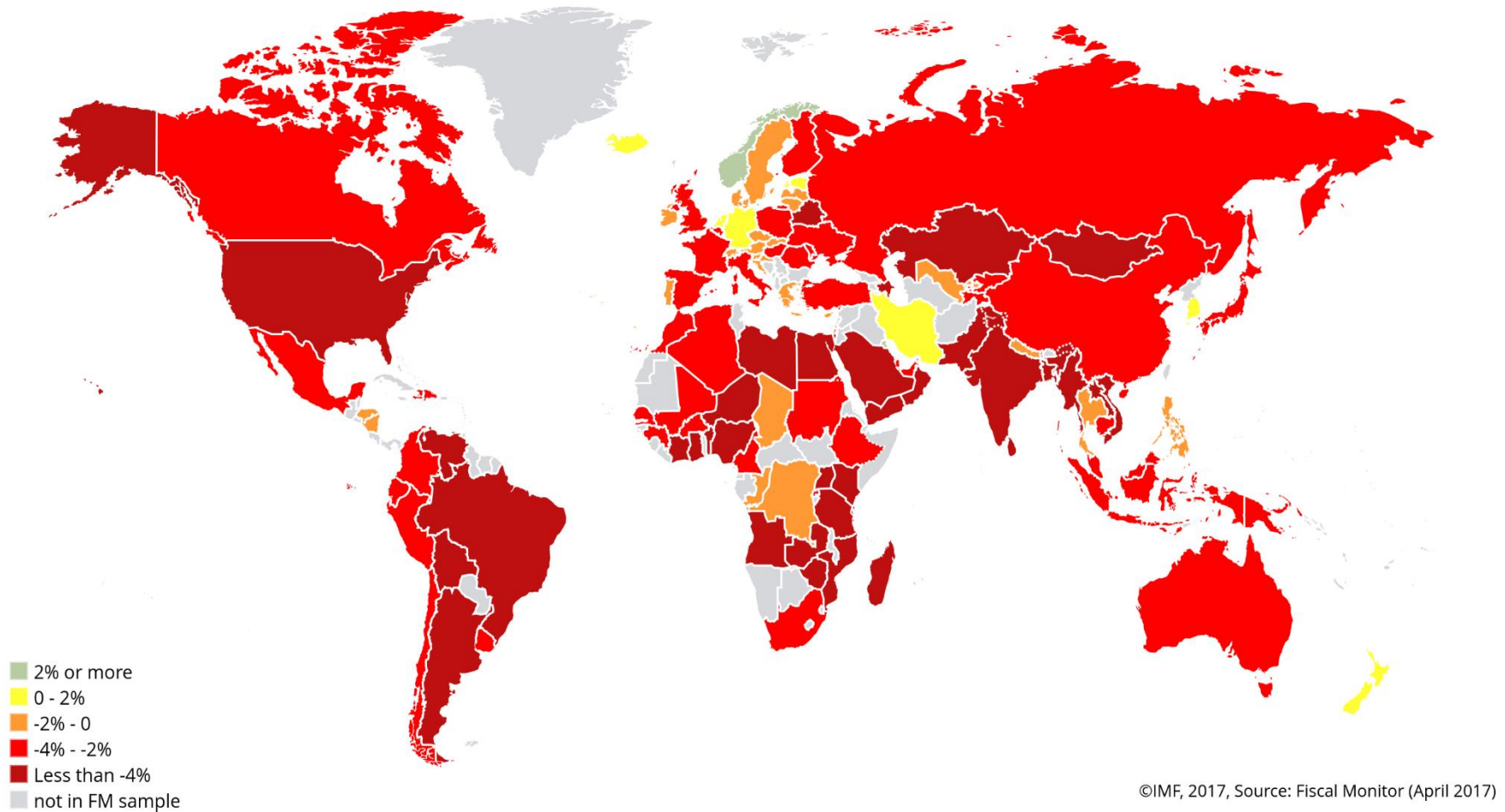
Net lending/borrowing (also referred as overall balance) (% of GDP, 2009)



Fiscal stance 2017 (post-crisis?)

IMF DataMapper

Net lending/borrowing (also referred as overall balance) (% of GDP, 2017)



■ Structural Reforms

- » Even more important as economies are aging ...
- » ... but remain unpopular

**Structural
reforms**

**Overstretched macro-management
(core problems are non-cyclical)**

**Monetary
policy**

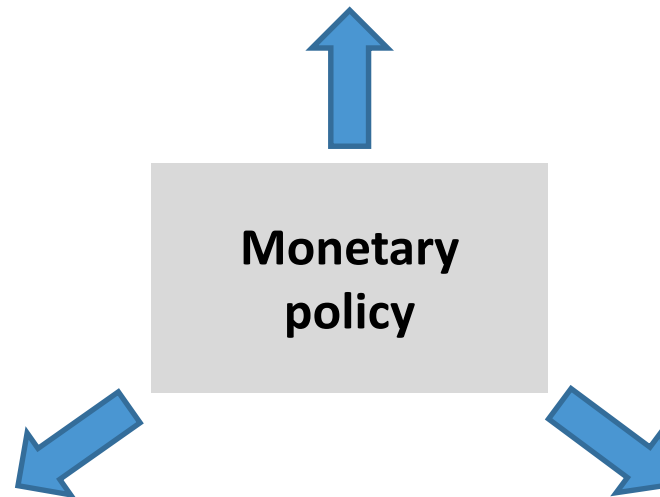
**Fiscal
policy**

■ Neo-protectionism

- » Beggar-thy-neighbor gains momentum
- » Popular (but destructive) temptation

**Neo-
protectionism**

Money-policy-nexus



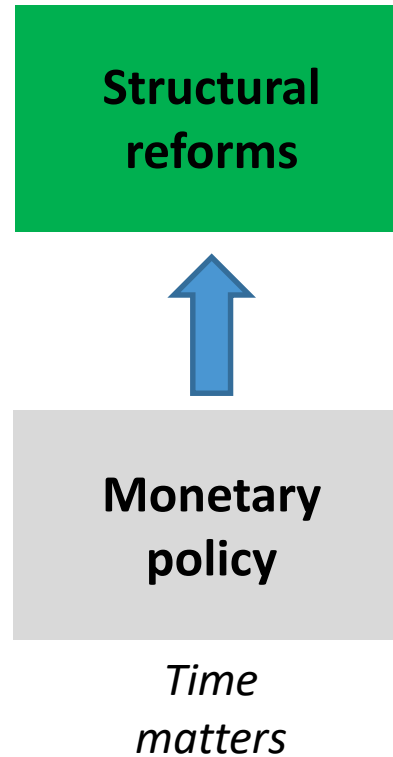
**Structural
reforms**

**Monetary
policy**

**Fiscal
policy**

**Neo-
protectionism**

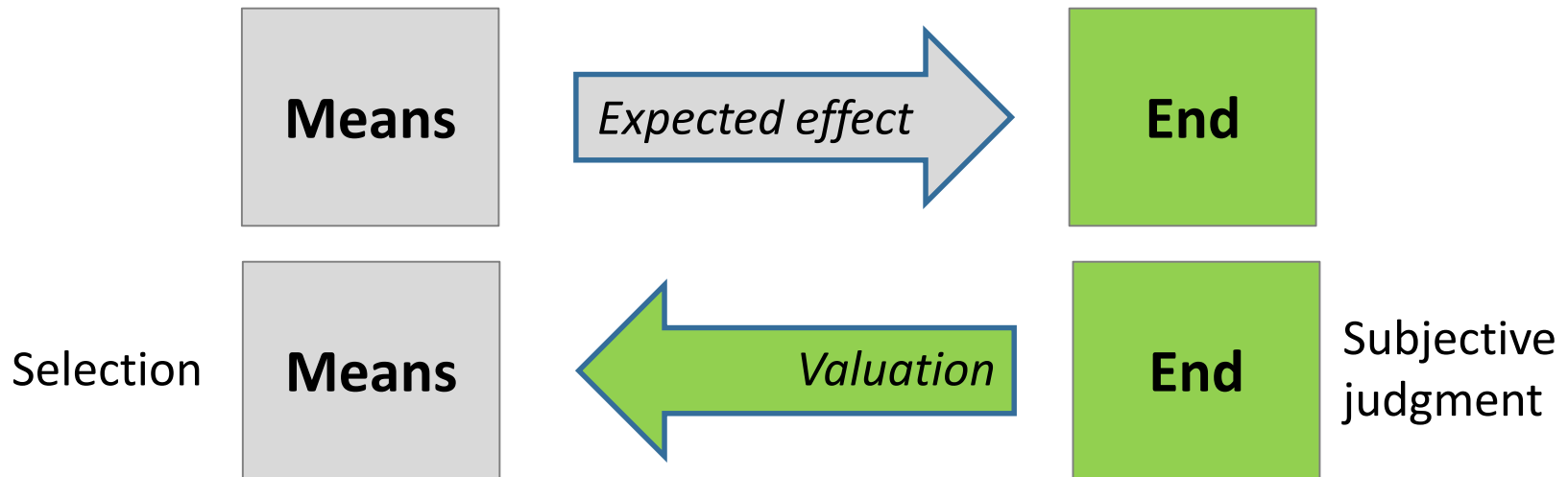
The Non-neutrality of money



Interest rates ...

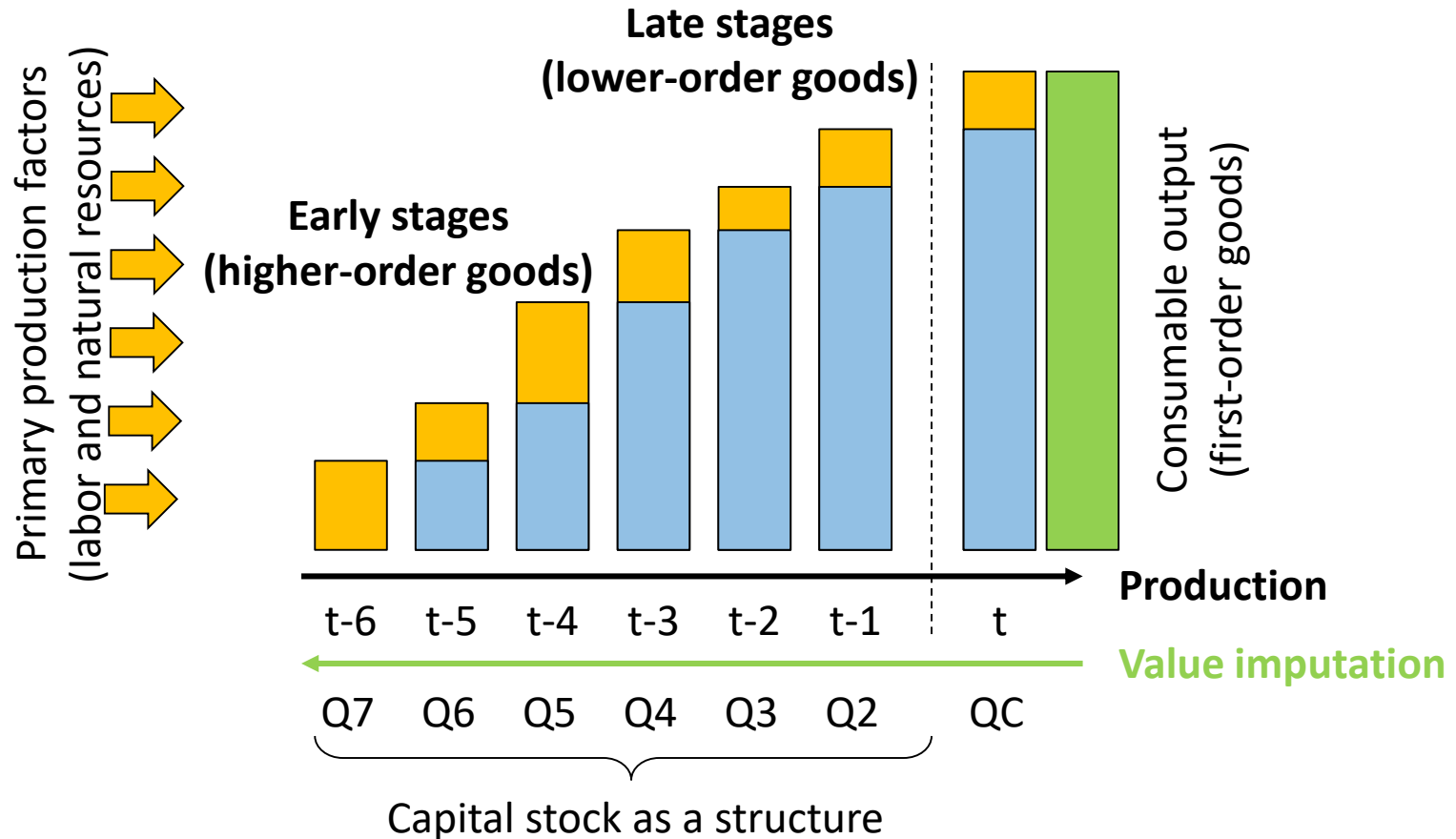
- ... just another instrument for macro-management?
 - ... or the key price relation within the market system?
 - » Time preference
 - » Coordinating savings and investment
 - » Component of all prices for goods and services (relative prices)
 - » Impact on capital/production structure
- ⇒ „Capital gives money time to cause trouble.“ (Garrison)

Human action: Means, ends, and values



- Reverse value imputation
 - » The end may not „sanctify“ the means, but it **values** it!
 - Limited knowledge
 - » Action under uncertainty (= speculation)
 - Rationality
 - » Humans do not purposefully act against their aims
- ⇒ **Final purpose of economic activity: Consumption goods**

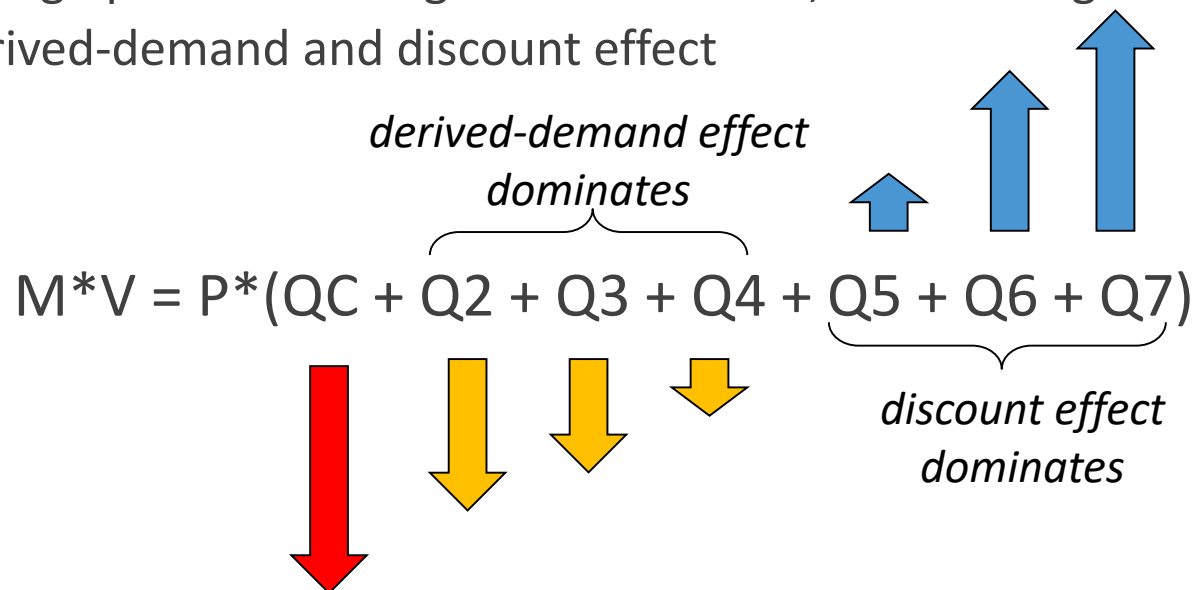
Production: A time consuming, multi-stage process



⇒ **Capital formation: intertemporal intermediate consumption**

- Saving

- » Saving up for something: Future demand, not a leakage
- » Derived-demand and discount effect



- Investment: Stage pattern matters (not volume alone)

⇒ **Entrepreneurial challenge: bringing capital structure in line with pure time preference (intertemporal arbitrage)**

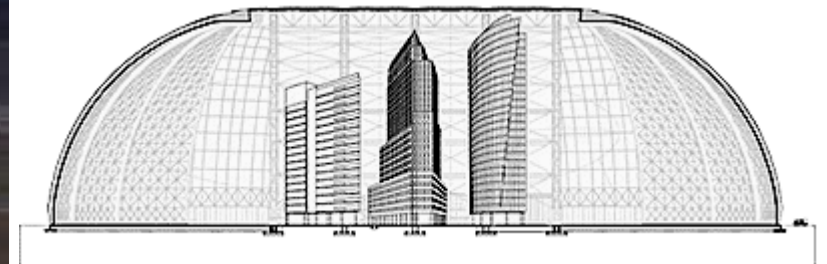
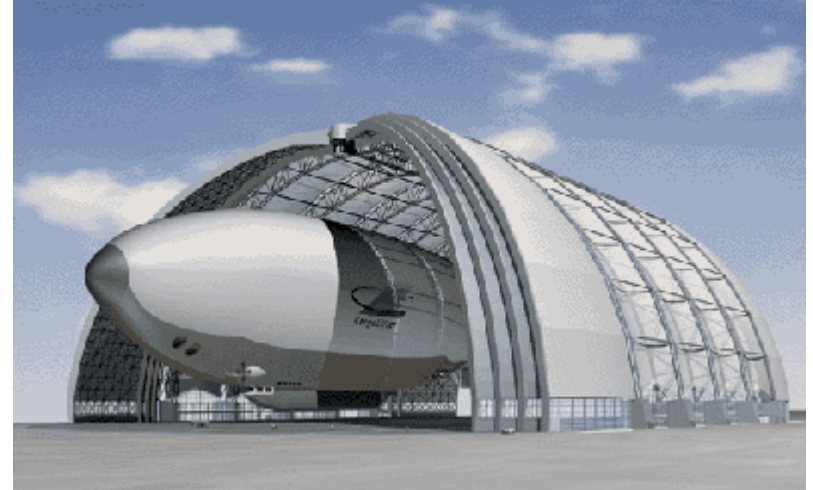
Two types of mal-investments

- **Idiosyncratic: Entrepreneurial ventures**
 - » Wrong expectations of one market participant
 - » Happens every day, no systemic risk
 - » Liquidation, reallocation of resources

- **Pervasive: Expansionary monetary policy**
 - » Systematically wrong expectations of all market participants
 - » Financial crisis (debt crisis = flip-side of heavy capital stock distortion)
 - Fragile financial system
 - Excess debt positions destabilizes monetary system

Case study Cargolifter

The plan ...



... and the outcome: Tropical Islands



Production cost:

78 million euro (1999/2000)



Liquidation value:

17.5 million euro (2003)

Case study Cargolifter

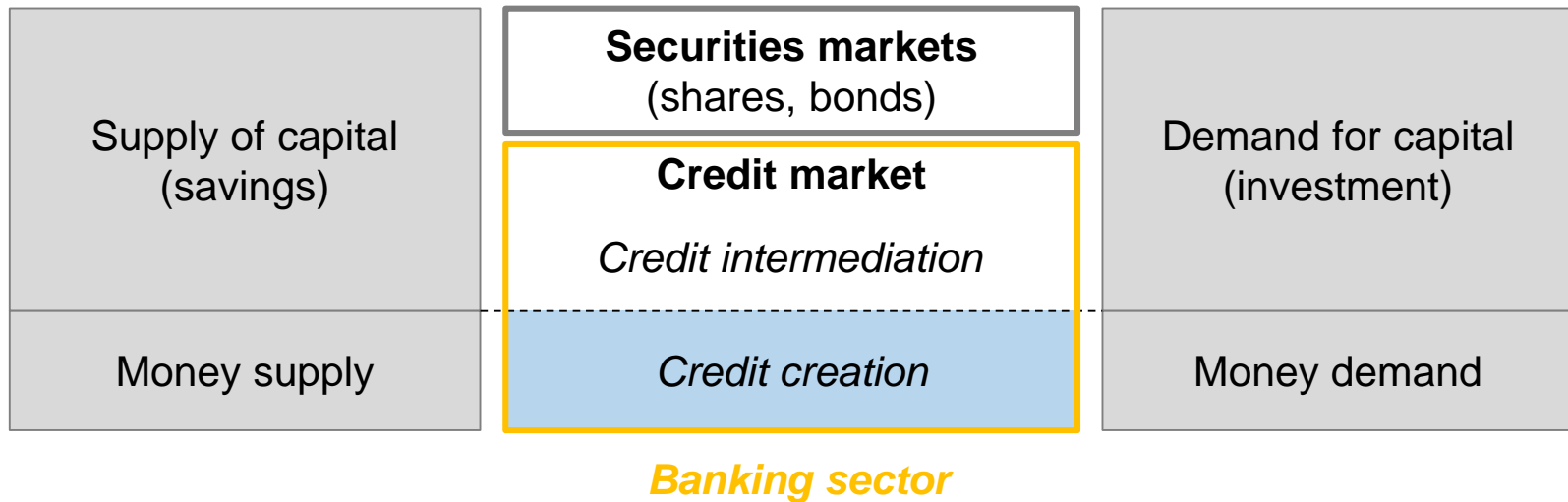
Cargolifter in the national accounts

A hangar is a hangar is a hangar ...

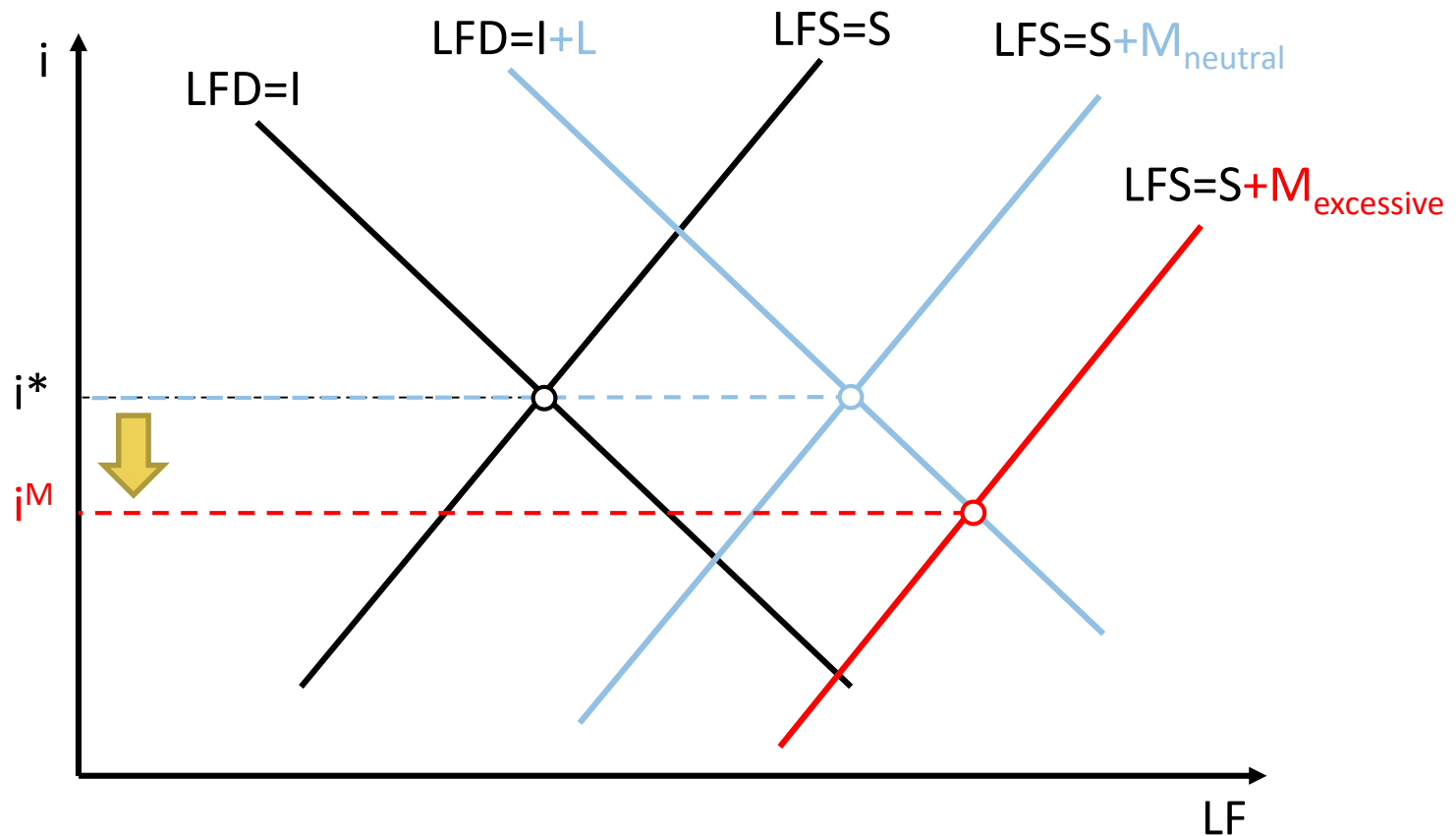
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Interest rate and monetary policy



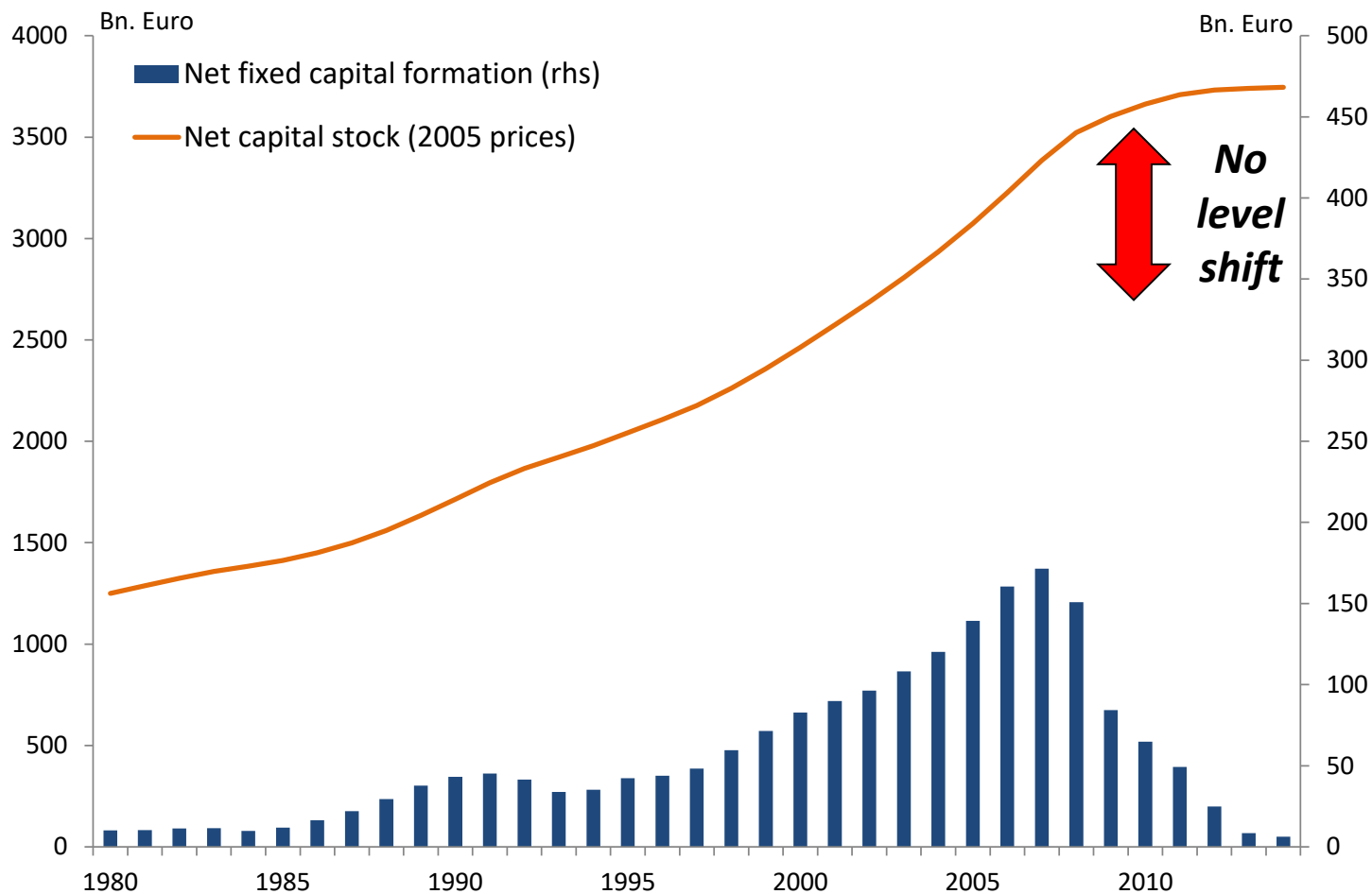
Case study Spain Ghost estates (example: Seseña)



Source: Oli Scarff/Getty Images

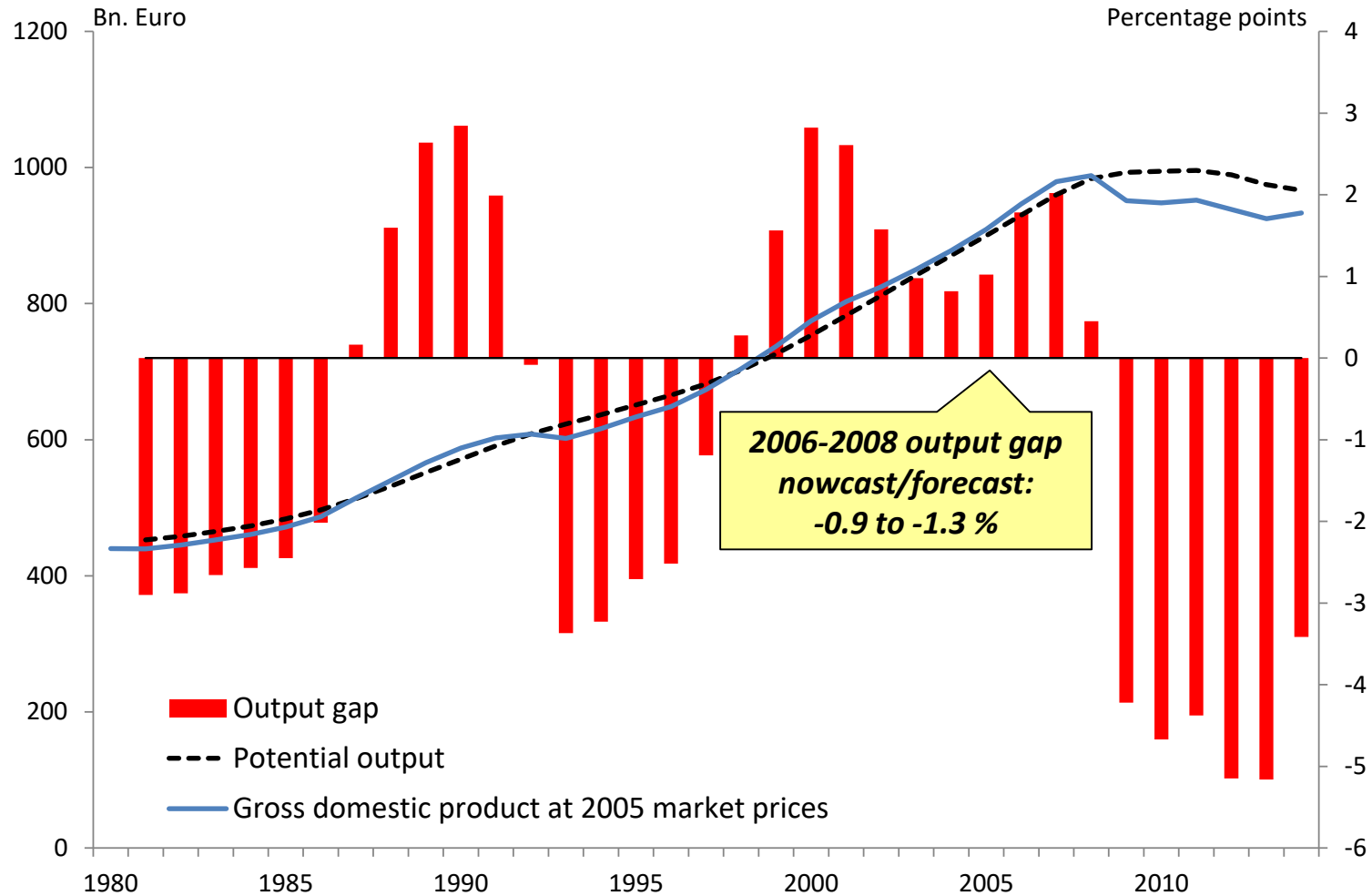
Case study Spain

Value of the capital stock?



Source: AMECO Database.

Ghost estates still part of potential output



Source: European Commission, AMECO and CIRCA databases.

Three options of coping with debt-crises

■ Public bail-outs

- » Shifts private debt to public sector
- » Private debt crisis \Rightarrow sovereign debt crisis
- » No solution for fiscally distressed countries

■ Inflating the debt away

- » Takes a long time, promotes zombification
- » Puts the currency at risk
- » Not targeted towards non-performing loans

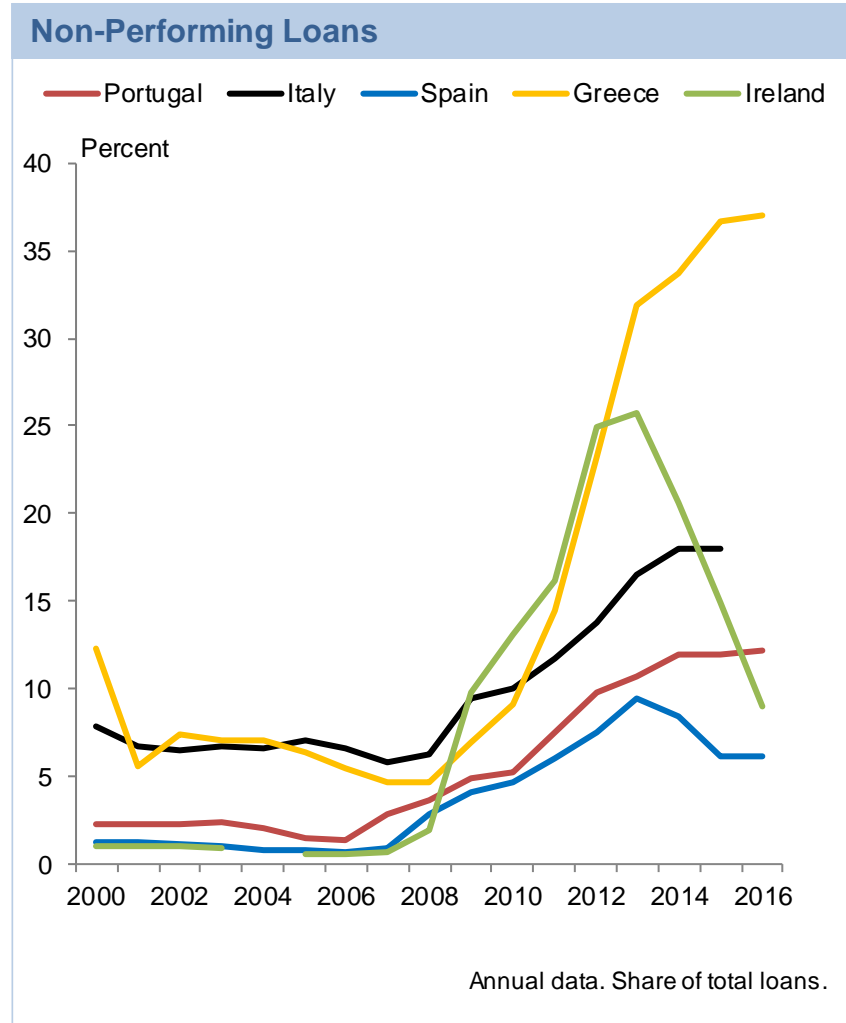
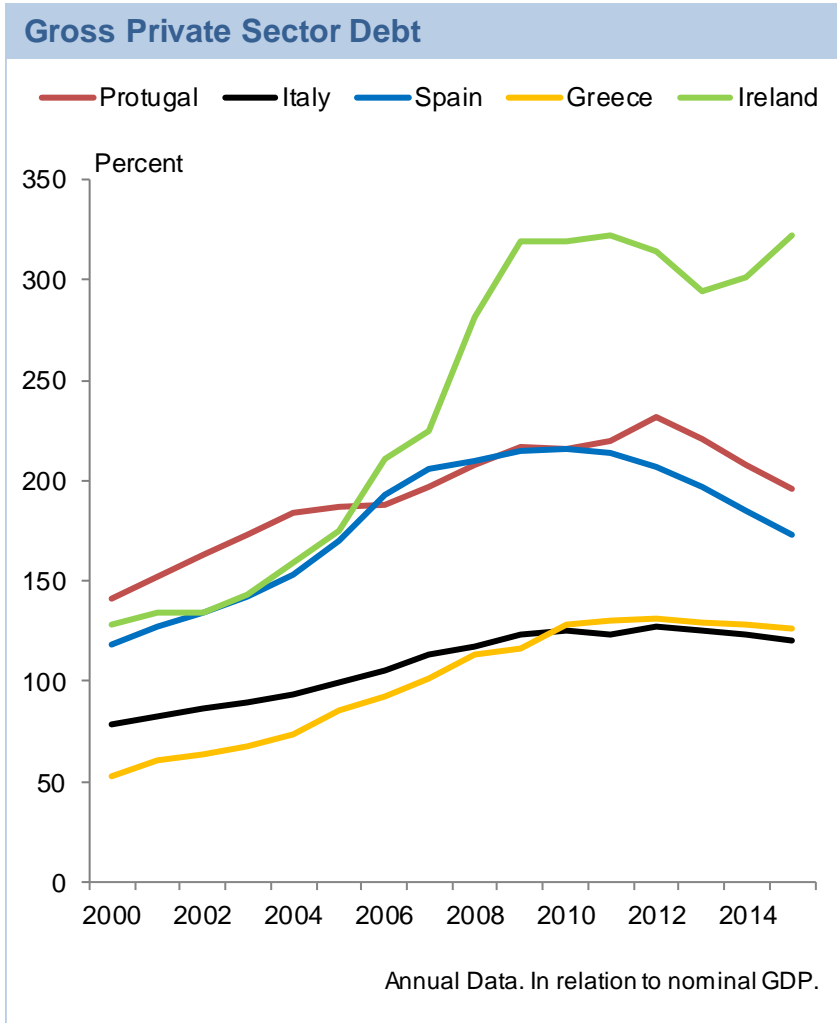
■ Liquidation

- » Tough (cold turkey) in the short-run ...
- » ... but targeted (and root cause oriented)
- » Puts capital at second (now first) best use

**Anti-capitalist
approach**
(harms principle of
accountability,
creates moral
hazard risks)

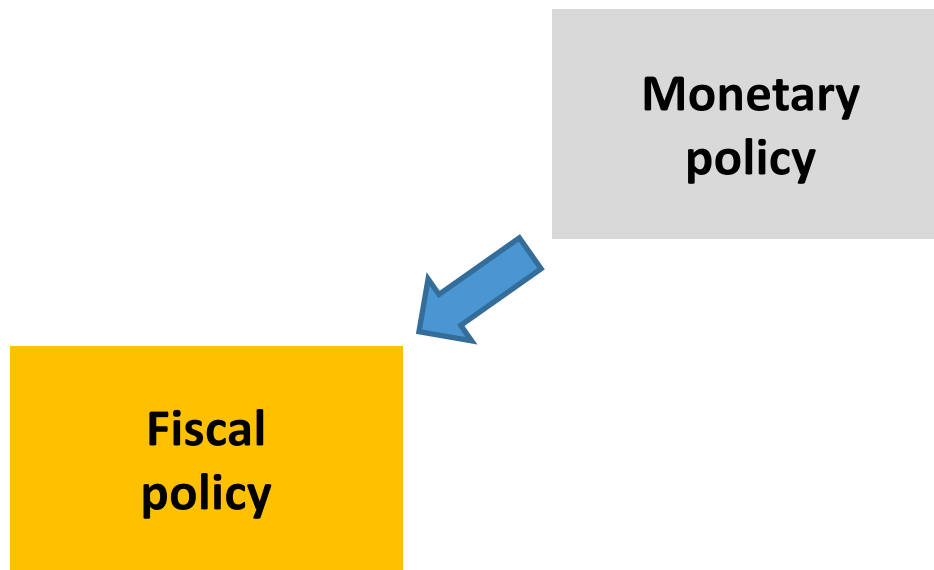
**Capitalist
approach**
(in line with free
market principles)

Flip-side of not liquidating (= “buying time”): Excess debt positions hamper credit channel



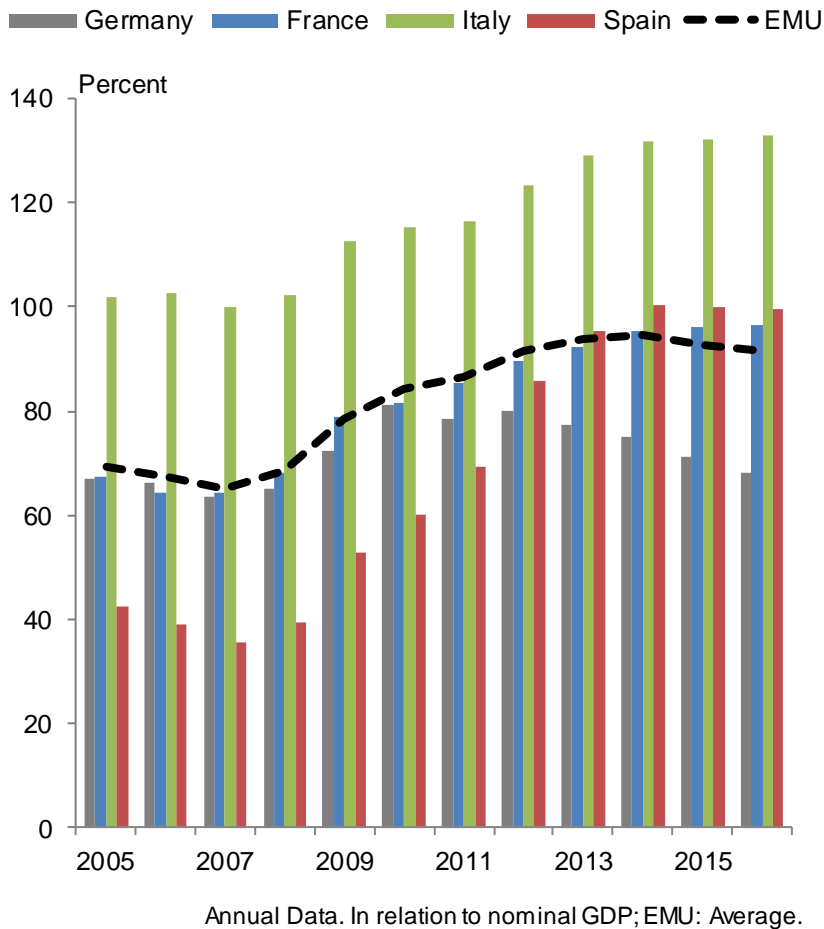
Data source: Bank for International Settlements, World Bank.

Easing fiscal consolidation?

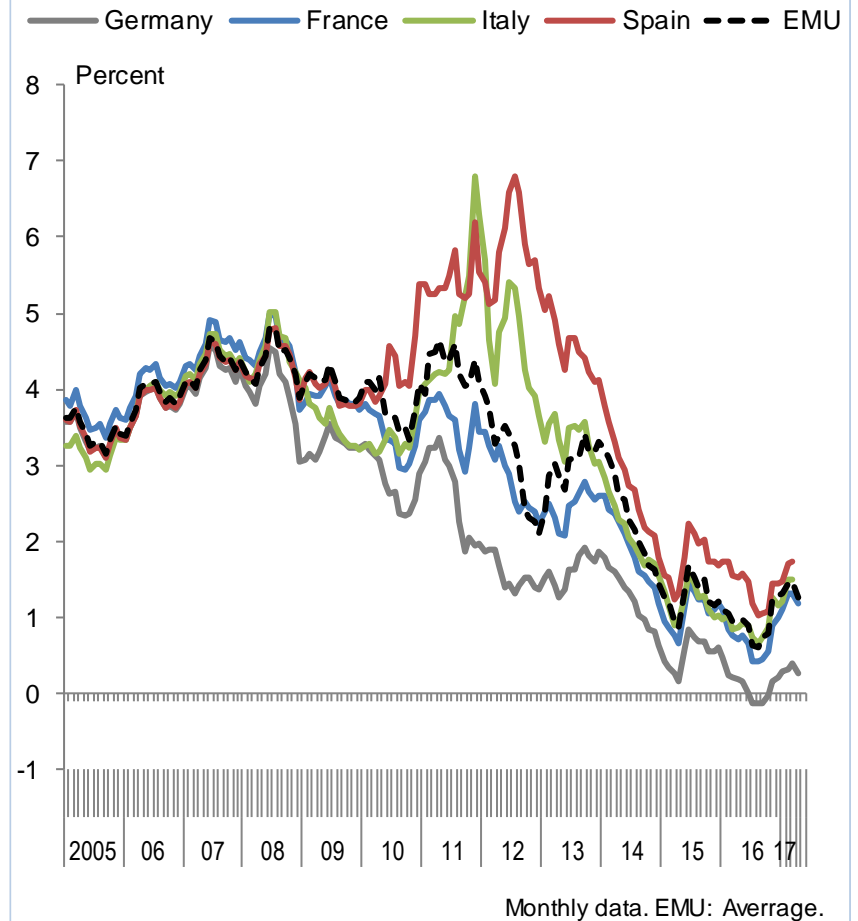


Euro Area: Monetary financing of governments

Gross Government Debt

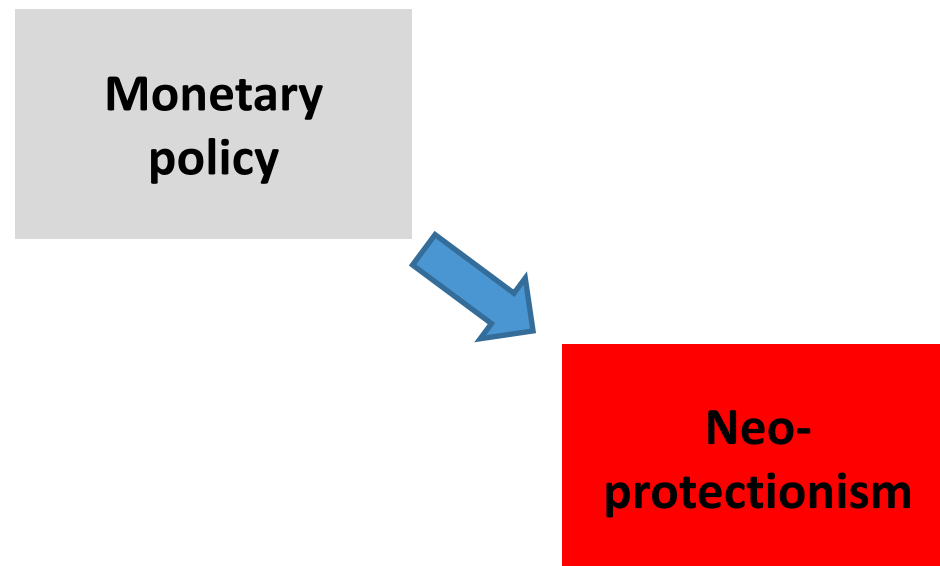


Government Bond Yields (10-year)

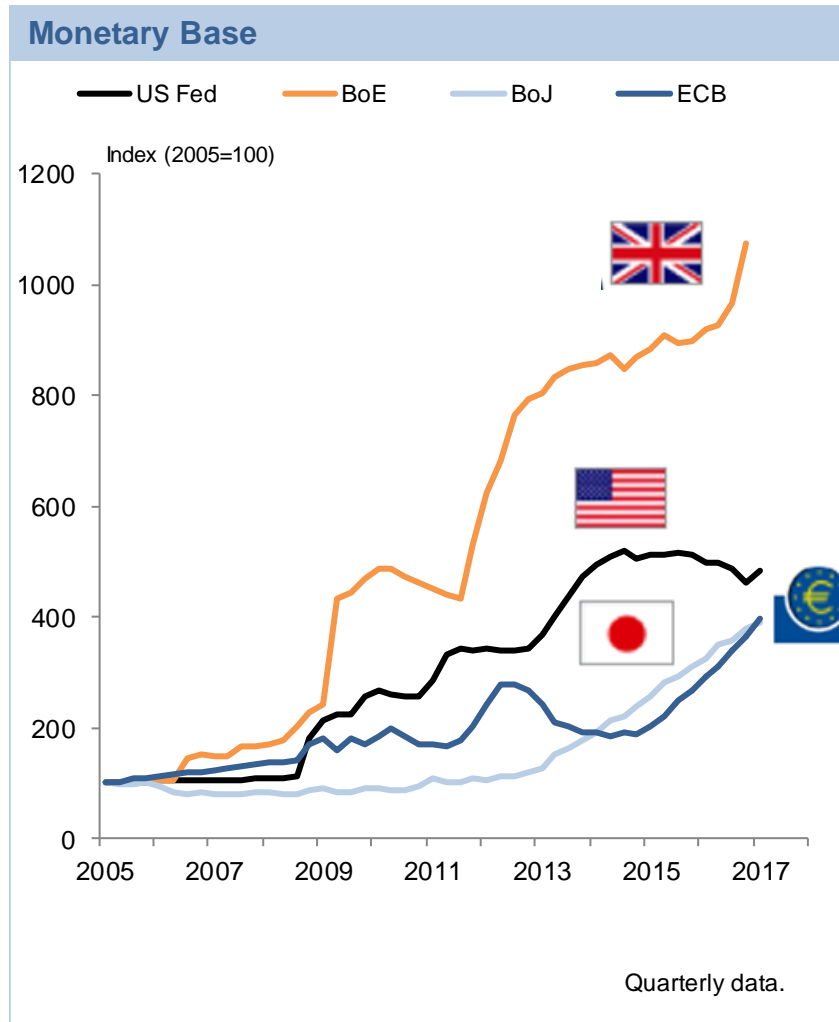


Data source: Eurostat, European Commission.

Monetary policy and currency manipulation



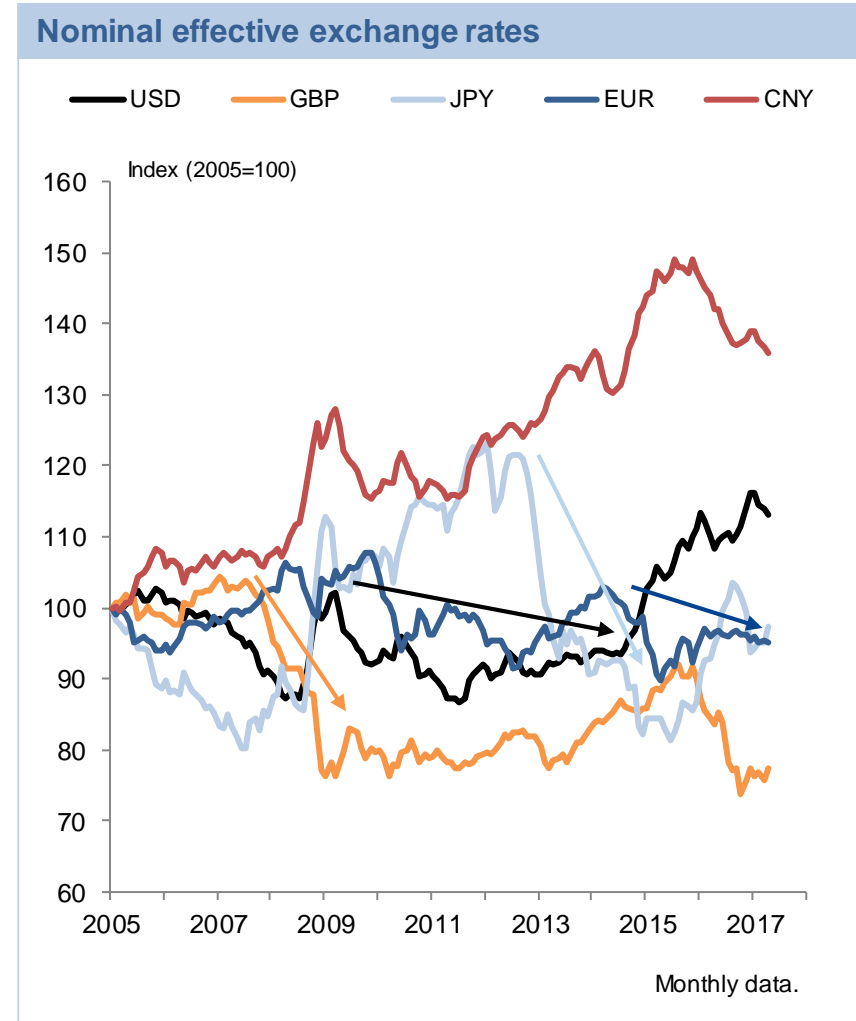
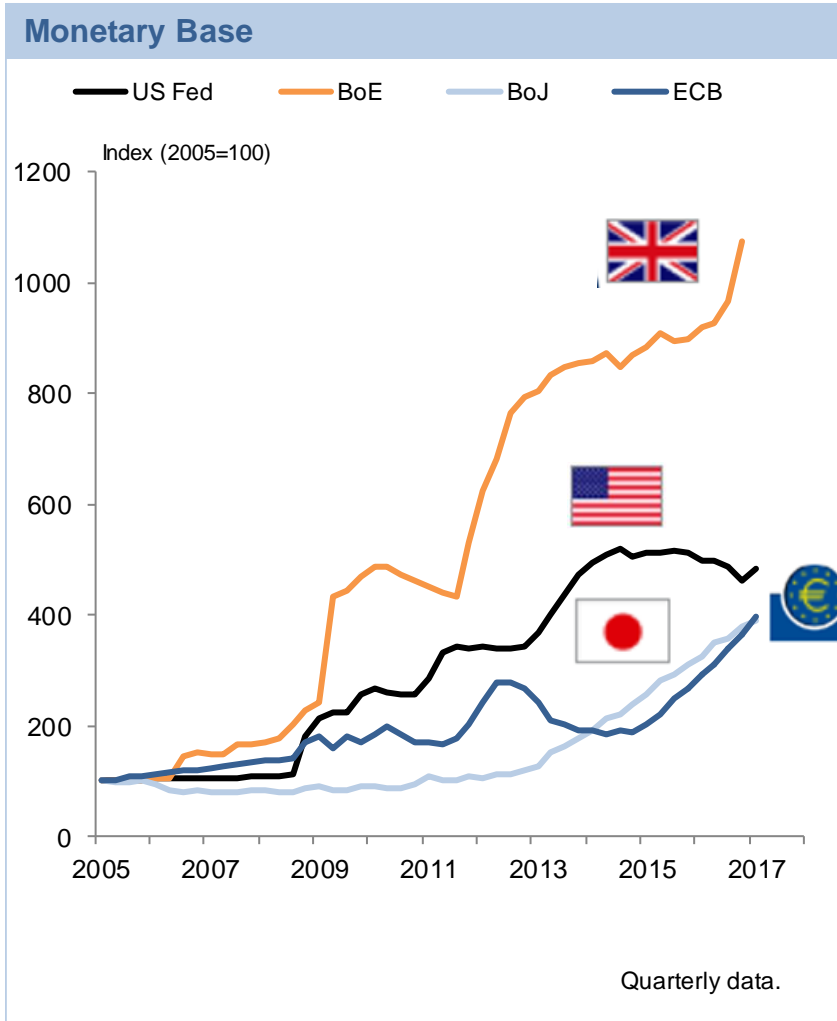
Quantitative „Easing“



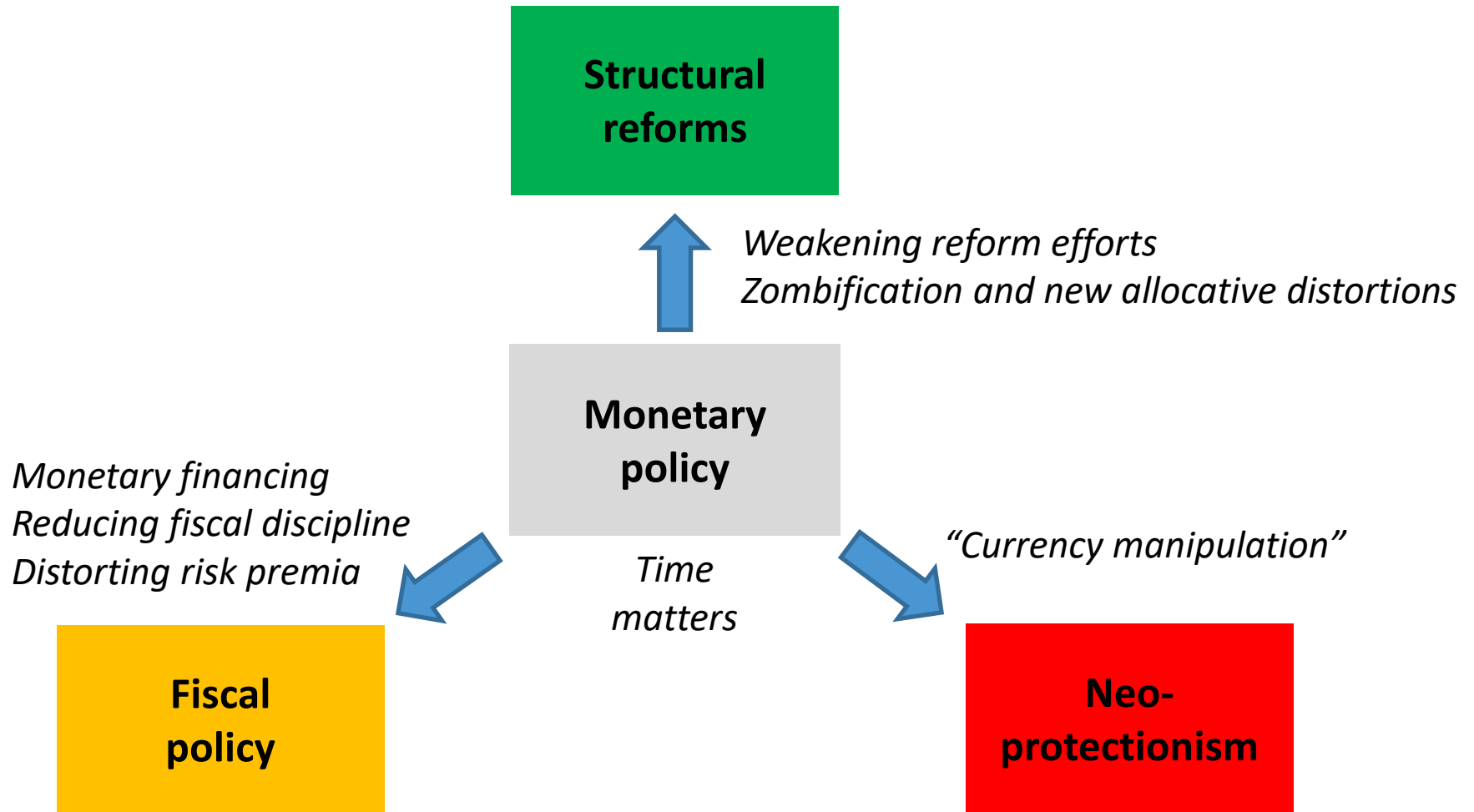
- **Type 1:**
Liquidity provision in times of financial stress
 - » Effective
- **Type 2:**
Stimulus at the zero lower bound
 - » *Domestically* ineffective
 - » Externally effective (in isolation)

Global QE: Risk of currency wars

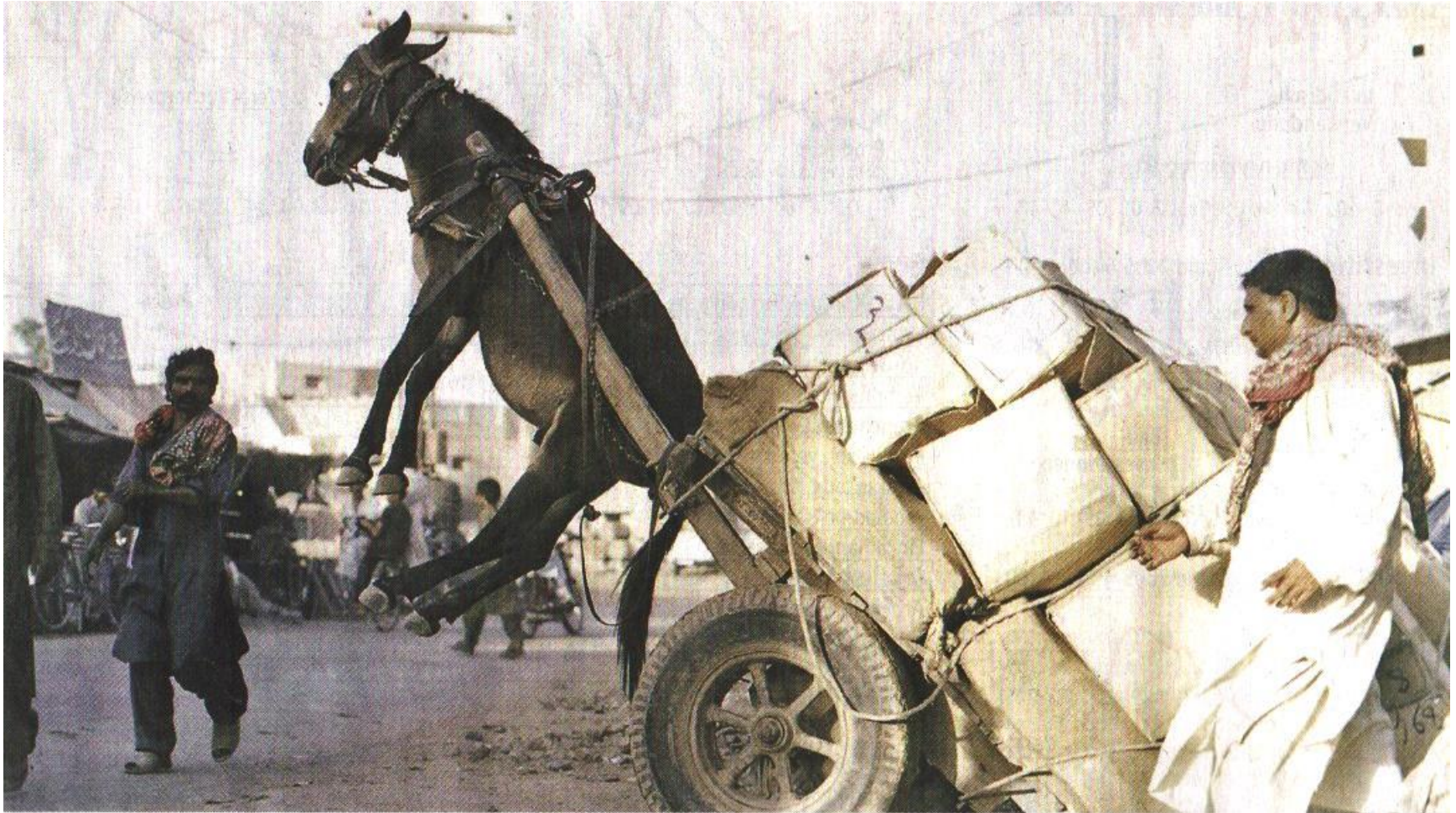
Source: Thomson Reuters Datastream, IfW-calculations



ZIRP/QE: A risky game to play (for longer)



Monetary policy: Overloaded



Quelle: FAZ, 26th October 2011, p. 11

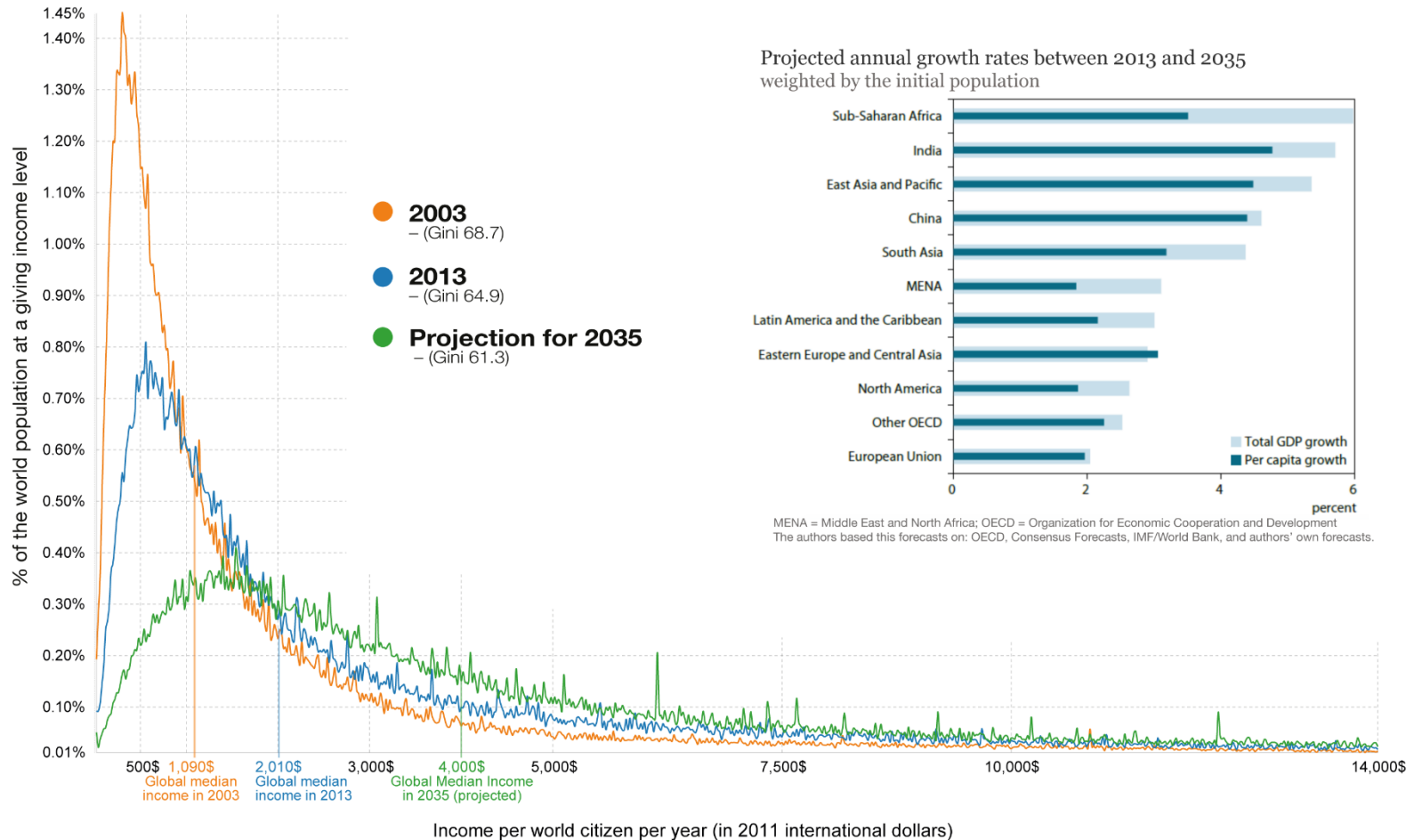
Debate:
Protecting losers of globalization
and/or technological progress?

- #1 poverty eraser: Capitalism
 - » Mass production ...
 - » ... for mass consumption
 - Income distribution: Global view
 - » Global convergence ...
 - » ... within-country divergence
 - Globally improved working conditions
 - Consumption possibilities
 - » Longer lifetimes
 - » Gains from globalization/technological progress
 - » Household composition matters
- ⇒ **Identifying losers is not trivial**

Global income inequality is shrinking ...

The global income distribution in 2003, 2013, and the projection for 2035

Incomes are adjusted for price changes over time and for price differences between countries (purchasing power parity (PPP) adjustment).



Source for all data: Tomáš Hellebrandt and Paolo Mauro (2015) – The Future of Worldwide Income Distribution, working paper. The interactive data visualization is available at OurWorldinData.org. There you find the raw data and more visualizations on this topic.

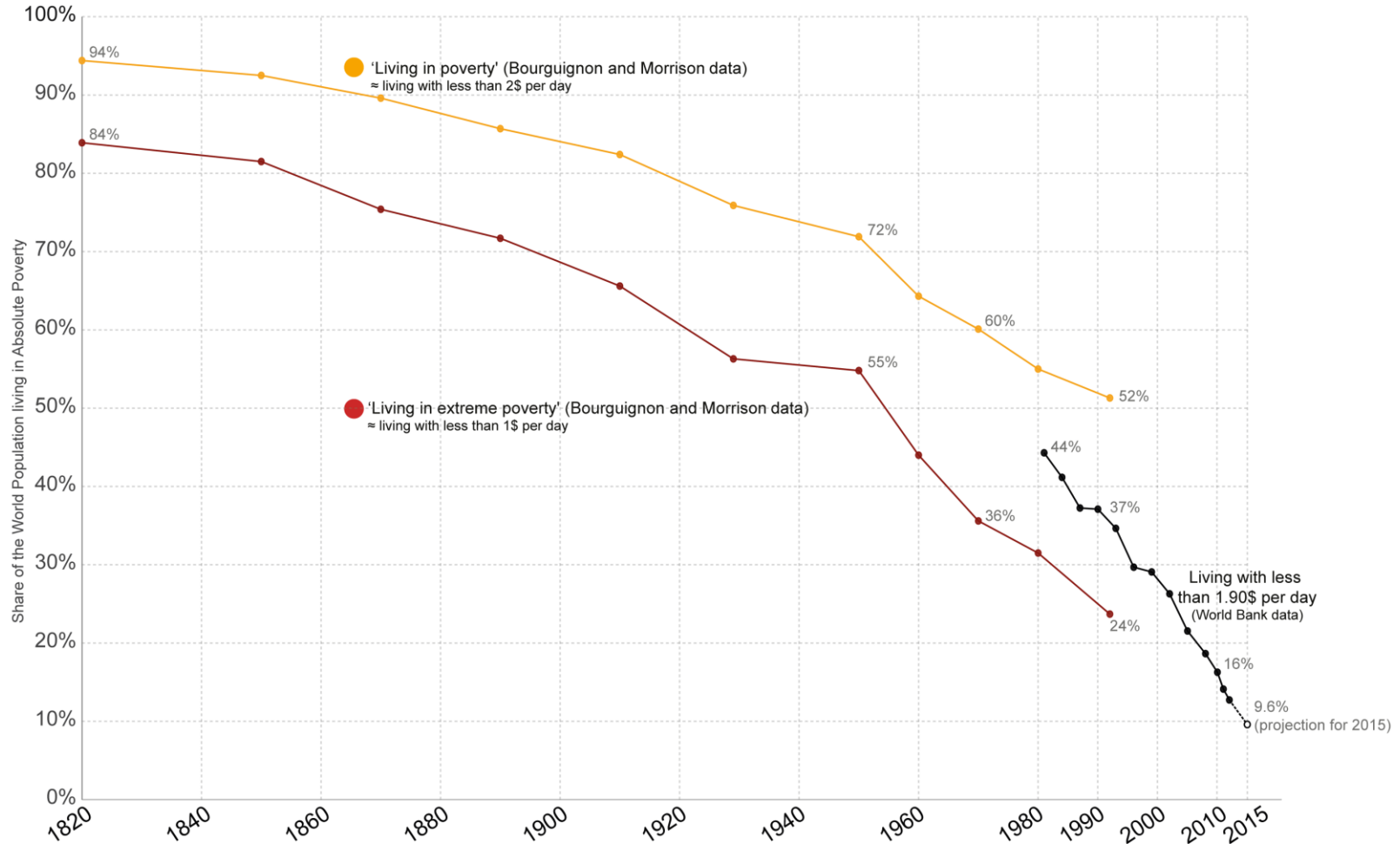
Licensed under CC-BY-SA by the author Max Roser.

... as is global poverty

Our World
in Data

Share of the World Population living in Absolute Poverty, 1820-2015

All data are adjusted for inflation over time and for price differences between countries (PPP adjustment).



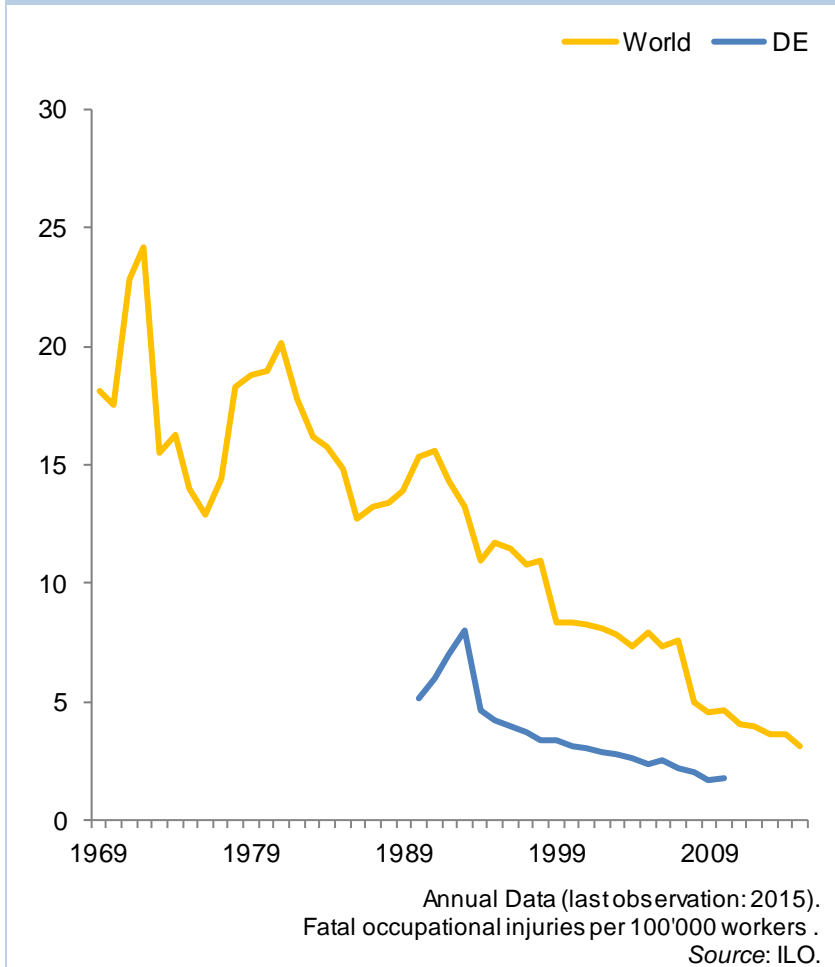
Data sources: 1820-1992 Bourguignon and Morrison (2002) - Inequality among World Citizens, In The American Economic Review; 1981-2015 World Bank (PovcalNet)

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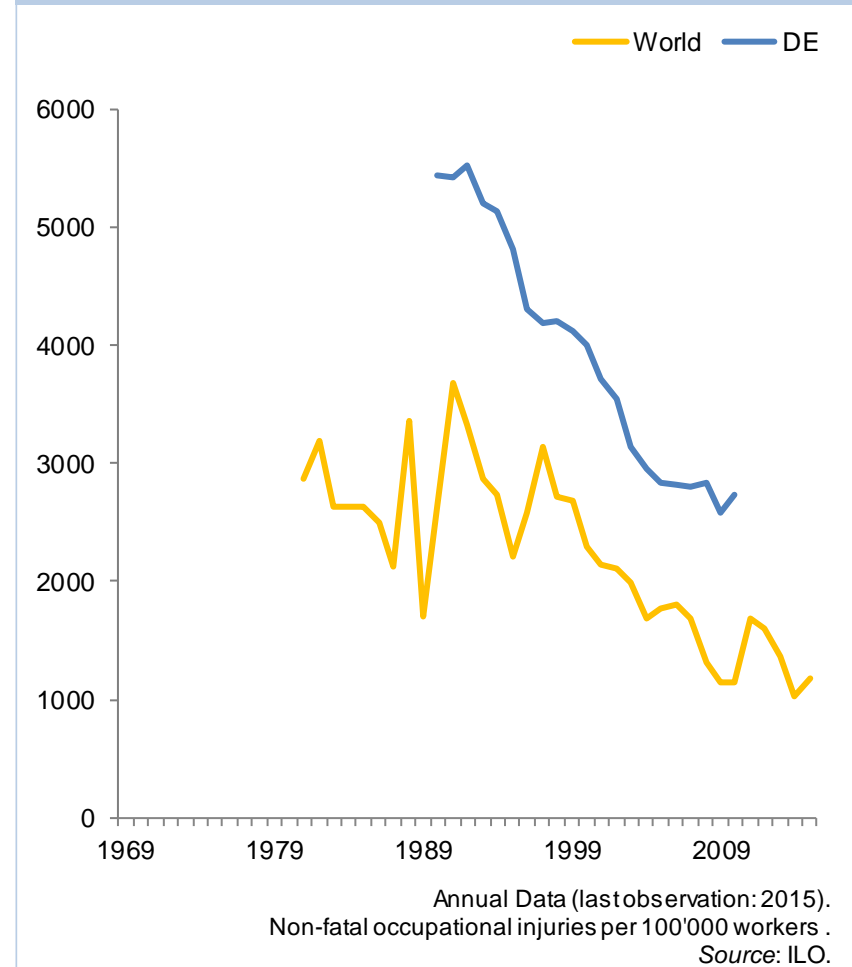
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Working conditions: Occupational injuries

Fatal Occupational Injuries

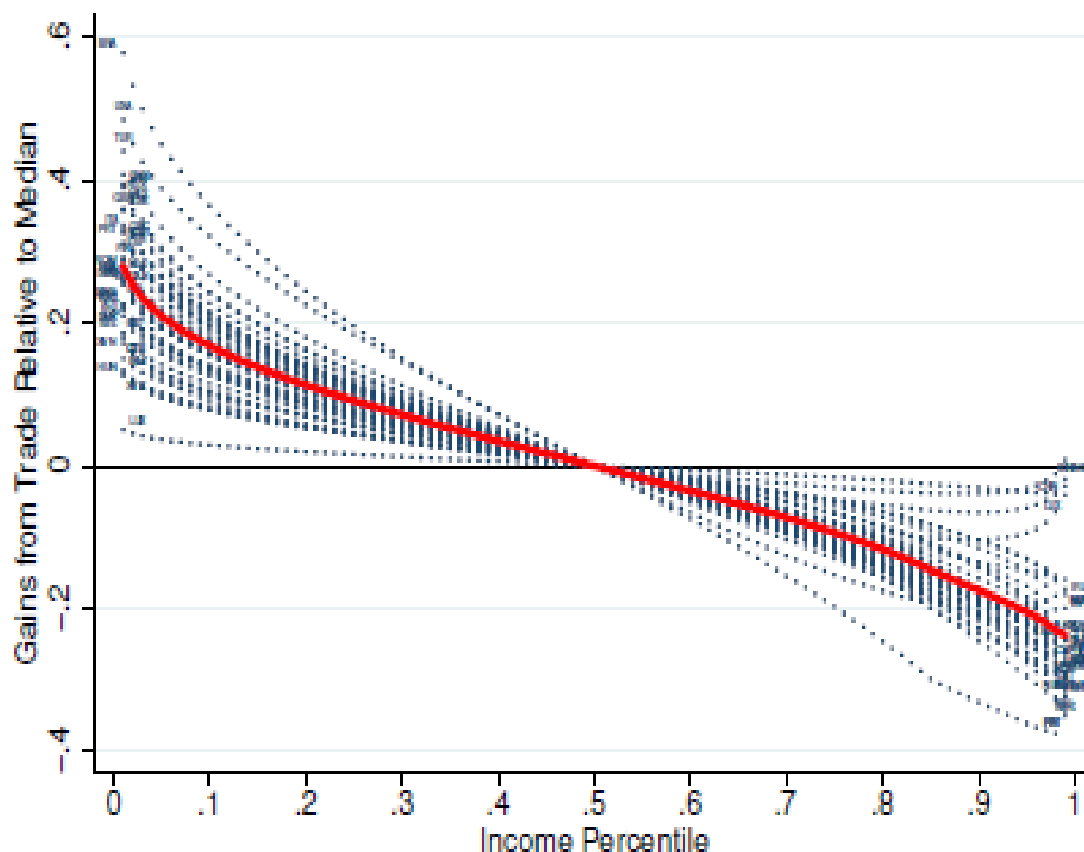


Non-fatal Occupational Injuries



Consumer perspective: Gains from global free trade

Figure 5: Distribution of Unequal Gains: Baseline Case



The deviations are relative to the median individual. The red line is the average across countries.

Source: Fajgelbaum, P. D., & Khandelwal, A. K. (2014). Measuring the unequal gains from trade. NBER WP 20331

- Low income households: higher expenditure share for tradable goods
- Global competition and division of labor make tradable goods more affordable
- World trade is mainly trade in mass production

Disruptive technologies?

- Capital stock as a structure
(unfinished entrepreneurial plans)

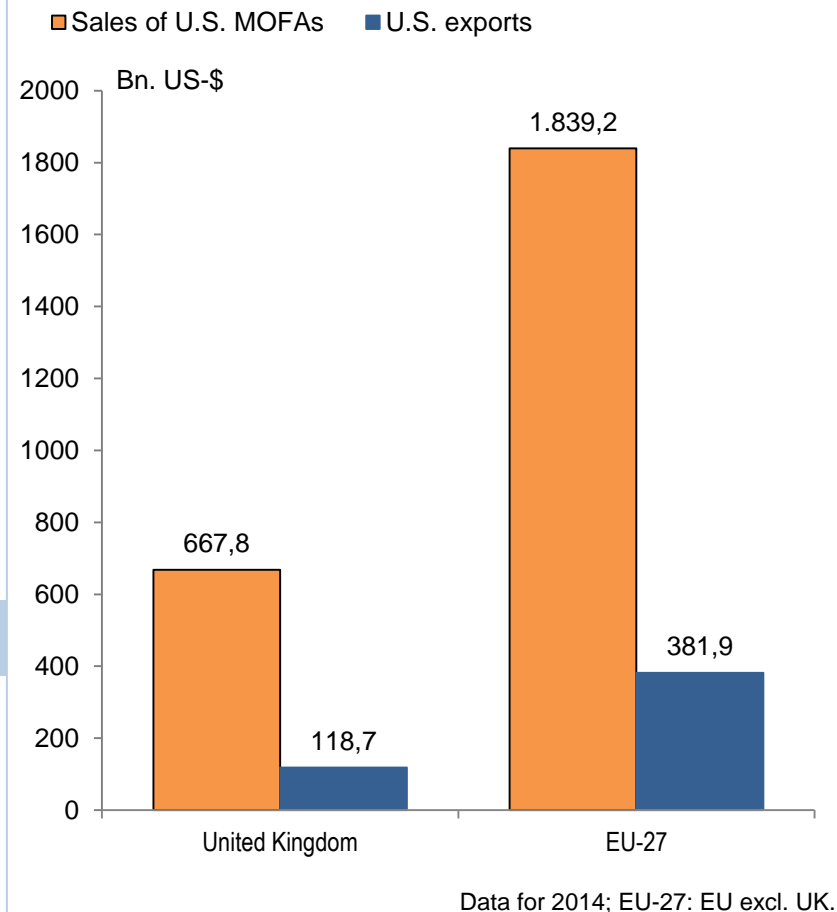
- Conservative/retarding element in free markets
 - » Sunk costs of incumbent technologies
 - » Premium for backward compatibility

- Technological progress
 - » Not exogenous ...
 - » ... but guided by preferences and scarcity
 - » Using existing resources (no mass unemployment)
 - » Opportunity cost \Rightarrow value productivity spill-overs

Transatlantic economic ties: FDI positions create common interests

- Bilateral trade balance
 - » EU-surplus: 115 bn. Euro
 - » Germany: 49 bn. Euro
- Export shares
 - » From EU to U.S.: 16 percent
 - » From U.S. to EU: 11 percent
- **FDI positions**
 - » From EU to U.S.: 32 percent
 - » **From U.S. to EU: 50 percent**

Fig. 3: Importance of the EU Market for the U.S.



- Macro-management is already overstretched
 - » Core problems are non-cyclical

 - “Buying time” strategy failed
 - » Lets fiscal discipline and structural reform efforts wane
 - » Creates new distortions, risk of feeding next financial crisis

 - Neo-Protectionism
 - » Economic nonsense
 - » Tempting for populists, but not without heavy opposition
- ⇒ **Structural reforms as only game in town ...**
- ⇒ **... even more so as societies are aging**
- ⇒ **Lower growth rates not a sign of dysfunctional capitalism**

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(Radical) Policy instruments to enhance the effectiveness of QE

- Buying risks upfront instead of lowering risk free yields
 - » More private sector securities
 - » Distortion of risk premia and related cost of capital
 - Targeting non-performing assets
 - » Monetary bail-out
 - » Turning the Eurosystem into a bad bank
 - Helicopter money
 - » Bypassing the credit channel to inflate the debt-overhang away
 - » Transforms the Eurosystem into a pure fiat money system
- ⇒ **Hardly in line with ECB's mandate, radical consequences**
- ⇒ **Chicago plan 2.0 requires credible post-resolution design**