
Secular stagnation: A view from the Eurozone¹

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In the Eurozone, rising dependency ratios, tougher financial regulation, debt overhang, and poor productivity growth are exerting downward pressure on equilibrium real interest rates. A key question is whether these trends are truly ‘secular’, or whether policy can improve matters. This chapter argues that there is significant scope to increase the efficiency of financial intermediation in the Eurozone, and that the potential for structural reforms remains much greater than in other advanced economies. Reforms that could help avoid secular stagnation in the long run would also boost demand today.

Seven years on since financial market turmoil signalled the start of the Great Recession, output in the Eurozone remains below pre-crisis levels, and unemployment stubbornly high. Potential growth looks little better: recent estimations from the European Commission suggest a medium-term potential of only around 1% (2014-2023) (European Commission 2013). And despite accommodative monetary policy, inflation is still below target. Against this background, it is not surprising that the Eurozone has been identified as one of the regions where secular stagnation is most likely to become reality (e.g. Buiter et al. 2014).

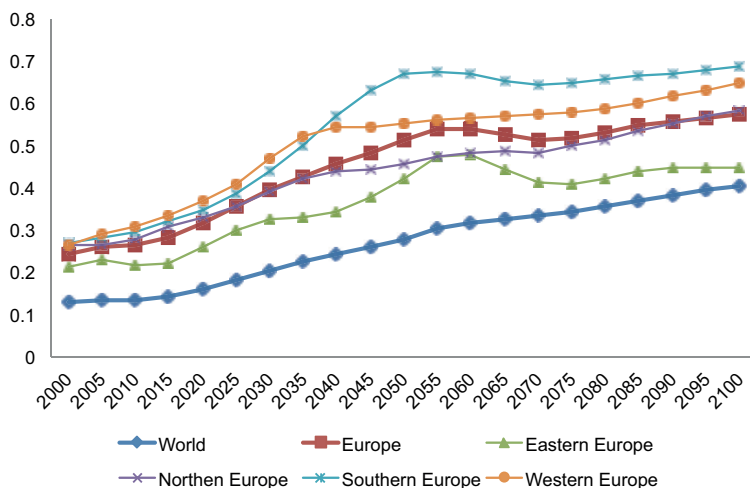
¹ The views expressed are our own and do not necessarily reflect those of the Banco de España or ECB. We would like to thank Eric Persson for his research assistance and Arnaud Marès for his input and for many insightful discussions that helped produce this contribution.

Is the threat of secular stagnation in the Eurozone real?

Secular stagnation usually refers to a situation in which saving can only equal investment at a negative real interest rate – an equilibrium that cannot be achieved because of the zero lower bound (ZLB) constraint on interest rates and low inflation. We can certainly see trends in the Eurozone that suggest this could be a possibility.

On the savings side, Europe's demographic prospects point towards rising savings rates. As seen in Figure 1, the ratio of the retired population (over 65 years of age) to the working age population (between 20 and 64) in Europe is projected to increase from 24.3% in 2000 to 35.4% in 2025, and to 57.5% by 2100. Even with public debt to GDP ratios much lower than they currently are (92.6% in 2013 for the Eurozone), this would render most social security systems incapable of providing pension benefits at the current replacement rates.

Figure 1 Population over 65 years of age/Population 20-64 years of age



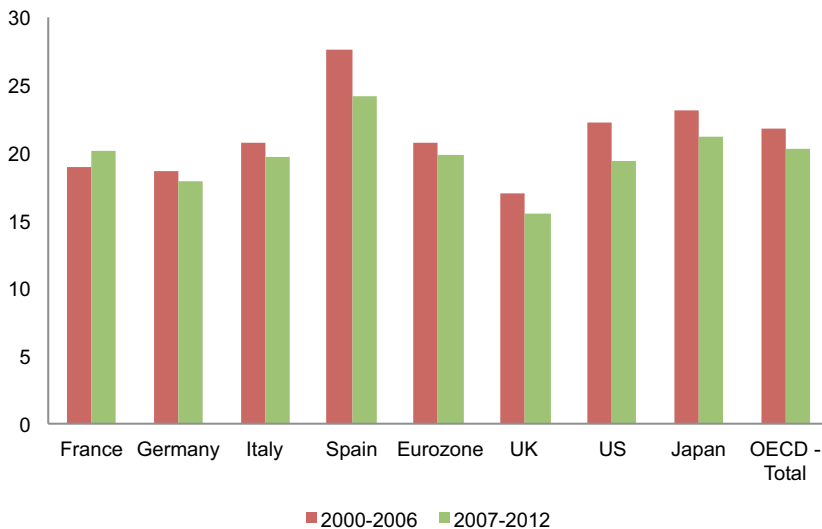
Source: The 2012 Revision of the World Population Prospects, United Nations.

The rise of life expectancy, combined with uncertainty about future pension benefits, can be expected to lead to a significant increase in savings per capita, both of workers and of the retired population. Even with the change in population composition towards

a higher weight of cohorts with lower savings rates, aggregate savings would increase (Backus et al. 2013, Carvalho and Ferrero 2014).

On the investment side, demand is currently weak. Figure 2 shows investment as a share of GDP in the Eurozone and the UK, US and Japan. In the Eurozone during the period 2007-2012, this share was almost one percentage point lower than the average for the period 2000-2006. Even taking into account cyclical factors, it seems unlikely that investment shares will return to their pre-crisis levels, which in several countries (such as Spain and Ireland) were exceptionally high because of huge residential investment.

Figure 2 Gross fixed capital formation (as a percentage of GDP)

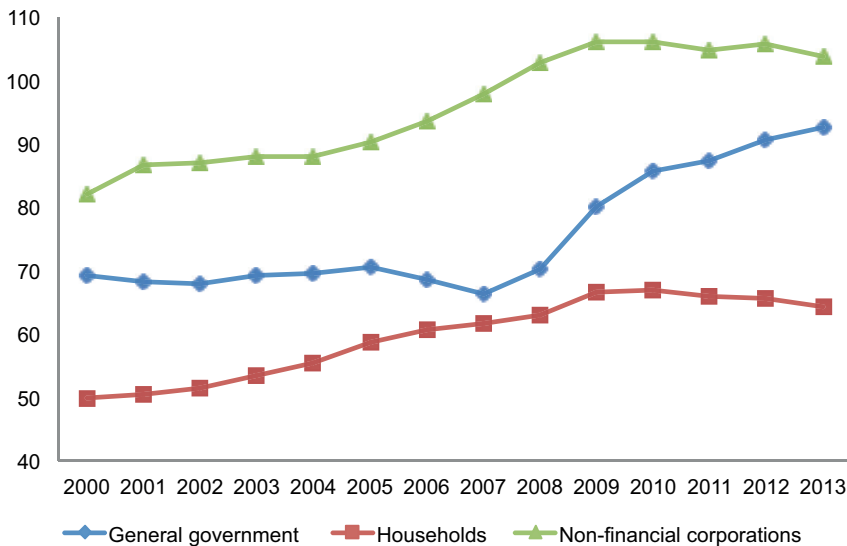


Source: OECD.

There are some reasons to be concerned that this trend might become structural. One is the rising cost of capital resulting from tougher financial regulation, which cannot be offset by interest rates constrained by the ZLB. Another is the debt overhang confronting both banks and firms in the Eurozone that implies a long deleveraging process – a process which, so far, has started only gradually (see Figure 3). Indeed, evidence from Eurozone firms suggests that deleveraging pressures are strongly affecting investment

behaviour. The effect is both on the supply side – higher bank lending rates – and the demand side – the inability of firms to take on new credit (ECB 2013).

Figure 3 Debt-to-GDP ratios (%)

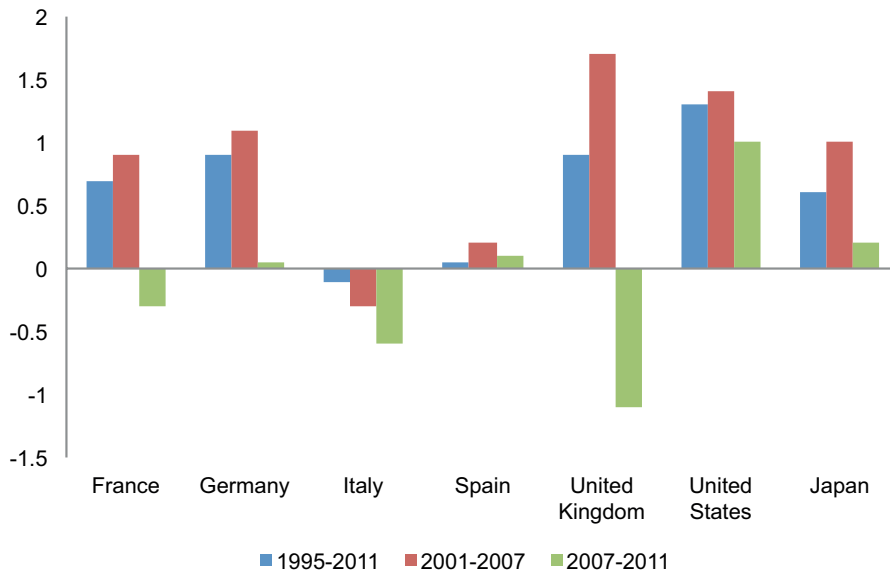


Source: ECB.

Low investment demand could also become persistent due to the Eurozone's weak productivity performance. Figure 4 shows an international comparison of recent total factor productivity (TFP) developments. Although there are differences among Eurozone economies, in general the Eurozone has lagged other advanced economies in productivity growth – and not just since the crisis.

Were TFP growth in the Eurozone to remain at such low levels, the set of profitable investment projects, even at very low long-run real rates, would not expand significantly. Together with the secular reduction in the relative price of capital, this would generate a decreasing trend in investment per capita.

Figure 4 Total factor productivity (growth rates in percentage, annual average)



Source: OECD.

Can secular stagnation in the Eurozone be avoided?

When thinking about secular stagnation, in our view the key point is not so much whether such trends exist, but whether they are truly ‘secular’. Put differently, how much potential is there for policy to reverse the downward drift in the equilibrium real rate?

Some of the long-run trends appear largely irreversible. Demographic patterns in particular are characterised by significant inertia. Even with some recovery in the fertility rate, increases in retirement age, and higher immigration flows from outside Europe, the ratio of the retired population to the working age population will continue rising strongly.

The outlook for investment demand, however, is in our view not so set in stone. There are two factors that could materially alter the investment environment in the Eurozone – and that are in fact largely unique to the region.

These are, first, the potential to lower the cost of capital by rebooting the financial sector and completing the single market in capital, and second, the potential to unleash productivity gains from structural reforms – a potential which remains much greater than in other advanced economies. While progress has been made in both areas in recent years, these challenges deserve to remain at the top of policymakers' agendas.²

Lowering the cost of capital

A lower cost of capital helps mitigate the constraint of the ZLB while, more generally, improving the risk-return profile for a given investment project. There are two reasons why we might expect to see this in the Eurozone.

First, through the ECB's comprehensive assessment of bank balance sheets, the deleveraging process in the Eurozone is starting to gather speed. The assessment seems already to have frontloaded the deleveraging of the banking sector. Bank balance sheets declined by around 20 percentage points of GDP in 2013 alone. As result, financial frictions that raise the cost of intermediation are expected to wane.

At the same time, this process creates the conditions for a gradual workout of the private debt overhang (Draghi 2014b). Acknowledging losses and raising capital is a pre-requisite for banks to restructure loans to distressed borrowers. This may in turn increase incentives to invest, as firms will not raise new finance to invest if the profits generated by that investment will be absorbed by servicing existing debt.

Second, deleveraging is initiating a broader and ultimately more important development, which is a shift in the structure of financial intermediation in the Eurozone. The Eurozone is in the process of transitioning towards a permanently smaller and more streamlined banking sector. This is leading naturally to the deepening of capital markets – if intermediation between savings and investment is taking place less through banks, then it must take place more elsewhere.

² See Draghi (2014a) for an in-depth exposition of a sustainable recovery strategy for the Eurozone.

This is a welcome development as it provides the impetus not only for a more diversified financing mix in Europe, but for the development of a genuine single capital market – something that has long been identified as key to lowering the cost of capital for European firms (European Commission 2001).

In particular, there is clearly a large untapped potential in Europe to reap economies of scale from financial integration. This is true especially for risk capital: venture capital investment in Europe is consistently much lower than in the US and rates of returns are worse (Veugelers 2011). This reflects the fact that the industry is fragmented across Europe: successful venture capital depends on a large deal flow to cover the majority of investments that will fail.

But it is also true for more established European companies, for whom the cost of raising capital is higher than in the US. The additional cost comes from the complexity of cross-border capital raising within the EU where, among other structural impediments, there is no single legal regime for rights in securities, insolvency or corporate governance. Thus, markets are generally less efficient and less contestable.

In other words, unlike in many advanced economies where financial markets are already highly efficient, there is significant scope in Europe to increase the efficiency of intermediation – and so to lower the cost of capital.

Boosting productivity

A lower cost of capital, however, is necessary but not sufficient to achieve higher investment. Put simply, it makes little difference unless there are productive projects to invest in. The important point about the Eurozone, however, is that its weak productivity performance is also an opportunity. Since many member states are far from the frontier of best practice in terms of structural reforms, productivity gains are easier to achieve and the potential magnitude of such gains is greater.

The link between structural reforms and productivity is not primarily via greater flexibility in the formation of wages and prices. This is certainly relevant for smooth macroeconomic adjustment, but perhaps more important for productivity is ‘horizontal’ flexibility – the ability of resources to reallocate within and across sectors to firms where they are used most productively.

Indeed, new micro-level research from the Eurosystem’s Competitiveness Network suggests that reallocation within the Eurozone could yield significant productivity gains. It finds that the distribution between the most and least productive firms within Eurozone countries is very large and skewed, with a few highly productive firms and many which have low productivity (CompNet Task Force 2014).

This is one of the main reasons why increasing labour market flexibility could produce major benefits. Flexible labour markets not only help limit unwarranted wage differentials between sectors, they also facilitate mobility between firms and, importantly, across countries. Eurozone countries have much potential to advance in this area: on the OECD’s Strictness of Employment Protection Legislation (EPL) indicator, only four Eurozone countries currently score below the OECD average (i.e. have higher-than-average labour market flexibility).

At the same time, there needs to be a balance between mobility and stability, and in certain countries labour market reforms could actually help boost productivity by improving the latter – especially for young workers. Of particular relevance here is reducing the dual nature of EPL in several southern European countries that contributes to inefficient worker turnover and lowers incentives to invest in job-specific skills.

Allocation of production factors is also why European policymakers are increasingly drawing attention to the ‘softer’ type of structural reforms linked to the business environment, as these are crucial for the productivity-enhancing process of firm birth, expansion and death (‘churning’). A few examples from the World Bank’s Ease of Business index illustrate the scope for Eurozone countries to make improvements (Figure 5):

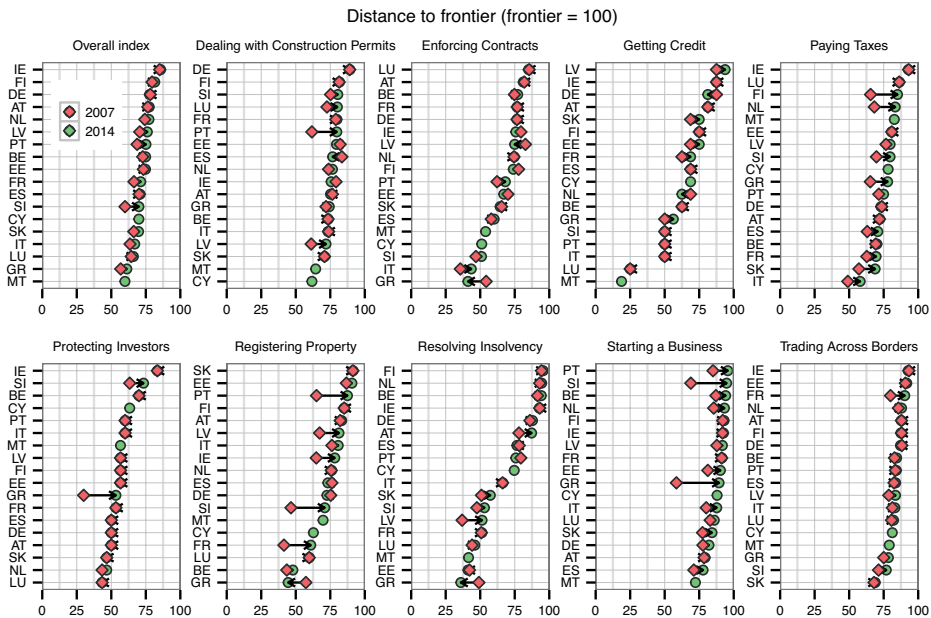
- If an entrepreneur wants to start a new business in Spain she has to go through ten separate procedures, while doing so in Slovenia requires only two. Similarly, for that business to be resolved and the resources reallocated takes less than six months in Ireland, while in Slovakia it takes about four years.
- If a successful firm wants to expand and invest in new capital, it would have to wait 200 calendar days in Ireland before a new warehouse gets electricity; in Germany it would only have to wait 17 days. That is not to mention regulatory distortions that discourage growth above a certain number of employees.
- If firms are in dispute over a contract, enforcing it in Italy requires 37 different procedures, and takes on average over three years. By contrast, an identical dispute in France or Germany would be resolved through about 30 procedures and would take a little more than a year.

While quantifying the benefits of these and other structural reform measures involves some uncertainty, simulations by researchers at the OECD suggest that a broad package of labour, product, tax and pension reforms would raise GDP per capita by about 11% after ten years for the average EU country under relatively quick reform implementation. The equivalent for the US is under 5% (Bouis and Duval 2011). Other empirical studies confirm that among the advanced economies the Eurozone, along with Japan, has the most to gain from structural reforms.

In short, one should not underestimate the power of structural reforms in Europe.³

3 For a formal model of how these reforms may contribute to faster deleveraging and, hence, short-term gains in employment, see Andrés et al. (2014).

Figure 5 World Bank Ease of Doing Business Index



Conclusion

Some observers may see the policy agenda we have laid out today as focused entirely on supply conditions. They may reasonably ask: “What about demand?” – for the longer demand remains weak, the greater the risk of labour and capital hysteresis, and then policymakers may find themselves running simply to stand still.

In our view, however, there is no contradiction. The same policies that will help avoid secular stagnation in the future will help boost demand in the current environment. The purpose of lowering the cost of finance and creating a more dynamic business environment is to raise investment – and investment is not only tomorrow’s supply, but today’s demand.

Figure 6 Expected real interest rates in the Eurozone



Moreover, rebooting the banking sector and deepening financial integration will reinforce the transmission of the ECB's monetary policy across the Eurozone. Monetary policy is very accommodative: as Figure 6 shows, riskless real rates are negative and expected to remain so for a long time. The more this accommodative stance feeds through to the real economy, the more the ECB will regain grip over demand conditions.

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