Economic Policy in a Low-Productivity, Low-Interest-Rate Environment

Karen Dynan
Harvard University and Peterson Institute for International Economics

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Notes for slides are at the end of the presentation.
Productivity growth and interest rates are low and will probably stay low for an extended period
Labor Productivity Growth in the United States

Source: U.S. Department of Labor
Note: Nonfarm business sector.
Labor Productivity Growth in G-7 Countries

5-year moving average

Source: OECD
U.S. Interest Rates

Source: Federal Reserve Board.
Global Long-term Interest Rates

Productivity growth and interest rates likely to rise a bit but remain relatively low

**Productivity growth** damped by low investment during and after the recession; investment is picking up

But a lower trend in multifactor productivity growth set in before the recession (Fernald, Hall, Stock, and Watson, 2017)

**Interest rates** held down by expansionary monetary policy in recent years; policy is normalizing

But the longer-term downtrend in interest rates reflects slower-moving forces—low growth, demographics, rising inequality
What are the implications for monetary policy?
The zero lower bound has been a constraint over the past decade for many central banks.

The Federal Reserve, the European Central Bank, the Bank of Japan, the Bank of England, and other central banks ran out of room to cut their policy rates.
The long-term decline in real interest rates presents real challenges

For example, the Federal Reserve currently thinks the long-run value of the federal funds rate is **2.8 percent**

But, they cut the policy rate by **5+ percentage points** in the last 3 recessions

<table>
<thead>
<tr>
<th>Recession</th>
<th>Starting fed funds rate</th>
<th>Lowest fed funds rate</th>
<th>Cumulative cut</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990 recession</td>
<td>8.25 percent</td>
<td>3.0 percent</td>
<td>5.25pp</td>
</tr>
<tr>
<td>2001 recession</td>
<td>6.50 percent</td>
<td>1.0 percent</td>
<td>5.50pp</td>
</tr>
<tr>
<td>2007 recession</td>
<td>5.25 percent</td>
<td>~ zero</td>
<td>~5.25pp</td>
</tr>
</tbody>
</table>
What are the options?

1. Don’t be squeamish about quantitative easing—it works, and risks of financial instability can probably be managed in other ways.
What are the options?

Empirical studies supporting the view that QE provided important countercyclical support to the economy

What are the options?

2. **Forward guidance can help**—for example, the FOMC noted in December 2008 that they anticipated that weak economic conditions were "likely to warrant exceptionally low levels of the federal funds rate for some time." **But, long-term rates can only fall a little further.**

3. **Negative short-term rates can help**—Europe and Japan have tried it, with central banks charging private banks on the excess reserves they hold. **But, there are limits in how negative you can go and how far long-term rates can fall.**
What are the options?

4. Raising the inflation target can help by raising the equilibrium policy rate. Most central banks currently target ~2 percent. But central banks leaders have voiced concern about damaging their credibility, and causing inflation expectations to become unanchored. So, they probably can’t raise the target very far.
What are the implications for fiscal policy?
Use aggressive countercyclical fiscal policy to maintain full employment

Prior to the financial crisis, monetary policy was seen as dominating discretionary fiscal policy as a stabilization tool

“Monetary policy is . . . generally accepted as the policy of choice when it comes to . . . stimulating a weak economy.”


“Fiscal policy, it had previously been concluded, was too slow, too clumsy, and too political to be relied upon.”


But, zero-lower-bound constraints (along with the sheer size of the crisis) have led to a *rethinking of that view*
Moreover, hysteresis seems to be real

The prime-age labor force participation rate has not fully rebounded to trend and business investment has lagged, so projected output today is much lower than before.

Evidence from the recent episode suggests fiscal policy helped


<table>
<thead>
<tr>
<th>Economic Impact of No Fiscal Stimulus</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP*</td>
<td>14,784.0</td>
<td>14,187.3</td>
<td>14,271.3</td>
<td>14,536.4</td>
<td>14,927.2</td>
<td>15,306.0</td>
<td>15,851.2</td>
</tr>
<tr>
<td>% Change</td>
<td>-0.6</td>
<td>-4.0</td>
<td>0.6</td>
<td>1.9</td>
<td>2.7</td>
<td>2.5</td>
<td>3.6</td>
</tr>
<tr>
<td>% Change</td>
<td>14,830.4</td>
<td>14,418.8</td>
<td>14,783.8</td>
<td>15,020.6</td>
<td>15,354.6</td>
<td>15,583.3</td>
<td>15,961.7</td>
</tr>
<tr>
<td>Real GDP*</td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

U.S. geographic cross-section evidence—2017 survey by Chodorow-Reich

“the cross-sectional evidence suggests a national zero lower bound multiplier of about 1.7 or above, at the upper end of most studies based on time series evidence.”
To get around “slow, clumsy, and political” concerns, use more automatic stabilizers

For example—when the unemployment rate crosses a certain threshold, you could automatically turn on extended unemployment benefits and reduce payroll taxes

Then automatically turn these benefits off when the unemployment rate goes back down
Over the longer-run, fiscal sustainability will be difficult to achieve

Dependency rates are rising

Health costs have grown faster than costs in other sectors
Old-age dependency ratios

Population 65+ Relative to Working-Age Population

Health care inflation vs. overall inflation

U.S. Consumer Prices

Source: U.S. Commerce Department.
Debt levels are already high in many countries

Net General Government Debt for Advanced Countries

Source: International Monetary Fund.
Debt levels are already high in many countries.

U.S. Federal Debt Held by the Public

Percent of GDP

Source: Congressional Budget Office.
Changes needed for tax policy

1. Increase tax incentives for work

Given that low productivity growth will probably damp future wage growth, there may be further declines in labor force participation (assuming the substitution effect dominates as it seems to have done in recent decades)

This would exacerbate fiscal pressures—both through lower tax revenue and through more need for social insurance

Best to focus on groups with most elastic labor supply (e.g. second earners) and those for whom the social concerns are greatest (e.g. low-skill men)
Changes needed for tax policy

2. Improve tax incentives for investment

Large literature documents features of current tax systems that lead to misallocation of resources and hold back productivity growth by (1) distorting investment by industry and assets, (2) distorting choice of financing for investment, and (3) distorting how businesses are organized and where they are located.

We should always be trying to fix these problems but it is especially important to do so now given low productivity growth.
Changes needed for tax policy

3. **Raise more revenues**

   Even assuming low interest rates persist (as CBO assumes), countries like the United States are not in a fiscally sustainable position under current law, with low productivity growth exacerbating the problem.

   So tax revenues will need to be higher (even assuming some cuts to spending on programs providing retirement income and health care).
Also need to maintain public investment spending

U.S. discretionary spending is now falling to its lowest share of GDP in decades; this is the category that includes growth-enhancing public investments in infrastructure, education, and research.

Source: Congressional Budget Office.
Conclusions (I)

The near-term global outlook may be good (given that nearly all countries are growing again), but low interest rates and low productivity growth pose major challenges for the longer run.

Low interest rates will limit conventional monetary policy:

- More thought needed on unconventional measures

Fiscal policy will need to play a bigger stabilization role.
Conclusions (II)

In addition to damping interest rates, low productivity growth exacerbates the fiscal pressures that are coming for many countries:

- Tax systems need to incentivize more work and better investment and to raise more revenues
- Governments need to maintain public spending on pro-growth investments
Notes

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Slide 3: Data from the OECD.
Slide 4: Data from the Federal Reserve Board.
Slide 8: Data from the Federal Reserve Board.
Slide 10: Data from Freddie Mac and the Mortgage Bankers Association.
Slide 20: Data are from the World Bank.
Slide 21: Data are from the U.S. Commerce Department.
Slide 22: Data are from the International Monetary Fund.
Slide 23: Data are from the Congressional Budget Office.
Slide 27: Data are from the Congressional Budget Office.