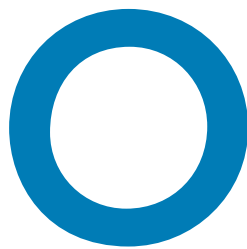


Interview with Barry Eichengreen, Professor of Economics and Political Science at the University of California, Berkeley



# Overview of the World Economy in the Short & Long Term

By Japan SPOTLIGHT

We are facing a volatile global economy over both the short and longer term. This volatility could be deepened by geopolitical crises around the world. However, before embarking on a geopolitical assessment, it would first be useful to have an economic analysis of it. *Japan SPOTLIGHT* was honored to have an interview with Prof. Barry Eichengreen, who is George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley. The interview was held the day before the US presidential election in November 2016, and therefore the outcome was not considered. But we believe the interview generally highlighted most of the issues relevant to the volatility of the global economy.

## Overall Assessment of Global Economy

**JS: What is your assessment of the economies of Japan, the United States and the European Union?**

**Eichengreen:** It's clear that the US economy is doing better but we are speaking on the eve of a very important election and anything I say about the US economy today could be different by tomorrow night. I think the current state of the economy is relatively positive. What happens next is entirely contingent on the outcome of the election. The EU economy has been doing better but I'm not confident about its future prospects. There is a banking problem that remains unresolved and that can create significant economic drag that makes it difficult to sustain an expansion. In addition, there is a lot of political uncertainty hanging over the EU economy. There is a referendum coming in Italy that may or may not lead to the fall of the Matteo Renzi government. There are elections next year in France and Germany, so what kinds of governments are returned is uncertain. That creates political uncertainty that leaves firms reluctant to invest and households reluctant to spend until the uncertainty is resolved. In terms of Japan, I do not think we've seen much of an improvement yet but I believe that the change in policy strategy in Japan going forward is the right thing and that makes me moderately more positive about the outlook there.



*Barry Eichengreen, Professor of Economics and Political Science at the University of California, Berkeley*

**JS: What is your opinion on the possible impact of "Brexit" on the EU and global economies?**

**Eichengreen:** My own view is that Brexit is a major negative shock for the United Kingdom. The effects have not materialized yet but I think we're now seeing the beginning of it. The depreciation of sterling is making imports and the cost of living much higher for British consumers who are going to stop spending because of the negative shock. While British firms and exports will become more competitive, real wages will decline and that will translate into less spending. In addition, there's again high uncertainty about how the process will play out. Will Prime Minister Theresa May be able to trigger Article 50 in March or will the recent judicial decision prevent her from doing so at least for some period? The outcome of that is uncertain. Industries don't like uncertainty, so I think the negative effect of Brexit on the UK is about to hit and when it does it will be a large negative.

The good news is that they have room to use policy in response and the Bank of England has relaxed policy and cut interest rates by 25 basis points. The new chancellor, Philip Hammond, has said he will not raise taxes but rather increase government spending to buffer the negative shock so that will at least moderate the negative impact somewhat. So part one of my answer to you is that Brexit is a major negative shock to the British economy at least as important as the 2007/2008 financial crisis. On the other hand, from the point of

view of the EU and the world, it's small. It really doesn't matter very much. The UK economy is 9% of the EU economy. It's 3% of the world economy. The main thing the EU cares about is that other countries do not emulate the UK and hold referenda of their own that throw the future of the EU into doubt. That will make the other EU members very unbending in their negotiations with the UK and send a message to other countries that trying to exit from the EU is going to be very costly. So I believe that will make the future even more difficult for the UK. But it won't matter very much one way or the other for the rest of the EU or the world.

## **Fiscal & Monetary Policy — Key to Short-Term Performance**

**JS: How would you assess the effects of monetary policy and fiscal policy in view of the G20 declaration in September recommending a more flexible fiscal policy?**

**Eichengreen:** It's clear that we have used fiscal policy too little up to now and that has forced central banks to use monetary policy too much because they have been the only policymakers in town. It would be desirable to rebalance policies supporting spending and demand more toward fiscal policy and away from monetary policy. But I have two observations about this. Number one, everybody talks about using fiscal policy more aggressively but there hasn't been much action yet. Take the case of the US. After the election will there be a president and a Congress who can work together to craft a modest infrastructure spending program and modest fiscal stimulus? The answer is: doubtful, whoever is elected president. And more generally, lots of countries have talked about using fiscal policy and they haven't done anything yet and it's not clear that there exists a political consensus to back the words with deeds. Actions speak louder than words and so far all we've had is words. Second, even if you agree that we should be relying more on fiscal policy and less on monetary policy that is not an argument for central banks to begin raising interest rates now. We need to see the fiscal action first at which point it begins to make sense for central banks to do less to begin to normalize and we haven't seen that yet.

**JS: People are beginning to worry about an exit policy from quantitative easing. In particular, the Bank of Japan is now taking a negative interest rate policy. What's your assessment of this?**

**Eichengreen:** I am not a fan of negative interest rates. I think they have unfortunate side effects. They weaken the balance sheets of the banks and they discourage bank lending, which is bad for the economy. I would much rather that central banks use securities purchases; that they buy government bonds, exchange created funds, mortgages, and avoid negative interest rates. But that does

not address the separate question of whether central banks should stop intervening in asset markets entirely and withdraw from monetary stimulus. In terms of normalization of interest rates, I think the question varies by economy. I think one can argue about whether it's appropriate for the Fed to take a first step in normalizing interest rates in December. There's an argument for doing so and one against. The two are finely balanced. But in the case of the UK, in the case of the eurozone, and in the case of the Bank of Japan, there's no sound argument now for normalizing interest rates.

**JS: Asian countries are worried about the possible negative impact of a US interest hike on their economies. What do you think about it?**

**Eichengreen:** I don't think this should be seen as a major concern. If the Fed were to follow the first 25 basis point increase in December with a whole series of additional increases that brought the US policy rate up to 3% or 4%, then there would be something to worry about.

## **Supply-Side Structural Reform — Key to Long-Term Performance**

**JS: Let's turn to structural reform. The G20 and other international fora have agreed to promote supply-side structural reform in order to overcome the current economic problems. What's your view?**

**Eichengreen:** That we need more structural reform is a statement of what is desirable rather than anything concrete. "Structural reform" is a phrase without much content, without enough specificity. What kinds of reform are needed and desirable are different in every country. I think having more flexible and productive economies is desirable but that kind of statement doesn't have any content about what needs to be done exactly in each country. It may be desirable in Japan to change the tax and other policies to raise fertility and it may be desirable in Indonesia to change tax and other policies to lower fertility. Calling for structural reform is only useful when the call includes specific recommendations about what each country concerned needs to do and recognizes that what needs to be done differs across countries.

**JS: Growth strategy is the third arrow of Abenomics. It consists of three main parts: labor market reform, fiscal reform and innovation policy. This last is something that many countries have in common: how to promote innovation and so enhance growth potential and productivity. What's your assessment of innovation overall?**

**Eichengreen:** Productivity growth is very slow. It is disappointing in the US, in Europe, in Japan and in emerging markets. At the same

time innovation seems to be proceeding rapidly. There are all kinds of dramatic advances in the human genome, in new materials, in information technology, in artificial intelligence, in big data and computing. So the mystery is that these two things are not linked. Normally we think that rapid innovation leads to rapid productivity growth and now we have the paradox that rapid innovation is not leading to rapid productivity growth. There are two resolutions. I don't know which one is right, but that will turn out to be critically important for the world. The first resolution is that it takes time for innovation to translate into productivity growth and we simply have not been patient enough. Give it another five or 10 years and we will have reorganized the economy to take advantage of these new innovations and efficiency and growth will surge forward. The second resolution is that most of these innovations are not important and they really don't matter for the world economy. It's fine that they can be used so that kids can play video games but that doesn't make much of a difference for the standard of living more generally, it doesn't improve the efficiency of healthcare provision or nutrition in developing countries and so forth. The appearance of rapid innovation is in fact misleading: illusion rather than reality.

**JS: Return on equity corporate governance seems to be the dominant trend now. Does that encourage or discourage innovation?**

**Eichengreen:** Innovation requires time to pay off. People invest in projects now, the return on which is uncertain, and if there is going to be a return they receive it in the future, five or 10 years from now. They were investing in how to build better batteries five years ago and now they're trying to deploy them in the form of electric cars and batteries for solar powered homes and so forth. If corporate governance requires executives and managers to produce profits this quarter, they won't be investing sufficiently in innovation. So corporate governance focused on returns is fine; corporate governance focused mainly on short-term returns is not fine.

**JS: In that case should management style be changed in order to encourage innovation?**

**Eichengreen:** Executives and managers respond to the incentives they are given by the stock market and so forth to produce returns. It's a fundamental dilemma in a financial market-based economy like the one we have.

## **Income Inequality as Most Important Issue**

**JS: The next focus in Japan is labor market reform. This is closely related to the issue of income inequality. What's your view of this issue?**

**Eichengreen:** The data are clear that income inequality has been

trending upward, not only since the financial crisis but well before. Increased inequality creates economic problems in that it is contributing to the global savings glut effect. Wealthy people save a lot and as their shared income goes up we get a global savings glut and inadequate spending and therefore inadequate demand and growth. And income inequality creates political problems. We have two presidential candidates in the US, Trump and Clinton, and a lot of the debate over who to vote for has to do with all the social tensions and problems created by income inequality in the sense that the wealthy are getting away with it and the bankers were not punished after the financial crisis, but they still get gigantic salaries and workers have been left behind. Their share of income has declined. Real wages have been falling for three decades. So I think inequality is both an economic and a political problem.

If we look across countries we see that the rise in inequality has been greater in some countries than others. In the US and the UK, the rise in inequality has been much greater than in France, Germany and Japan. Part of the answer is different tax policies. It's easier in the US and the UK for people if they are wealthy to limit the taxes they pay. Both tax policy and other labor market policies. They have labor unions in Germany and Japan, but they have all but disappeared in the US and the UK. Labor unions are not there to push for higher earnings and a higher share of corporate earnings for their members, contributing to the problem. So the growth of inequality is a universal problem but it has grown more severe in some countries than in others.

**JS: You mentioned tax policy as a possible remedy. What kind of policy exactly?**

**Eichengreen:** Higher marginal income tax rates on people with high incomes. And if you think that the problem is not income inequality but rather wealth inequality, then higher taxes on the wealthy would be the solution. People in the US dislike that idea on the grounds that higher marginal taxes on income would discourage effort, but if you look at the data there's no correlation between marginal tax rates on high incomes and how rapidly economies grow.

## **Prospect of Aging Society**

**JS: How do you think we can overcome the issues presented by an aging society?**

**Eichengreen:** Aging is a serious challenge for countries and governments, starting with South Korea, Taiwan and Japan and extending to Italy and a number of other European countries. In among the challenges is that older people require more spending on health care and the like, with which government has to help and eventually older people pay fewer taxes so that does create fiscal problems. I don't see any alternative but to try to address them. Older people have paid into the tax system during their working years. If they

then become net beneficiaries of the system when they're older, that looks right, and societies need to try and accommodate that.

## Global Governance Today

**JS: You've mentioned the G20 and we have the G7 and other institutions. Do you think these work well in achieving particularly macro-policy internationally?**

**Eichengreen:** No I don't. I think that probably the most important groupings from the point of view of macro-economic policy are the G20 and the International Monetary Fund. The G20 has 24 members, not only the 20 countries, but an IMF representative and a couple of others and the IMF has 200-plus members. They are the relevant bodies. They both issue communiqués about desirable economic policy coordination and then, by and large, governments go ahead and do what they were going to do anyway. I think there have been a few exceptional episodes like the response to the global financial crisis in 2008/2009 when the stakes were very high. The importance of the problem was transparently clear and there was successful policy coordination. But I think those episodes are the exception.

**JS: Do you have any ideas of how to strengthen the mechanism of global governance?**

**Eichengreen:** I think the G20 is a useful grouping but it is a bit arbitrary. Nobody has the power to decide who is in and who is out. There are worthy countries that are out, so the legitimacy of the institution is questionable. I think the IMF is the institution that needs to be strengthened if we're serious about strengthening global governance and macro-policy coordination. Asian countries still feel they are under-represented at the IMF, that they are not listened to when the decision is taken as to who the managing director should be. Their quota shares still do not reflect their weight in the world economy and until that is fixed the IMF is not going to be regarded as a legitimate and effective venue for policy coordination.

**JS: In speaking about global governance, should the WTO or mega-regional FTAs be strengthened?**

**Eichengreen:** What's important is not to go backwards in terms of imposing new trade restrictions. Going forward, and eliminating existing trade restrictions through the Trans-Pacific Partnership or Trans-Atlantic Trade and Investment Partnership is less important. Trade barriers are low. Tariff barriers are close to zero. Going forward is not important. Going backwards could be disastrous on the other hand. So I don't buy the bicycle theory that you always have to be going forward to further trade liberalization. Rather, I would argue that the degree of trade liberalization that we have today is broadly desirable. Let's stay where we are right now and let what we have

right now work for everybody. There's a protectionist backlash because existing arrangements do not work for everybody. Going forward with new agreements that are not obviously necessary and will only make the people who are left behind by existing trade liberalization even angrier would be a mistake.

**JS: In the case of the BRICS economies, they still have tariff and non-tariff barriers. Some intellectual property rights in some countries are not well developed.**

**Eichengreen:** An intellectual property rights agreement that is masquerading as a trade agreement does no one any good. Is it an intellectual property rights agreement designed to benefit Apple and Toyota or is it designed to benefit Indonesia? Trying to force countries to reform by applying external pressure on them is not a good idea. In the past we've had lots of experiences where the IMF and advanced countries recklessly told emerging markets to remove their capital controls and open their financial sectors to the rest of the world and what we got was financial crises. For countries to reform — including the BRICS — they need to reform at home under their own volition. To force them to reform by subjecting them to more external pressure through international trade and financial agreements would be dangerous and counterproductive.

## Asia as Leader of Global Economy

**JS: What about Asia as the engine of global growth?**

**Eichengreen:** Prospects for Asia going forward will hinge on what happens in China. If China continues to grow by 6.7%, Asia will do well and it will be an engine of growth for the world. If Chinese growth decelerates slowly and smoothly to 6% next year or 5.5% the year after, Asia will continue to do fine. Were Chinese growth to collapse, as some people forecast, then Asia would not do well and it would not be an engine of growth for the world. No one knows what will happen.

My guess would be that Chinese policymakers have the situation under control. They know they have a corporate debt problem that they are going to resolve; they know they have to continue to rebalance from investment toward consumption, which they will; and they know that liquidity has been growing too quickly in China and the housing market has been too unstable. They will gradually get those things under control. That's my best guess and my hope.

But that could turn out to be wrong. China could experience a growth crisis. Growth could come down to 3%. That's an alternative scenario in which Asia would do poorly. **JS**

*Written with the cooperation of Ian de Stains OBE who is a writer and consultant.*