Interview with Dr. Joseph Gagnon, Senior Fellow at the Peterson Institute for International Economics in Washington D.C.

Strong US Economy Could Turn Global Economic Outlook Positive as the Delta Virus Variant Increases Uncertainty

By *Japan SPOTLIGHT*

Whether the US economy, the largest in the world, is on course for a stable recovery from the pandemic-hit economic decline in 2020 will be a key to the prospects for global economic health. We interviewed Dr. Joseph Gagnon, senior fellow at the Peterson Institute for International Economics, a US think tank. He is a distinguished academic who has also worked as a policy maker for the US Treasury Department and the Federal Reserve Board. He is thus a leading thinker on US fiscal and monetary policy.

(Interviewed on July 27, 2021)

Concerns About Inflation in the United States

JS: There are growing concerns over inflation in the US, due to an expansionary monetary and fiscal policy continuing during the pandemic. This policy could weaken the dollar and provoke inflation. Do you think that is a relevant concern? Does this differ depending on the short or long term? And how do you see the issue of propping up zombie companies through public policy?

Dr. Joseph Gagnon

Gagnon: The concern about zombie companies everywhere, especially in Japan, is a huge mistake. Zombie companies are good for the economy as long as the economy is operating below potential and as long as inflation is below the central bank's target. More zombie companies are better than fewer because if you put them out of business you just make the deflationary pressures worse, with more people unemployed and less aggregate demand making the whole economy worse. So it is a complete mistake to worry about zombie companies until the inflation rate is well and persistently above the central bank's target. Only then are they a problem, and only then do they reduce productivity growth. So I think this worry about zombie companies is very harmful, has caused a lot of damage in Japan and is causing a lot of damage elsewhere and should be stopped immediately. It will be many years before any country has to worry about zombie companies; in the meantime, they are very beneficial.

Turning to inflation, you mentioned a scenario under which loose monetary policy causes the dollar to depreciate and that is inflationary – I don't think that scenario is ever going to happen. I see two possible outcomes: one is what the market expects, that we don't get much inflation and monetary policy stays loose and the dollar stays where it is, providing normal growth and normal inflation and very little change in the exchange rate. I think the markets expect that. The other risk which I think is more likely, but the market does not believe as much, is that the economy is much stronger, and growth is much faster than people expect. Employment growth is faster, the unemployment rate falls very far to around 3% and perhaps even lower. This means that the inflation we see this year turns out to continue into next year. In that case, the Federal Reserve (Fed) is going to have to tighten more than the market expects, and the dollar will rise more than the market expects. We won't know till maybe March or June of next year. During the rest of this year it is going to be very difficult to gauge underlying inflationary pressures. You are going to see some prices falling – car prices will be falling so negative inflation in those prices, but other prices will be rising such as rents and it will be hard to disentangle the overall message on inflation for the rest of this year. Next year is when all those temporary factors will be gone, and then we will have a sense of where the economy is heading.

Prospect for the US Economy in 2022

JS: At this moment, the 2021 US GDP growth rate is predicted to be around 6-7% according to the

majority of economists, and the unemployment rate around 3-4%. Are these accurate estimates for 2021? And would this economic performance continue into 2022?

Gagnon: My own forecast is a lower unemployment rate – below 4% and by some point next year closer to 3%. Instead of 6% growth I might see 7% or 8% growth.

JS: Would this economic performance likely continue into 2022?

Gagnon: Yes, because the fiscal stimulus that we just got actually has a little bit of its spending into next year, and probably we will get this infrastructure and other packages in the next couple of months, so there will continue to be forces upholding the economy next year. Growth won't be 6% or 8% next year but it will be at least 2%, probably 3% or 4%.

JS: So that means the dollar would be strengthened as a result of this strong growth?

Gagnon: My view is that the dollar will go up but probably not till next year.

Direction of US Monetary Policy in the Future

JS: Looking at the economy in the long run, you mentioned that at this moment expansionary monetary policy shouldn't be a problem in terms of the efficiency of the economy. But in the long run monetary policy will be tightened – is that right?

Gagnon: My best guess is that the Fed will have to start raising interest rates at some point, not this year but maybe next year, but I don't think we are going to see very high interest rates. All of this fiscal policy might be raising the interest rate a percentage point or so, so it's not a huge thing but it is noticeable. You might see interest rates in the US 100 or 200 basis points higher for a couple of years than currently projected.

JS: We agree with you regarding economics, but in terms of politics would it be possible to raise interest rates?

Gagnon: Not a problem. Interest rates are very low, and a lot of people would like them to go up, and unless they get up to 5-10% (which is not going to happen) then there is no worry. As long as the economy is strong, I think that US President Joe Biden in particular would rather have interest rates higher by 1 or 2 percentage points than a much higher inflation rate.

JS: In the US there are some serious political questions regarding the income gap. Poor people may have a different view on the interest rate hike.

Gagnon: I don't think so – first, poor people don't earn or pay any interest, so they don't care. (Some poor people take out credit card or payday loans at very high interest rates, but those rates are not much affected by Fed policy.) People slightly above the bottom may borrow to buy a car or a house and they would appreciate low interest rates but it's not a big deal for them. The big thing for the people at the bottom of income distribution is jobs. If the unemployment rate goes below 4% significantly, those people will have very strong increases in their wages, and we have seen that many times. That is far more important than any small hike of interest rates. It's not an issue.

Job Security

JS: Job security is a very important goal for economic policy. In your view, is US macro policy working well to achieve this goal?

Gagnon: If you listen to Fed Chairman Jerome Powell, for two years now he has been talking about the benefits of a "high pressure economy". He wants full employment everywhere and he talks about how this has disproportionate benefits for the people at the bottom of the income distribution, the low-wage workers. They were getting big gains when the unemployment rate was 3.5% two or three years ago. I think they are starting to get them again, coming out of the pandemic, and he is very happy with that. I hope to write a paper on this in the fall. In my view, every advanced economy – starting with Japan in the early 1990s and spreading to Europe and North America in the late 1990s – has been operating below potential pretty much continuously. I do not believe the estimates put out by the IMF, the OECD, the Bank of Japan and the Fed of potential output gaps and unemployment gaps; they are all wrong. The closest one to being correct is the one by the US Congressional Budget Office which has a good estimate of the natural rate of unemployment, but even they are too pessimistic. The natural rate of unemployment is even lower, so potential output is even higher than they think. Inflation is very resistant to going below zero and where that resistance happens is a little different in Japan, the US and Europe. In Japan, the floor is around zero while in the US and Europe it is about 1% inflation. Getting below that floor is very hard to do. You can have a lot of excess unemployment, output can be below potential for many, many years without causing further declines in inflation, because it stops at that bound or limit of no inflation. Central banks have misunderstood where potential is because they didn't see that bound on inflation and so all advanced economies – starting with Japan – have had major macro policy errors for decades. I think Powell is the first central bank governor to understand this correctly.

JS: Consumption growth in the post-pandemic era could be key to achieving robust economic growth. All countries are worrying about consumption growth and working hard to restore it. In the US wages have stagnated in recent years, but do you think wages need to be raised to restore consumption?

Gagnon: I would support an increase in the minimum wage in the US, but I don't think that's the most important thing; frankly, the minimum wage is technically $7 an hour but you can't hire anybody for less than $12 or $15 dollars an hour these days. It should be raised to $12 or even $15 per hour in major urban areas. We have seen very strong wage growth at the low level over the past few years. Before that there was stagnant wage growth for a long time, and I think there are two reasons for this.

One is that the US economy was operating below potential for most of the past 20 years and when you are below potential, the people who are hurt the most are the people at the bottom, just as when you are above potential the people who are helped the most are those at the bottom. We have been below potential which hurts those at the bottom disproportionately. We will be back above potential next year and that will help the bottom. The other factor has to do with competition. Several studies have found that the US economy has gotten less competitive in terms of markets and competition within markets. The number of companies in each market is smaller now, there are fewer companies with more market power earning excess profits that go to the management and shareholders but not the workers, and that has increased as a share of the economy which means that the wages at the bottom haven't kept up with overall GDP growth because some of the GDP growth was just going to the owners and the management. That has been a process that has been going on for 30 years or more, so I think that the Biden administration sees that and wants to reverse it. If you raise taxes on companies and rich people and increase benefits to poor people with childcare and healthcare and so on, you can help offset that and that is what the government is trying to do here. I don't know if that is happening in Japan, if Japanese markets are less competitive and the profits are going to just a few people. If you look at the OECD studies on how efficient and competitive markets were, the US was always ranked highly. Japan was a kind of dual economy where the goods industries were very competitive, but the services industries were very uncompetitive. Now you have more efficient retailers and other service distribution changes in the past 30 years so maybe you have caught up, while the US has become less competitive. The OECD used to say that the US was much more competitive than Japan, especially in services, and maybe that has changed.

JS: You mentioned the US economic growth potential, but what would happen to that potential due to the pandemic? Would it have a negative impact on it?

Gagnon: I don't fear big effects but there are two smaller effects that are offsetting. More people are retiring. They lost their jobs, the stock market has done well, their housing has done very well; so they are wealthier than they expected and don't want to go back to work. On the other hand, you see a lot of businesses trying new ideas and technologies during the pandemic and those are increasing productivity and may remain. There is a mix of less labor growth going forward and maybe more technology growth. I don't see a big net effect on the central growth rate, but it is good news because it means more output per worker. I see the US potential growth rate as something close to 2%.

JS: On the question of wage hikes, somebody mentioned that the reason why the US wage increase rate is low is due to the weakening power of labor unions – would you concur?

Gagnon: It might be true, it could be part of the less competitive conditions, but I think that is looking backward to the past 20 years. In the past two years that has all changed, and there is a big change at the bottom of the labor distribution.

US Debt Management Policy

JS: Moving to the question of debt, US Congress members are very concerned about the stability of government debt. Once interest rates rise as the economy gets on a recovery path, the debt might possibly rise with growing interest payments. How can US policymakers manage this question in the long run?

Gagnon: I don't worry about it too much. You can't borrow forever, but I think that the amount governments can borrow has increased as interest rates have come down globally. This phenomenon is not limited to Japan or the US, and the biggest single factor is low birth rates. Lower birth rates mean lower growth rates, which mean lower interest rates. The other factor is longer life spans. Longer life spans are a harder thing to judge because they might first lower and then raise interest rates, but the net effect so far has been to lower interest rates – it might change. Some people think that the nature of technology has changed, as pointed out by Larry Summers. If you look at General Motors and Google – which are two very different companies – they both have about the same amount of sales in terms of revenue, but General Motors has about 10 times as much capital stock – all the factories and equipment and dealerships around the world. It takes far more investment to generate that revenue for a company like General Motors; whereas for Google there is very little investment, basically just some buildings and computers in them.

The amount of investment you need to generate growth is less than it used to be and that holds the interest rate down because there is less need to borrow. That has been holding interest rates down. Some countries have big savings rates and have been exporting them to the rest of the world by government policy that buys up foreign assets. All the oil revenue money that used to be spent is now saved, and that pushes interest rates down. All these factors have combined to push interest rates down and this looks likely to continue for a long time. There is one study by Charles Goodhart and Manoj Pradhan that claims that it is going to turn around soon but they are only looking at one of several factors and that is too simplistic. The new thing since their book is the change in US fiscal policy, and that will tend to push up interest rates. Even with all the fiscal stimulus that the US has had and is likely to have, most estimates are that it will only raise US interest rates by maybe 1% in the long run. So it's not completely going to reverse what we have seen, and some people say less than 1%. So somewhere between 0.5% and 1%. It is not going to push interest rates permanently back to where they used to be (interest rates may rise more than 1% temporarily as the Fed responds to temporarily higher inflation).

But your question would be, yes, but what if the economy is so strong that the Fed must raise interest rates even more to keep inflation in check? Well, that would be a surprise but would be in the context of a very strong economy and we would have time to gradually adjust. The US government, although divided, will eventually adapt and it doesn't have to be within a year or two – they have several years to adapt. It would almost certainly be in the context of strong economic growth which would make it easier to do that. If we don't get strong economic growth, then interest rates are not going to go up.

JS: Apart from the question of interest rates, a budget must be prepared for so many challenges. In the case of Japan in particular, preparations for an aging society will require major social expenditure. In that sense, older countries including the US and Japan are in a difficult position because due to the pandemic they must increase government expenditure for restoring infrastructure. In the future, there may be some new demands on the fiscal budget. How can we prepare for such additional expenditure? Some are recommending a kind of "Tobin Tax" globally overall. Would this be a good idea in your view?

Gagnon: First, too many people are too worried about fiscal policy. In Japan people have been worried about fiscal policy for a long time, and it's been a mistake. Fiscal policy has never caused Japan problems. The way to judge whether fiscal policy is a problem is to look at longest-term interest rates in real terms corrected by inflation, and they are very low in Japan. That means that the market is not worried, even 30 years down the road, which is also true in the US. In its latest budget, the White House showed the true cost of the US national debt in terms of real interest rates, and the debt is a negative burden on the US. We actually earn money by borrowing rather than it costing money. I bet the same is true in Japan and if it is not, it is because you have not created enough inflation.

Secondly, the best way to deal with fiscal policy in Japan is to get more inflation. I am convinced that if Japan could raise its inflation rate by 2 or 3 percentage points to 3% or more, interest rates will not rise by that much in the long run. Therefore, you will reduce the burden on the government because interest rates will be below the growth rate of the economy and below tax revenues. The best tax is an inflation tax: Japan needs an inflation tax and that would be the best solution in my view.

The Digital Economy in the US

JS: The digital economy is progressing significantly during the pandemic. This could be helpful in raising productivity.

Gagnon: I tend to think that the private digital currencies like Bitcoin and so on are just a Ponzi scheme, mere bubbles. Regulators should clamp down hard on them and I don't think they serve any useful purpose. I don't think they are going to be transformative and are rather like gambling. Some people will make money, some people will lose, but it is a waste for the economy – rather like having a gambling casino. People need to understand that these things are fundamentally useless except for criminals.

JS: How about digitization in general, as a force for pushing up productivity and producing jobs?

Gagnon: Maybe – I worry that there is also cost. The criminals and ransomware attacks and cyber-attacks are a concern. I don't have a good sense as to how much of a cost there is. Productivity growth was strong in the pandemic, but that was partly just because the type of people who lost their jobs tended to be lower productivity workers. There are all kinds of issues going on – issues relating to how businesses operate; restaurants are doing more takeout and automating their ordering systems, but I am not sure how important these issues are.

US Macro Policy's Global Impact

JS: The possibility of the rise of interest rates in the US may cause problems in developing countries due to capital flight. Do you think a US interest rate rise will be moderate, so that will not happen?

Gagnon: The US interest rate rise will likely be moderate so there could be some of that, as well as some offsetting benefits. One of my concerns is the extent to which people in other countries borrow in dollars, which is very risky. If US interest rates rise and you have borrowed in dollars, you will be hurt. I don't know why governments allow this, but it is not really a concern of the US. We don't encourage foreign countries to use the dollar so much that they borrow in it; every country should borrow in its own currency and needs a good monetary and fiscal framework to do that. We've seen big progress in so many countries like South Korea and throughout Asia, such as Thailand – they can borrow in their own currency. The same is true in many Latin American and African countries, but there are also still many that continue to borrow in dollars. If you didn't borrow in dollars, then your central bank has the freedom to move interest rates separately. Obviously if the dollar rises because of strong US interest rates, that may be a reason to raise interest rates in foreign countries to keep their own currencies from falling too much, to be too inflationary. It would be in the context of strong US growth which would buy a lot of imports; I think the US trade deficit is going to get bigger, and that will help exports from other countries and help offset the costs. So I think you will see some rotation away from consumption and investment into exports in these countries, and they should be able to handle it. Many countries are poorly run and will make mistakes and blame the US as they always do. No one is forcing them to make these mistakes. We all must respond to each other; we are all interdependent and shouldn't blame each other for problems.

Conclusion – US Economy & Macro Policies Are on the Right Track

JS: Judging from your answers today, you believe that US economic growth is achieving an ideal economic recovery, not only in light of the US domestic economy but also the global economy. Is this correct?

Gagnon: Yes. I believe that the US is going to have a strong recovery and both monetary and fiscal policy have been excellent. I have been amazed at how strong the fiscal response has been, and I think we are going to have a stronger year than the forecasts even. A lot of forecasters in the Fed are still worried about the effects of the pandemic, and looking at Japan where vaccination rates are low, I can sympathize, as this is not good for the economy. This is a worry and reduces demand for US exports and is thus a drag on the US economy. But in terms of the US, Canada, and Europe where vaccination rates are high, we are going to have a very strong recovery because even with the uptick in cases in the US, 99% of people who are not vaccinated are people who have chosen not to be vaccinated because they are not afraid of the virus. So they are not going to stop going out, shopping, working and spending money. And those that are vaccinated are probably not going to stop either so even with cases rising in America, I don't see an economic slowdown, I see strong growth. (Recent news that vaccines are less effective in preventing mild infections from the Delta variant compared to previous variants does raise some concern. But the effectiveness remains strong in terms of severe illness and death, so any economic effect should be mild.) I think forecasters in the US are too cautious about the pandemic. I think that the fiscal stimulus is so strong that it will offset any slow growth and slump in US exports. We haven't seen two years in a row with this much deficit spending since 1943; it is just enormous. JS

Written with the cooperation of Joel Challender who is a translator, interpreter, researcher and writer specializing in Japanese disaster preparedness.