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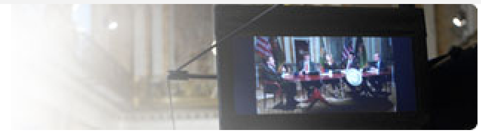

Remarks by Under Secretary Nathan Sheets at the German Institute for Economic Research (DIW Berlin)

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As Prepared for Delivery

BERLIN – Since joining the Treasury, I have attended a seemingly endless stream of G-20 meetings in destinations including Brisbane, Australia; Antalya, Turkey; Hangzhou, China; and now Berlin, Germany. The diversity of locales notwithstanding, the discussions at these meetings have a recurring theme: The performance of the global economy has remained lackluster, and the growth we have is unbalanced and insufficiently inclusive across all parts of society.

There is broad agreement in the G-20 that our ultimate objective is strong, sustainable, balanced, and inclusive global growth. There also is agreement that the global economy is falling short of this goal in two important ways.

First, trend growth for many countries individually, and for the global economy as a whole, has slowed in the years since the financial crisis, and potential output has remained below our reasonable aspirations. G-20 participants recognize that strengthening the supply side of our economies is necessary for increasing employment, boosting productivity, and raising standards of living for future generations.

But there also is agreement that we are falling short in a second way. Specifically, the global economy continues to be plagued by cyclical slack. Some progress has been made in recent years, but there is still much more to be done. Aggregate demand and spending are well below even our reduced estimates of the potential capacity to produce. The economic consequences of this shortfall have been significant. First, cyclical weakness has meant an inability to provide suitable jobs for many citizens. For example, there are nearly 5 million more unemployed workers in the euro area today than before the crisis. Second, it has translated into pronounced disinflationary pressures. For example, in numerous countries throughout the euro area, as well as in Japan, core inflation is close to zero, suggesting ample supply relative to demand. And third, the growth of global trade has ground to a halt, which has particularly weighed on emerging market economies.

While there is consensus that global economic performance is disappointing on both the supply-side and the demand-side, countries differ in their views as to the causes of this disappointing performance and what policies can most effectively address the current challenges. The G-20 countries have committed to use all policy tools – monetary, fiscal, and structural – to achieve our goals. But what is the right balance among these tools? What is our individual and collective responsibility?

In the remainder of my remarks, I will address this debate. A key insight is that the supply-side and the demand-side of the economy are vitally interlinked. A viable program to move the global economy forward must include reinforcing and complementary steps to raise productive capacity and to reduce the cyclical slack that now prevails.

<u>Strengthening the Supply Side</u>

Let me begin with the supply side of the equation. The diagnosis that the disappointing performance of the global economy has, in part, reflected a shortfall on the supply side provides a rationale for structural reforms. Examples of such reforms include measures to make labor and product markets more flexible and competitive as well as steps to streamline regulation, privatize state-owned firms, and increase openness to international trade and investment. Such reforms should help increase innovation, improve the climate for investment and entrepreneurship, stimulate labor supply, and make the economy more diversified, flexible, and resilient.

The nature of the structural reforms that are necessary varies from country to country. For example, in Italy, labor market reforms are crucial to raising worker productivity and enhancing competitiveness going forward. Commodity exporting countries, like South Africa and Brazil, must diversify the structure of their economies to reduce exposure to volatile commodity prices. And the Chinese authorities face the challenge of rebalancing toward private consumption. The G-20's Growth Strategies Initiative is designed to focus on these issues.

<u>The Limits of Structural Reforms</u>

Well-designed structural reforms will help ensure that global economic performance is vibrant in the medium to long run. However, as a general matter, they do not address the problems of underutilized labor resources and disappointing growth that many economies continue to face today. These challenges instead reflect sustained softness in global demand.

It is sometimes argued, including by some here in Germany, that the enactment of structural reforms will unleash a powerful dose of private-sector confidence that will stimulate the economy. While such scenarios cannot be ruled out entirely, the early stages of intensive structural reform programs can have a negative impact on near-term growth, and thus are not a substitute for appropriate measures to stimulate demand. Specifically, when countries implement structural reforms, firms that are less competitive tend to lose market share; inefficient sectors are squeezed by increased competition; wages in sheltered industries are often pushed down and their work forces reduced; and privatization may bring downsizing and rationalization of state-owned firms. Such developments lay the groundwork for stronger performance over time; but the near-term uncertainties, transition costs, and effects on labor and household incomes may be pronounced and contractionary.

<u>The Necessary Role of Demand-Side Policies</u>

As I noted at the outset, there is broad agreement across the G-20 that the global economy continues to be plagued by cyclical slack. But there is still division as to how macroeconomic policies should respond to the shortfall in global demand. As is well known, we at the U.S. Treasury have long argued for countries to forcefully employ strong stimulative policies to address this situation. Such stimulus appropriately includes monetary measures, where inflation is well contained, and fiscal measures, where the government has space.

Our support of meaningful demand-side stimulus rests on five empirical realities. First, demand-side policies have been effective in the United States. In the years following the financial crisis, U.S. policymakers took forceful action to stimulate demand, fully employing both monetary and fiscal tools. The Federal Reserve slashed policy rates, injected liquidity, and bolstered demand through unconventional balance sheet policies. Fiscal policy also provided critical stimulus. Such measures prevented an even more severe downturn and fueled a recovery that outpaced those of most other advanced economies.

Second, there are vital links between the demand-side and the supply-side. Policies to support near-term demand have sometimes been dismissed as "sugar stimulus" and deemed to provide only a temporary boost to the economy. But this overlooks an important point: Resources that are not being utilized tend to depreciate and become less productive. This is true of machines and structures, which rust and decay, but it is also true of labor and expertise. As our experience of recent years highlights, people out of work today find it harder to secure employment tomorrow. Periods of high cyclical unemployment can leave long-lasting scars on labor market conditions and workers' earning profiles.

Macroeconomists have labeled these important links between the performance of the economy today and the capacity to produce in the future as "hysteresis." Newly established firms, which are important drivers of job creation, may be especially vulnerable to these effects, due to their typically smaller financial buffers.

Third, an argument sometimes lodged against stimulative fiscal policies is that they increase the public debt burden to be shouldered by future generations. But my reading of the empirical evidence is markedly different. The appropriate gauge for assessing the burden of the debt is not the absolute amount of debt that is owed but, rather, the amount that is owed relative to the capacity to repay. In other words, the denominator of the debt-to-GDP ratio is as important as the numerator.

Given that periods of cyclical weakness can scar the economy's productive capacity, a lagging policy response may adversely affect future debt sustainability. Specifically, prolonged periods of cyclical weakness impede the economy's capacity to generate tax revenues and, more generally, limit the resources available to service the debt. Absent strong nominal GDP growth, the reduction of debt-to-GDP ratios is dependent entirely on austerity, which risks prolonged stagnation or even economic contraction.

The first slides provide some related evidence. Japan in recent decades has seen the ratio of its general government debt to GDP grow sharply relative to that of other countries. But the difference has not been a faster accumulation of debt – the numerator of the ratio. As the next slide illustrates, other G-7 countries have experienced expansions in their debt levels comparable to Japan's. Rather, the remarkable difference has been the growth of nominal GDP – the denominator of the ratio. In other G-7 countries, nominal GDP has expanded steadily, in aggregate, while in Japan the sustained failure to defeat deflation contributed to a stagnation of nominal GDP. So, while medium-term fiscal sustainability depends on the evolution of the budget balance, it also hinges crucially on the achievement of growth and price objectives.

Fourth, the burdens of the prolonged downturn have fallen disproportionately on the young. As shown in the next slide, this has particularly been the case for the euro-area periphery. Spain and Greece face a major challenge—their youth unemployment rates (that is, for workers younger than 25 years old) have fallen a bit recently, but remain over 40 percent. In Italy, the situation is only a little less severe.

These data highlight a striking irony. Those who oppose calibrated fiscal stimulus measures in the name of not leaving debt for future generations may inadvertently be intensifying headwinds facing the younger workers they aim to protect. Such high unemployment rates raise serious questions as to whether today's young workers will have the skills they need to drive economic growth in the decades ahead.

Fifth, strong demand is a crucial driver of confidence. Those who question the advisability of stimulative macroeconomic policies often point to the need to restore confidence in the business community. But nothing is likely to jumpstart business confidence (and, for that matter, consumer confidence) more powerfully than evidence of rising demand and stronger GDP growth. Indeed, a benchmark theory of investment—the so-called "accelerator model"—links business investment directly to the rate of economic growth. Firms boost their levels of investment once they actually see evidence of stronger demand for their products.

Implications for the Euro Area and Germany

I would now like to touch briefly on what this means for Europe, and more specifically, for Germany.

First, some data. Growth in the euro area has recovered slowly from the global financial crisis. Real GDP today has risen less than 2 percent from its 2008 level, while domestic demand over the same period has fallen 1 percent. Hence, all of the net increase in GDP in the years since the crisis is due to external demand. In line with this observation, as the next slide illustrates, the euro area's current account has moved from near balance before the crisis to a surplus of nearly 3½ percent of GDP in 2016. This substantial swing is due to persistently weak consumption and investment, combined with a sizable real effective depreciation of the euro.

The situation in the euro area today is one of under-utilized resources, particularly labor resources. Unemployment has remained persistently above 10 percent, versus 7 percent prior to the crisis. Without a stronger stimulative push to increase demand, the many millions who are still out of work will see their skills erode. What was once temporary unemployment threatens to become intractable structural unemployment – the hysteresis effect that I mentioned earlier. As shown in the next slide, that may already be happening, as nearly half of the euro area's unemployed are now classified as long-term unemployed, a sharp increase from just several years ago.

And as I mentioned earlier, the young are disproportionately bearing the burden. Very high rates of youth unemployment mean that vast numbers of young workers are not getting the experience and skills they need to contribute productively in the years ahead.

Responding to this challenge requires complementing structural reforms with macroeconomic policies to boost domestic demand. There are a range of views on how much policy space, especially fiscal policy space, is available. That said, the European Commission's recent recommendation that the euro area as a whole undertake fiscal expansion of up to 0.5 percent of GDP in 2017 is a constructive step. The Commission's view on this important issue underscores the critical role that fiscal policy can play in supporting domestic demand, as well as the scope for positive cross-country spillovers, especially when monetary policy is at the zero lower bound.

I am mindful that the run-up in public debt in the wake of the financial crisis has tempered the willingness of many policymakers to deploy what is left of their fiscal arsenals. However, absent faster nominal GDP growth, it is probably unrealistic to expect that debt-to-GDP ratios in the euro area will decline in a sustained way. As a complementary point, Canada, the UK, and the United States have been much more aggressive in supporting their economic recoveries, incurring public debt twice as rapidly as in the euro area. Nonetheless, their debt-to-GDP ratios have risen only a bit more than in the euro area because of faster growth in nominal GDP.

Notably, Germany has fared much better than most of the economies in Europe. Unemployment is much lower and wages have risen somewhat. But – as outlined in the next slide – with weak investment in productive capacity and consumption declining relative to disposable income, German domestic demand has remained too soft, the economy too dependent on exports, and the current account surplus has widened further. In parallel, Germany continues to record a massive imbalance in its saving relative to its investment, with excess saving over the last four years totaling nearly €1 trillion.

Were Germany to spend some of this excess saving, the impact would be significant. Stronger demand growth in Germany would trigger faster wage growth, higher household incomes, stronger demand for German-made products, and stronger demand for foreign-made products.

Clearly there is scope in Germany for more public infrastructure investment. And, as shown in the final slide, with long-term bund rates at virtually zero, one cannot envision a better time than now to boost investment in real productive assets. Doing so would increase German incomes today and German potential growth in the future. It would provide real benefits for current and future generations. And of course, the spillovers to the rest of Europe and the global economy would be beneficial as well.

Concluding Thoughts

In sum, sound economic policies, both in the euro area and elsewhere, must seek to appropriately balance supply-side and demand-side considerations. Measures to stimulate demand during periods of weakness are necessary both to ensure favorable economic growth today and to safeguard the capacity of the economy to produce tomorrow.

Indeed, structural reforms and macroeconomic stimulus can, and should, play complementary roles. For example, to the extent that labor market reforms exert drag in the near term, well-designed macro stimulus can buffer the adverse effects. This, in turn, helps ensure that reforms proceed in an environment that is as supportive as possible.

Moreover, as policymakers take steps to boost demand in their own economies, positive spillovers flow to the rest of the world. These spillovers serve to support growth and limit the depth of cyclical downturns elsewhere.

For these reasons, strong domestic demand led measures must be a central part of our efforts to catalyze a resilient, balanced, and inclusive global economy.

For the slides referenced in the remarks, please click here.

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