Lost in transition

Challenges

Denis Kessler

October 2014

Following a financial crisis, economies go through transitional periods punctuated by significant transformations. It is difficult to have a clear vision of such periods, as many of the changes are new, and ways of thinking dating from before the crisis are generally no longer relevant. Without their traditional markers, and no longer understanding some of the developments underway, economic decision-makers seem lost. Here are a few examples of issues raised by the current transition.

The functioning of the labour market is increasingly being called into question. The central bankers who met this summer in Jackson Hole did not select this topic by chance. The FED had stated that its policy would change when the unemployment rate dropped to 6.5%. However, the current decline in unemployment in the USA seems to owe more to a decrease in the labour force participation rate than to job creation. If this is the case, the drop in unemployment does not necessarily indicate a genuine economic recovery that would justify an increase in interest rates. This decline in the participation rate can also be seen in Europe, Japan and even China. Are we witnessing a change in households’ behaviour? Is this transitional or permanent?

Moreover, changes in productivity are also confusing. The statistics confirm that productivity gains are slowing down in developed economies, yet we do not really know the reasons why. On the one hand, the expansion of services – which generate fewer productivity gains than industry – would explain such a slowdown – but on the other hand new technologies and the increase in automation imply greater productivity gains.
There are also questions surrounding the effectiveness of monetary policy. Despite the implementation of policies that are more than accommodating, economies are stagnating or experiencing sluggish and hesitant recoveries. The famous money multiplier seems to be trending towards zero. Regardless of interest rate levels, investment and consumption are not picking up, and private sector credit is declining. However the money is created, we are now fearing deflation, whereas prior to the crisis inflation was the major concern. Indeed, most of the liquidity being created returns to central bank balance sheets via bank deposits, rather than sustaining the economy. Due to this ineffective monetary policy, central banks are seeking new means of action and are turning to governments to ask for structural reforms.

This is when governments discover that budgetary policy is not what it used to be. Convinced prior to and during the crisis that public deficits were supporting economic activity, they are now struggling to realise that the opposite is true: long-term recovery requires the correction of deficits and the reduction of public debt. What can be said then about the surrealist debate on austerity measures, which are criticized (particularly in France) for their alleged negative effects, while save for a few exceptions they have not even been implemented? Some governments, entrenched in old certainties, are literally lost. Above all, they have not yet grasped that structural reform of the fiscal system, the labour market and the welfare state was not just useful, but absolutely essential to recover from the crisis.

International interaction in a globalised economy is adding to a debate full of misunderstandings. We believed in a kind of economic convergence, and yet post-crisis we are witnessing divergence. Does this decoupling of economies – between the USA and Europe, within Europe or between Asia and the rest of the world - belong to this specific phase in the global cycle, or is it a long-term factor?

To understand this, from now on we must make the distinction between an international economy and a global economy: nation states do not always understand that production factors are mobile, and that we are going to witness increasing separation between value creation and territory, leading to major fiscal and social repercussions. “Designed in California, made in China, sold in France…” The potential for production
reallocation is now much greater, and the conventional reasoning with regard to international multipliers is becoming obsolete.

When governments are lost and do not find the means to create a new roadmap, they get stuck, stay put and stop providing any direction. While people search for some meaning to all of this, their doubts are continually increasing. The transition needs to be explained!