Secular Stagnation is Not Destiny: Faster Growth is Achievable with Better Policy

Jean Boivin — *Deputy Chief Investment Officer, Blackrock Investment Institute; Former G-20 Finance Deputy, Canada; Former G-7 Finance Deputy, Canada*

Tiff Macklem — *Dean, Rotman School of Management, University of Toronto; Former Senior Deputy Governor, Bank of Canada*

Will global growth accelerate as the world economy transitions from recovery to expansion, the transformational potential of new information-based technologies is realized, and a widening spectrum of developing economies join the global trade and financial system? Or are we doomed to secular stagnation, owing to some combination of slower demographic growth, fewer big innovations, a shrinking middle class, and chronic private and public underinvestment?

These are big questions. Although we have learned much about many of the factors influencing global growth and convergence, we don't know much about their relative magnitudes and pacing. Indeed, given the competing factors at play and the historically unpredictable patterns of technological progress and economic convergence, the answers to these questions will likely remain unknowable for some time.

We should not let this paralyze us.

Whether new information technologies have sparked a third industrial revolution or not, there is considerable scope for G-20 countries to grow. The global economy is far from the efficient production or policy frontiers. Better public policies and an improved global financial architecture can unleash significant additional growth.

Many of the policy levers that influence growth are national in scope, and countries can and should take action that is targeted to their particular circumstances. There are, however, some policy levers that are critical to growth that can only be deployed at a global level to be effective. Others have important spillovers to other countries that need to be taken into account. Here, the G-20 should take the leading role.

We begin by examining what is holding back medium-term growth in Canada, and where domestic policy should be directed to raise potential growth. This is interesting from a global perspective as it illustrates how we can apply *what we do know* about the drivers of growth to an advanced economy. Other countries may see parallels with their situations, or be spurred to action themselves.

We will then turn to areas where the G-20 needs to take a greater leadership role. At its most fundamental level, the best contribution the G-20 could make to boosting global growth would be to re-energize trade and financial integration, while ensuring global financial stability. This has four essential ingredients: trade liberalization, financial reform, exchange rate flexibility, and a framework for international financial linkages and spillovers. These elements are not new, and some progress has been made. But an unwavering focus will be required to spur growth and avoid secular stagnation.

Raising Medium-term Growth in Canada

Thanks in large part to a credible monetary policy regime, the best fiscal situation in the G-7, and a well-regulated and sound financial system, Canada weathered the global financial crisis considerably better than other countries among the G-7. It was the first to fully recover output and the jobs lost in the Great Recession. In addition, Canada has several other key strengths, including a well-educated and increasingly flexible labor force, privileged

global access to capital, and abundant commodities that the world desires. Nevertheless, in the last couple of years, growth has disappointed. Elevated household indebtedness is weighing on consumers, and deteriorating international competitiveness is eroding export growth.

To increase medium-term growth, Canada should focus on two priorities: closing its investment and innovation gaps, and "going global."[1] We examine each in turn.

1. **Invest and innovate.** Since 2000, productivity growth in Canada has languished, and Canadian competitiveness has deteriorated. In 2000, Canada ranked 7th in the World Economic Forum's Global Competitive Index; today it ranks 14th.

While we don't yet know whether new information technologies have fundamentally changed the growth potential of the world, at a micro firm-level, there are several stylized facts about productivity that have both a sound theoretical basis and considerable empirical support.[2] In particular, more productive firms tend to:

- invest more in machinery and equipment (M&E), particularly in information and communications technology (ICT);
- employ more workers with higher educational attainment; and
- invest more in research and development (R&D) and innovation.

Canada has some examples of tremendously successful global firms that have invested heavily in new technology, skills and R&D. But on average, Canada has gaps along all three dimensions.

- On average, Canadian firms invest less in M&E and ICT than their U.S. counterparts and as a result, Canadian workers have only about *half* as much M&E and ICT capital stock to work with as their US counterparts.[3]
- Canada has a well-educated workforce that compares very favourably in OECD rankings when it comes to primary and post-secondary education, but Canadian firms lag in the employment of PhDs and other post-graduates, especially in the sciences, engineering and business.[4]
- In business sector spending on R&D, Canada ranks a disappointing 22nd among OECD countries, and when it comes to innovation capacity, the World Economic Forum rates us 27th, far behind Switzerland, Germany and the United States.[5]

Public policy has done much to address Canada's productivity and innovation underperformance, from sound macro and regulatory frameworks for monetary, fiscal and financial sector policies, to low corporate taxes and strong public spending on R&D. What is needed is *more competition* in a number of the protected sectors that underpin Canada's cost structure, combined with a societal shift towards *greater entrepreneurialism*. Simply put, Canada needs more entrepreneurs. It needs to build entrepreneurialism into its educational system at colleges and universities and provide better training for our scientists who seek to commercialize their ideas. Canadian executives need to have an "innovate-or-perish" mentality, and they need to learn from successful innovation ecosystems.

2. **Go global**. Canada's location right next door to the United States—the largest and richest market in the world—has been a tremendous boon to its growth and prosperity. Thirty percent of Canada's GDP comes from exports, three-quarters of which go to the United States. But in recent years, the U.S. has not been the engine of global growth it once was, and Canada's exporting firms have suffered.

Part of this is cyclical, and with the U.S. economy now showing sustained momentum, the prospects for Canada's exports and growth have improved. But the other part is structural. The global financial crisis only accelerated the shift in the centre of economic gravity from the U.S. to rapidly growing emerging market economies (EMEs), particularly

in Asia. In 2000, less than half of global growth came from emerging and developing countries; today, it is nearly three-quarters. Yet only about 10 percent of Canada's exports go directly to fast-growing EMEs, while 85 percent go to slow-growing advanced economies.[6] Canada needs to strengthen its links with fast-growing economies, and Canadian firms need to invest in developing business in these markets. This is a long game, which will require a more global mindset among Canadian business, a better understanding of local markets outside of North America, and investment in global supply chains.

It will also require a major investment in infrastructure in Canada to build gateways to the Pacific and Atlantic Oceans so that Canadian businesses can get their products to rapidly-growing markets. Nowhere is this need more acute than in the commodity complex. Sustained increases in the demand for energy, food and metals in emerging markets present a tremendous opportunity for Canada—but only if it can get the product to market. Achieving this will entail very large infrastructure investments in rail, pipelines and ports. The enormous scale and longevity of these investments are a hurdle for private investors, and the G-20's focus on financing for long-term growth and infrastructure is very helpful in this regard. However, domestic issues—regulatory uncertainty, aboriginal land claims, and environmental disputes—present even larger hurdles for private investment. Resolving these will require leadership from all levels of government in Canada.

These policy prescriptions are within Canada's reach all by itself and reflect *what we do know* about productivity growth. Acting together, the G-20 could further raise Canada's growth prospects significantly.

What Can the G-20 Do to Raise Medium-term Growth?

To raise global growth, the G-20's essential role is to ensure an open and resilient global trade and financial system. This requires a concerted focus on four mutually reinforcing ingredients:

1) a freer flow of goods, services and capital;
2) an efficient and resilient global financial system that is less prone to crisis;
3) flexible and market-determined exchange rates to improve the allocation of resources and facilitate adjustment; and
4) a more complete understanding and framework for international financial linkages.

We examine each in turn.

Re-energize trade liberalization. Greater trade and financial integration can increase the global GDP level by allowing better diffusion of technology and best practices, increasing competition and productivity, improving the allocation of resources and capital globally, and diversifying risk. Evidence also suggests that freer trade cannot only increase but also accelerate the growth rate of global GDP, by serving as a vehicle for technology diffusion.[7] These are also the mechanisms by which convergence occurs, allowing the growth benefits to be shared around the world.

In the aftermath of the global financial crisis, global trade collapsed, falling by roughly 15 percent, and is now growing at only one third of its pre-crisis rate.[8] Weak demand and changing global trade patterns are part of the explanation, but increased protectionism—both explicit and implicit—is also part of the story. The World Trade Organization estimates that trade-restrictive measures put in place since the financial crisis now cover five percent of G-20 imports, with the most recent evidence suggesting that they are now more prevalent than at any time in the last three years. This is holding back global growth and is a major challenge facing the G-20.

While there has been some recent progress on bilateral trade agreements, the multilateral trade agenda needs to be re-energized. In our view, the best outcome would be to complete a meaningful and comprehensive multilateral agreement that

goes beyond the G-20 countries. Unfortunately, the most ambitious initiatives in this arena have been stalled for some time, but multilateral regional initiatives such as the Trans-Pacific Partnership would represent a significant step forward. Coordinated unilateral trade liberalization, whereby every country agrees to reduce tariffs on different things, even if not part of an explicit quid pro quo, could help make progress and achieve positive spillovers. The G-20 should play a greater leadership role in promoting these initiatives and eventually connecting them.

Complete the reform of the global financial system. Trade liberalization goes hand-in-hand with greater financial integration, and the global financial system has been an essential enabler propelling global economic growth. Despite frequent shocks to the system, it facilitated a remarkable post-war expansion of advanced economies and ushered in a new era of rapid economic growth in new integrated emerging market economies. But as the global financial crisis laid bare, it can also be a source of instability, with devastating consequences.

Robust domestic policy frameworks and well-developed domestic financial markets are essential and this requires effective international coordination. The G-20 reform of the global financial system has been its most successful reform undertaking. Thanks to the leadership and coordination efforts of the Financial Stability Board (FSB), much has been done globally to strengthen risk management and supervision, increase capital and liquidity buffers, strengthen financial market infrastructure, align incentives, and improve crisis management.[9] While completing the reform of the global financial system is now within reach, two areas require a final "push."

First is shadow banking. As standards have risen in the regulated sector, there is increasing evidence of rapid growth in the shadow-banking sector, particularly in some EMEs. Lack of transparency and standardized protocols have the potential to lead to unforeseen interconnectivity and risks. Because shadow banking encompasses a wide range of heterogeneous players and activities, and differs across jurisdictions, it is neither desirable nor realistic to have Basel-style standards. Countries must have some discretion on how to implement the principles within their jurisdiction. But if we are to restore trust, these principles need to be sufficiently "crunchy" that we can assess whether FSB members have indeed put in place reforms that fully live up to the spirit and intent of agreed principles.

Getting to "crunchy principles" is proving difficult in some areas. At times, agreements to high-level principles look more like agreements to disagree on crucial details. The G-20 needs to cut through these disagreements and accelerate progress. Peer reviews that shine light on implementation across the G-20 may be helpful in identifying where implementation needs to accelerate and where more crunchy principles are required.

Second is recovery and resolution. Much progress has been made here, but two critical elements remain. First, a comprehensive bail-in regime must be developed that will provide both an efficient and final buffer to protect tax payers, and support continuous operation of the core functions of systemically-important financial institutions at the point of failure. Secondly, this needs to be combined with credible cross-border cooperation agreements between relevant authorities. Without these two elements, we risk a more fragmented, less efficient global financial system that is ultimately less stable.

Increased exchange rate flexibility is also important. More progress towards market-determined, flexible exchange rates is essential to enable the financial system to avoid and absorb shocks. A more efficient mechanism to enable the adjustment of relative prices is a necessary release valve that reduces pressures on the system as a whole and, by providing appropriate price signals, facilitates needed reallocation of resources within and across economies. The lack of flexibility in some parts of the world generates imbalances and increases the burden of adjustment required by others.[10]

This is why exchange rate flexibility has been at the center of discussions within the G-20, and progress has been achieved. Global current account imbalances have been significantly reduced, with China's current account surplus declining from a peak of 10.1 percent to 2.3 percent of GDP, and China is now allowing greater, if still limited, exchange rate flexibility.

The G-20 needs to build on this positive momentum if we are to reap the gains of a more open, more integrated global economy. Global imbalances are accumulating at a slower rate globally, but divergence in net foreign positions is still growing. Moreover, depressed global demand played an important role in reducing current account imbalances. As global demand recovers, imbalances can be expected to widen They are, in fact, already large and growing in some places, such as Germany with a surplus of 7 percent of GDP.

The international monetary system remains overly rigid, particularly as we face the implications of asynchronous recoveries across advanced economies and the prospect of divergent monetary policies. As of 2014, aggregate reserves of G-20 emerging-market economies have reached nearly $6 trillion, or about 28 percent of their GDP—well beyond any conceivable precautionary motive. Moreover, countries representing roughly 40 percent of the U.S.-dollar trade weight have been thwarting foreign exchange adjustment, either through quasi-fixed exchange rates, with ongoing capital controls or the threat of using them. At $4 trillion, China's reserves alone have increased by over two-thirds since January 2010. Without further progress, there is a risk of a vicious circle settling in, where insufficient adjustments spill over onto others, leading G-20 members to take more individual actions further preventing necessary adjustment.

Better understanding of international financial linkages is essential. The financial landscape is in constant evolution, and greater financial integration can increase the importance of financial market dynamics that are not yet well understood. Over the last few years there has been a greater appreciation of the risk-taking channel as a driver of asset prices, such as asset owners crowding into or chasing returns and extrapolative expectations, both of which can be exacerbated by a low interest rate environment.[11] These channels have started to be more explicitly acknowledged in domestic policy frameworks and macroprudential policy tools are being developed.[12] But whether this acknowledgment and the tools being developed are efficient remains to be seen. Moreover, with greater global financial integration, these channels become global in nature, and macroeconomic policy setting in one country can have financial stability repercussions in another. Concerns around such "spillovers" have featured prominently in G-20 discussions in recent years.[13] However, the fact that policymakers are beginning to pay greater attention to the risk-taking channel and its cross-border manifestation is a good thing, and the G-20 needs to make sure that it properly integrates this into macroeconomic frameworks and policy decisions. This is essential to both protecting financial stability and to reducing the temptation to thwart exchange rate adjustment.

Conclusion

At the global level, the persistent headwinds from the global financial crisis are being felt beyond the typical cyclical horizon. A significant global output gap remains, and an immediate objective of G-20 policymakers is to close it. Relevant authorities have already signaled that this will require the injection of further policy stimulus in some countries, while stimulus is withdrawn in others. This policy divergence will induce capital flows and required exchange rate adjustments. The unprecedented nature of the stimulus already in place and the potential magnitude of the adjustments give the G-20 a critical role to play: The effectiveness of these policies will benefit from a common understanding across the G-20 and will need to be properly communicated.

While closing the global output gap will help to raise growth, a sustained increase will require a

considerable push on structural reform. Many of these reforms are best deployed domestically, and here the G-20's role is to support these initiatives by acting as a commitment device supported by a transparent accountability mechanism. There are also important reforms required to build a more open and resilient international trade, financial and monetary system. These are essential to raising medium-term growth, and they can only be pursued jointly by the G-20.

To both support needed domestic reforms and international resolve, the G-20 Finance Ministers and Governors have set an aspirational goal of raising global output by 2 percent over the next five years. This is a big step forward, and represents the first time the G-20 went beyond stating that the "recovery is too weak," and articulated and communicated what it wants to achieve. On the basis of that objective, measures that will be put forward can now be evaluated and progress can be assessed. This represents a significant strengthening of the G-20 accountability process and provides stronger incentives to deliver.

The stakes are incredibly high. Faster growth is within reach, but it will require countries to take action individually and collectively. Secular stagnation is not destiny, but avoiding it will take determination and resolve.

References

Adrian, T. and H.S. Shin. 2008. "Financial Intermediaries, Financial Stability and Monetary Policy." Paper prepared for the economic policy symposium "Maintaining Stability in a Changing Financial System." Jackson Hole, Wyoming. August.

Alvarez, F., Buera, F. and R. Lucas. 2012. "Idea Flows, Economic Growth, and Trade", Working Paper.

Bank of Canada. 2011. *Renewal of the Inflation-Control Target*, Background information, November. www.bankofcanada.ca/wp-content/uploads/2011/11/background_nov11.pdf

Bernanke, Ben S. 2011. "Global Imbalances: Links to Economic and Financial Stability." Remarks at the Banque de France Financial Stability Review Launch Event, Paris, France February 18.

Boivin, J., Lane, T. and C. Meh. 2010. "Should Monetary Policy Be Used to Counteract Financial Imbalances?" Bank of Canada Review.

Carney, M. 2009. "The Evolution of the International Monetary System." Foreign Policy Association, New York City. November. www.bankofcanada.ca/wp-content/uploads/2010/03/sp191109.pdf

Carney, M. 2012. "Some Current Issues in Financial Reform." Canada Club of Montreal, Quebec. http://www.bankofcanada.ca/2009/11/evolution-international-monetary-system/

De Munnik, D., Jacob, J. and W Sze. 2012. "The Evolution of Canada's Global Export Market Share." Working Paper No. 2012-31, Bank of Canada.

Dion, R. and R. Fay. 2008. "Understanding Productivity: A Review of Recent Technical Research." Bank of Canada Discussion Paper 2008-3.

Lucas, R. E. 2009. "Trade and the Diffusion of the Industrial Revolution." *American Economic Journal: Macroeconomics*, 1, 1-25.

Lynch, K. 2010. "Canada's Innovation Deficit." *Policy Options*, Institute for Research in Public Policy, March.

Lynch, K. 2012 "Economic Renewal, Innovation and Budgets: A Longer-Term Perspective." Ottawa. www.researchmoneyinc.com/conferences/201205/media/Economic%20Renewal%/

Macklem, T. 2011. "Canada's Competitive Imperative: Investing in Productivity Gains." Productivity Alberta, Edmonton. www.bankofcanada.ca/2011/02/canada-competitive-imperative-investing/

Macklem, T. 2012. "Raising the House of Reform." Rotman Institute for International Business. Toronto. www.bankofcanada.ca/2012/02/raising-the-house-of-reform/

Macklem, T. 2013. "Regearing our Economic Growth." W. Edmund Clark Distinguished Lecture, Queen's University, www.bankofcanada.ca/2013/regearing-our-economic-growth/

OECD. 2012. *Canada Economic Survey*.

Rajan, R. G. 2006. "Has Finance Made the World Riskier?" *European Financial Management* 12 (4): 499–533.

Stein, J. 2013. "Yield-Oriented Investors and the Monetary Transmission Mechanism." Banking, Liquidity and Monetary Policy," a Symposium Sponsored by the Center for Financial Studies, Frankfurt, Germany. http://www.federalreserve.gov/newsevents/speech/stein20130926a.htm

World Economic Forum. 2014. *Global Competitiveness Report 2013-14*.

Endnotes

1. For a more complete discussion of these themes, see Lynch (2010, 2012) and Macklem (2011, 2013).

2. Dion and Fay (2008) provide an excellent survey of the international and Canadian evidence.

3. Macklem (2013).

4. OECD (2012).

5. World Economic Forum (2014).

6. De Munnik, Jacob and Sze (2012).

7. See, for example, Lucas (2009) and Alvarez, Buera and Lucas (2012).

8. Using OECD data on trade volumes (OECD Stat).

9. Carney (2012) and Macklem (2012).

10. Carney (2009) and Bernanke (2011).

11. Rajan (2006), Adrian and Shin (2006), Boivin, Lane and Meh (2010), and Stein (2013).

12. Bank of Canada (2011).

13. In their September 20-21 Communique, Finance Ministers and Central Bank Governors stated: "We are mindful of the potential for a build-up of excessive risk in financial markets, particularly in an environment of low interest rates and low asset price volatility. We will monitor these risks and continue to strengthen macro-economic, structural, and financial policy frameworks, and other complementary measures, as the best response to managing risks, and meet our G-20 exchange rate commitments."