A decade without recovery: Why secular stagnation characterizes contemporary capitalism

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As 2017 draws to a close, marking the tenth year after the onset of the Great Recession, optimism about the prospects of a robust recovery is being voiced in many circles. News that the US economy grew at 3 per cent during the hurricane-blighted third quarter of 2017, close to the 3.1 per cent recorded in the previous quarter, has once more revived claims that the world economy has left the Great Recession behind. For example, the International Monetary Fund's *World Economic Outlook* released in October 2017 noted: “The pickup in growth projected in the April 2017 World Economic Outlook (WEO) is strengthening. The global growth forecast for 2017 and 2018—3.6 percent and 3.7 percent, respectively—is 0.1 percentage point higher in both years than in the April and July forecasts. Notable pickups in investment, trade, and industrial production, coupled with strengthening business and consumer confidence, are supporting the recovery.”

However, there is adequate reason to believe that this optimism is guarded at best, since the scale and sustainability of this so-called recovery is still in doubt. One reason is that back to back 3 per cent annualized rates of growth in consecutive quarters has been observed more than once since the 2008 crisis. In fact, as recently as the second and third quarters of 2014, rates of GDP growth in the US stood at 4.6 and 5.2 per cent respectively. The IMF too is quick to hold back, saying “the recovery is not complete: although the baseline outlook is better, growth remains weak in many countries. The outlook for advanced economies has improved, notably for the euro area, but in many countries inflation remains weak, indicating that slack has yet to be eliminated.”

Charts 1 and 2 being out clearly a number of features of G 20 growth performance over the last decade. First, is the rather remarkable recover that these economies staged from the depths of the recession in in the third quarter of 2009, reflected in the v-shaped section of the curve. Second, a retreat from the post-recovery growth and a return to a new normal of growth in the 2-3 per cent range. Third, the much poorer performance of the advanced economies when compared to the G 20 as a group, influenced no doubt by China and India. Fourth, the return to a second recession in the European Union as a result largely of austerity in the peripheral countries. In sum, the long-term picture is one of a loss of momentum with the a significant setback when compared to the peak recorded in the recovery that immediately followed the crisis. In the event, unemployment in the Eurozone is still above the pre-crisis level and real wage growth is sluggish and has even turned negative in some countries.

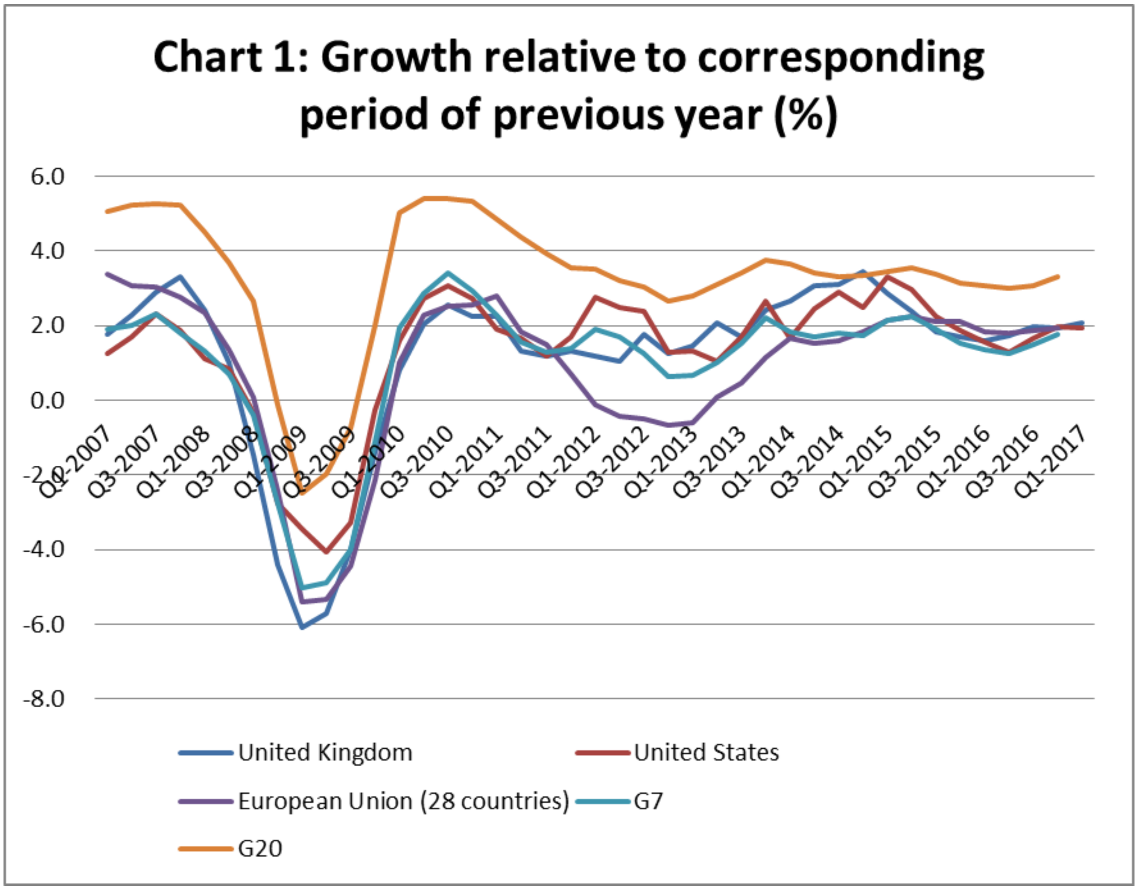
Chart 1: Growth relative to corresponding period of previous year (%)
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
-8.0
Q1-2007
Q3-2007
Q1-2008
Q3-2008
Q1-2009
Q3-2009
Q1-2010
Q3-2010
Q1-2011
Q3-2011
Q1-2012
Q3-2012
Q1-2013
Q3-2013
Q1-2014
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United Kingdom
United States
European Union (28 countries)
G7
G20

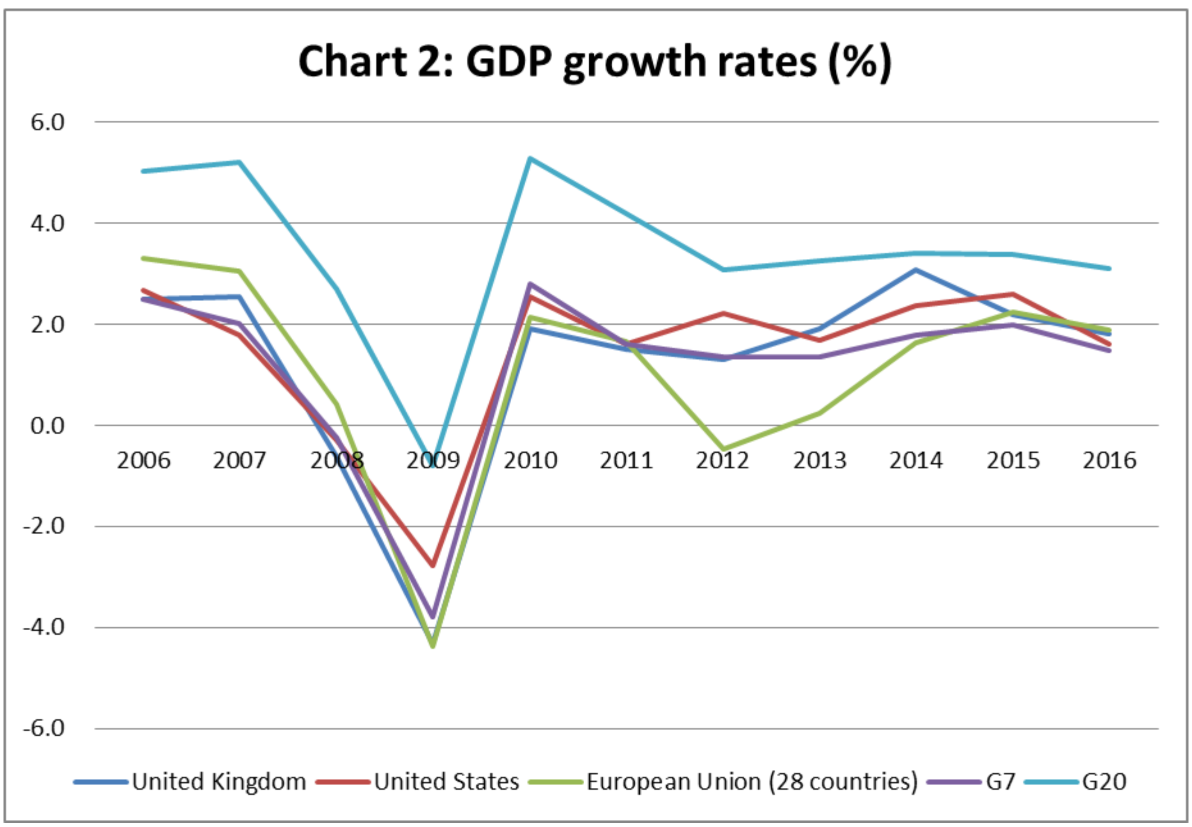
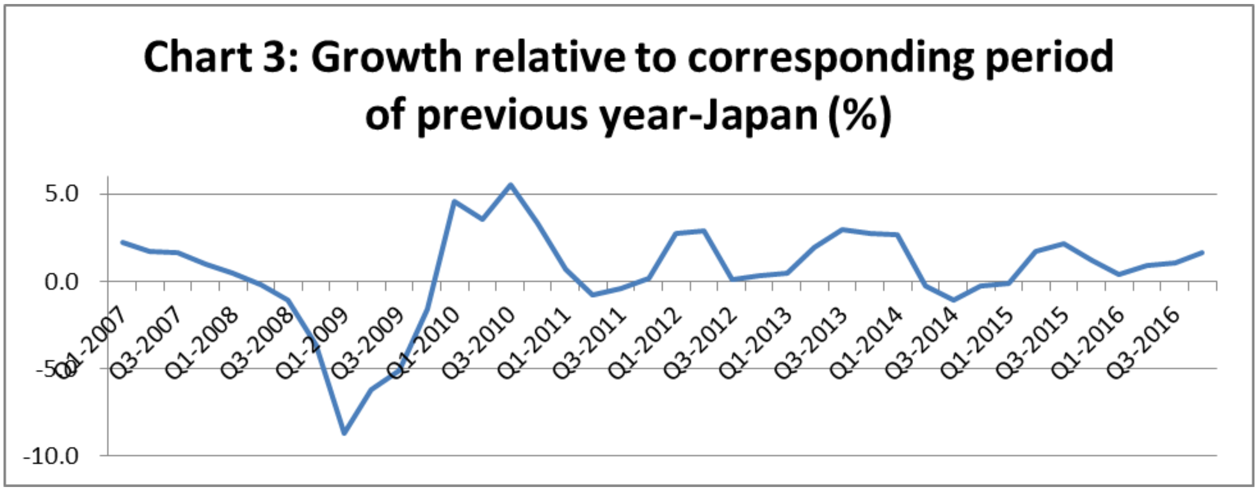
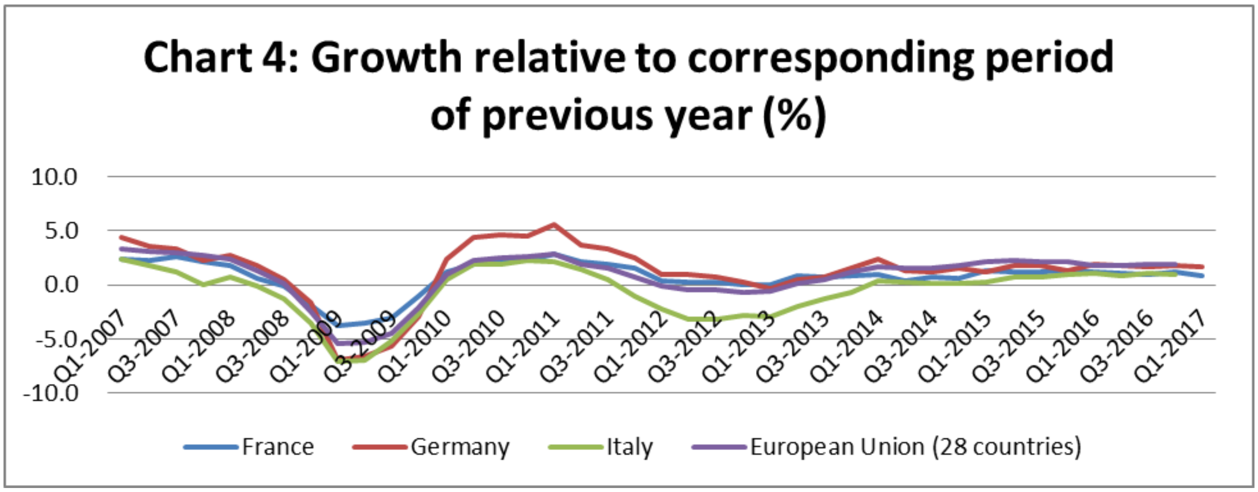


Chart 2: GDP growth rates (%)
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
United Kingdom
United States
European Union (28 countries)
G7
G20





As has been argued by many, these trends in growth while triggered initially by the crisis, is reflective of the failure of many advance country governments to sustain the fiscal stimulus that underlay the v-shaped recovery, with a turn to fiscal conservatism in core developed countries and austerity in the peripheral countries among the advanced economies.

Explaining secular stagnation

There is no disagreement that the source of the Great Recession was the 2007-08 financial crisis in the US and Europe. That crisis heralded by Bear Sterns hedge fund bankruptcy in July 2007 and the Lehman collapse in September 2008, damaged the settlements system because of counterparty risk, rendered markets illiquid and froze the credit pip. This impacted the real economy that was tipped into the recession described. It is that decade-ago crisis that the world economy has still not significantly recovered from. Despite upbeat financial markets and some recent signs of buoyancy, global growth remains well below pre-crisis levels.

The early retreat from the pro-active fiscal stance and stimulus resorted to in response to the crisis led to primary or exclusive reliance on monetary policy instruments, such as quantitative easing through bond purchases and interest rate reductions. The adverse effects on growth of the former were not compensated for by the latter, with infusion of large volumes of liquidity at near zero interest rates helping banks and financial firms to stabilize and return to profit. This improvement in the profitability of financial firms, however, proved to be inadequate by itself to raise consumption spending and investment in the economy.

The retreat from proactive fiscal policy was justified on the grounds that a high public debt to GDP ratio was an ingredient in a recipe for stagflation. Increased taxation of surplus incomes to finance larger state expenditures was not considered an option, despite evidence of growing inequality. The crisis offered an argument as to why raising tax rates was not feasible. The corollary was that, having saved the banks and financial firms, governments could not turn their attention to restoring growth and strengthening safety nets for those who had been rendered unemployed and/or were hit badly by the financial crisis.

Once governments succumbed to the pressure not to use tax- or debt-financed fiscal spending as a means of stimulating a recovery, monetary policy measures, such as liquidity infusion and interest rate reduction, became the principal instruments to spur the recovery. Implicit in this dependence on monetary policy is the idea that private expenditure financed with debt at low interest rates would substitute for public expenditure to revive demand and growth. Since banks are less willing to lend because of fear of default, monetary policy is directed in the first instance at these institutions. But, the reliance on such policies even when they are not effective has had some bizarre effects. One such is the movement of rates to negative territory, to push banks into lending rather than holding interest bearing deposits with the central bank. This reflects the desperation that has overcome central banks which find that deep rate cuts have not stalled the downturn and ensured recovery.

In his 1943 essay on the “Political Aspects of Full Employment”, Michal Kalecki had argued that the opposition to government spending in capitalist economies leads to dependence on stimulating private investment through other means, such as reducing interest rates or cutting taxes. But this he noted can have bizarre consequences. If, for example, the rate of interest or income tax is reduced in a slump (to counter it) but not increased in the subsequent boom (to keep it going), “the boom will last longer, but it must end in a new slump: one reduction in the rate of interest or income tax does not … eliminate the forces which cause cyclical fluctuations in a capitalist economy. In the new slump it will be necessary to reduce the rate of interest or income tax again and so on. Thus in not too remote a time the rate of interest would have to be negative and income tax would have to be replaced by an income subsidy.”

The problem today is worse, because rate cuts are not even correcting the slump, as the transmission of the effects of those cuts is not eliciting the consumption and investment responses that increase demand and boost output. Negative rates reflect the belief that interest rate cuts can drive growth in diverse ways. Lending rates are expected to come down and encourage households and firms to spend and/or invest more, raising demand. Investors not wanting to pay governments for holding their money are expected to turn to asset markets like the stock market. That is expected to raise financial asset prices and trigger the oft-cited "wealth effect". And, since low and negative interest rates in a country would discourage foreign investors from investing in bonds and financial assets in the country concerned, the currency can depreciate, improving the competitiveness of exports.

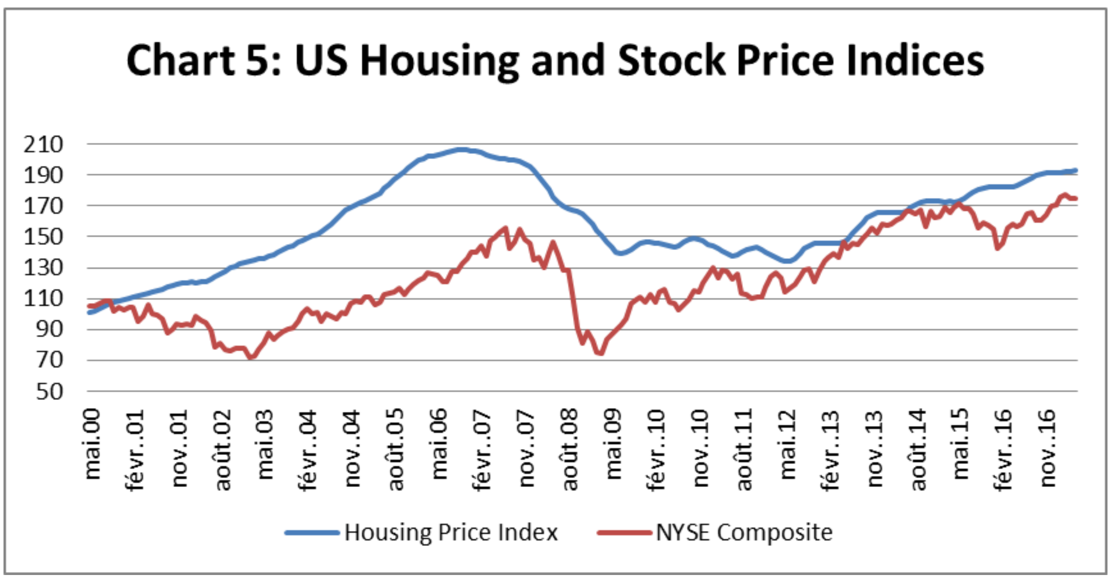
In practice, none of these expectations have been realized. Overburdened by a legacy of debt and uncertain about incomes and profits in the midst of a recession, households and firms have been reticent to borrow more. And, even when they are willing, banks have been unwilling to extend their credit exposure, despite the pressure to lend stemming from low or negative interest rates on reserves held with the central bank. Government bonds have not been an alternative, since increased demand for them have driven their yields to negative territory as well. Finally, with all countries relying on the interest rate lever to raise growth, currencies while depreciating vis-à-vis the dollar, have moved more or less in tandem relative to each other. This has neutralised the competitiveness benefits from depreciation relative to the dollar.

With none of the expected outcomes of using monetary policies in the form of quantitative easing and low or negative policy rate being realized, the fundamental tendency is to slow growth. On the other hand, with economies flush with cheap money, features similar to those which prevailed prior to and led up to the 2008 crisis are now visible in different forms to differing degrees in the developed economies.

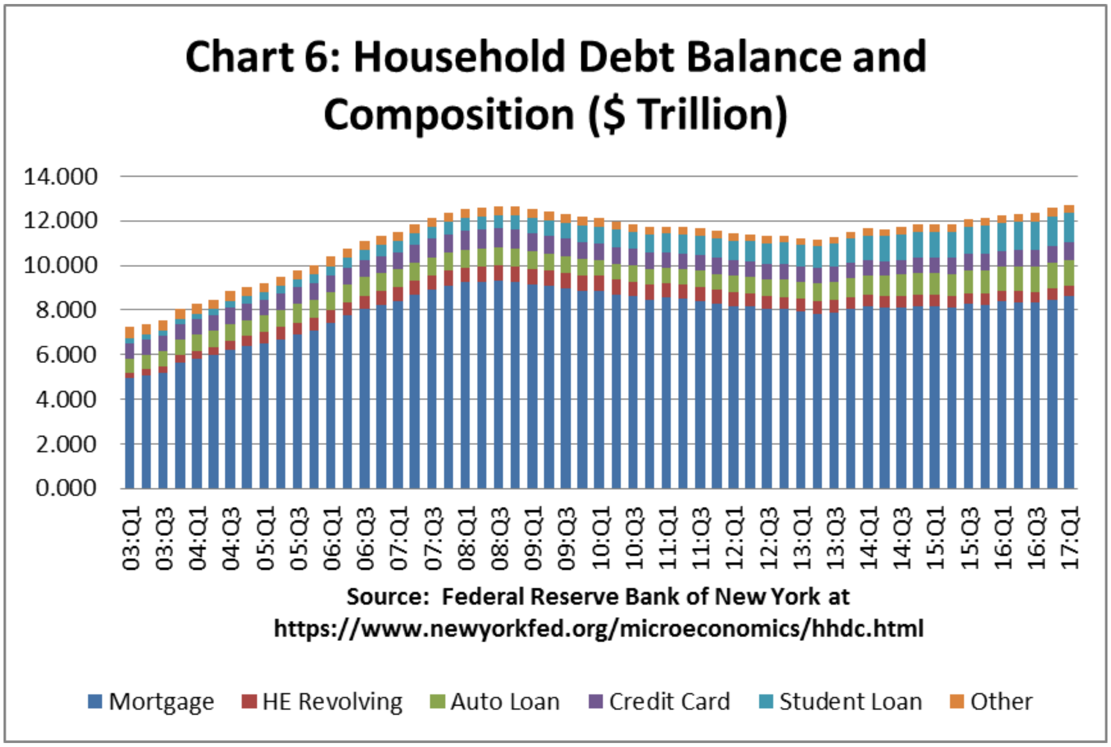
The US experience with recovery

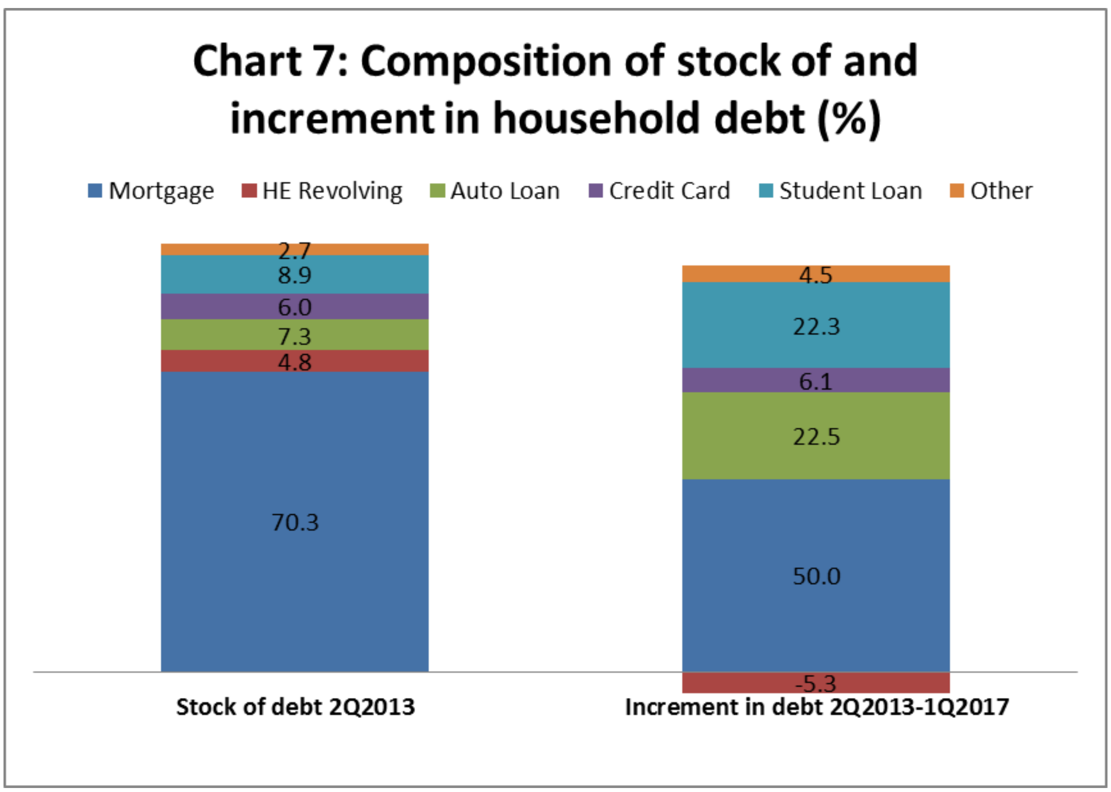
In the United States, for example, access to cheap liquidity encouraged investment in equity and bonds, so long as they offered a positive spread relative to the available capital. One consequence of this arbitrage was a 'revival' in capital markets with the New York Stock Exchange composite index surging from its early 2009 crisis induced trough to levels that exceeded its pre-crisis mid-2007 peak (Chart 5). However, the similarity with the pre-crisis trend ended there. Before 2007, asset price inflation was seen as spurring a "wealth effect", with beneficiaries of asset price appreciation encourage to spend more on consumption and investment, financed with debt. One reason for this, as noted earlier, was that both borrowers and lenders were not willing to join in another credit spree, because they were burdened with debt and/or had burnt their fingers recently. The other was that the wealth "accumulated" in this fashion, or through capital gains in equity markets accrued to the already rich, among whom the wealth effect was far less significant.

The fragility this gives rise to is compounded by the problems that negative interest rates create for banks that are under pressure to lend. With the increase in liquidity swelling the volume of deposits on which some interest has to be paid and with returns from holding deposits with the central bank falling and even turning negative, bank profitability that had been restored from the low it touched in the aftermath of the 2009 crisis was under pressure. This does seem to have increased lending by the banks to those who were willing or even desperate to borrow in the depressed economic environment. According to data from the Federal Reserve of New York, total household indebtedness stood at $12.73 trillion as of March 31, 2017, which was $50 billion above its previous peak reached in the third quarter of 2008 and 14.1 percent above the trough that was touched in the second quarter of 2013. In effect, a slow process of deleveraging that had begun in the third quarter of 2008, after the crisis, was reversed starting the second quarter of 2013, though total household debt was still 54 per cent above the level it was at in the first quarter of 2003 when a global liquidity surge started unfolding. (Chart 6).



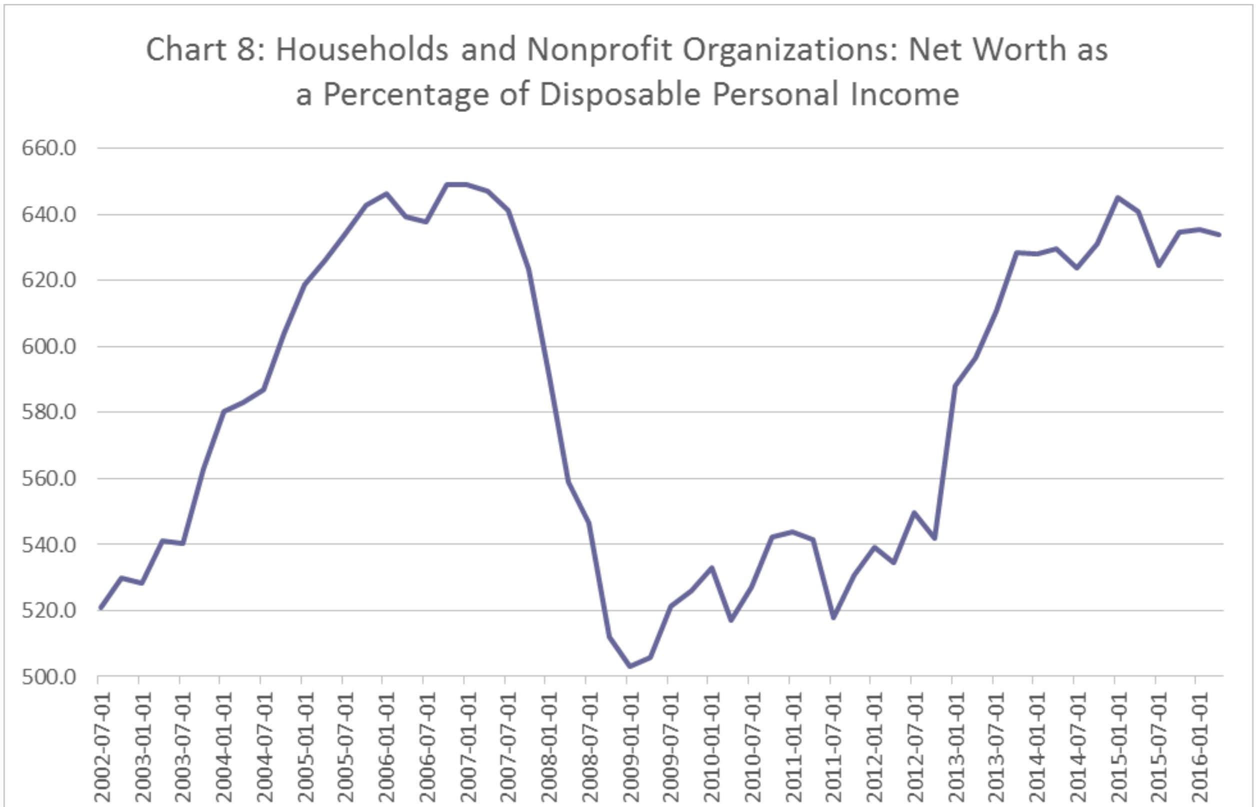
What is interesting is the composition of the increase in household credit in the US between the second quarter of 2013 (2q-2013)and the first quarter of 2017 and the composition of the stock of household debt in the first quarter of 2013. Mortgage loans that accounted for 70 per cent of outstanding household debt in 2q-2013 contributed only 50 per cent of the increment in household debt between 2q-2013 and 1q-2017 (Chart 7). On the other hand, auto loans and student loans that accounted for 7.3 and 8.9 of the 2q-2013 stock, contributed 22.5 or 22.3 per cent of the increment in debt between that date and 1q-2017. In other words, close to 45 per cent of the increase in credit in the period when banks have been "forced" to lend, was on account of auto loans and student loans. Total outstanding auto loans at $1.17 trillion are up 66 per cent from the post crisis trough in 3q-2010 and the student loan total has more than doubled (to $1.3 trillion) relative to 1q-2009.





There are a few implications that follow from this dramatic change at the margin in the composition of household debt. First, it appears that given the still incomplete process of deleveraging and the uncertainty associated with accepting housing assets as explicit or implicit collateral, banks are making an effort to diversify their lending away from the housing market to the extent possible. Second, since loans for automobile purchases are small in size and short in duration and can be securitized to reduce risk of losses this is an area where lenders have chosen to move, only to find willing borrowers who are able and/or willing to take on such debt since they believe they can trade in the asset in case they are unable to service the debt. Third, unemployment and changes in requirements in the labour market are driving the young to look for higher degrees at the cost of building up large debt. And despite the risks of default because of failure to obtain jobs that offer the required income stream, banks have decided to accommodate this demand as part of their diversification strategy. Finally, debt financed educational spending does not directly result in material demand. On the other hand the magnitude of student debt, because of high college fees and the burden of servicing that debt, requires deferring entry into mortgage agreements and postponing home ownership. So, the increase in this component of household debt, not only lacks the output expansion effects that borrowing for buying houses or cars would, but also reduces the demand for mortgage loans. Hence, the growth-inducing effect of this round of increased household borrowing is likely to be lower than it was in the past.

These factors notwithstanding, the 'early' return to borrowing on the part of households, with half of the increment in debt being on account of mortgage loans, has had a salutary effect on the housing market. So, as Chart 5 shows, the post-crisis decline in the housing price index, which had bottomed out in mid-2009, has been reversed since mid-2013. As a result both financial asset prices and housing asset prices have been rising, though the latter began its rise after a considerable lag. A consequence of this asset-price inflation is that the ratio of the net worth of households and non-profits to personal disposable income has risen from its post crisis low in early 2009, with that rise gathering momentum after mid-2011 (Chart 8).



Source: Federal Reserve Bank of St. Louis at https://fred.stlouisfed.org/series/HNONWPDPI

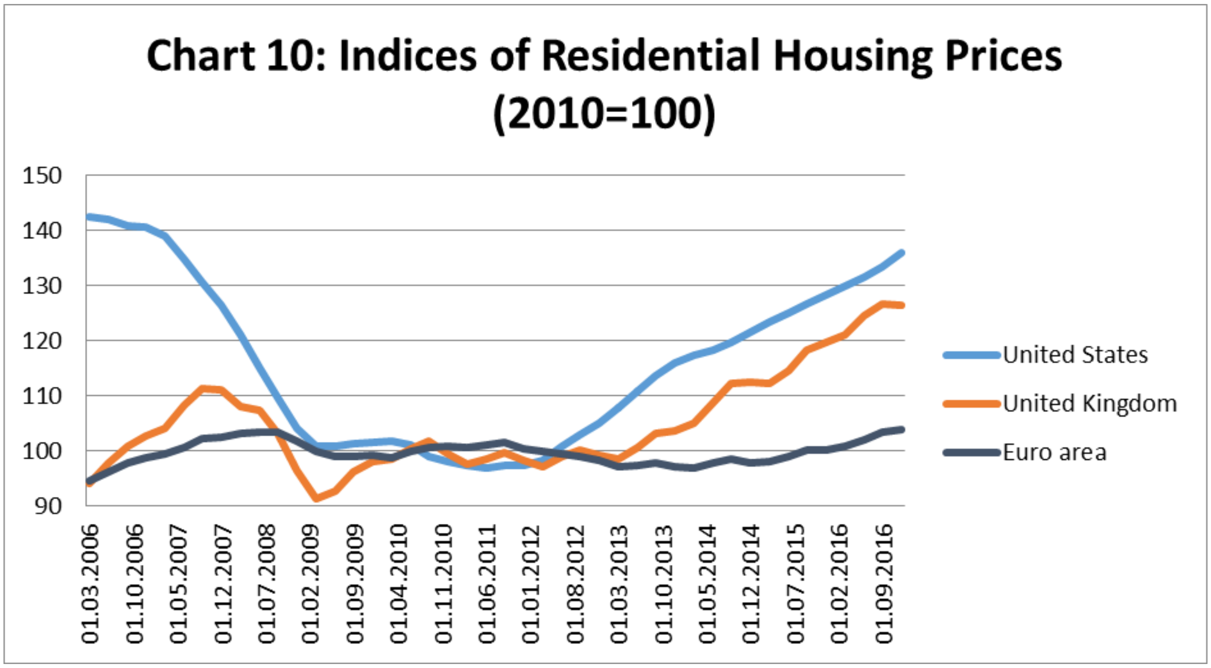
Fortunately or unfortunately, depending on one's perspective, this recent bubble has already run up against constraints. It is now becoming clear that auto loans were provided to many who did not have the ability to meet the debt service commitments involved, and banks did that because they diluted their standards and because they could still persuade investors to buy into securities backed by these loans. According to the Financial Times of 30 May 2017, which quotes Morgan Stanley, (Ben MacLannahan, "Debt pile-up in US car market sparks subprime fear", https://www.ft.com/content/bab49198-3f98-11e7-9d56-25f963e998b2), the share of auto securities tied to "deep subprime" loans — those given to borrowers with scores below 550 on the commonly-used FICO creditworthiness scale — rose from 5.1 per cent of total subprime deals in 2010 to 32.5 per cent last year." Now defaults are rising as many borrowers are unable to service the debt and unable to pay it off by selling the asset, because of a collapsing used car market that has brought prices down to levels below the value of unpaid debt. According to reports, "7.35 per cent of auto loans moved into arrears of at least 30 days in the first quarter, compared with just over 10 per cent in the worst days of the downturn." The situation with student loans is worse. The percentage of loan balances going into "serious delinquency" has been hovering around a 10 per cent annual rate over the past five years. As a result banks are pulling back, undermining even this limited stimulus that could spur recovery.

The problem is that the prospect of the persistence of low growth in the US comes at a time when the expectations of a shift from a monetary to a fiscal stimulus generated by the coming of a new administration are waning. While the Trump administration has promised a tax cut stimulus, there is no concrete plan to ensure that this does not result in a substantial widening of the fiscal deficit. This is likely to result in obstacles to implementation. Meanwhile, there is no evidence yet of a significant step up in infrastructure spending, which too is likely to run up against a fiscal constraint.

Implications for Europe

It is in this light that talk of a recovery in Europe must be assessed. The difficulty in Europe is that households have not even been brought back to the market for debt. Household debt In the Euro Area decreased to 58.70 percent of GDP in the third quarter of 2016 from an all time high of 63.90 percent of GDP in the fourth quarter of 2009 and a record low of 46 percent of GDP in the first quarter of 1999 (Chart 9). This has been combined with austerity to keep growth low as discussed above.

One consequence of this has been that residential prices in the Euro area have not shown the same post-2012 buoyancy as in the US and the UK (Chart 10). While housing prices in the US and UK have risen quite sharply since 2012, the same has not been true of the Euro areas. Despite this evidence from selected countries such as Italy for the first quarter of 2017 is cited to argue for a European recovery that is more absent than real.



A feature of economic performance in the Eurozone that needs to be underlined is the substantial variation in growth across countries. A stand out case is Germany, which has sustained growth on the basis of exports to other European countries and to the rest of the world. As a result Germany has been a leading contributor to global trade imbalances. While China runs a much larger trade surplus with the US when compared with Germany, the latter's aggregate trade surplus with the 'rest of the world' was, at around $300 billion in 2016, $50 billion higher than China's aggregate surplus.

Germany's Schauble admitted there was a problem when he said that the European Central Bank's (ECB's) monetary policy, which had to be set for the Eurozone as a whole, was too loose for Germany, resulting in turn in a euro exchange rate that was "too low" for a country with its competitive advantages. Thus, in his view, 'quantitative easing' by the ECB, that was infusing too much euro liquidity into the world economy, was keeping the euro low and increasing German exports, leading to a large trade surplus with countries outside the EU like the US. But this is amounts to an apology for pursuing what is in essence a mercantilist strategy of growth that keeps domestic wages and consumption down, suppresses domestic public and private sector investment and pursues a conservative fiscal policy that delivers unwarranted and globally damaging fiscal surpluses.

Revisiting the recovery argument

Once we take this growth scenario into account, the principal cause for celebration if any is the falling unemployment rate in the developed economies. According to the IMF's latest *World Economic Outlook*, the unemployment rate in the advanced economies is estimated to have fallen from its 8.3 per cent high in 2010 to 6.2 per cent in 2016 and a projected 5.7 per cent in 2017. In the US, the unemployment rate touched a 16-year low of 4.3 per cent. Some of this decline is because of the discouraged worker effect, or the tendency for those who have been looking for employment for long and not finding it to report themselves as not seeking work anymore. That leads to a fall in the number of unemployed actively seeking work but not finding it, captured in the unemployment rate. But with the labour force participation rates rising recently, there is reason to believe that unemployment is indeed falling.

So, what we have is evidence of a still-moderate recovery in the world economy combined with a falling "headline" unemployment rate as indicated by the official statistics. While this is mild cause for satisfaction for policy makers, inasmuch as the worst of the recession seems over even in Europe (where real per capita output is expected to grow 2 per cent in 2017), it is also a cause for concern since the increasing "tightness" in the labour market has not been accompanied by an acceleration of wage growth. According to the IMF, wage growth was just 1.8 per cent in 2016 and is likely to rise 2.3 per cent in 2017, which compares with an average of 3.4 per cent during 1999 to 2008. An important reason, buried by the IMF in multiple and often trivial explanations of why wage growth does not keep pace with employment growth, is the poor quality of additions to employment, involving part time, precarious jobs that pay poorly. That is, not only is the recovery of output growth volatile and moderate, but the jobs that recovery delivers are not just limited but also qualitatively poor. The popularity of policies aimed at making the labour market flexible and reducing wage "rigidities" has only contributed to this accumulation of low paying part-time employment or self-employment. That is something that has implications for wage growth, which the headline unemployment rate does not capture.

With wage growth sluggish, inflation too has remained low, despite low productivity growth, with the inflation rate for 2016 placed at 1.5, 1.8 and 1 per cent in the US, Euro area and Japan, and projected at 2.2, 2.1 and 1,5 per cent respectively for 2017. The new wisdom is that the "Phillips curve", that was seen as pointing to an inverse relationship between the unemployment rate and inflation, has 'flattened out', so that there is little by way of a relation between trends in unemployment and prices.

This has created a peculiar situation for policy makers in the advanced economies, where for a long time proactive monetary policies have been privileged and fiscal conservatism and 'consolidation' seen as non-negotiable. Since central bankers wielding the monetary lever were supposed to be concerned with inflation and growth, in that order, when inflation was running low monetary policy was loose and interest rates kept low to favour growth. Conversely, when inflation was high, the pursuit of an inflation target led to the adoption of tight money polices and measures to raise interest rates, so as to dampen demand in order rein in inflation at the expense of growth. Central bankers adopting, consciously or otherwise, simple rules of thumb when designing monetary policies (such as the much-cited Taylor's rule for setting interest rates) were seen as all powerful. But these rules were based on the premise that when growth accelerated and unemployment fell, inflation would rise, and vice versa. When the 2007 financial crisis broke, this perspective came in handy. Growth slumped and unemployment spiked, and, as expected, inflation was low. So once self-imposed fiscal stimulus limits had been reached, the focus was on monetary policy, involving the infusion of liquidity into the system and the maintenance of low, near zero or even negative policy interest rates, to stimulate the recovery. As noted, one important means to liquidity infusion was bond purchases by the central bank at relatively high prices. According to the *Financial Times* (August 16, 2017), the six central banks that adopted policies of "quantitative easing" — the US Federal Reserve, the European Central Bank, the Bank of Japan, the Bank of England, and the Swiss and Swedish central banks — now hold more than $15 trillion of assets, or more than four times the pre-crisis level. Of this, more than $9 trillion is in government bonds, amounting to one-fifth of the $46 trillion total outstanding debt owed by their governments. The rest consists of other bonds and securities. Overall the US Fed's balance sheet rose from a little less than $1 trillion before the crisis to $4.5 trillion currently. But others are ahead or not far behind. While the ECB's total balance sheet stands at $4.9 trillion of assets, including nearly $2 trillion in eurozone government bonds, and the Bank of Japan's balance sheet reflects $4.53 trillion of holdings, of which 85 per cent are Japanese government securities. The balance sheet size of the different central banks relative to that of their economies was by June 2017, 39 per cent of GDP in the case of the European Central Bank, 23 per cent in the case of both the Federal Reserve and the Bank of England and 94 per cent in the case of the Bank of Japan.

However, as emerges from our discussion, there are three problems associated with the pursuit of such a monetary strategy. The first, is that it was not too successful in triggering a recovery, which has been ten years coming and is still, as noted, moderate in intensity and volatile in nature. The second is that it triggered forms of the speculative, carry trade in which low cost money is borrowed to invest in assets varying from government bonds, equity and emerging markets paper of different kinds to real estate and alternative assets, leading to a self-reinforcing rise in asset prices globally. The third is that, in the pursuit of this policy, while growth has moderately revived and unemployment fallen, inflation has remained stubbornly low, providing no conventional arguments for central bankers to unwind their balance sheets, reverse the spike in liquidity and raise interest rates. But failing to do that keeps asset price inflation high, increasing the possibility that the bubble could burst, precipitating another financial crisis. Quickly unwinding central bank balance sheets by selling accumulated assets, could, however, set off a collapse in asset prices and deliver another kind of financial crisis. This strengthens the case of those who argue that, since inflation is low, there is no reason to change the prevalent monetary policy stance.

This has troubled global policy institutions, who fear that having got drunk on easy money, the financial sectors in advanced economies may implode once again. In June, Claudio Borio, the head of the Bank of International Settlements' monetary and economics department underlined the fact that: "The most fundamental question for central banks in the next few years is going to be what to do if the economy is chugging along well, but inflation is not going up." In his view, "Central banks may have to tolerate longer periods when inflation is below target, and tighten monetary policy if demand is strong — even if inflation is weak — so as not to fall behind the curve with respect to the financial cycle." (*Financial Times*, June 25, 2017).

In sum, central bankers need to reverse much of what they did over the last decade, even if they don't have high headline inflation, but only asset price inflation as a justification. Faced with this situation, central banks are deciding to scale back their policy of "quantitative easing" in the form of liquidity infusion through asset purchases. The Federal Reserve has already implemented that, while the European Central Bank announced end-October that it would halve its bond-buying programme from €60 billion to €30 billion a month starting from January 2018. But none is willing to commit to a quick unwinding of balance sheets, for fear of precipitating a different kind of crisis as markets react to a radical change in the easy money environment they have gotten used to. Even if bond sales by central banks is resorted to, the measure will go only a part of the way. Asset holding by central banks will remain well above their pre-crisis levels for quite some time. Whether this gradual approach will prevent a financial crisis stemming from a collapse of inflated asset prices, which some fear an end to the era of easy money could precipitate, only time will tell.