Risks of long-term stagnation overblown

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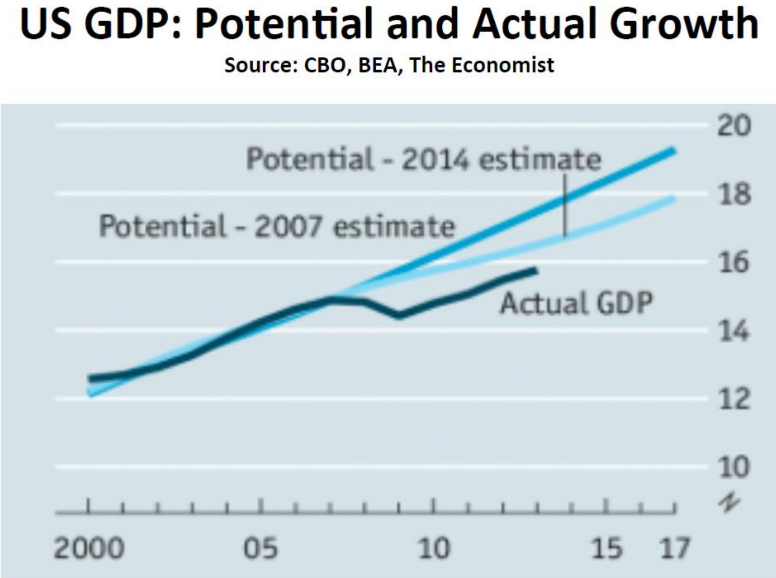

ONCE again, the phrase "secular stagnation" is popping up in reports and discussions on the global investment outlook.

Secular stagnation — persistently weak economic growth — can result from a sustained deficiency of demand, continuing low growth in productivity, or from a slowly growing/shrinking workforce. One of its consequences, over the medium term and longer, is that investment returns are very low, even negative.

In my view, secular stagnation is unlikely in countries like the US and Australia. However, with populations ageing and with enthusiasm for productivity-boosting reforms waning, both countries are likely to experience modest reductions in potential growth rates and in average investment returns. Japan has experienced a couple of decades of secular stagnation and the eurozone is at serious risk.

The concept developed in the 1930s when many economists and investors feared capitalist economies would suffer a sustained glut of saving. After World War II, it was revived under a new name ("under-consumption theory") only to take a long hibernation through the 1950s and 1960s when demand for goods and services in Western economies grew strongly.

The oil price shocks of the 1970s led to the return of fears of stagnation — quickly rebadged as "stagflation". As the oil producers' cartel weakened and central banks brought inflation under control, those fears subsided.

Fears about long-term stagnation (and, with it, low investment returns) have come to the fore again during and since the global financial crisis. At first, they were part of predictions for "a new normal". Recently, Larry Summers — a former head of Treasury under Bill Clinton, and also President Obama's preferred pick as chairman of the US central bank before the position went to Janet Yellen — has launched a hard-hitting campaign on the long-term risks to the US and global economies from sustained weak growth. No old wine in new bottles for him: he prefers the phrase secular stagnation, from the Great Depression almost 80 years ago.

As Summers sees it, even in the decade preceding the financial crisis, the US economy was kept afloat only by debt and asset bubbles. He foresees a lasting glut of saving in the US, Asia and the Middle East — at a time when opportunities to invest and to raise productivity are limited, and when growth in the US workforce is constrained by the ageing population. This will "reduce normal levels of interest rates … (and) we're getting financial bubbles before we get full employment".

In my view, the risk of secular stagnation is being exaggerated, particularly for countries such as the US and Australia — though both economies seem likely to experience some slowing in trend rates of economic growth, and somewhat lower average returns from investments, because populations are ageing and productivity gains are harder to come by.

As my chart illustrates, the US Congressional Budget Office has revised its expectation for potential growth in the US but still recognises it's predominantly cyclical factors that largely explain the US economy's current weakness. I should add that the US central bank seems far too optimistic about prospects for a big cyclical rebound in the labour force participation rate and gives too little attention to the lags in monetary policy has its effect.

I agree with Fidelity's Michael Collins: "There are solutions to the prospect of secular stagnation such as sustained increases in infrastructure spending. And then there's the possibility that Summers is overstating the case for endless stagnation.

The world could simply be undergoing the sluggish growth that is expected after a financial crisis. Carmen Reinhart and Kenneth Rogoff found that damage from a financial binge takes years to repair.

Economies have built-in mechanisms to drive economic cycles, even if those recoveries can sometimes come too slowly for many, including the most articulated and respected economists.

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