Refuting Secular Stagnation in the Global Economy

By Paul Ehrlichman

When I read about a particular point of view about the future, I want to understand the philosophical framework that guides the writer’s thinking. So here I define the key idea upon which my outlook on the global economy is built:

Humans appear to be the only species with foresight. The ability to abstractly ponder consequences of our actions is both a blessing and a curse. Our foresight drives the construct that predicting the future must change the future, and this construct tends to result in a constant series of unexpected outcomes.

Most attempts to mathematically explain markets and the economy fail miserably because they ignore this distinctly human dynamic of anticipation, adaptation, imitation, and reflection. Therefore, many of the ideas I present below have been formed by accounting for the complexity of human behavior and the belief that the world is shaped by our often-flawed expectations of the future.

From this standpoint, I believe that we are experiencing a sluggish recovery from a deep cyclical recession rather than secular stagnation. The global economy is in a painful period of adjustment and rebalancing as unsustainable drivers of economic growth give way to new ideas, new leadership, and innovation that will lead to sustainable growth. As part of this transition, the locus of beneficial economic reform and global growth is shifting to the East. Taken together, I believe these factors place the global economy on the path to renewed and long-term prosperity.

The Panic of 1873: A Better Parallel

Ben Bernanke is a student of the Great Depression of the 1930s. Because he was chairman of the Federal Reserve during the 2008–2009 global financial crisis (GFC), the Great Depression has defined both policy and the prevailing view of the global economy. It also has led to the expectation of a long period of below-trend growth and the risk of a deflationary spiral popularly known as “secular stagnation.”

But the Panic of 1873 might be a better guide for thinking about long-term developments in today’s global economy. Scott Reynolds Nelson, a professor of history at the College of William and Mary, draws similarities between the two crises (Nelson 2008). By 1871, the world was focused on U.S. post-Civil War reconstruction and the founding of the German Empire. New financial institutions and liberalization of incorporation laws led to a credit-fueled real estate and investment boom in Europe. Capital flowed across the Atlantic Ocean to fund massive spending in the emerging U.S. economy, particularly the railroad industry. The beginning of the industrial revolution along with an expansion of global trade led to expectations of a golden age of peace and prosperity.

Increasing leverage, however, allowed asset prices and the expansion of industrial capacity to move beyond what was justified by real business conditions. Cheap U.S. goods flooded European markets in an American commercial invasion that sent thousands of European farmers, merchants, and manufacturers into bankruptcy. European banks became worried about solvency and began calling in overseas railroad loans, choking the boom in U.S. rail construction. On September 18, 1873, the investment bank Jay Cooke & Company declared insolvency. The New York Stock Exchange then closed for 10 days. Over the next two years 18,000 businesses failed and the unemployment rate hit 8.8 percent. Falling commodity prices and monetary-policy blunders led to a period of deflation. Populist-based laws also extended the downturn with increased tariffs, taxes, regulations, and transfer payments. The contraction lasted until 1879 in the United States and two years later in Europe and Britain, but the economic landscape had shifted structurally. A new superpower had emerged and the period of recessionary adjustment had laid the groundwork for the Gilded Age and the empires of Morgan, Carnegie, and Rockefeller.

Post-panic, the United States became the locus of global economic growth and transformed into a manufacturing and mercantile powerhouse. U.S.-centric technological innovations fueled the subsequent industrial revolution. The cost of goods plunged as
productivity levels jumped, leading to better living standards for millions. Nelson (2008) summed up the parallels between the Panic of 1873 and the GFC with the following:

_In the end, the Panic of 1873 demonstrated that the center of gravity had shifted west—from Central Europe to the United States. The current panic [the crisis of 2008–2009] suggests a further shift—from the United States to China and India._

1873 Redux: The Global Financial Crisis

The resemblance of this period of boom, bust, and painful transformation to the post-GFC world is startling. Excessive optimism and use of new credit instruments fueled speculative bubbles in technology, real estate, and commodity investment over the 20 years pre-GFC. The United States played the role of 1870s Europe in leading the financing of these booms as China played the role of the emerging superpower that shifts global competitive dynamics. Belief in the super cycle of never-ending developed-country demand for goods resulted in a massive oversupply of tradable goods and commodities. Monetary and political blunders extended the duration of the downturn. Nevertheless, this is also a period of rebalancing and transition from unsustainable to sustainable drivers of global growth.

After a crisis, market dynamics relentlessly shift capital from weak to strong hands as consumers and companies with adequate liquidity benefit from cheaper tradable goods and productive asset prices. The bad actors tend to retain significant political and social power; they resist the process and receive bailouts and other benefits from targeted expansionary government programs. The British fell into this trap during the 1873 recession and substantially lagged the worldwide recovery well into the 1890s. To a large degree, the United States post-GFC acted similar to the United Kingdom 125 years ago. The government effectively subsidized companies and sectors at the core of the downturn by nationalizing their liabilities and shifting the costs to taxpayers. The U.S. government directly and indirectly supported automakers, homebuilders, mortgage lenders, banks, and renewable energy firms, building the largest public debt in the nation’s history. The primary macroeconomic effect was to maintain a large amount of inefficient capacity that delayed a recovery in wages, business investment, and real consumer spending. These actions may have softened the post-crisis recession but they also resulted in an extended period of sluggish growth. Economists, among them James K. Galbraith in his 2014 book _The End of Normal_, generally view this below-trend recovery pace as structural in nature. Galbraith, former Treasury Secretary Lawrence Summers, and economist Paul Krugman among others, contend that a combination of past excesses, policy errors, demographics, lagging innovation, and productivity will lead to a period of secular stagnation.

Policy Responses and Risks

To avoid such stagnation, the U.S. Federal Reserve lowered interest rates to effectively zero and began a program using the unconventional tool of quantitative easing (QE), where the central bank buys up government and/or other securities to lower interest rates and increase the money supply. This policy mix was adopted eventually by the central banks of Europe, Japan, and the United Kingdom and led to weakness in the respective non-dollar currencies. The effectiveness of QE in boosting the real economy has been mixed; the suppression of interest rates led to a rise in financial asset prices. Central-bank policy supported debtors at the expense of savers and helped shift the burden of excessive leverage to the public sector.

China reacted to the global financial crisis with a massive program of government spending on public infrastructure such as housing, roads, dams, schools, and hospitals. Much of this flowed to local governments and led to overinvestment in real estate. The impact on the global economy of this fiscal expansion was temporary but meaningful bounce in commodity prices and sales of consumer goods until early 2011. Continental Europe faced a banking-led crisis and the end of a debt-fueled economic bubble in many of the peripheral nations. The eurozone countries of Portugal, Ireland, Italy, Greece, and Spain began unsustainable spending binges fueled by low interest rates but without accompanying levels of productivity necessary to support their economies. These sharp economic, political, and fundamental differences within Europe delayed and shaped government response to the crisis. In coordination with the European Central Bank (ECB), the weakest countries were placed on a path of sharply reduced fiscal and current account deficits. The region’s financial institutions were required to significantly increase capital adequacy, which had the effect of shrinking lending capacity. The initial impact of these policies was painful as unemployment rose and growth remained depressed, causing the public to push back against austerity. The ECB at first maintained too-tight a monetary policy given the conditions, then embarked on a powerful program of quantitative easing by the end of 2014.

Japan, suffering from nearly 20 years of sluggish growth, had few policy options given already-high public debt and near-zero interest rates. After the election of Prime Minister Shinzo Abe to a second term in December 2012, the government believed that the country's problems were structural in nature and sought to change the behavior of institutions, companies, and society. Businesses were incentivized to increase profitability and growth. The Bank of Japan shifted from a policy of high real rates that accepted deflation and a strong yen to a massive program of qualitative and quantitative easing that explicitly supports an expansion of fiscal stimulus. With this the “three arrows” of monetary, fiscal, and structural support for economic growth came to define the program called “Abenomics.”

All these actions have created two material risks. First, nearly $20 trillion in global debt creates potential for another credit crisis. Debt represents consumption or investment in excess of current production and savings. In a normally functioning economic system, borrowers and lenders freely determine the
quantity and price of debt, thereby balancing the tradeoff between future and current production and consumption. Under quantitative easing, the price of money and quantity of debt is artificially set, affecting asset valuations and returns on invested capital. Normalization of monetary policy might produce sharp adjustments to asset prices, especially bonds, which would pressure highly leveraged consumers, businesses, and nations. Investors could rush to sell credit instruments at the same time companies would see a reduction in the ability to bolster profitability with leverage, stock buybacks, and acquisitions. This would produce a combination of recession and rising rates and potentially inflation as the value of money fell relative to real assets.

The second risk surrounds the response of political and civil society to periods of significant rebalancing and transition. New leaders can gain power through the politics of blame, division, and populist responses to short-term needs. Global trade and collaboration can grind to a halt if countries fearful of secular stagnation pursue lose-lose restrictive trade, tariff, and financial market policies. People experiencing economic pain can be fooled into thinking that a stronger defense and displays of military might will restore their economy and lost glory.

Looking Past China’s Slowdown Reveals a Powerful Shift to the East
In his 2012 book Antifragile, Nassim Nicholas Taleb explains that progress is driven by pain and failure, which provide clear information about what not to do and signal the need to seek new ways of doing things. If the world can avoid turning to violence and war, the aftermath of periods such as the GFC are catalysts to innovation, transformation, and prosperity. Nowhere is this transformation more apparent than in Asia, where ambitious investment and robust gross domestic product (GDP) growth is leading a shift in the locus of economic power from the developed West to the East (see figure 1).

Weijing Zhang (2015), a professor and advocate of market-based reforms in China, notes the following:

*History and causal observation suggest that ideas and leadership are the two most important forces in all institutional changes. However, they have been absent or downplayed in conventional economic analysis of institutional changes.*

Nowhere is this more the case than in Asia. New leadership and new ideas, most prominently in China, Japan, and India, are viewed currently with skepticism, mistrust, and even derision by Western economists and investors.

Prime Minister Abe has tried to break Japan out of a two-decade slump through a broad program of reforms. Abe explicitly targeted improving profitability as measured by return on equity (ROE) and growth in earnings as the focus of his economic recovery plan. He worked to shift the policies and roles of key business ministries, the Bank of Japan, and the Tokyo Stock Exchange. Japan’s large public pension funds followed with a revised asset allocation policy that favors shares of firms that meet targeted criteria of high ROE and positive growth. Profits are improving quickly and are expected to rise significantly over the next two years. This would translate into higher tax revenues, rising wages, and greater returns for investors, and result in lower deficits, increased consumer incomes and spending, and rising wealth for Japan.

New leadership in India also is embarking on structural reform to address restrictive levels of regulation, bureaucracy, corruption, and disparities in education, income, and wealth. In his first year as prime minister, Narendra Modi has reduced inflation and cut the current account deficit to 1 percent of GDP, down from nearly 5 percent in 2013. India lacks basic transportation, sanitation, and other infrastructure to support growing service, consumer, and manufacturing industries. As fiscal deficits and inflation fall, a decline in interest rates will allow for the large investments necessary in these areas.

By far the most ambitious and influential economic transformation is that of China. Observers outside China are just beginning to grasp the longer-term implications of the world’s second-largest economy shifting from a centrally planned to a market-driven financial system. Economists and investors, focused on China’s recent slowdown in GDP growth or its local-government debt repayment concerns, are largely missing this important longer-term shift. Expressing frustration with the short-sightedness of global asset managers, Ben Powell (2015) from the Asian strategy team at Barclays stated in a research note earlier this year, “I see the opening of capitalist opportunities on a scale perhaps unprecedented in human history in China over the coming ten years.” Jian Chang, Barclays’ chief China

![Figure 1: Eastern Economies on Higher Growth Trajectory](image-url)
With three distinct goals, YDYL provides a foundation for upgrading Chinese industry and shifting to a consumer-led economy. First is a focus on regional infrastructure designed to utilize excess capacity in construction labor and basic materials as well as enhance growth in underdeveloped countries and the Western interior provinces. The newly created Chinese-centric Asia Infrastructure Investment Bank, New Silk Road Fund, and New Development Bank together have attracted members from 57 countries and initial capital of $240 billion. These banks are designed to provide less-restrictive funding than the World Bank, International Monetary Fund, or Asian Development Bank.

The second YDYL goal is to generate rising incomes and more-efficient infrastructure that will help grow export demand for Chinese consumer goods and services. The third and final goal is the full integration of China into the global economy with the creation of internationally leading companies, a fully convertible currency, and robust capital markets.

The Chinese also hope to earn higher returns on their US$4 trillion in foreign reserves by funding YDYL investments (see figure 3). Combined with other financial reforms to encourage greater investment in local equities and bonds, this could put pressure on global interest rates as the Chinese continue to liquidate foreign debt holdings. Increased demand for basic materials also could arrest the decline in commodity prices and raise inflation expectations. For example, a 5-percent rise in road, rail, and electric power assets in YDYL countries would consume 14 percent of Chinese steel capacity along with 74 percent of copper and 39 percent of aluminum.

In sum, Asia’s largest economies simultaneously are pursuing structural reform agendas that clearly have the potential to shift the global economic landscape to the East. Unlike the burst of speculative spending during the super cycle that preceded the GFC, these initiatives will be implemented over a longer time period and are built upon a foundation of sustainable and being led by an expanding private sector and growing domestic-consumer sector (Chang 2014).

The centerpiece of Li’s reform is the “One Belt, One Road” initiative, locally known as Yi Dai Yi Lu (YDYL), through which China is exploring new markets to internationalize and promote its renminbi. This plan encompasses 4 billion people and 23 percent of total global GDP in what’s becoming known as the “New Silk Road Economic Belt.” Most countries within this geographical area already are growing faster than the world average (see figure 2).

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**Figure 2: GDP per Capita in Eastern Economies Has Vast Potential**

Source: IMF World Economic Outlook, October 2014

**Figure 3: Silk Road May Be Tip of Iceberg for Chinese Foreign Investment**

self-reinforcing dynamics, namely rising productivity and incomes.

Toward a Sustainable Path of Prosperity

The transformation occurring across the East is a sharp contrast to the secular stagnation that has gripped the West, where recovery has failed to reach take-off velocity. The sluggish 1.1-percent rate of global GDP growth in the first quarter of 2015 was the weakest for an expansion since 1998, heralding a rush of media interest in the proponents of secular stagnation. Summers (2014) has been reinterpreting history, suggesting in a keynote address at the 2014 National Association for Business Economics Policy Conference that easy money, unsustainable public spending, and policies designed to inflate asset prices and direct investment to a particular sector, namely housing, no longer are viewed as contributing to the 2008–2009 recession. Instead, Summers points to the ineffectiveness of these policies to deliver sustainable economic growth as proof that we have been in a period of secular stagnation for a number of years. John Ryding, chief economist at RDQ Economics, recently analyzed the 2002–2007 expansion, subsequent downturn, and current recovery in his report, “Demystifying and Debunking Secular Stagnation” and found the evidence not supportive of Summers’ conclusions. Ryding (2015) observes that “since growth was above potential and the unemployment rate fell below most estimates of full employment, it is quite possible (indeed we believe probable) that growth would have been acceptable and stable had the Fed pursued a sustainable monetary policy.”

Rather than reflecting a new structural dynamic, the disappointing global economic recovery reveals a deep balance-sheet recession caused by monetary and policy errors that induced people to buy things they could not afford with money they did not have. The end of such an environment should be welcomed as the global economy moves to sustainable drivers of growth and expanding prosperity. The distinction between secular stagnation and a slow recovery from a particularly deep downturn has important implications for expectations about monetary and fiscal policy as well as relative risk-adjusted returns. If the global economy is on a path back to trend-line growth, then countries and sectors with cyclical operating leverage should experience improved capital flows. Rising interest rates and inflation could challenge the long-bond bull market as well as the defensive and interest-rate-sensitive sectors of the equity market. This shift in performance of financial assets would create a classic pain trade for global investors, but the reallocation to investment in productive assets would aid the real global economy.1

In thinking about current sluggish growth as more of a cyclical condition, Simon Cox, BNY Mellon’s Asia Pacific investment strategist, teamed with the Economist Intelligence Unit to assess the impact if “things were to go right in the world economy” (Cox 2015). In the resulting analysis, “The G4: Undiminished Expectations—Room to Recover,” a combination of pent-up demand and returning to solid growth in the United States, Japan, India, and China would add $18 trillion to global GDP by 2020.2 This is akin to creating an economy the size of the United States or China over the next five years and illustrates how the narrative of secular stagnation could prove spectacularly wrong. The imbalances that led to the global financial crisis have resulted in a sub-par economic recovery, and history shows that despite broad pessimism and real challenges these conditions often produce powerful periods of discovery, innovation, and progress.

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Endnotes

1. Pain trade: The tendency of markets to deliver the maximum amount of punishment to the most investors from time to time.

2. This analysis is summarized at http://www.bnymellon-imapac.com/hk/news-views/article/the-g4-undiminished-expectations—room-to-recover—paper-1/.

References


