The global economy is in serious danger

By Lawrence Summers

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Tthe Dow Industrial average on the floor of the New York Stock Exchange. (Justin Lane/EPA)

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As the world's financial policymakers convene for their annual meeting Friday in Peru, the dangers facing the global economy are more severe than at any time since the Lehman Brothers bankruptcy in 2008. The problem of secular stagnation — the inability of the industrial world to grow at satisfactory rates even with very loose monetary policies — is growing worse in the wake of problems in most big emerging markets, starting with China.

This raises the specter of a global vicious cycle in which slow growth in industrial countries hurts emerging markets, thereby slowing Western growth further. Industrialized economies that are barely running above stall speed can ill afford a negative global shock.

Policymakers badly underestimate the risks of both a return to recession in the West and of a period where global growth is unacceptably slow, a global growth recession. If a recession were to occur, monetary policymakers would lack the tools to respond. There is essentially no room left for easing in the industrial world. Interest rates are expected to remain very low almost permanently in Japan and Europe and to rise only very slowly in the United States. Today's challenges call for a clear global commitment to the acceleration of growth as the main goal of macroeconomic policy. Action cannot be confined to monetary policy.

There is an old proverb: "You do not want to know the things you can get used to." It is all too applicable to the global economy in recent years. While the talk has been of recovery and putting the economic crisis behind us, gross domestic product forecasts have been revised sharply downward almost everywhere. Relative to its 2012 forecasts, the International Monetary Fund has reduced its forecasts for U.S. GDP in 2020 by 6 percent, for Europe by 3 percent, for China by 14 percent, for emerging markets by 10 percent and for the world as a whole by 6 percent. These dismal figures assume there will be no recessions in the industrial world and an absence of systemic crises in the developing world. Neither can be taken for granted.

We are in a new macroeconomic epoch where the risk of deflation is higher than that of inflation, and we cannot rely on the self-restoring features of market economies. The effects of hysteresis — where recessions are not just costly but also stunt the growth of future output — appear far stronger than anyone imagined a few years ago. Western bond markets are sending a strong signal that there is too little, rather than too much, outstanding government debt. As always when things go badly, there is a great debate between those who believe in staying the course and those who urge a serious correction. I am convinced of the urgent need for substantial changes in the world's economic strategy.

History tells us that markets are inefficient and often wrong in their judgments about economic fundamentals. It also teaches us that policymakers who ignore adverse market signals because they are inconsistent with their preconceptions risk serious error. This is one of the most important lessons of the onset of the financial crisis in 2008.Had policymakers heeded the pricing signal on the U.S. housing market from mortgage securities, or on the health of the financial system from bank stock prices, they would have reacted far more quickly to the gathering storm. There is also a lesson from Europe. Policymakers who dismissed market signals that Greek debt would not be repaid in full delayed necessary adjustments — at great cost.

Lessons from the bond market

It is instructive to consider what government bond markets in the industrialized world are implying today. These are the most liquid financial markets in the world and reflect the judgments of a large group of highly informed traders. Two conclusions stand out.

First, the risks tilt heavily toward inflation rates below official targets. Nowhere in the industrial world is there an expectation that central banks will hit their 2 percent targets in the foreseeable future. Inflation expectations are highest in the United States — and even here the market expects inflation of barely 1.5 percent for the five-year period starting in 2020. This is despite the fact that the market believes that monetary policy will remain much looser than the Fed expects, as the Fed funds futures market predicts a rate around 1 percent at the end of 2017 compared with the Fed's most recent median forecast of 2.6 percent. If the market believed the Fed on monetary policy, it would expect even less inflation and a real risk of deflation.

Second, the prevailing expectation is of extraordinarily low real interest rates, which is the difference between interest rates and inflation. Real rates have been on a downward trend for nearly a quarter-century, and the average real rate in the industrialized world over the next 10 years is expected to be zero. Even this presumably reflects some probability that it will be artificially increased by nominal rates at a zero bound — the fact that central banks cannot reduce short-term interest rates below zero — and deflation. In the presence of such low real rates, there can be little chance that economies would overheat.

Many will argue that bond yields are artificially depressed by quantitative easing (QE) and so it is wrong to use them to draw inferences about future inflation and real rates. This possibility cannot be ruled out. But it is noteworthy that bond yields are now lower in the United States than their average during the period of quantitative easing and that forecasters have been confidently — but wrongly — expecting them to rise for years.

The strongest explanation for this combination of slow growth, expected low inflation and zero real rates is the secular stagnation hypothesis. It holds that a combination of higher saving propensities, lower investment propensities and increased risk aversion have operated to depress the real interest rates that go with full employment to the point where the zero lower bound on nominal rates is constraining.

There are four contributing factors that lead to much lower normal real rates:

●First, **increases in inequality — the share of income going to capital and corporate retained earnings — raise the propensity to save.**

●Second, an expectation that growth will slow due to a smaller labor force growth and slower **productivity growth reduces investment and boosts the incentives to save.**

●Third, increased friction in financial intermediation caused by more extensive regulation and increased **uncertainty discourages investment**.

●Fourth, reductions in the price of capital goods and in the quantity of physical capital needed to operate a business — think of Facebook having more than five times the market value of General Motors.

Emerging markets

Until recently, a major bright spot has been the strength of emerging markets. They have been substantial recipients of capital from developed countries that could not be invested productively at home. The result has been higher interest rates than would otherwise obtain, greater export demand for industrial countries' products and more competitive exchange rates for developed economies. Gross flows of capital from industrial countries to developing countries rose from $240 billion in 2002 to $1.1 trillion in 2014. Of particular relevance for the discussion of interest rates is that foreign currency borrowing by the nonfinancial sector of developing countries rose from $1.7 trillion in 2008 to $4.3 trillion in 2015.

has now gone into reverse. According to the Institute of International Finance, developing country capital flows fell sharply this year — marking the first such decline in almost 30 years, as the amount of private capital leaving developing countries eclipsed $1 trillion.

What does all this mean for the world's policymakers gathering in Lima? This is no time for complacency. The idea that slow growth is only a temporary consequence of the 2008 financial crisis is absurd. The latest data suggest growth is slowing in the United States, and it is already slow in Europe and Japan. A global economy near stall speed is one where the primary danger is recession. The most successful macroeconomic policy action of the past few years was European Central Bank President Mario Draghi's famous vow that the ECB would do "whatever it takes" to preserve the euro, uttered at a moment when the single currency appeared to be on the brink. By making an unconditional commitment to providing liquidity and supporting growth, Draghi prevented an incipient panic and helped lift European growth rates — albeit not by enough.

Any discussion has to start with China, which poured more concrete between 2010 and 2013 than the United States did in the entire 20th century. A reading of the recent history of investment-driven economies — whether in Japan before the oil shock of the 1970s and 1980s or the Asian Tigers in the late 1990s — tells us that growth does not fall off gently.

China faces many other challenges, ranging from the most rapid population aging in the history of the planet to a slowdown in rural-to-urban migration. It also faces issues of political legitimacy and how to cope with hangovers of unproductive investment. Even taking an optimistic view — where China shifts smoothly to a consumption-led growth model led by services — its production mix will be much lighter. The days when it could sustain global commodity markets are over.

The problems are hardly confined to China. Russia struggles with low oil prices, a breakdown in the rule of law and harsh sanctions. Brazil has been hit by the decline in commodity prices but even more by political dysfunction. India is a rare exception. But from Central Europe to Mexico to Turkey to Southeast Asia, the combination of industrial growth declines and dysfunctional politics is slowing growth, discouraging capital inflows and encouraging capital outflows.

No time for complacency

What is needed now is something equivalent but on a global scale — a signal that the authorities recognize that secular stagnation, and its spread to the world, is the dominant risk we face. After last Friday's dismal U.S. jobs report, the Fed must recognize what should already have been clear: that the risks to the U.S. economy are two-sided. Rates will be increased only if there are clear and direct signs of inflation or of financial euphoria breaking out. The Fed must also state its readiness to help prevent global financial fragility from leading to a global recession.

The central banks of Europe and Japan need to be clear that their biggest risk is a further slowdown. They must indicate a willingness to be creative in the use of the tools at their disposal. With bond yields well below 1 percent, it is doubtful that traditional quantitative easing will have much stimulative effect. They must be prepared to consider support for assets such as corporate securities that carry risk premiums that can be meaningfully reduced and even to recognize that by absorbing bonds used to finance fiscal expansion they can achieve more.

Long-term low interest rates radically alter how we should think about fiscal policy. Just as homeowners can afford larger mortgages when rates are low, government can also sustain higher deficits. If a debt-to-GDP ratio of 60 percent was appropriate when governments faced real borrowing costs of 5 percent, then a far higher figure is surely appropriate today when real borrowing costs are negative.

The case for more expansionary fiscal policy is especially strong when it is spent on investment or maintenance. Wherever countries print their own currency and interest rates are constrained by the zero bound, there is a compelling case for fiscal expansion until demand accelerates to the point where interest rates can be raised. While the problem before 2008 was too much lending, many more of today's problems have to do with too little lending for productive investment.

Inevitably, there will be discussion of the need for structural reform at the Lima meetings — there always is. But to emphasize this now would be to embrace the macroeconomic status quo. The world's largest markets are telling us with ever-increasing force that we are in a different world than we have been accustomed to. Traditional approaches of focusing on sound government finance, increased supply potential and avoidance of inflation court disaster. Moreover, the world's principal tool for dealing with contraction — monetary policy — is largely played out and will be less effective if contraction comes. It follows that policies aimed at lifting global demand are imperative.

If I am wrong about expansionary fiscal policy and such measures are pursued, the risks are that inflation will accelerate too rapidly, economies will overheat and too much capital will flow to developing countries. These outcomes seem remote. But if they materialize, standard approaches can be used to combat them.

If I am right and policy proceeds along the current path, the risk is that the global economy will fall into a trap not unlike the one Japan has been in for 25 years, where growth stagnates but little can be done to fix it. It is an irony of today's secular stagnation that what is conventionally regarded as imprudent offers the only prudent way forward.