‘Whatever it takes’ breaks down

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Key Points

- High hopes for global economic growth in 2014 have been dashed by still-declining growth and inflation, and outright global deflation is becoming more likely.
- The policy measures enacted thus far to reinvigorate the economy are not working, and policymakers have expressed no clear idea about what to do next.
- Central banks and governments must be more open about alternative approaches to managing the threat of stagnation and low growth and should prepare for a period of sharp market correction that may make these new policies more necessary.

The 2014 US economic outlook was less than sanguine in January. As I wrote that month,

As we enter 2014, we are at a crossroads on the question of boosting sustainable growth. Monetary and fiscal measures to increase short run or cyclical growth are largely played out—with fiscal policy in a consolidation phase, which entails less fiscal stimulus, and monetary policy having approached its limits as a means to stimulate the economy. However, a long-run growth enhancement goal, suggested by the secular stagnation hypothesis, may be an especially poor guide to policy, since we know so little about effective ways to boost long-term growth.¹

Sadly, 2014 has indeed proven to be a disappointing year for the global economy. Hope for better economic growth has endured and supported markets, while growth and inflation have in fact drifted lower. In the light of this reality, delegates to the October 2014 International
Monetary Fund (IMF)/World Bank meetings in Washington were able to agree on one important thing: the global economy, especially in Europe but also in Asia and the United States, is slowing again, and outright deflation is drawing ever closer. In short, secular stagnation continues to be a serious problem.

Existing policy measures, such as they are, simply are not working. US growth has not risen above its under 2 percent trend line, quarterly volatility notwithstanding (figure 1). The second-quarter growth pace was 4.6 percent, while the first-quarter US growth pace was −2.1 percent. Europe is slipping into outright deflation and its third postcrisis recession as Germany and France appear deadlocked over how much or how little extra stimulus the European Central Bank (ECB) should be allowed to apply.

**Figure 1. Year-over-Year Real Gross Domestic Product per Capita**

![Year-over-Year Real Gross Domestic Product per Capita](source: US Department of Commerce, Bureau of Economic Analysis)
Struggling Global Markets

ECB head Mario Draghi has begun to look like an emperor no longer clothed in the two-plus years since he declared the ECB would do “whatever it takes to preserve the euro.” If only he, or anyone else, knew what it takes, perhaps we would be able to achieve consensus on how to move toward more sustainable long-term growth.

A first step could be to involve Germany in an extra push toward quantitative easing (QE) in Europe. However, Draghi is hampered further by the fact that the Federal Reserve has already tried QE2 without much success even in meeting the challenge of blunting disinflation, let alone in boosting growth. In any case, this month sees the end of the Fed’s QE2 experiment.

Japan, Asia, and most emerging market (EM) countries are part of a drab tapestry of falling global growth. Japan, despite QE, has not forged a stable higher growth path, with actual growth during the second quarter at a −7.1 percent pace and little promise of a rebound in the third quarter. Japan’s hope for a return to sustainable, noninflationary growth has waned.

Japan’s bad 1997 habit of burying any green growth shoots with a solid dose of tax increases of uncertain timing and degree has returned in 2014 at an especially poor time for Japan and the global economy. Apparently, Japanese Prime Minister Shinzō Abe is feeling domestic political pressure about reflations. Old folks in Japan like the falling prices that he wishes to combat and dislike the reflationaly impact of a weaker yen. At a global level, pressure from rising discomfort over the weaker yen in a world of weak demand growth has followed the Bank of Japan’s quantitative and qualitative monetary easing efforts. “Japan is back” now has a hollow ring to it, as policymakers both inside and outside of the world’s third-largest economy do not know whether to applaud or criticize Japan’s heretofore simulative mix of aggressive QE accompanied by a willingness to soften fiscal stringency.

China is struggling with a slower economy as its ability and inclination to pursue aggressive stimulus have faded into a need to consolidate spending programs and contain speculation in real estate, just as in late 2008. Some are expecting China’s growth rate to slip below 7 percent in the
third quarter. The IMF has lowered its China growth projection for the coming year from 7.3 percent to about 7 percent in the space of just a few months.

Beyond China, overall EMs depend on exports and rising growth and inflation. They have suffered as advanced economies have weakened. The EM growth outlook has declined all year to well below the modest 5 percent pace expected earlier this year. The IMF, having cut its 2014 EM growth projection by 0.1 percent since April 2014, has further reduced its 2015 EM growth projection by 0.2 percentage points. If oil prices continue to fall, the harm to growth of Russia’s oil-driven economy will intensify. Ominously, the IMF’s estimate of the chance of a 2015 European recession has risen from about 20 percent last April to nearly 40 percent today.

Is There a Plan B?

An honest, data-driven analysis of the paths of macro policy and the global economy since last year leaves us admitting that we simply do not know what, if any, steps to take next. That was pretty clear in the gloomy dialogue among the delegates to the fall IMF/World Bank meetings. The IMF’s outlook for 2014 global growth slipped from 3.5 percent in April to 3.3 percent in October and may still be too optimistic.

These discouraging outcomes should not be surprising. Fiscal policy is at a modest contractionary setting in most countries, while monetary policy discussions are largely about tapering. The tapering discussion is conducted with considerable discomfort in view of the May 2013 “taper tantrum” response to Chairman Ben Bernanke’s hints that it would be nice to get away from the QE strategy.

Some have suggested a preemptive move to allow rates to rise earlier. The aim of this type of action has heretofore been preempting an inflationary resurgence. But persistent US disinflation, the opposite of what QE critics expected, has shifted the emphasis of Fed’s easy money critics to the possible chaotic consequences if bubbles burst. Actually, we are back to the 2008 “Are we in a bubble?” game. Unfortunately, as in 2008, no one knows the answer.
The lack of vision about what comes next that surfaced at the IMF/World Bank meetings has left markets with rising doubts about a hopeful, Goldilocks outcome whereby central banks can fix the economy by boosting prices of risk assets and crushing volatility without causing inflation. The inability of central banks to either cause inflation or prevent deflation is consistent with continued existence of a liquidity trap.

Now, as it becomes clearer that Fed and central banks in general have no new measures to offer, save later interest rate boosting in the United States, households’ and firms’ waning confidence is slowing growth further.

The negative signals emanating from the IMF/World Bank meetings have had their effect on markets. US stocks have given up all of the 2014 gains and appear to be headed still lower. We are led to ask, as usual, whether this time is really different. That is, is the real “risk-off” correction, or the movement of investors away from risky positions, in progress? No one really knows, least of all the policymakers who prefer to hope in the face of falling growth and inflation for 3 percent US growth, along with some follow-on in Europe, Japan, and EMs.

**Measuring Fear**

The surge in volatility that has accompanied these rising doubts suggests that the risk-off option is more probable for investors than it has been for some time, perhaps since 2012. While the possibility always remains that risk-off could turn to “risk-on” with some help from a nervous Fed, the degree of investor fear measured by the VIX—a volatility index that measures investor fear—has jumped to levels not seen since the madness of the 2012 US threat to default on its debts (figure 2).
The Fed’s rising nervousness has been illustrated by a tendency toward rapidly shifting views among Fed leadership. Fed Vice Chairman Stanley Fischer went from an October 9 assessment that the Fed could begin tightening around mid-2015—or perhaps a little earlier than the ever-shifting consensus—to an opposite, outright risk-on call on October 11, saying that if the global economy continued to weaken, the Fed would further delay its move to higher rates. No doubt his former IMF colleagues strongly supported the October 11 statement, although they may not have been reassured by the idea that a simple delay in raising rates would boost the economy, nevermind overcoming secular stagnation. It certainly has not worked so far.

St. Louis Federal Reserve President James Bullard urged on October 16 that the Fed might even consider a fourth round of QE—further delaying full tapering—if the global economy continues
to weaken. It is odd that this call comes after a sell-off. The world economy has been weakening for at least six months.

No one has asked what happens if the US economy weakens again or if deflation takes a firmer hold in Europe and the US. What will the Fed do beyond talking about a slower move to positive rates while its critics continue to warn of an even more damaging asset bubble?

Many are starting to realize that monetary policy is either pushing on a string or dangerously wrong. If the Fed overdithers or markets simply adopt more firmly the view that monetary policy is impotent while volatility spikes and risk assets are sold, what, if anything, is the antidote to weaker growth? If policy really is just supporting an unsupportable asset bubble, the incipient danger of a bursting rises daily.

**Now What?**
The coming weeks and months may bring some answers to these questions, but while they hang like an incipient storm over global markets, global economic activity is freezing. Especially ominous is the steady drift toward deflation that creates a self-reinforcing drag on the economy. Outside of the vibrant technology sector, most business managers far prefer cost cutting to capacity expansion as a means to preserve profit margins (figure 3). The result is that as aggregate supply grows slowly, aggregate demand grows even more slowly, sapped by the drag on incomes resulting from the cost cutting spurred by increasingly uncertain outcomes.
If managers think that the Fed and other policymakers do not know how to fix the economy, then how should they know themselves? Why should they invest to expand capacity in the face of persistently weak demand? Better to hold off on real investment until we all see either a more convincingly durable recovery or a capitulation—a risk-off, weaker economic scenario that will at least produce a clearer path toward what needs building and what does not.

Some have suggested that most “real” managers or decision makers in the production sector would prefer the latter capitulation scenario, which clears the air. They may get their wish. The outcome in the fullness of some interim pain may be even better than that tied to the current persistent limbo scenario. But there is no guarantee.
The IMF, meanwhile, has gamely tried to tip the scale toward resuming growth of output and employment while fighting deflation with a proposal that zero borrowing costs and rising infrastructure needs—highways, bridges, roads, education, and the like—taken all together present a global compelling case for self-financing fiscal expansion. Many are doubtful, especially in view of the difficulty of identifying the best-payoff infrastructure projects to undertake, and few such projects are underway despite zero financing costs alluded to by the IMF. If self-financing fiscal stimulus is a real possibility to produce growth, the still deficit-obsessed policymakers in Europe, Japan, and the US have shown no signs of noticing: when it comes time for tax cuts and more spending, Germany says, “No”; Japan says, “Boost taxes”; and the US says, “Sorry about the political gridlock.”

We have reached an impasse and a realization that just as anticyclical fiscal and monetary policy have limited power to improve the economic outlook and certainly have little power to overcome secular stagnation, a passive monetary policy that amounts simply to delaying a rise in interest rates along with a counterproductive drift to fiscal drag certainly is not going to boost short- or long-term growth. The usual suspects—notwithstanding their benefits, tax cuts and restructuring—get plenty of lip service but little actual support. Governments and central banks are largely immobilized by disagreements over existing policy. That unfortunate reality was clearly on display at the October 2014 IMF/World Bank meetings.

As I have hinted, the litany of failure with regard to encouraging growth and ending deflation, let alone overcoming an apparent tendency toward secular stagnation, has raised the possibility of trying something completely different. Suggestions abound, including that the Fed should preemptively raise the Fed funds rate to 1 percent or thereabouts, getting us past the great wall of worry attached to the time when rates actually have to go up. Such a bizarre, risky step would restore some flexibility (the ability to raise or lower interest rates) to the Fed’s tool kit.

This looks like a 2014 version of the Austrian “cold shower” approach to getting past the aftermath of a financial crisis and restoring growth by letting the crisis play itself out as we go back to allowing markets to determine the interest rates, exchange rates, and inflation pace to support a positive equilibrium growth path. Advocates need to remember that such a process
would be more likely to succeed absent current high levels of government interference in the tax code, financial markets, and regulation.

Given the extremely disappointing path of the global economy over the past year, the cold shower may be a tempting alternative. That said, it is not at present a viable possibility for today’s already nervous policymakers. And it is risky. Rather, we continue to watch and wait until something gives, perhaps driven by the emergence of a substantial sell-off in markets—the aftermath of which somehow clears the decks for a return to higher levels of investment.

It would be immensely appealing to wrap this conundrum up in a neat bundle and propose a set of convincing, viable solutions. But I cannot. Like many others, I expect market volatility will continue to rise while exacerbating the weakness of demand growth in households and supply growth in producers. At some point, excess demand will emerge to boost investment, provided intensifying deflation does not create destabilizing excess supply by increasing further the demand for cash.

Surely the time has come for central banks and governments to be more open about alternative approaches to managing the current threat of secular stagnation and low growth. They could start by initiating an aggressive global program to assure that deflation will not return. The outlook on this front, in view of the comments heard around the IMF meetings, is somewhat mixed.

Governments, for their part, should show an openness to explore alternative means of encouraging growth, such as pursuing a more aggressive path toward deregulation, tax cuts, and a promise of less government interference within the marketplace. The German-French impasse on steps to prevent deflation is not encouraging.

All that said, it will take time and perhaps extraordinary fear of a bubble to prompt constructive action. Meanwhile, we may be entering a period of a sharp market correction that we can only hope underscores the rising need to remove growth-crushing policies and move away from empty declarations about doing “whatever it takes” to enhance global growth.
Notes
