The end of "secular stagnation"?

Improving economic data do not necessarily indicate underlying health

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IN PERIODS of economic stress all sorts of theories are entertained about the nature of the problem. When better times return, some theories fade from memory. Others linger, however. During the economic mess of the past decade, economists frightened themselves with tales of "secular stagnation": a nasty condition that dooms its victims to chronically weak growth. Now that the economic outlook is brightening a bit—deflation has been dispatched, and for most advanced economies 2017 is forecast to bring a third consecutive year of economic growth—it is tempting to laugh off the idea of secular stagnation as a bit of crisis-induced hysteria. Tempting, but also premature.

In a time of secular stagnation, the normal relationship between saving and investment goes haywire. People save some portion of their income each year. Because one person's spending is another's income, such saving can drain away demand and lead to recession, unless the funds set aside by savers are reinjected into the economy through lending to those looking to invest: as when banks lend savers' deposits to businesses, for example. Central banks help manage this process. When planned saving threatens to outstrip desired investment, they will reduce interest rates to keep the two in line and the economy on track. But when secular

stagnation strikes, the gap between what people want to save and what they want to invest grows too large to reconcile. The interest rate needed to balance the two drops, ultimately to below zero. Central banks are stymied. The result is chronic economic weakness: low growth, low inflation, low interest rates and the constant threat of recession.

Several years ago those symptoms could be found across much of the global economy. No longer. Headline inflation is trending upward, even in Europe and Japan. Commodity prices have stabilized, helping struggling emerging markets. And America's Federal Reserve has begun raising its benchmark interest rate, suggesting that the American economy is no longer trapped in a world in which rates cannot be pushed low enough to keep growth on track. In a speech on March 3rd Janet Yellen, the chairwoman of the Fed, reckoned that America was ready for more rate hikes than in 2015 and 2016, including at least three this year.

But the most devilish aspect of the secular-stagnation story is that good times do not necessarily indicate underlying health. The persistent gap between desired saving and investment that it describes can result from a scarcity of attractive investment options—owing to an ageing population or a slowdown in technological progress, for example. But it can also be driven by the concentration of income among those with little inclination to spend. Income inequality could contribute to stagnation, for instance, by leaving a shrinking share of income in the hands of the poorer households that would most like to spend.

In such cases, the bonds of secular stagnation may temporarily be broken by a period of financial excess in which bubble conditions drive speculative investment, or in which groups short of purchasing power borrow from those with savings to spare. The reason to doubt the solidity of this recovery is that we have been in such circumstances before, only to watch it end in tears. In the late 1990s, for example, soaring tech stocks drove a wave of investment in internet infrastructure which yanked the American economy out of a jobless recovery. When that fever broke, the economy slumped again, until the global financial system found a way to funnel credit to American households looking to buy or borrow against a home. In the euro area, thrifty core economies lent heavily to the periphery, often against soaring property prices, fueling an economic boom that ended disastrously.

Post-traumatic stress

Is this time different? It is, a bit. Across advanced economies, borrowing capacity is still impaired after the trauma of the crisis; and banking reforms mean that credit

taps cannot be turned back on so easily. Those obstacles might simply delay rather than prevent a return to form, however. A mood of optimism is fueled by a stock market that is scaling new heights. In America, household debt is rising again, driven by loans to students and for cars. Across advanced economies, private debt as a share of GDP is above the pre-crisis level and rising fast (see chart). Most dramatic of all has been the increase in borrowing in China, where private debt as a share of GDP has nearly doubled since 2008. It seems very unlikely that the world economy would have escaped its deflationary doldrums without this vast credit expansion, which has kept its building boom rumbling along.

Economists sympathetic to the secular-stagnation story argue that there are ways to escape the trap. Firms might suddenly find new capital projects in which to invest: thanks, perhaps, to technological advance. An effort to reduce inequality could be a way out: the rich could be taxed and their wealth redistributed rather than lent. A massive public-investment campaign would be another. Emerging markets contributed to the world's savings glut by buying government bonds in order to build up their foreign-exchange reserves, funneling money to governments of advanced economies with little appetite for fiscal stimulus. Rather than see the private sector overextend itself, those rich-country governments could instead seize the opportunity to borrow more, soak up excess savings and invest the proceeds in new roads and railways, electric grids and broadband.

If the secular-stagnation idea holds, central banks face a stark choice until politicians do some of these things. The Fed, poised to raise rates later this month, seems confident it can tap its brakes and keep the American economy on a safe growth trajectory. But it might face a nastier dilemma: to tolerate the rising asset prices and indebtedness which enable recovery, or to choke off recovery and wait for the government to solve the problem. Just what sort of story best describes the state of the economy—and how scary it is—will become clear this year, one way or another.

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