IS THE WORLD BECOMING FLAT?

By

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Since the 2008 recession, world economic growth has been slowing down everywhere and there is a consensus among economists, investors, bankers and others that this economic stagnation will continue worldwide for a long time to come.

As one pundit said: "The world is stuck in the slow lane and nobody seems to know what to do about it".

The economic statistics seem to bear this out. Prior to 2008, many developed countries were enjoying annualized growth rates in the 3 to 4 percent range. China and some of the emerging markets were enjoying growth rates in the double digits.

Since 2007 however, world growth rates have fallen significantly and continue to fall with almost every updated forecast. Canada's annualized growth rate for 2016 was recently reduced by the OECD from 2% to 1.4 %. The U.S. rate has been revised from 2.4% in November, 2015 to 2.0 % in February, 2016. During this same time frame, the world rate has also been revised downward from 2.8% to 2.5% and this rate, of course, includes developing countries which have still enjoy much higher rates than the world average. European counties are almost all at about 1.5%. Japan is 1% and Russia is -1.0%. China's growth rate, which averaged 9.88% from 1989 until 2015, is currently forecast at 6.3% for 2016, the lowest growth in 25 years.

In its February 2016 economic update, the OECD stated that all sectors of the economy have forecast downgrades in their growth forecasts since November, 2015 and, further, there continues to be a significant slowdown in global trade growth. This being so, it seems more than likely that the trends will continue. Interestingly, the Trudeau government in its recent budget has used a growth rate of 0.4% which some observers point out is probably too low but politically very shrewd.

There is other data which paint a very negative outlook for the world economy. Governments' debt-to-GDP ratios have risen significantly around the world since 2008. Yet long term interest rates remain extremely low. Ten year government bond rates in the U.S. are around 2%. They are around 0.5% in Germany and 0.2% in Japan. Many market commentators believe that real interest rates could be around zero or even go negative for another decade and that inflation could stay close to 1% during this time frame.

Clearly, considering all these negative economic outlooks, there is ample evidence to support the experts who claim that, not only are we currently experiencing economic stagnation, but that it will continue for some time to come and probably even get worse.

Economists contend that countries need to have annual growth rates on a continuing basis approaching 3% in order to sustain economic prosperity and, if they are right, and the doomsayers are also right, we could be in for a rough ride.

The question arises, of course, why is this happening and what can we do about it?

As you might expect, there are a number of theories going the rounds and several of these are being promoted by very prominent scholars.

Kenneth Rogoff blames the problem on debt buildup. Ben Bernanke blames the problem on a savings glut. Paul Krugman says it is a liquidity problem.

In this paper I have chosen to address three other theories that seem to be generating much discussion in economic circles.

The first is called "Secular Stagnation". The second has been dubbed "Supply Side Headwinds". Finally, a theory called "The Demographics of Stagnation".

Secular Stagnation

The well-known proponent of this theory is Lawrence Summers, a former U.S. Secretary of the Treasury and a Professor of Economics at Harvard University.

In a nutshell, this theory holds that the economies of the developed world are suffering because of an increasing propensity to save and a decreasing propensity to invest (spend).

Excessive saving acts as a drag on demand thereby reducing growth and inflation. The imbalance also pulls down real interest rates.

So, when the desired levels of saving exceed desired levels of investment, we experience shortfalls in demand and stunted growth.

In the last six years or so, real interest rates have been near zero and have even turned negative in Europe and Japan. During this same time frame, inflation has also stayed very low. Summers is particularly concerned that real interest rates have remained so low for so long and that they are expected to stay that way. He also reminds us that demand has been weakening for some time.

Summers argues that during this time there has also been an increasing propensity towards saving and a decreasing propensity towards investing or spending.

He points out that the central banks in the G7 have collectively improved their balance sheets by $5 trillion. Large corporations such as Apple and Google are awash in cash but are reluctant to distribute more of it to their shareholders. The top 1% is accumulating untold wealth but is hording it or simply swapping paper among their peers to buy existing assets. At the individual level, people are saving more for retirement or to hedge against costs that used to be covered by employers because these benefits are being taken away by employers. CIBC claims in a recent report that individual Canadian investors are currently sitting on $75 billion in extra cash. This is money which has been accumulating since the 2008 recession and that would normally be invested.

He concludes that we have reached the tipping point and that there is an undesirable imbalance between saving and investments. There is too much saving (or hording) and this is a major cause of reduced demand and low growth.

To solve the problem he recommends that governments working in concert with each other use fiscal policy to reverse the trend. He believes that monetary policies have run into diminishing returns. He contends that the core problem of secular stagnation is that "the neutral' real interest rate is too low and that this rate cannot be expanded through monetary policy". He also makes it clear that international intergovernmental co-operation and co-ordination is absolutely crucial for the use of fiscal policy to succeed.

He also points out that fiscal policy is the best way to incent public spending on infrastructure, such as roads, bridges, sewers, transit, etc., all of which is badly needed.

He believes the key priority at the G-20 summit in China this September should be to increase global demand. After all, he says, "Raising demand is actually not that difficult, and it is much easier than raising the capacity to produce".

Interestingly, while Summers and Krugman differ as to the causes of the problem, they both agree that fiscal policy is the best tool to correct the problem. However, in an interview with Fareed Zaharia on Fareed's GPS program on March 6, Krugman stated he supported using fiscal policy but would avoid using tax policy. He fears that any funds generated by tax policy would likely be saved or used to pay down debt and not be used for additional spending.

Bottom line . . . Summers believes strong government intervention using fiscal policy is necessary to solve the problem.

Supply Headwinds

This theory is proposed by Robert J. Gordon in his new book, the Rise and Fall of American Growth. Mr. Gordon is a professor of Economics at Northwestern University.

In a nutshell, Mr. Gordon argues that from 1870 to 1970, Americans benefited from a number of developments which dramatically transformed living and working conditions in the U.S. and which created huge consumer demand and demand for investment but, that since then, technological advances don't really compare to the ones that transformed the U.S. economy in the earlier century. Therefore, more recent developments have not spurred the same consumer demand or the same demand for investment. In other words, the supply side of the economy is now a major part of the problem.

From 1870 to 1970, there was a bonanza of breathtaking and transformative innovations. He identifies five Great Inventions which occurred during this century: electricity, urban sanitation, chemicals and pharmaceuticals, the internal combustion engine and modern communication.

These innovations led to new and often labour saving conveniences which allowed more and more people to abandon hard physical labour for good. Because of these transformative innovations, we now enjoy conveniences such as electric lights, running water, flush toilets, central heating, automobiles, airplanes, telephones, radios, vaccines, antibiotics, all conveniences which we currently take for granted.

However, Gordon argues that since then most technological advances have only resulted in marginal improvements in our well being. Most often they only build on or exploit or refine existing knowledge. We have fancier and safer automobiles, better heating and air conditioning systems, clearer and larger television sets, smarter phones, faster and more comfortable trains, more effective antibiotics, improved surgical procedures and on and on.

Nevertheless,, while useful and while they usually lead to improved productivity and additional comfort and convenience, these technological advances are not transformative. This being the case, he argues they do not generate the kind of explosive demand necessary to support strong economic growth.

He concludes that he cannot foresee the new transformative technologies needed to drive the necessary growth and predicts economic growth will remain around 1% for some time.

His critics, and apparently there are many, are less pessimistic than he is and are optimistic there will be major advancements around emerging technologies such as artificial intelligence or genetic engineering. They also point out that he fails to mention his own mixed record as a forecaster. In a 2003 essay titled "Exploding Productivity Growth" he optimistically stated that productivity in the United States would grow at an average of 2.5% per year for decades. Yet, as we know the nest year, 2004, was the tail end of the high growth rates that had started in the 1990s and which have been going downhill since then.

Bottom line………Gordon is hoping some inventive entrepreneurs will come up with the transformative technologies that will solve the demand problem. Moreover, he does not put forth any policy suggestions which might be used to accomplish this.

The Demographics of Stagnation

This theory has been put forth by Ruchir Sharma who is the author of a forthcoming book titled "The Rise and Fall of Nations".

In a nutshell, this theory holds that the declining population growth rate together with the changing population demographics i.e. the slower growth in people of working age and the greater growth of more elderly people, will result in lower economic growth.

The author says the experts have largely overlooked these changing demographics, particularly the collapse of the working age population, and claims this may be one of the most important factors in the negative prognosis for world economic growth.

Unfortunately the book is not yet available but from articles I have read, he seems to be arguing that due to low fertility rates and healthier older people, there will be relatively fewer people of working age available to produce the goods and services to fill consumer demand. Coincidently, there will be fewer working people with the purchasing power to support robust consumer demand. And, while there will be a larger number of older people, they will only need minimal goods and services at minimal prices. These older people, whose number is statistically increasing every day, spend less, save more, pay fewer taxes, etc. In other words, even with their growing numbers, they will not create enough robust consumer demand of the kind necessary to drive meaningful and sustained economic growth.

It is true that unemployment rates for the working class remain high at the present time which suggests they are in over supply. This is particularly true for the younger people in the workforce. However, it can be argued that a major factor contributing to this problem is the mismatch between job opportunities and the skills necessary to fill them. There are jobs in many sectors of the economy but there are not enough workers with the necessary skills to fill these jobs. As the demographics of the population continue to shift there should be continuing pressure on more education and probably different kinds of education for young people which should alleviate this problem to a large degree.

It is widely understood that the replacement fertility rate (the rate below which the population starts to shrink) is 2.1%. Currently, world population growth is predicted to be around 1 to 1.5% and is trending downward which means on a world basis we are already below the replacement rate.

Further, as Indicated earlier, declining population growth generally is having a significant impact on the working class population. Between 1960 and 2005, the global work force grew at an average rate of 1.8%. And since then has dropped to 1.1%, and is likely to drop further given the declining fertility rates throughout the world. In the United States it is 0.5% compared to 1.7% from 1960 to 2005. It is already below that in some countries such as China and Germany.

Some economists claim that a one point decline in population growth will eventually reduce economic growth by a percentage point. The percentage drop can very well be higher when an increasing proportion of the population, such as older people, is not making any significant contributions to society either by producing something or as consumers.

Governments around the world are very much aware of the problem and many are already taking steps in an attempt to deal with it. Many countries have implemented guest worker programs. Several countries, especially in Europe, have increased the retirement age from 65 to 67 to keep more people in the workforce. Many countries, at least until the recent wave of terrorism, had adopted more aggressive immigration policies to attract workers although eventually this is a zero sum game because the number of available workers remain the same. They are just located in different places.

Quite apart from the concern about the looming drop in the working class, many countries have also become very concerned about the alarming drop in fertility rates generally. China has changed its one-child policy. India has abandoned its forced sterilization campaign. A number of developed countries have programs to subsidize motherhood. In some countries such as Chile and France, the subsidies increase for additional children.

Notwithstanding all these efforts, it is generally felt measures such as these will not be enough to turn the tide and population growth will continue as a major challenge. Many believe the problem will likely get worse.

The author reminds us there are many factors which will continue to drive down population growth. These include wide spread birth control education, the growing acceptance of birth control methods, the increase in educational levels among women, the increase in working women, economic hardship, economic prosperity, to name a few. Therefore, it is fair to conclude that the rate of population growth and the proportion of working age people will continue to decline and based on this theory, there will also be a negative impact on world economic growth. Indeed, there could be "negative" growth on both fronts.

Bottom line……the solution lies in a change in human behaviour with an occasional nudge from government policy and, as we know, neither is very predictable.

Dear reader, which of the three theories do you believe?