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Are we heading for a secular stagnation?

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Longterm Outlook

When the economy is well, people are well. But just how well is the economy going to be in the coming years? Some economists believe the idea that we will be entering a secular stagnation – or have already entered it – to be a realistic scenario. What does that mean?

A secular stagnation is characterised by a long-term (secular, derived from the Latin “saeculum” – century, lifetime) low-level rate of economic growth (stagnation). Under normal circumstances, central banks would cut interest rates during recessions or periods of low economic growth so as to make it more appealing for companies to raise capital for investment purposes. That is not possible in a secular stagnation.

When the key-lending rates are already very low, they cannot be cut any further – at least not by any significant degree. This leads to the seemingly paradoxical situation of key-lending rates being still too high to generate a trend reversal at zero percent. As a result, interest rates remain sustainably low without inducing any form of long-term economic stimulus.

10Y government bond yields adjusted for inflation

Sources: Bloomberg, EAM

Why do companies invest so little?

There are a few reasons. Low or indeed negative population growth causes aggregate demand and thus the need for investments to decline. This means that investments yield a lower return. Also, productivity growth has been falling for years in the OECD states. This may come as a surprise, given the noticeable technical progress, but history shows that technological progress often takes years or even decades to arrive across the entire economy.

In addition, some progress is not reflected in the GDP or the bottom line of companies. Just think of the numerous free digital services. And finally, some industries have seen a significant degree of concentration in recent decades. The more power companies have on the market, the less they need to invest to stay competitive.

Productivity growth in the USA? and the Eurozone?

Source: OECD. Risk note: Past performance is not a reliable indicator of the future performance.

What can be done?

Monetary policy reaches its limits when it comes to a secular stagnation. In a cashless society it would theoretically be possible to cut interest rates significantly below zero, which would then make investments with a low expected return profitable as well. However, while this option has been discussed by economists, it will probably remain a theory in the foreseeable future. Another option – in fact, one that is already in use – is to reduce the credit risk premiums, i.e. spreads, through purchase programmes for securities from the central banks. This, too, makes capital cheaper for companies.

On the downside for investors, the yield on the various markets has been on the decline. Also, the limited usefulness of this strategy comes with its own set of risks. The valuation, i.e. the ratio of return to risk, rises, and the asset becomes more expensive. This means that the risk of drastic overvaluation (i.e. bubbles) rises as well. This tendency also reinforces inequalities in society, because those who already have a lot of wealth benefit most. Central banks therefore have to use this tool very carefully so as not to cause more damage than good.

A stronger role for fiscal policy would lend itself as an alternative to monetary policy. State investments in, for example, infrastructure (not the least in the context of climate change) could partially make up for the lack in demand from private households and the corporate sector. In addition, such investments could also boost the rate of return for private investments. Economic institutions such as the IMF – formerly not known to support demand-side economics – have realised the importance of a stronger role of the state. Given the current record level of debt it remains to be seen whether politicians will choose to go down that road.

Conclusion

The above-described case of a secular stagnation is not only a theoretical one. The prime example of an economy that has been caught in such a situation for years is Japan. The main characteristics of a secular stagnation are all there: low population growth, low economic growth, low interest rates, low inflation; and generally low rates of return on the capital markets. Europe seems to be heading for a similar scenario, and the USA appears to be close.

On the whole, the situation has probably deteriorated further in the wake of COVID-19, despite the positive aspects of a stepped-up acceleration of the digitalisation process. Trends such as falling population growth will be hard to reverse for a long time, much like the powerlessness of the central banks. We will see whether the Japan scenario can be averted in the medium term. If at all, it is most likely to work on the back of increased competition, fewer inequalities in society, and a paradigm shift towards a significantly more important role of state-sponsored investments.

Legal note:

Prognoses are no reliable indicator for future performance.

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