OXFORD ECONOMICS

Are the advanced economies facing a lost decade?

Executive Summary

- Recent weeks have seen a slew of weaker-than-expected data releases from the major economies, raising doubts about whether the expansion in the developed nations is sustainable.
- One reason for the apparent loss of momentum has been the moderation of growth in the emerging markets, as central banks have tightened monetary policy in response to rising inflation. The weakening trend in growth indicators can also be linked to temporary adverse factors, including supply chain disruptions form the Japanese earthquake and tsunami, as well as the sharp rise in oil prices earlier this year.
- While this reasoning offers some reassurance that the slowdown in the advanced economies will prove transitory, the fact remains that the economic recovery is proving unusually weak compared to other post-War cycles. In fact, history shows that financial crises are typically followed by a lengthy period of retrenchment that lasts almost as long as the preceding credit surge.
- This presents a rather bleak context for the medium-term outlook, especially when taking into account that both the US and Europe still face deep structural problems. Although the ratio of non-financial sector debt to GDP has come off its highs, this measure of leverage has not declined materially.
- Disappointing payrolls data from the US also hint at deeper seated problems, as the key to sustaining any expansion is employment growth. The US may now be facing a rise in structural unemployment as the bloated construction and real estate sectors shrink.
- What makes the latest slowdown in growth particularly hazardous is that it is coinciding with the withdrawal of policy stimulus. In fact, the IMF estimates that the removal of fiscal stimulus faced by the developed economies in 2012 will be the most severe since 1981.
- Our view has always been that the recoveries in both the US and Europe would be relatively bumpy and muted compared to recent historical experience. This view remains valid and we believe that the recovery in the developed nations has now reached a stage where it is self-sustaining, particularly when set in the context of continued rapid growth in the Emerging Markets. Fears of a ‘lost decade’ resembling Japan in the 1990s are thus overplayed.

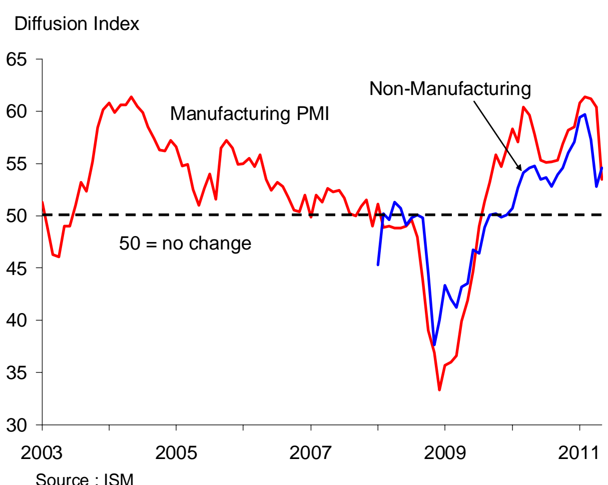
Introduction

Only two years into the recovery and incoming data indicates that the global economy has weakened anew, raising doubts about whether the expansion in the advanced economies is sustainable. So does this disappointing economic data indicate that we are already heading into another downturn, or is this merely a temporary softening of the global recovery? More generally, does the disappointingly sluggish pace of the recovery among the advanced economies signal that they are facing a 'lost decade' resembling Japan's experience in the 1990s?

Economy hits another 'soft patch'…

Recent weeks have seen a slew of weaker-than-expected data releases from the major economies. The global composite PMI indicator for May showed manufacturing output growth slipped to a near two-year low, with national data pointing to slower rates of expansion in the US, the Eurozone and the UK. In the Eurozone, the manufacturing PMI fell sharply in both May and June to its lowest level in 18 months. National PMIs have signaled a broad-based slowdown in the pace of recovery, with headline indices retreating from their April levels in all the Eurozone member states covered.

Chart 1: United States ISM Report on Business



In the United States, the latest employment report was very disappointing, showing payrolls grew at the slowest pace in eight months in May, while the unemployment rate unexpectedly climbed to 9.1% of the workforce from 9% in April. With higher prices eating into wages, consumer spending also stagnated in May and consumer confidence is very low. Data from the housing market also continued to be gloomy, with the S&P Case-Shiller price index down by 4% in April 2011 compared to a year earlier.

One reason for the apparent loss of momentum among the industrialised nations has been the moderation of growth in the emerging markets, which have been the engine of the global recovery. This slowdown had been foreseen, as many emerging market economies have been tightening monetary policy in response to rising inflation. And insofar as what we are seeing is the engineering of soft landing for the Emerging Markets, and the avoidance of overheating, it can be considered a positive development. By avoiding the risk of a boom-and-bust cycle, the scene would be set for a more sustainable long-term expansion.

Nonetheless, growth in the developed world has still disappointed expectations. Against this background, investors are worried that the global expansion may be faltering, recalling memories of the double-dip recession fears that were commonplace during the summer of 2010. While the slowdown last year proved no more than a temporary 'soft patch', there are concerns that the current lull could prove more protracted.

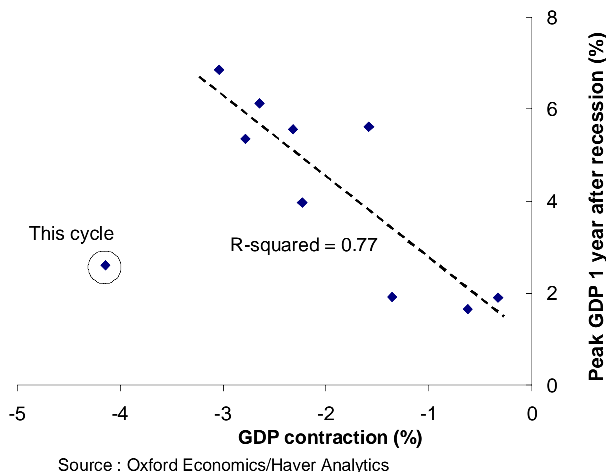
In fact, the consensus view is that the current slowdown will again prove to be short-lived, as the weakening trend in growth indicators can be linked to temporary adverse factors. First, supply chain disruptions from the Japanese earthquake and tsunami have had a direct impact on manufacturing and the auto industry in particular. Second, there was a sharp rise in oil prices of around $40 per barrel between November 2010 and April 2011. Of itself, this would have been enough to have dampened global growth. But with oil prices having eased substantially in recent weeks, this should hopefully provide some relief to consumers and businesses, helping to underpin a rebound of activity in the autumn.

…amidst an unusually sluggish recovery

While this reasoning offers some reassurance that the slowdown in the advanced economies will prove transitory in nature, the fact remains that the economic recovery in developed economies is proving unusually weak compared to other post-War

cycles. An economy typically recovers to its previous peak output in less than a year. More importantly, history suggests that there is a close correlation between the depth of recession and the speed of the subsequent recovery. This relationship appears to have broken down following the recent recession, however, which has proved to be the deepest in the post-War period (see Chart 2). Viewed from the perspective of Friedman's 'plucking' model of business cycles[1], this pattern appears to be puzzling. Based on this model, recessions are largely due to cyclical contractions, which tend to dissipate more quickly the larger the size of the downturn.

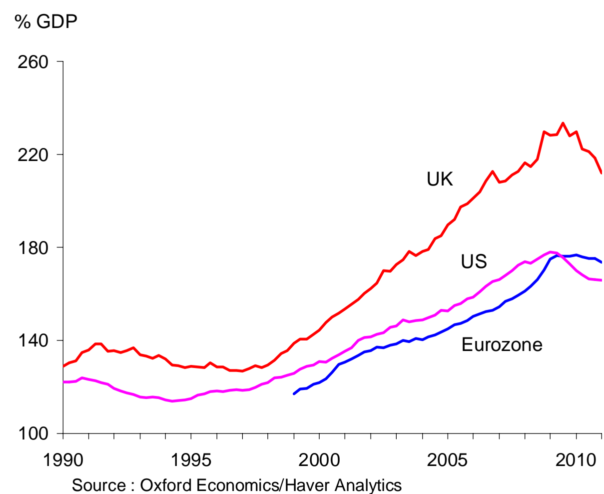
Chart 2: US GDP troughs and rebounds



It seems that previous economic cycles may not provide a useful guide to the dynamics of the current cycle. But this may not be too surprising, as many features of the recent downturn are exceptional. More specifically, this recession combined a financial crisis within the world's largest economy with a synchronized global downturn. So it may be more instructive to examine how recoveries have unfolded in economies that have experienced financial and banking crises over the past few decades. Unfortunately, this does not give reason for optimism. A study of 15 post-War financial crises by Carmen and Vincent Reinhart[2] concluded that they are typically followed by a lengthy period of retrenchment that lasts almost as long as the preceding credit surge.

This presents a rather bleak context for the medium-term outlook, especially when taking into account that both the US and Europe still face deep structural problems. Although the ratio of non-financial debt to GDP has come off its highs, this measure of leverage has not declined materially and remains very large by historical standards (see Chart 3). Indeed, Larry Summers, who was President Obama's chief economic adviser until the end of last year, recently warned that the United States is now halfway to a lost decade resembling Japan's experience in the 1990s. In particular, deleveraging by US consumers may have a long way to go and the US savings rate, which stood at 4.9% of disposable income in April 2011, would need to rise substantially if it is to return to the average level of close to 8% that characterized the years prior to 2000. Although the current account deficit has improved, this has mainly reflected a worsening domestic investment performance rather than higher savings. In fact, investment amounted to just 15% of GDP in Q1 2011, representing a multi-decade low.

Chart 3: Non-financial sector debt/GDP



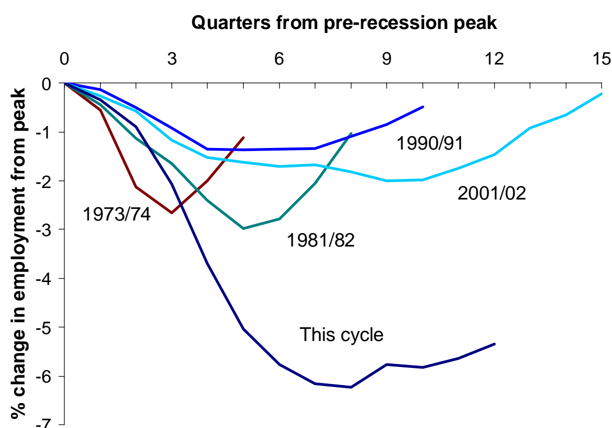
US structural unemployment on the rise

Disappointing payrolls data from the US also hint at deeper seated problems. Indeed, the current economic cycle has been unusual in terms of the differential impact on employment across the advanced economies, as we highlighted last year in

[1] Friedman, M. (1993), "The Plucking Model of Business Fluctuations Revisited," Economic Inquiry, 31(2)
[2] Reinhart and Reinhart (2010), "After the Fall", NBER Working Paper No.16334

a Special Report ("Why Have G7 Unemployment Rates Diverged?", July 2010). The rise in the headline unemployment rate has been particularly sharp in the United States, for example, while the number of job losses has been more muted among the core Eurozone economies.

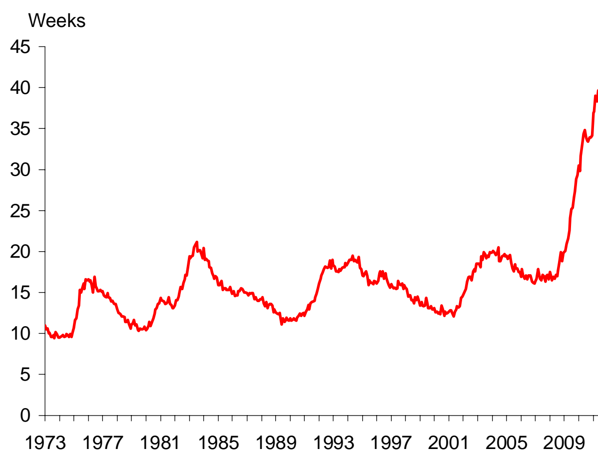
Chart 4: US employment in past downturns



Source : Oxford Economics/Haver Analytics

Employment losses in the United States have also been exceptional when compared to past domestic cycles (see Chart 4) and job creation during the recovery phase has so far proved slower. As a result, the mean duration of unemployment in the United States has now climbed to 40 weeks, twice the peak duration experienced in the past three recessions (see Chart 5). As the unemployed tend to lose skills and motivation the longer they are without work, this raises the likelihood of a rise in structural unemployment – which thanks to a flexible labour market has not been a significant problem for the US economy during the post-War period.

Chart 5: Average duration of US unemployment



Source : Oxford Economics/Haver Analytics

In part, the large impact on unemployment in the United States may reflect the structural adjustments underway within the bloated construction and real estate sectors. It may also be a consequence of the increased flexibility of the US jobs market and the relative ease of shedding workers during a downturn (compared to labour markets in Europe). But this wage and price flexibility can also increase the risk of deflation in an economy faced with an overhang of debt, where deleveraging in the private sector has resulted in interest rates at their lower bound amid downward pressure on output.

QE2 draws to a close…

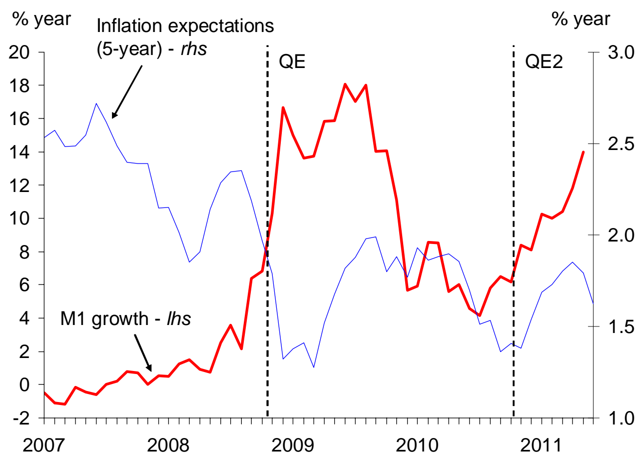
Policymakers are cognisant of the dangers posed by price deflation to a highly leveraged economy. Deflation increases the real burden of debt, prompting firms and consumers to rush to repay loans as credit dries up. This depresses demand, leading to additional price cuts that further inflate debt levels, potentially leading the economy into a deflationary spiral.

With interest rates at the zero bound, central bankers used unconventional monetary policy tools in the aftermath of the financial crisis to stimulate the economy and ensure that inflation remained in positive territory. These non-conventional policies included so-called quantitative easing (QE), which involves purchases of government securities. As activity recovered, most central banks have gradually wound down their QE policies, although the Federal Reserve embarked on a second round of such policy support in November 2010 when it was concerned that core inflation was falling toward zero. Dubbed "QE2", this second round of unconventional monetary policy support is set to finish on 30th June.

During the two rounds of QE, the Fed has bought a total of $2.3 trillion of government and mortgage-backed bonds. The programs were designed to work by increasing the money supply, helping to inflate asset prices, thereby boosting wealth and confidence, leading to higher consumer spending. The programs also aimed to lower the value of the currency (helping to improve the trade balance), and raise inflation expectations (thereby lowering real interest rates). As illustrated by Chart 6, this policy tool does appear to have been effective in terms of

easing financial conditions and lifting inflation expectations. Indeed, analysis by the Federal Reserve economists of the first round of QE concluded that yields on longer-maturity securities were reduced by around 50 basis points[3].

Chart 6: US inflation expectations and M1 growth

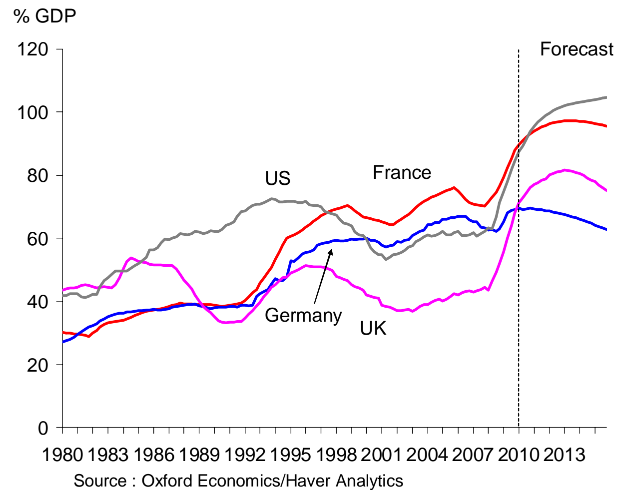


Source : Oxford Economics/Haver Analytics/Cleveland Federal Reserve

Nonetheless, there are also concerns amongst policymakers that the effectiveness of QE may be waning. First, banks appear to be hoarding much of the cash injected into the economy, as demonstrated by the sharp increase in excess reserves of commercial banks held at the Federal Reserve (although this increase is distorted by the decision to pay interest on these reserves). Second, the benefits of the Fed's QE policies to the economy were dampened by the rise in global commodity prices that is likely to have been partly related to these policies. As most commodities are priced in US dollars, a weaker dollar tends to push up the price of commodities. The QE regime also supported capital flows into alternative asset classes, including commodities, which further supported prices.

Against this background, there seems to be little immediate appetite for the Federal Reserve to sanction another round of QE at this point in time, especially as the core inflation rate is no longer uncomfortably low. So while the Fed will replace maturing debt holdings (until at least the end of the year), it is unlikely to make new purchases after the end of June. As QE2 winds down, money supply growth is thus likely to slow from current levels.

Chart 7: Government debt as a share of GDP



Source : Oxford Economics/Haver Analytics

Nonetheless, a third round of QE cannot be ruled out at some point in the future, especially if there are signs that core inflation is slowing toward zero. Another risk relates to how the market will adjust to the loss of Fed purchases. The Fed has argued that the main impact of QE2 occurred through the stock of debt that was purchased, rather than the flows of purchases. Still, given the large upcoming supply of net issuance (linked to the large budget deficit and expanding level of public debt), concerns over sovereign creditworthiness could generate an adverse market reaction, resulting in a sharper-than-expected rise in yields on benchmark US government bonds. If this threatened to dampen US economic growth, then the Fed would likely prime the pumps for another round of QE.

…and fiscal support is being withdrawn

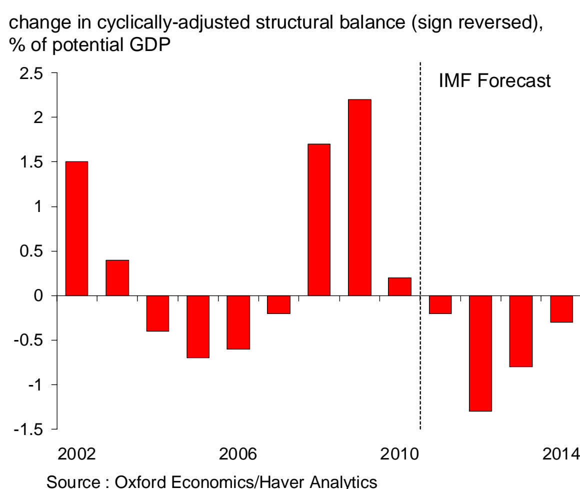
Expansionary fiscal policy has also been a key factor supporting the economic recovery in developed economies over the past two years. What makes the latest slowdown in growth particularly hazardous is that it is coinciding with the withdrawal of this policy stimulus. In fact, the IMF estimates that the removal of fiscal stimulus faced by the developed economies in 2012 will be the most severe since 1981 (see Chart 8).

In Europe, governments have already embarked upon ambitious fiscal austerity programs to satisfy the financial markets that their public finances are on

[3] Gagnon *et al.* (2010), "Large-scale asset purchases by the Federal Reserve: Did they work?", *Federal Reserve Bank of New York Staff Reports No. 441*, March.

a sustainable path. Meanwhile, within the United States, there appears to be little appetite within Congress for additional fiscal stimulus given the present trajectory of the public debt ratio, which we forecast to exceed 104% of GDP by 2014. The White House is negotiating deficit cuts of between $1 trillion and $4 trillion over the next decade to win the Republicans' agreement to raise the ceiling on federal debt. The current stand-off over raising the debt ceiling also raises the risk that the US will have to make more substantial short-term spending cuts.

Chart 8: Fiscal stimulus in advanced economies

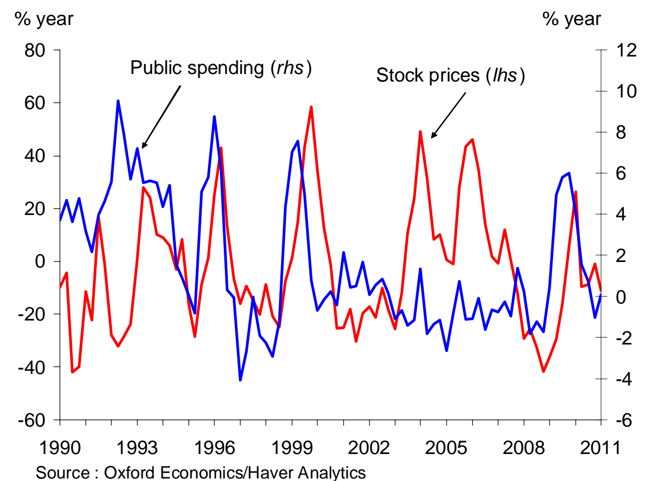


Source : Oxford Economics/Haver Analytics

It is likely that a last minute compromise will eventually be reached on raising the debt ceiling. But it is clear that the US public sector is stretched to the point where it has become a source of risk itself. This was underscored by the ratings agency Standard & Poor's, after it cut the long-term rating outlook for US government debt from stable to negative in April, reflecting concerns over the lack of progress in cutting the budget deficit.

Against this background, the outlook remains uncertain as it is not clear how the private sector will cope when fiscal policy support is removed. Indeed, history suggests that policy tightening after financial crises can derail fragile recoveries. For example, the Japanese economy showed temporary signs of life when macroeconomic policy was supportive during the 1990s, but private activity soon faded when that policy support was withdrawn. Likewise, fiscal stimulus in Japan was associated with temporary rallies in the equity market during the 1990s, which subsequently proved illusory (see Chart 9). Equity investors in the advanced economies could therefore be disappointed in coming months if Japan's experience provides a useful guide.

Chart 9: Japanese public spending and equity prices



Source : Oxford Economics/Haver Analytics

Of course, it should be borne in mind that the Japanese stock market was highly overvalued at the beginning of the 1990s, so the Japanese experience may not provide such a useful guide in this respect. Moreover, the Japanese government passed a series of fiscal stimulus packages in the 1990s that were often wound down very abruptly, before the economy had had time to strengthen. One example of such sudden fiscal tightening was the ill-fated decision to increase the VAT rate by 2 percentage points in 1997, which plunged the fragile Japanese economy back into recession.

Of course, it is difficult to know how much independent momentum the advanced economies can sustain until that policy support is withdrawn. If the recovery stalls, then US policymakers would likely set aside their differences and vote for a further round of (limited) fiscal stimulus spending. In contrast, the scope for another round of fiscal stimulus is much more limited in Europe and political opposition is likely to prove unyielding.

But there are reasons for optimism...

As the major economies emerged from recession in 2009 we warned that the recoveries in both the US and Europe were likely to be relatively bumpy and muted compared to recent historical experience. We highlighted how the normalisation of macro policy

settings and a transition toward solid growth based on private final demand would require significant structural adjustments in many economies.

This view remains valid and we believe fears that the recovery in the advanced economies is coming to an end are exaggerated. The softening of growth in Q2 likely reflected a number of temporary factors that are already fading. In particular, oil prices have retreated from their highs, which should provide some relief to businesses, while the decline in petrol prices will help to support consumer spending.

Compared to the temporary slowdown in the summer of 2010, financial conditions are now more supportive. Labour markets in Europe are now far healthier and despite the disappointing employment report in May, the pace of US job creation so far in 2011 is nearly double what it averaged in 2010. The corporate sector is also better placed to withstand a temporary softening in demand, following an additional year of expansion in profits, retained earnings and cash holdings.

Growth in the emerging markets should also remain a supportive factor. Although this has moderated of late this may well represent a 'soft landing' for these economies, which will allow the expansion to proceed on a more sustainable basis. Although slower growth in the Emerging Markets is currently being felt in the advanced nations, the avoidance of a boom-and-bust cycle in these economies has also markedly enhanced the sustainability of the recovery in the advanced economies. We expect the Emerging Markets to continue providing the main driving force behind the global recovery over the next few years.

...despite the mounting risks for 2012

Clearly the recovery in advanced economies will have to contend with significant headwinds relating to ongoing private sector deleveraging and the removal of policy stimulus. A sudden fiscal tightening in the US or a sovereign debt default in the Eurozone also present significant risks that would threaten financial markets and economic growth on both sides of the Atlantic. Notwithstanding these difficulties, we believe that the recovery in the developed nations has now reached a stage where it is self-sustaining, particularly when set in the context of continued rapid growth in the Emerging Markets. Fears of a 'lost decade' resembling Japan in the 1990s are thus overplayed.

Against this background, we expect US economic growth to pick up to the 3-3½% range for the rest of this year and on an annual basis for 2012 and 2013. Within the Eurozone, growth will be more subdued, but the economy should still expand by a fairly healthy 1.9% in 2011 and 1.6% in 2012. But prospects are mixed at the country level. Among the "core" Eurozone member states, GDP is forecast to rise by 2.2% per year on average in 2011–15, a growth rate slightly higher than in the decade before the crisis. By contrast, in the "periphery," GDP is forecast to rise by only 1.2% per year in the next five years, not even half the pace of the decade before the crisis.