The Economist

Free exchange
Economics

Secular stagnation

Glut busters

May 15th 2014, 12:58 by R.A. | LONDON

WITH eminences like Larry Summers sparking new interest in the idea of "secular stagnation", a particular view about the macroeconomics of the pre-crisis period seems to be coalescing. America was in the grips of a savings glut, the story goes, driven by several factors, such as: reserve accumulation by foreign governments and central banks, high levels of saving by pre-retirement Boomers, and the concentration of income in the hands of rich households with low propensities to consume. Available savings piled up while attractive investment opportunities remained flat or (in some versions of the story) declined. This imbalance corresponded to a chronic demand shortfall and tumbling interest rates. As interest rates fell it became ever harder for the central bank to buoy up demand by cutting its policy rate.

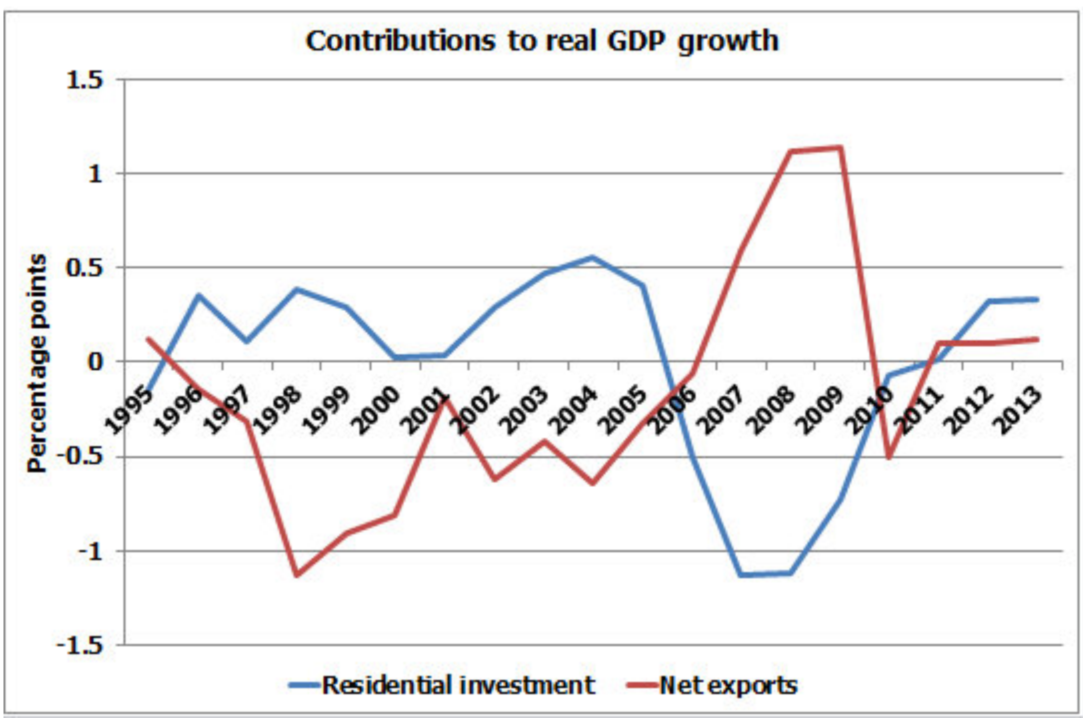
Weak demand was only overcome when an unsustainable bubble-creating mechanism was established. Low rates drove asset prices higher. That, in turn, supported rapid growth in private debt, and together soaring debt and asset prices lifted demand high enough to generate full employment (through the mechanisms of rising consumption and house-building). But this obviously couldn't go on forever and didn't; when credit could grow no more the economy collapsed. Since we haven't solved the underlying savings glut, the American economy now has three options, according to this view:

1. Suffer through the same low growth ("secular stagnation") that was characteristic of the early 2000s.
2. Use monetary policy to raise demand through higher asset prices and credit growth, restoring decent growth but creating a risk of new bubbles.
3. Use deficit-financed fiscal policy to absorb excess savings and boost demand, without relying on rapid growth in private credit.

Certainly, parts of this story are correct. But is this really the best way to describe what was taking place? Consider a slightly different narrative.

In the early 2000s America was in the grips of savings-glut-like conditions. But the most relevant bit of the glut dynamic was the fact that it resulted from accumulation of dollar assets, which caused the dollar to strengthen. This process went hand-in-hand with, and reinforced, rapid growth in trade with poorer economies. And the combined effect of these trends was a sharp rise in the relative cost of American tradable goods: a massive shift in America's real exchange rate.

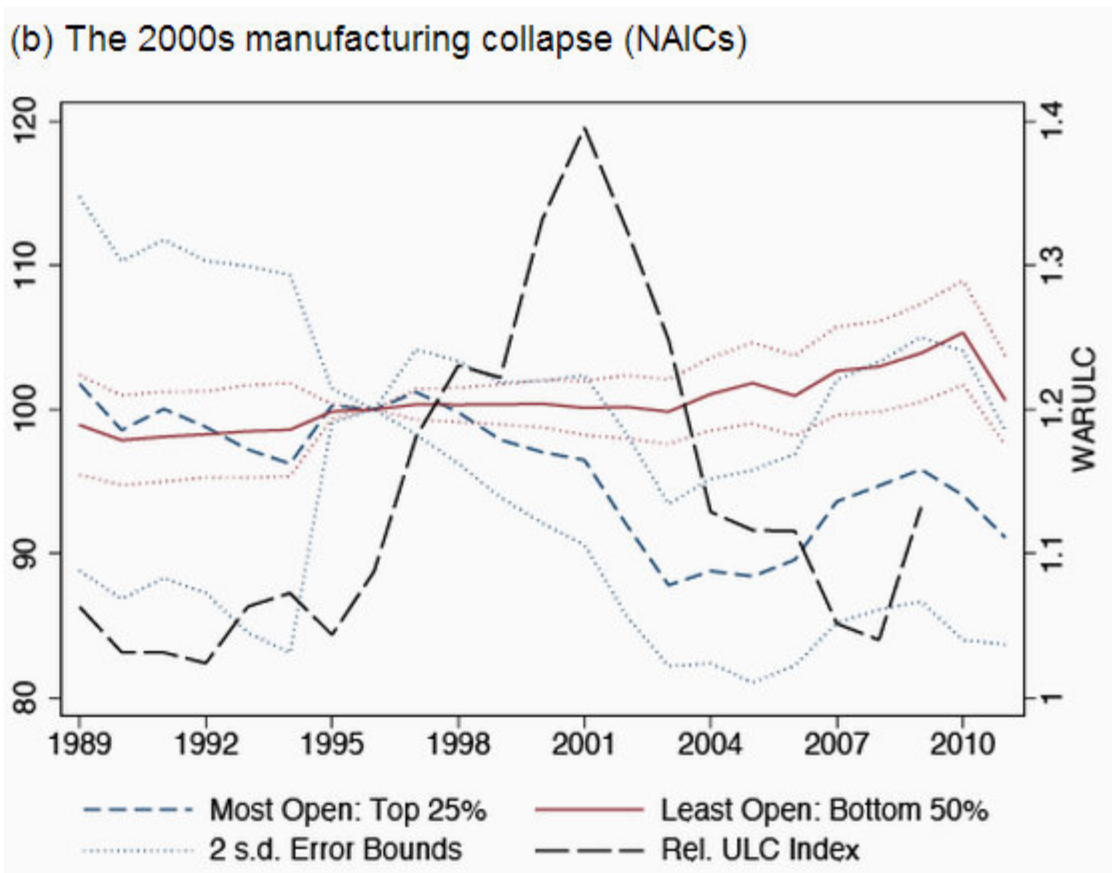
What would we expect to happen in such a circumstance? Well, we would expect a big blow to industries that were cost-sensitive and highly exposed to foreign markets. We would expect to see large current-account deficits and for net trade to be a substantial drag on growth. We might anticipate that the central bank would struggle to boost demand given weakness in external demand, and we might expect that efforts to boost demand would overwhelmingly work by lifting growth in non-traded sectors. You might get something like this, in other words:



One might then argue that the problem in the 2000s was not that the Fed haplessly created a bubble in order get the economy going again, setting the stage for a big disaster in the process. The problem was that it didn't do enough. What it ought to have done to boost the economy was intervene aggressively in foreign-exchange markets to dampen the dollar's rapid appreciation.

This is the implication of interesting research by Doug Campbell, a PhD candidate from the University of California, Davis, who recently wrote a piece (http://www.voxeu.org/article/causes-secular-stagnation) on expensive dollars and secular stagnation for VoxEU. In a recent paper (http://dougcampbell.weebly.com/uploads/1/0/2/2/10227422/exchange_rate_indices.pdf) co-authored with Ju Hyun Pyun, of the Korea University, he estimates a measure of America's real exchange rate, augmented to take account of productivity differences and gaps in price levels between America and its poorer trading partners. All told, the authors reckon the dollar experienced an effective appreciation of 48% between 1990 and 2002. They write that "US prices in 2002 were higher relative to other trading partners than at any point since the Great Depression".

What sort of effect might that have? This chart provides gives one a sense of the damage:



We see a spike in relative unit labour costs. That coincides with a sharp drop in manufacturing employment in the most open manufacturing industries, alongside a slight rise in employment in manufacturing industries least exposed to foreign competition. Mr Campbell turns up similar patterns in the early 1980s, when the Fed's efforts to whip inflation led to soaring real interest rates and a similar round of dollar appreciation.

Now obviously, direct intervention in foreign-exchange markets is not the sort of thing

America is supposed to do (although American governments have never been reluctant to pressure other economies to let their currencies appreciate). But this is a taboo that needs rethinking. Depreciations have historically been the most effective way to lift expectations for growth and inflation. And correspondingly, we should not underestimate the contractionary effect of a substantial currency appreciation. America could conceivably break its way out of secular stagnation if the Fed contrived to raise inflation expectations by other means. But the surest way to escape the current doldrums (and, for that matter, to boost inflation expectations) is to directly weaken the dollar.

Taking a step back, one could easily argue that *not* intervening to weaken the dollar is by far the more dangerous policy approach. America produces the world's primary reserve currency and the world's primary safe asset. The Fed must inevitably be a global monetary hegemon. A world in which the global monetary hegemon is constantly courting financial bubbles in an effort to prop up demand does not seem likely to be a particularly stable one. What's more, as Cornell University economy Eswar Prasad argues in his recent book "The Dollar Trap", the crisis strengthened the dollar's position in the world economy (and certainly lifted global demand for safe dollar assets). One could imagine a scenario in which crisis deepens the dollar's global role, simultaneously linking global fortunes even more closely to America's and making it harder for the Fed to achieve sustainable growth at acceptable financial risk.

And of course, we shouldn't pretend that there is anything sacred about the de facto monetary system often called Bretton Woods 2. In the modern economic era the world economy has toyed with several different monetary systems. Which is to say: we've scrapped failed systems in the past and shouldn't overestimate the cost of doing so again.

Must this involve direct foreign-exchange market intervention by the Fed? Not necessarily. Either aggressive QE or a dramatic change in monetary guidance or target could sharply weaken the dollar—though if foreign central banks are actively resisting depreciation there is no substitute for the printing press. (In the event that America did decide to print, active resistance elsewhere wouldn't necessarily be a bad thing; currency wars are only bad for those who opt not to play along.)

But to return to a point I made earlier this week (http://www.economist.com/blogs/freeexchange/2014/05/lousy-recoveries) : the Fed will not do any of the above autonomously. The decision to change the global monetary system will be political, just as it was in 1933 and in 1971, when American presidents made the necessary policy shift. Such decisions only tend to be made when the status quo is clearly untenable or when large political majorities demand a different course. Unfortunately, America's secular stagnation mess does not seem likely to test either limit for some time to come.