Grand Experiments That Are Too Big to Fail

As the great and the good gathered in Davos to ponder the next big thing, the pummeling of global equity markets brought key assumptions into question. Yet, their collective heads stayed buried in the snow with regard to the big ideas from years past, namely, the three grand economic experiments launched by the U.S., Japan and China following the Global Financial Crisis.

The fate of the global economy depends on the success of these unconventional efforts to boost economic growth. Yet all three ventures are now in danger of failing because none of them addresses the fundamental challenge of ↗*structurally slow growth*.

The first grand experiment began in 2008, when the Fed embarked on its zero interest rate policy (ZIRP) and unleashed quantitative easing (QE) to depress interest rates further. Since then, each time economic growth has faltered, the Fed has doubled down — with QE2 in 2010, "Operation Twist" in 2011, and the unlimited bond-buying program dubbed QE3 in 2012. Finally, with economic growth improving in 2014, the Fed resolved to start a rate hike cycle in 2015, ending seven years of ZIRP.

Almost immediately after the first rate hike, newfound recession fears have put many on edge. Of course, economic cycles are inevitable in market-oriented economies, which alternate between periods of rising and falling growth. Some of these slowdowns end in "soft landings," others in recession. But it is clear from our cyclical viewpoint that the Fed started hiking rates unusually late, a year inside a slowdown.

The data show U.S. growth slowing throughout 2015, according to the broad coincident indicators of aggregate output, employment, income and sales used to decide official business cycle dates. For instance, year-over-year (yoy) growth is at 1½-year lows for GDP and nonfarm payroll jobs, let alone industrial production growth, which is at a six-year low. Still many, including the Fed, expect growth to bounce back. But unless that happens soon, its rate hike plans will likely be overwhelmed by the sustained cyclical downturn in growth.

A central goal of the Fed's grand experiment has been to demonstrate that — given sufficiently aggressive and timely QE — the U.S. would not "become Japan," returning repeatedly to ZIRP and QE. They have been blazing a path that the Bank of England and the European Central Bank hope to follow, expecting an eventual return to "business as usual." However, if the Fed cannot begin a true rate hike cycle after seven years of ZIRP — a prospect made more real by volatile equity markets — it would force others to reconsider the risks of their own economies "becoming Japan."

"Abenomics" is another grand experiment, launched three years ago with a promise to leave Japan's "lost decades" behind. Its "three arrows" included not only unprecedented QE, but also muscular fiscal policy and structural reforms. Its success would show policymakers everywhere the way out, even if their economies did "become Japan."

However, Abenomics is also tottering. In 2014, Japan experienced its fourth recession since 2008 before barely avoiding a fifth one in 2015. Meanwhile, CPI inflation remains near zero, and household spending, which makes up nearly 60% of its GDP, has dropped over 4% since early 2014. The potential failure of these two grand experiments — in the U.S. to avoid "becoming Japan," and in Japan to exit its "lost decades" — is ominous. A third grand experiment, launched in China following the Global Financial Crisis (GFC), involved not only massive monetary easing, but truly colossal fiscal stimulus that included pouring more concrete in the three years ending in 2013 than the U.S. had in the entire 20th century. The resource bust that followed has sent deflationary shockwaves around the globe, and the repercussions are not over yet.

Years of robust growth had fostered the belief that China was led by infallible technocrats who always knew what levers to pull, and when. But their handling of the stock market crash and exchange rate volatility since the summer has undermined confidence in China's ability to pull off a tricky transition to a consumer-driven economy.

Policymakers need to confront the inconvenient truth that long-term trend growth is declining practically everywhere. Recent Fed minutes have begun that process, acknowledging that the equilibrium real rate, which "currently is close to zero … would likely remain low relative to [pre-GFC] estimates" if "productivity does not pick up and if demographic projections … are borne out." That "might increase the frequency of episodes in which policymakers would not be able to reduce the federal funds rate enough to promote a strong economic recovery … in the aftermath of negative shocks."

The ↗*math is too simple* to ignore. Potential labor force growth will average ½% per year for at least the next decade, and U.S. labor productivity growth may well stay around ½% a year, its rough average for the last five years. These add up to 1% long-term potential GDP growth, which actual GDP growth can surpass only temporarily during a cyclical upswing — and certainly not during a cyclical slowdown. This is a challenging problem, with demographics practically set in stone, and a boost to productivity growth realistically possible only in the long run.

Consequently, after years of ZIRP and QE attempting to pull demand forward from the future, central banks are increasingly powerless when it comes to the economy itself. They can "print" money, but not economic growth. The world is watching, so those who are thought to walk on water cannot afford to be seen to have feet of clay.

If U.S. growth keeps slowing this year, recession risk will rise, and the Fed will likely revisit ZIRP, in one way or another. The failure of Abenomics is not inevitable, but appears increasingly probable. And while China is not yet facing a hard landing, growth continues to slow, raising legitimate concerns about its leaders' capability to avoid one.

By clinging to unrealistic growth expectations, the economic establishment has effectively bet everything on the success of these grand experiments, and the risk of losing that bet is rising inexorably. Ultimately, only policies that genuinely address the challenges of demographics and productivity have a chance to succeed. It is high time for that discussion to begin.

