CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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Low Growth, Low Inflation, Loose Monetary Policy and Turbulent Politics around the Word

In the very recent elections for the European parliament, fringe parties opposed to the European project drew more votes than the traditional parties in several countries. One might read this as popular backlash against the very undemocratic actions taken during the Eurozone crisis.

Very consequential decisions affecting people in Greece and Italy, for example, were taken by EU heads of government (and were largely dictated by Germany). These policies were then implemented by unelected 'technocrats' who replaced the elected heads of government in Greece and Italy.

This process is hardly a demonstration of the beneficence of the European Union.

By

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As summer approaches, we are presented with a world of geopolitical tension, most notably the adventurism of Russia, and political activity in three spheres: First is India's recently concluded and decisive election of the Hindu nationalist BJP party, lead by Narendra Modi--who presided over the massacre of at least two thousand Muslims in his home state of Gujurat in 2002 and whose travel ban to the United States has only been lifted very recently. Second is the disheartening military coup in Thailand, yet another in the long series of military interventions in a country that pretends to be a parliamentary democracy. Closer to home is the third, the spectacular success in European parliamentary elections of the 'Eurosceptics'.

These latter are mostly a bunch of right-wing, anti-immigration parties hostile to the European Union (with a few left-wing parties among them) and they surpassed the traditional parties in France, the United Kingdom, and Greece, among others. Little to cheer in any of these results. We have discussed in these letters for a few years the anti-democratic policies of the European Union, directed by Germany, in the Eurozone crisis. The imposition (by Germany and by unelected 'technocrats' in Brussels) of terrible fiscal strait-jackets on the people of Greece, Italy, Spain, Portugal and Ireland has not gone unnoticed by voters in those and in the less troubled and richer European countries. The European Union evolved from the European Coal and Steel Community, established in 1951 among the core countries of Europe, largely in response to the series of terrible wars of the nineteenth and twentieth centuries between European countries. While the founding impetus may have been recognition that European countries ought to cease trying to destroy each other time after time, the progress of European unification has been the based on the promise of improving living standards and growing economies. Whoops.

The fiscal crisis of 2008 and 2009 and its deep recession, followed by the sovereign debt crisis of 2011 and 2012 and its 'second-dip' recession put to an end, well and truly, the premise of economic betterment for the people. The resolution of the Eurozone crisis saw the removal of heads of governments in 'peripheral' countries and the transfer of leadership to unelected technocrats who would impose the Berlin and Brussels line of fiscal austerity. Even today, when Spain, Italy, Greece and the rest have ended their economic contraction, unemployment remains above 25% in some countries, wages have fallen, and economies have shrunk drastically. Whether or not the German prescriptions have been the right ones is, perhaps, less important for the political future of

Europe than has been the imposition of these policies by utterly undemocratic methods. The sixty-year project of European unification, tolerance, and peace appears to have cracked. These elections bode ill.

Economic growth in developed countries ranges from unremarkable in America and Britain, to almost non-existent in Europe. But, there is growth, not contraction.

What will be the source of strong, synchronized global growth? It is hard to see it. One concludes that there will be no one strong engine.

As these political dramas unfold, the economies of the world's developed countries plod forward unremarkably, exhibiting the most modest growth and very little vibrancy. Developing country economies, ablaze with vitality in the first decade of the century, have almost all slowed markedly since then. In previous decades, a single source of economic dynamism was present to lead the world to higher levels of growth. Now one searches in vain for that leading player. In the last decade, China's insatiable appetite for commodities and exceptional growth lifted many other economies. For decades, the American consumer was the reliable engine of world-wide economic growth. Neither plays that role now; China's growth has fallen sharply and its economic activity has a large domestic component, as compared to the earlier era of high imports and exports. The American consumer faces low wage growth and is still seeking to recover from the calamities of the bursting of the housing bubble and the associated sub-prime mortgage crisis. This recovery is manifesting itself in higher personal saving and lower personal spending, a situation that restrains economic growth.

Thus, we can expect the continuation of low inflation, low growth, and central bank largesse. This may be the prescription for the development of asset bubbles, a phenomenon that rarely ends well.

What can upset the Fed's explicit determination to maintain low interest rates and expansionary monetary policy? There is vocal opposition to Fed policies and even to its very independence on the political right in Washington. Janet Yellen and the Fed governors need to hone their diplomatic skills in order to maintain the independence of the Federal Reserve.

Meanwhile, exceptionally low inflation in all the developed countries gives rise to persistent fears, especially in Europe, of a descent into the realm of deflation, i.e., falling prices. The sharp decline in the interest rates on US government bonds this year--the ten-year treasury yielded 3% at the beginning of the year but recently less than 2.5%--reflects expectations of low economic growth and of very low inflation. The same phenomenon obtains in the Eurozone countries, where the underlying inflation rate is barely positive and government bond yields are exceptionally low.

All developed countries have engaged in fiscal policies of austerity, characterized by restrained government spending, despite the sharp decline in private sector spending. Government budget deficits have fallen markedly. The countervailing forces have been the central banks, especially the Federal Reserve, which have pursued previously-untried policies of monetary easing. Whether these policies have promoted economic growth and stimulated employment is not entirely certain. What is quite clear is the very salutary effects on asset prices, including prices of stocks and bonds. The Fed explicitly promises to maintain its extremely 'accommodative' policies for a long time to come.

The result, in the backdrop of modest economic growth and the 'resolution' of the Eurozone crisis, is an extended bull market in bonds and stocks characterized by generally low volatility. That is, sharp price swings in financial markets have become more rate. Given that economies of developed countries will probably continue to grow modestly, given that ongoing central bank largesse is in the cards, it is certainly possible that stock prices will continue higher. Given the extremely low inflation and the likelihood of only modest economic growth, bond prices will probably remain stable. Asset bubbles--unwarrantedly high prices of stocks or bonds--are a possibility, more than a trivial one. What can derail the quiet march higher in stock prices? The unpredictable and dangerous Mr. Putin can upset things; other geopolitical ructions always present risks. Another risk is political pressure on the Fed, causing it to restrain is monetary policies. Many on the political right in America (notably Rand Paul) who favor fiscal austerity aim to bring Fed policy under the control of Congress and to end its independence. Stay tuned.

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