The 7-year slump: Why the global economy can't seem to get started

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The Great Recession brought about a massive action by multiple countries to revive the world economy but all those efforts seem to have been for naught

Bill Hammond has navigated a globally focused business through 37 years and a half-dozen economic cycles. But he’s never seen anything quite like the long, slow, on-again-off-again recovery that the world economy remains stuck in, years after things should have returned to normal. Frankly, he’s worried.

"It has become clear that we are really dealing with a different kind of economic recovery than anyone has experienced since World War II," says Mr. Hammond, chief executive officer of Hammond Power Solutions Inc., a Guelph, Ont. company that makes electrical transformers for industrial clients around the world.

"This is far different from any recession I have seen."

Seven years after Europe and the United States slipped into what would become the one of the deepest global recessions in history, and five and a half years since the North American economy returned to growth, the recovery remains a perplexing, inconsistent and frustratingly elusive work in progress.

Hammond Power's financial statements read like a summary of the recovery that never quite arrived: A slide in revenue during the recession, followed by an encouraging rebound to above pre-recession levels in 2012 fuelled by the commodity boom and government stimulus spending on infrastructure – only to slip back again after that short-lived boom fizzled.

Profits have never come close to their 2008 peak. The company, which sees little room for further expansion in Canada, is focusing on growth in the United States and selective markets in Europe, India, and other parts of the world.

In many respects, the global economy looks much better than it did several years ago. Growth is modest but generally positive; unemployment has declined; the financial system still has some issues, but is on much more solid ground compared with the brink on which it teetered in 2008. Yet much like Mr. Hammond's company, the economy has never really gotten back to its old self. Every step forward seems to be followed by a stumble backward.
In Canada, the pattern is disturbingly similar. The U.S. revival was supposed to finally lead Canada's economy to the promised land, but our recovery glass once again looks half-empty. While U.S. demand for Canada's exports is expected to lift the economy, the plunge in prices for oil and other commodities will hold some major sectors and economic regions down.

And the world has started 2015 in full stumble. The International Monetary Fund this week cut its forecasts for global growth by 0.3 percentage points to 3.5 per cent this year and 3.7 per cent next year. That would make four successive years of growth below what has historically been considered its "trend" rate – which suggests that the economy is actually getting further away from returning to its full capacity, rather than closing the gap. A rapid succession of central banks, including Canada's, rushed this week to ease monetary policy, to fight against the slowing pace and resurgent deflation fears.

The recovery is also becoming increasingly uneven. While the IMF raised its forecast for the United States, advanced economies outside of the U.S. are expected to grow by a thin 1.7 per cent this year. Japan slipped into recession last fall, and the troubled eurozone will be lucky to scratch out growth of much more than 1 per cent.

The malaise is also spilling over to the once-fast-growing emerging markets. Powerhouse China is facing its slowest growth in a quarter century. Russia, crippled by the plunging oil price and economic sanctions in response to its actions in Ukraine, is destined for recession.

"I have never seen as much global instability," says Betty Lou Pacey, who runs a Vancouver-based specialty lighting company with international suppliers and clients. She just returned from seeing a client in Argentina, where inflation is running at about 40 per cent. Even in her primary market of the United States, where so much of the world's recovery hopes are now pinned, she senses the tremors from the nagging global woes and the lingering hangover from the recession: Big U.S. restaurant chain clients are no longer investing in renovations.

"I mean, we've got the euro, which has got troubles. We've got political issues all over the world. Where this is going, I don't know."

And there's a growing concern that the recovery is running out of chances. The average expansion phase of economic cycles over the past half century is about six years. As this underdeveloped recovery limps toward its sixth birthday, there is a growing sense of impatience to figure out just what is going wrong and to fix it – before the clock runs out.

**Monetary stimulus**

What recovery in demand the global economy has achieved has come with a great deal of help from ultra-low interest rates and extraordinary monetary stimulus from major central banks. But these extreme measures, meant to stave off a financial system collapse and a descent into deflation, have remained entrenched far longer than central bankers ever imagined. At a time when central banks had expected to be returning their interest rates
to more normal levels, their economies remain too fragile to stand without support from highly stimulative monetary policy.

Indeed, central banks have recently stepped up their efforts as the global economy again faltered. The European Central Bank this week launched a major quantitative easing program, while the Bank of Canada cut its key rate for the first time in nearly six years. China, Japan, Norway, India, Denmark and Switzerland have all recently eased their monetary policy.

Even in the United States, where the recovery is going full-steam and growth of a healthy 3.6 per cent is forecast for this year, the Federal Reserve has kept its pedal to the metal - its key interest rate remains essentially at zero, and the Fed looks likely to raise it only very slowly over the next few years.

"This period has been enormously frustrating for central bankers and market participants alike," says Fidelity Investments portfolio manager David Wolf, who served as an adviser to the past two Bank of Canada governors. "I don't think any of us would have thought five years ago that we would be sitting here now with rates still on the floor almost everywhere."

Mr. Wolf says central banks have been fighting an uphill battle, as factors such as government austerity programs, high consumer debts and tighter financial sector regulations have all conspired to restrain economic activity.

"Monetary policy has been the only game in town fighting against all these headwinds."

UCLA economics professor Roger Farmer says that in this recovery, monetary policy simply hasn't transmitted to the economy the way it normally does. Usually, rate cuts and other forms of monetary stimulation increase the flow of money to the broad economy, which spurs spending and investment. But in many major world economies, most notably in Europe and Japan, broad money supply has been very slow to grow in response to central banks' priming of the financial system. And the money that has flowed through to the broader economy has not translated to business investment.

"The normal channels by which monetary policy operates are simply not working," he says.

Debt

As the Great Depression taught us, this kind of transmission failure is typical of severe economic downturns brought on by financial sector crises. A big reason for that is the excessive debt that brought on the financial crisis in the first place – something the world still hasn't adequately reined in.

Last fall's Geneva Report, an annual paper on world economics published by the International Centre for Monetary and Banking Studies and the Centre for Economic and Policy Research, pegged total world debt (government, corporate and household) at a record 212 per cent of gross domestic product as of the end of 2013, up from 174 per cent in 2008. Some countries, such as the U.S. and Britain, have largely swapped
excessive private sector debts for higher government debt burdens; in others, including Canada and many emerging markets, household debts have risen to troubling levels.

Economists say high debts feed a vicious circle that impedes post-financial-crisis economic recoveries. Money that might otherwise go to spending and investment is instead eaten up by debt servicing and reduction, which slows economic growth. And slower economic growth generates less income to pay back debts, slowing the debt reduction process. This is why financial crisis recessions are so hard to shake.

"This was always going to be a longer-than-average recovery," Mr. Wolf says.

**Global trade**

Another problem has been a persistent lack of traction in international trade, which had been a key engine to the global economy's strong growth in the pre-crisis era.

From 1996 to 2007, world trade volumes grew by an average of 7 per cent a year, according International Monetary Fund data. Since 2010, it has grown by just 4 per cent a year.

Peter Hall, chief economist at Export Development Canada, said trade had been expected to be the salvation for advanced economies, as booming emerging markets seemed to come through the crisis largely unscathed, offering an ongoing source of demand as those markets continued their march toward modernization. But the lingering weakness of developed-world demand has increasingly worn on emerging economies, which have remained more reliant on external demand to keep their economic engines humming than many observers had hoped. The IMF forecast emerging-market growth at a modest 4.3 per cent this year, their weakest since the recession ended.

"There was a presupposition by many that emerging markets had gotten lift on their own, that they were able to self-generate growth. In fact, the growth was fuelled in large part by massive stimulus programs," Mr. Hall says. "They are still follower economies."

"In 2008, we were all talking about the BRICs [Brazil, Russia, India and China], they were going to be our solution," says Scott Shepherd, CEO of Northstar Trade Finance Inc., a Vancouver-based company that provides financing for exporters and foreign buyers. "But Brazil has melted down. I have huge exposure in Brazil. I followed a bunch of exporters there, and they're having a hard time." He also has exposure in Russia, where geopolitics and plunging oil have decimated the economy.

"I've been doing international business for 32 years and I've never seen anything like this," he says. "A huge, interconnecting global trading system has developed, where somebody sneezes over there and someone gets a cold over here. It's all interrelated."

**The China syndrome**

Chief among the emerging-market disappointments is China, whose massive economic clout and rapid growth was expected to lead the way out of the recession – especially for commodities-rich countries such as Canada that were counting on China's seemingly insatiable demand for raw materials. Instead, China has bent under the weight of sluggish
Western demand for its exports, and is in the midst of an economic pause as it works to transition its economy to more domestic-driven demand and away from struggling export markets. The growing pains have also manifested themselves in a real estate bubble and an overstretched banking sector, which the Chinese government is trying to cool.

China is expected to grow by a little less than 7 per cent this year – still torrid by Western standards, but far from the double-digit growth that was routine in the pre-recession years. Canada’s exports to China were down 5.5 per cent by dollar value in the first 11 months of 2014 from the same period in 2013, led by sharp declines in iron ore and coal. Weaker commodity prices certainly played a part in that – but the slowdown in Chinese demand was the key cause of that price weakness.

"They were hungry for everything for a while. But the demand has gone down," says Mike Yochlowitz, the fourth-generation director of sales at family-owned scrap metal company ABC Recycling of Burnaby, B.C. Total volume of non-ferrous shipments to China processed through ABC Recycling’s facilities last year was down 40 per cent from the heady days of 2010. On a recent trip to China, Mr. Yochlowitz saw customers struggling with higher labour costs, and some of his Chinese clients had seen their financing tighten by upward of 40 per cent, evidence of the country's efforts to get credit conditions under control.

Ms. Pacey, whose lighting business has sourced components from China for decades, saw first hand the evidence of China’s slowdown when she went to tour several factories there in October – only to find near-empty facilities.

"You're walking through these huge buildings – I mean, massive – and nobody's there," she says. "It's weird."

Too much capacity

The bottom line, economists say, is that the global economy still has excess capacity. While many economies, especially in the developed world, shed substantial capacity during the recession’s deep downdraft, there is more capacity to produce than there is demand for that output. The IMF estimates that the world's advanced economies are still operating at about 2.5 per cent below their capacity – and chronically below-normal global growth means demand hasn't been sufficient to close that gap.

The continued overcapacity has meant little need to hire more workers. The International Labour Organization reported this week that the global labour market still hasn’t fully recovered what it lost in the 2008-09 crisis. It said global employment is 61 million jobs below its long-term trend line, reflecting the gap that opened up during the crisis and has never closed. The global unemployment rate of 5.9 per cent is still above pre-crisis levels (5.5 per cent in 2007), and the global labour force participation rate remains below pre-crisis levels, indicating that an additional nearly 40 million people worldwide have abandoned looking for jobs entirely.

"Global economic growth remains significantly below pre-crisis trends and is too slow to close output and employment gaps that opened due to the crisis," the ILO said in its annual report on labour trends.
The labour slack also means employers are under less pressure to raise wages. Put it all together, and the result is a lack of money making its way into consumers' pockets - which translates into a lack of consumer spending. Thus the overcapacity is not only caused by a lack of demand, but it is fuelling and perpetuating a lack of demand.

Mr. Hammond believes companies built up too much capacity because of the overheated optimism spawned by the rise of China as an economic superpower.

"With China not being the global engine of growth as it was up until 2012, we're back to the reality and challenge that in most of the world's largest economies ... more than 60 per cent of GDP is generated by consumer spending," he says. But with employment growth sluggish, and the jobs that have been created paying less than ones that were lost during the recession, there is just no momentum, Mr. Hammond adds.

How do we break out?

Breaking free from the clutches of a post-financial-crisis funk isn't easy. Prof. Farmer notes that it took a massive government fiscal response - specifically, the financing of a world war - to bring the Great Depression to an end. U.S. government spending soared from 15 per cent of GDP to 50 per cent. "People are not prepared to go to those extremes," he says.

But there are plans afoot for a more modest, and more peaceful, effort by global governments. Last year, the Group of 20 countries, which account for roughly 90 per cent of the global economy, agreed to work together to raise the level of global output by 2 per cent, over and above the typical growth trend, by 2018. It might not sound like much, but it's enough to finally lift the world out of its post-crisis rut and permanently expand the global economy's punching power.

The plan calls for co-ordinated government policies that would "restore near-term demand, remove medium-term supply constraints, and build consumer and business confidence." It includes commitments for increased spending on infrastructure, fostering private sector investment, regulatory reforms to promote competition and removal of trade barriers.

Many economists believe infrastructure investment may be governments' best way to contribute to the solution. While Prof. Farmer is quick to say he's not a fan of big-spending government stimulus largesse, he argues that the current ultra-low interest rates do give governments the cheapest borrowing costs they have seen in decades, affording them an inexpensive opportunity to invest in a wide range of projects that would enhance productivity and produce long-term economic dividends.

As for Mr. Hammond, he advises Canadian business operators to "run tight and be flexible." And he suggests business owners get used to the idea that the good old days are gone for a while.

"We certainly don't expect this decade to be as positive as the very good years of the last decade."