

INVESTMENT POLICY MEMO

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THE LIMITS TO GROWTH

The future is always unknown, and at present it remains rather more uncertain than usual. Nevertheless, some answers are taking shape to the outcome of what we have described as an unprecedented economic “experiment.” It appears nearly certain that the enormous amounts of government spending and monetary stimulus that have been thrown at the specter of a debt-deflation crisis have succeeded in avoiding anything like a repetition of the Great Depression.

That still leaves a wide range of possible outcomes, from a repeat of Japan’s “Lost Decade” of negligible economic growth to a sharp economic rebound similar to the way most recessions have ended since World War II. And there are also more than the usual number of ominous signs that we may be entering yet another decade of increased turmoil and violence within and between nations. We think all of these are meaningful possibilities; but that the most probable is an economic recovery somewhere in the middle, with slow growth because of the excess capacity of businesses and the need for households and many institutions to pay off debts by saving more and buying less.

As so often in the past, we have been surprised once more with the efficacy for the general good of policies that are intrinsically venal and evil. With few exceptions the banks have got their way. Bondholders and shareholders have been bailed out along with depositors. The illogical but profitable prohibition on reducing mortgage debt in bankruptcy proceedings has been preserved. Direct help for consumers and homeowners has been pitifully small compared to the massive amounts of government capital injected into failed banks, insurance companies and automobile manufacturers – or still more shocking the government guarantees extended to banks and hedge funds so they could buy each other’s toxic assets with renewed debt leverage and leave the tax payers to take the final losses. Trickle down economics has usually been regarded by most Democrats as shameful hypocrisy; but now it has been embraced by the party and its leader in a direct continuation of the policies proposed and initiated by Henry Paulson and other officials in the Bush administration.

We have argued all along that these policies were inefficient, in the sense that they required much larger amounts of money to achieve a given amount of progress against unemployment and depression, than direct government spending on purchasing goods and services like renewable energy, universal health care, increased child care, or even more guns and tanks. To be sure these expenditures are a part of the stimulus package; but they are a small part of the total government effort: roughly \$500 billion out of \$4 *trillion*. The sheer magnitude of this “other” 3.5 trillion dollars – roughly one quarter of the annual output of the U.S. economy and one tenth of the global economy – accounts for its success. If you give a huge amount of money to the rich, the part that trickles down is still substantial. Or to turn Robert Burns’ famous poem inside out: the vilest plans of oligarchs ‘oft work OK.

If something like the Great Depression is now quite unlikely, it follows that stock markets should sell at higher values. And, indeed, they are selling at substantially higher values than they were in early March, when this change in the economic outlook was first recognized. (Many others bought more stocks well before we did, as often happens at stock market bottoms when we prefer to maintain a cautious attitude until most doubt is dispelled.) However, the absence of a Great Depression does not equate to robust and healthy global economies. As we explained above, we think there is a good chance that the United States and other rich countries are entering a prolonged period of zero economic growth or minimal economic growth. Because it is so similar to the so-called Lost Decade in Japan (now going on nearly two decades), we will call this outcome the Lost Decade. The most likely case is an economic recovery beginning soon; but, again, not growing fast enough in the United States, Europe or Japan to meaningfully reduce current levels of unemployment. Let's call this scenario Limited Growth.

Between them, Lost Decade and Limited Growth seem much more likely descriptions of the next five to fifteen years than all other possibilities combined. This prospect has provoked cries of alarm from the same spectrum of economists, journalists and businessmen and women who raised their voices in favor of vigorous action in 2007 and 2008 to forestall a depression. We joined their call then and we join them now; but, many of them, including Martin Feldstein, Nouriel Roubini and Paul Krugman, have left the distinction between depression and anemic growth to the nearly invisible fine print. After all Japan has been growing at about one percent a year, the Lost Decade rate, for nearly 20 years and the dire effects are seemingly small compared to a depression. And northern Europe has been growing at the Limited Growth rate, between 2% and 3%, for more than two decades, again without any obvious disaster and while managing in most ways to maintain a standard of living that compares favorably with the U.S.

Perhaps making the best of slow growth is more pragmatic than trying to speed it up. But the voices of alarm are certainly correct that with slow growth, with unemployment in the United States and Europe lingering at ten percent, with debt burdening every sector of the economy, and the financial system still in precarious shape, there will remain a possibility that the economy falls back into a disastrous collapse. And in such a case, it is likely, as we and they have argued repeatedly, that the enormous sums already provided to rescue the system and the inefficient ways in which they were applied to reward the wealthy before rescuing the rest, may make it politically impossible to come to the rescue again. We think the likelihood of this is small; but the enormous consequences of a renewed plunge toward depression mean it must be seriously prepared for, no matter how unlikely.

What are the limits to growth that leave us these prospects of glacial economic advances? At the moment, at least in Europe and America, they are primarily the interactions of accumulated excess debt, falling prices of real estate and financial assets, and declining incomes and employment. As assets and income fall households and businesses become less able and less willing to carry their debts. Depressed assets are sold at still more depressed prices or borrowers simply default. All of this results in more unemployment and still more distress for additional borrowers, including corporations, banks and governments. While households and banks have reduced their debts somewhat in the last year or so, we are still in the very early stages of this process. The more everybody saves and pays off debt, the less everybody buys, and the slower the economy grows (or the faster it shrinks).

A second limit to growth is the receding tide of globalization. This is not only the renewal of protectionism and other nationalist economic policies, it is also the natural completion of certain processes. The sweep of globalization over the past fifteen or twenty years has been a period in which America grew rapidly by borrowing money from China and other countries that were providing us with goods beyond what we could produce. This meant that we could grow faster than would otherwise have been possible and the Chinese could also grow rapidly by moving surplus workers from agricultural employment into factories using low-skilled labor to make goods for export to the United States and other wealthy countries. This process is now unwinding for a number of reasons, including: Most emerging market countries have accumulated adequate foreign exchange reserves. Doubts have increased sharply about the future of the dollar and the debt burdens of the U.S. and other rich countries. With U.S. and European growth turning negative, imports have absorbed a disproportionate share of the decline, forcing the emerging markets to stimulate demand in their own countries.

Globalization has been a cause of low inflation and has been advanced by low inflation. Now that process is halting or reversing, first because the massive movement of rural workers to urban occupations in emerging market countries has caused rapid increases in the wages necessary to continue attracting more workers; second, because the rapid growth of emerging countries added to the demands of wealthy countries has finally led to increasing scarcity for most commodities, especially food and fuels. The authors of *The Limits To Growth* thirty-seven years ago predicted that food and commodities would become increasingly scarce in our 21st Century. They also predicted that pollution would become a toxic limit on further economic growth, although they did not anticipate the particularly strong constraint that global warming might impose.

While we do not foresee an immediately pretty future for the world, the stock market is once again another story. We think it has fully discounted Lost Decade, the worst of our most likely outcomes. If we experience Limited Growth, let alone a normal recovery, the returns to stocks would be outstanding. In the unlikely event that we slip into a depression, stocks would obviously be very disappointing. In the somewhat more plausible event that the world is impacted by a new upsurge of war or terrorism, many stocks would still do extremely well.

Accordingly, we have been increasing stock holdings from the very low levels of early March. Our emphasis has been on consumer staples, healthcare, energy, information technology and finance. We have been investing primarily in the United States and emerging markets. We continue to invest about one quarter of most portfolios in cash and bonds, because of the positive returns they would provide in a depression or Lost Decade. Our times remain interesting and dangerous while we strive, as always, to avoid losses.