Secular stagnation: the time for one-armed policy is over

Larry Summers (2013, 2014, 2015) has revived the notion of secular stagnation that goes back to Alvin Hansen (1938). In Summers's case, secular stagnation describes a persistent tendency for aggregate supply to exceed aggregate demand. His by now familiar narrative focuses on the failure of interest rates (and in an open economy the real exchange rate) to equilibrate aggregate demand and aggregate supply, as the neutral real interest is now negative and below the lowest achievable value for the actual short-term risk-free real interest rate (say, the real value of the Federal Funds rate).[1] Such an outcome could come about if the neutral real interest rate were to be less than around -2.5%, if the inflation target is at 2% and given an effective lower bound on the nominal risk-free interest rate at -0.5% (with a generous estimate of the carry cost of currency at 50bp). Starting from a position of excess capacity and inflation well below target, even a mildly negative neutral real rate might be out of reach for the monetary policy maker. Summers argued that the US was threatened by secular stagnation and he and others have since noted that this threat may, if anything, be even greater for a number of other advanced economies, notably the euro area or Japan.

Is Secular Stagnation a major threat?

We share Summers's concern about persistent demand deficiency, due to aging populations, increasing inequality and high levels of (private and public) debt. In our view, it threatens a broad range of advanced economies (even though the US may be among the least vulnerable), and may soon capture some emerging market economies, too, with China at material risk. We also accept that demand-side hysteresis (when a negative output gap depresses capital expenditure and persistent unemployment reduces the effective supply of labor causing weak demand and a negative output gap today to lower the future path of potential output) is a material problem.

As rightly highlighted by Bernanke (2015a,b), in a financially connected global economy, addressing saving-investment imbalances requires an international perspective. However, if anything that may make it more difficult to overcome the problem of secular stagnation. We therefore disagree with Bernanke (2015a,b)'s assessment that the threat of secular stagnation (and negative real interest rates) is likely to go away soon, for several reasons. First, we are not convinced negative risk-free real interest rates are destined to be a transient phenomenon (we see no empirical support for the (implicit) assumption that the (risk-adjusted, after-tax) marginal efficiency of physical investment is necessarily always positive). Even if negative real rates do not persist indefinitely, they may be around long enough to cause significant damage in the absence of the required policy interventions. Second, in our view, it is unlikely that the days of high-saving EMs are over. Even if saving rates in China is on a downward trend, investment as a share of GDP may fall even faster. Third, it is questionable, in our view, that a few major policy distortions in high-saving countries (notably supposedly undervalued exchange rates in China and Germany) are too blame for very low real interest rates across many advanced economies and that therefore eliminating those policy distortions would remove the threat of secular stagnation.

What's supply got to do with it?

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[1] The neutral real rate is the Wicksellian natural real interest rate, also called the equilibrium real rate of interest, which is the short-term risk-free real interest rate that balances planned saving and investment (or actual real GDP and potential real GDP) in the medium term at full employment and with inflation at its target level.

'Technological exhaustion' – the low-hanging fruit on the tree of knowledge has been plucked (even if only for IT (Fernald (2014)) – is an unlikely cause of stagnation, cyclical or secular, in our view. The poor performance of productivity in many advanced economies and emerging markets is probably more a reflection of the difficulty of accurately measuring technological progress, and of myriad man-made supply-side constraints, than of the world running out of indeas, space and oomph to innovate.

But that does not mean that supply-side issues are irrelevant to secular stagnation. Quite the opposite. For instance, some recent declines in inflation that may have raised the real policy rate above the neutral real rate have clearly been the result of (relatively benign) supply-side shocks rather than weak demand, e.g. the increase in the effective supply of oil due to the North American shale revolution.

The effects of supply-side developments on the aggregate ex-ante saving-investment balance can indeed be subtle. In a world of fast-growing productivity and disruptive innovation, demand may fail to keep pace with supply, which suggests that for a while, (appropriately measured) high productivity growth may be associated with high or rising unemployment. Supply-side hysteresis whereby supply-side distortions, including dysfunctional institutions, policies, rules, regulations and practices depress current and expected future potential output growth, which in turn depresses effective demand can also be a serious problem, notably in the euro area. High costs of hiring and firing workers may turn labor into a quasi-fixed factor and could thus discourage complementary capital formation. The same holds true for incentive-dulling taxes, intrusive and distortionary regulations of product and labour markets and slow legal procedures, all of which discourage investment and hiring. The opposite point, that faster TFP growth, potential output-enhancing deregulation and other efficiency-oriented supply-side reforms can weaken employment and demand, may of course also have merit at times, mainly because of the uncertainty they create for those at risk of being adversely affected by such developments.[1] Policy uncertainty generally may weaken both private investment demand and consumption demand.

What to do about it? Two-armed policies are needed.

We are much less optimistic than Bernanke (2015a,b) that the challenge of secular stagnation may be resolved soon through reduced saving by China or major oil exporters. Indeed, there is unlikely to be a silver bullet against secular stagnation, and the necessary policy responses will likely have to be wide-ranging. Conventional and even unconventional monetary policy (changes in the size and/or composition of the central bank's balance sheet) are not quite up to the task, in our view. The sensitivity of demand to changes in interest rates is probably too low and increasing the dosage of unconventional monetary policy risks stoking asset bubbles. That is true, even if steps are taken to remove the effective lower bound on nominal policy rates, as we have advocated elsewhere (see Buiter (2004, 2007, 2009a,b,c, 2010, 2014, Buiter and Panigirtzoglou (2001, 2003) and Buiter and Rahbari (2015)). Fiscal policy may be needed, but with public sector debt at high levels in many advanced economies, a combined monetary-fiscal stimulus – i.e. helicopter money – would likely be needed to close the output gap.

But focusing on macro demand management policy alone is unlikely to be the optimal policy response. The demand-side drivers of secular stagnation include excessive indebtedness and high (income and wealth) inequality. The

[1] The basic argument of Krugman, Stiglitz and others for why structural reforms in secularly stagnating economies may hurt more than it helps is somewhat different, however. In their presentation, structural reforms lower the price level, which – with nominal rates already at the lower bound – exacerbates the issue of real interest rates being above the neutral real rate, particularly in the presence of a debt overhang (see e.g. Krugman and Eggertsson (2012)).

optimal response to the threat of secular stagnation therefore includes extensive debt restructuring where there is an overhang of debt and policy measures (including in tax policy, benefits policy, and education policy) to halt and in part reverse the persistent increase in inequality.

But adequate supply-side measures are also needed. These include improving infrastructure in countries, like the US, where woeful infrastructure has been a headwind to private investment. They include pension, social security and healthcare reform in countries where uncertainty about the future of defined-benefit pensions, social security and funding for health and long-term care creates a saving motives for self-insurance reasons. They also include reforms of the judicial system in countries, like Italy, where court cases over even minor contractual disputes can take years and discourage both capital investment and hiring. Reducing unnecessary uncertainty and investment-deterring tax distortions is always desirable. When we have a material effective demand failure, the case for the appropriate re-design of institutions and policies is even stronger.

The time of one-armed policy design is over. In many economies, both demand-side stimulus and supply-side reform are likely to be required to close the output gap along the strongest possible path for both actual and potential output.

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