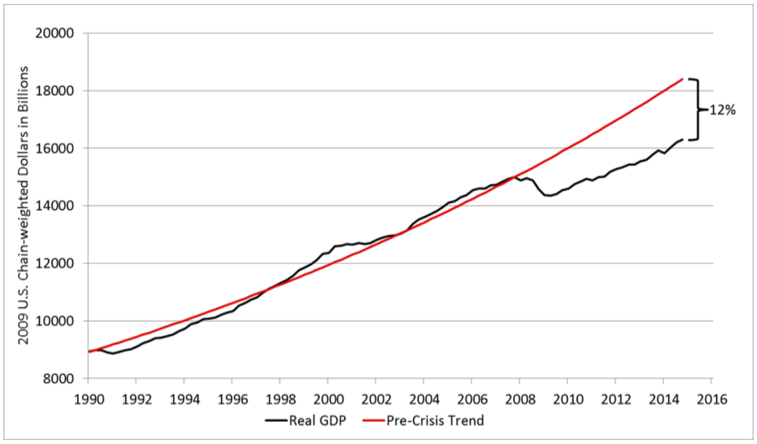
What's Causing the Slow Economic Recovery in the US?

Excerpted and adapted from Lawrence Summers, "The Age of Secular Stagnation: What It Is and What to Do About It," February 15, 2016, *Foreign Affairs*.

Most observers expected the unusually deep recession of 2007-2008 to be followed by an unusually rapid recovery, with output and employment returning to trend levels relatively quickly. Yet even with the U.S. Federal Reserve's aggressive monetary policies, the recovery (both in the United States and around the globe) has fallen significantly short of predictions and has been far weaker than its predecessors. Had the American economy performed as the Congressional Budget Office forecast in August 2009—after the stimulus had been passed and the recovery had started—U.S. GDP today would be about $1.3 trillion higher than it is.



Almost no one in 2009 imagined that U.S. interest rates would stay near zero for six years, that key interest rates in Europe would turn negative, and that central banks in the G-7 would collectively expand their balance sheets by more than $5 trillion. Had economists been told such monetary policies lay ahead, moreover, they would have confidently predicted that inflation would become a serious problem—and would have been shocked to find out that across the United States, Europe, and Japan, it has generally remained well below two percent.

In the wake of the crisis, governments' debt-to-GDP ratios (the ratio of total government debt to the output of the economy) have risen sharply, from 41 percent in 2008 to 74 percent today in the United States, from 47 percent to 70 percent in Europe, and from 95 percent to 126 percent in Japan. Yet long-term interest rates are still remarkably low, with ten-year government bond rates at around two percent in the United States, around 0.5 percent in Germany, and around 0.2 percent in Japan as of the beginning of 2016. Such low long-term rates suggest that markets currently expect both low inflation and low real interest rates to continue for many years.

The key to understanding this situation lies in the concept of secular stagnation, first put forward by the economist Alvin Hansen in the 1930s. The economies of the industrial world, in this view, suffer from an imbalance resulting from an increasing inclination to save and a decreasing inclination to invest. The result is that excessive saving acts as a drag on demand, reducing growth and inflation, and the imbalance between savings and investment pulls down real interest rates (rates adjusted for inflation). When significant growth is achieved, meanwhile—as in the United States between 2003 and 2007—it comes from dangerous levels of borrowing that translate excess savings into unsustainable levels of investment (which in this case emerged as a housing bubble).

Just as the price of wheat adjusts to balance the supply of and demand for wheat, it is natural to suppose that interest rates—the price of money—adjust to balance the supply of savings and the demand for investment in an economy. Excess savings tend to drive interest rates down, and excess investment demand tends to drive them up. …[I]t is common to refer to the real interest rate that balances saving and investment at full employment as the "natural," or "neutral," real interest rate—think of the price that equates the supply and demand for apples. Secular stagnation occurs when neutral real interest rates are so low that they cannot be achieved through conventional central-bank policies. At that point, desired levels of saving exceed desired levels of investment, leading to shortfalls in demand and stunted growth.

This picture fits with much of what we have seen in recent years. Real interest rates are very low, demand has been sluggish, and inflation is low, just as one would expect in the presence of excess saving. Without many good new investment opportunities, savings have tended to flow into existing assets, causing asset price inflation.

For secular stagnation to be a plausible hypothesis, there have to be good reasons to suppose that neutral real interest rates have been declining and are now abnormally low. And in fact, a number of recent studies have tried to look at this question and have generally found declines of several percentage points. Even more convincing is the increasing body of evidence suggesting that over the last generation, various factors have increased the propensity of populations in developed countries to save and reduced their propensity to invest. Greater saving has been driven by increases in inequality and in the share of income going to the wealthy, increases in uncertainty about the length of retirement and the availability of benefits, and reductions in the ability to borrow (especially against housing). Reduced investment has been driven by slower growth in the labor force, the availability of cheaper capital goods, and tighter credit (with lending more highly regulated than before).

Other explanations for what is happening have been proposed. Kenneth Rogoff's theory of a debt overhang, which builds on a history of financial crises he wrote with Carmen Reinhart, ascribes current difficulties to excessive debt buildups—think of all the mortgage debt that built up between 2000 and 2007—and subsequent attempts to reduce that debt (mainly defaults). But although this surely contributed to the financial crisis, it seems insufficient to account for the prolonged recovery. Moreover, the debt buildups theory provides no natural explanation for the generation-long trend toward lower neutral real interest rates. It seems more logical to see the debt buildups described by Rogoff as the consequence of a growing excess of saving over investment and the easy monetary policies necessary to maintain full employment.

Robert Gordon, meanwhile, has argued for what might be called supply-side secular stagnation—a fundamental decline in the rate of productivity growth relative to its golden age, from 1870 to 1970. Gordon is likely right that over the next several years, the growth in the potential output of the American economy and in the real wages of American workers will be quite slow. But if the primary culprit were declining supply (as opposed to declining demand), one would expect to see inflation accelerate rather than decelerate.

Ben Bernanke has emphasized the idea of a savings glut emanating from cash thrown off by emerging markets. This was indeed an important factor in adding to excess saving in the developed world a decade ago, and it may well be again if emerging markets continue to experience growing capital flight. But both the timing and the scale of capital export from emerging markets make it unlikely that it is the principal reason for the major recent declines in neutral real interest rates.

Paul Krugman and some others have sought to explain recent events and make policy recommendations based on the old Keynesian concept of a liquidity trap. As Krugman has emphasized, this line of thinking is parallel to the secular stagnation one because it holds that the economy is unable to reach an interest rate that would equate investment with the level of savings available—thus the excess savings is "trapped." But most treatments of the liquidity trap treat it as a temporary phenomenon rather than a potentially permanent state of affairs, which is what the evidence seems to be showing.

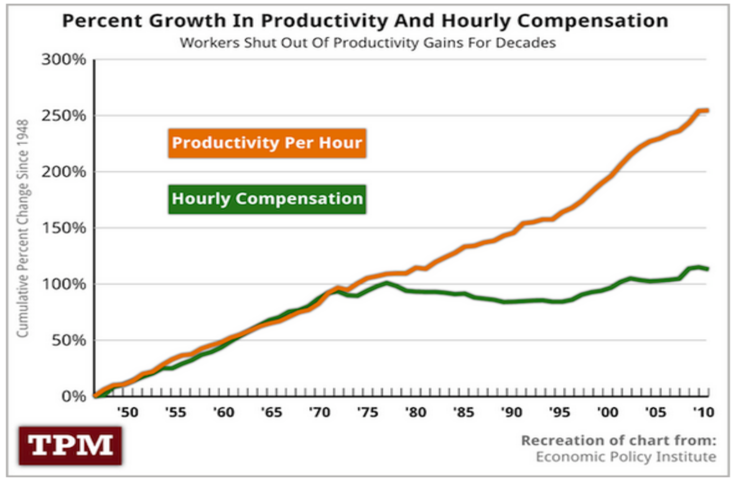
The core problem of secular stagnation is that the equilibrium neutral real interest rate is very low. This rate, however, cannot be increased through the Fed's monetary policy, which tries to reduce rates by increasing the funds available to lend—there are already more than businesses want to borrow. That is why primary responsibility for addressing secular stagnation should rest with fiscal policy, which increases the demand for funds rather than the supply. An expansionary fiscal policy can absorb excess savings, stimulate growth, and raise neutral real interest rates.

Fiscal policy has other virtues as well, particularly when pursued through public investment. A time of low real interest rates, low materials prices, and high construction unemployment is the ideal moment for a large public investment program. It is tragic, therefore, that in the United States today, federal infrastructure investment, net of depreciation, is running close to zero, and net government investment is lower than at any time in nearly six decades.

It is true that an expansionary fiscal policy would increase deficits, and many worry that running larger deficits would place larger burdens on later generations, who will already face the challenges of an aging society. But those future generations will be better off owing lots of money in long-term bonds at low rates in a currency they can print than they would be inheriting a vast deferred maintenance liability.

Traditional concern with fiscal deficits has focused on their impact in pushing up interest rates and retarding investment. Yet by setting yields so low and bond prices so high, markets are sending a clear signal that they want more, not less, government debt. By stimulating growth and enabling an inflation increase that would permit a reduction in real capital costs, fiscal expansion now would crowd investment in rather than out. Well-intentioned proposals to curtail prospective pension benefits, in contrast, might make matters even worse by encouraging increased saving and reduced consumption, thus exacerbating secular stagnation.

The main constraint on the industrial world's economy today is on the demand, rather than the supply, side. This means that measures that increase potential supply by promoting flexibility are therefore less important than measures that offer the potential to increase demand, such as regulatory reform and business tax reform—both of which have the potential to increase profits and make businesses more willing to invest. Other structural policies that would promote demand include steps to accelerate investments in renewable technologies that could replace fossil fuels and measures such as support for unions and increased minimum wages which would raise the share of total income going to lower and middle classes with a high propensity to consume. Thus, John Maynard Keynes, writing in a similar situation during the late 1930s, rightly emphasized the need for policy approaches that both promoted business confidence—the cheapest form of stimulus—and increased labor compensation.



Secular stagnation and the slow growth and financial instability associated with it have political as well as economic consequences. If middle-class living standards were increasing at traditional rates, politics across the developed world would likely be far less surly and dysfunctional. So mitigating secular stagnation is of profound importance.

Writing in 1930, in circumstances far direr than those we face today, Keynes still managed to summon some optimism. Using a British term for a type of alternator in a car engine, he noted that the economy had what he called "magneto trouble." A car with a broken alternator won't move at all—yet it takes only a simple repair to get it going. In much the same way, secular stagnation does not reveal a profound or inherent flaw in capitalism. Raising demand is actually not that difficult, and it is much easier than raising the capacity to produce. The crucial thing is for policymakers to diagnose the problem correctly and make the appropriate repairs.