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Sluggish Postcrisis Growth: Policies, Secular Stagnation, and Outlook

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In the aftermath of the recent global financial crisis, advanced economies have continued to experience sluggish growth. Is this slow postcrisis growth the result of a policy response that was overly reliant on monetary policy, which ran into the zero interest rate lower bound before growth was restored? Looking deeper, is secular stagnation,¹ which is related to the zero lower bound and was recently brought to the fore by Larry Summers, another potential cause for advanced economies' failure to return to precrisis growth levels? This note seeks to answer these questions as well as identify what alternative policies might be pursued by advanced economies to escape secular stagnation, should stagnation proponents be proven correct. After a brief review of secular stagnation, Summers' hypothesis is tested through a review of academic literature and opinion pieces. However, the secular stagnation theory is not without its critics; moreover, there is a debate between "Keynesian versus Schumpeterian" economists, which could help to shed light on the medium-term postcrisis outlook.

Policy makers in advanced economies at the center of the global financial crisis can claim to have prevented a new "Great Depression." However, recovery since the outbreak of the crisis more than five years ago has been sluggish, just barely keeping pace with population growth and normal productivity in the United States, and faring much worse in other industrialized countries. Despite recent signs of incipient recovery, the current economic environment appears to be characterized by insufficient aggregate demand, with below target inflation rates and persistently low interest rates across industrialized economies.

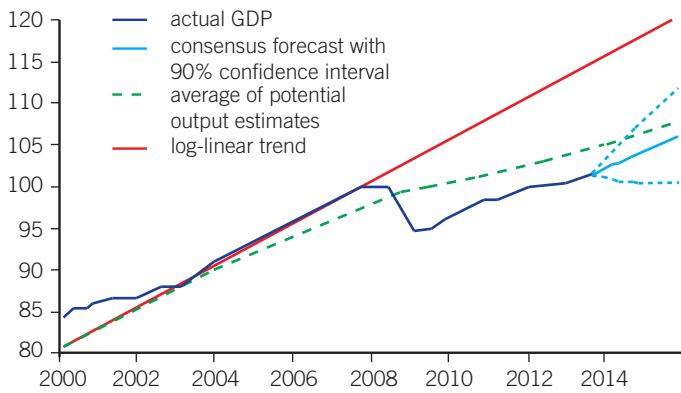
This raises a number of key questions: first, to what extent does the sluggish postcrisis growth performance in advanced countries reflect the policy choices made during and in the wake of the crisis? In particular, has policy been overly reliant on monetary policy accommodation? A second, deeper question is to what extent does the poor growth performance reflect an underlying secular stagnation, previously

masked by asset bubbles and the like before the crisis became apparent? If such stagnation does exist, does this reflect demand or supply side factors, and what different implications would either have for policy?² This third question has launched an unfinished, critical debate between "Keynesian" and "Schumpeterian" economists that has yet to be resolved, with the outcome likely to have a major role in the views on medium- to long-term advanced market growth prospects.

Sluggish Postcrisis Growth

Several key features help outline the ongoing recovery in advanced economies (figure 1). First, the precrisis aggregate growth trend has disappeared, either because it was not sustainable to begin with, and/or because trend growth has declined postcrisis. Second, although a new "Great Depression" has been avoided, actual gross domestic product (GDP) remains subpar, having fallen about 13 percent relative to precrisis growth trends. Growth has also fallen relative to the lat-

Figure 1. Aggregate G4^a GDP, Potential, and Trend



Source: Davies 2013.

a. The G4 includes the eurozone, Japan, the United Kingdom, and the United States.

est International Monetary Fund (IMF) and Organisation for Economic Co-operation and Development (OECD) estimates for potential output. Finally, despite the possibilities of a GDP catch-up in two years, as outlined in the central GDP projection, success depends upon policy makers accurately calibrating their responses to the wide range of idiosyncratic challenges ahead (Canuto 2014).

Moreover, as shown by Kose, Loungani, and Terrones (2013), the ongoing recovery in advanced economies has been sluggish and fragile compared to three previous recessions. Real GDP per capita returned to ascending trajectories soon after temporary inflections during past downturns, whereas for the recent crisis, it not only started decelerating prior to the global recession year (2009), but has not yet fully recovered its peak levels.

At first glance, this is not surprising given the nature of the factors underlying the crisis: the pervasiveness and magnitude of asset booms and busts; the design flaws of the euro-zone that only fully revealed themselves as the crisis unfolded; the degree of synchronization of individual country recessions; the policy uncertainty resulting from a loss of confidence on the sufficiency of established policy blueprints; and more. Moreover, any transition from a previously booming economy to a “new normal” would necessarily entail a significant reallocation of resources, with creation/destruction of jobs and productive assets. As remarked by Rajan (2013):

The bust that follows years of a debt-fueled boom leaves behind an economy that supplies too much of the wrong kind of good relative to the changed demand. Unlike a normal cyclical recession, in which demand falls across the board and recovery requires merely rehiring laid-off workers to resume their old jobs, economic recovery following a lending bust typically requires workers to move across industries and to new locations.

Taken together, these factors mean that trend growth likely followed something similar to the dotted orange line in figure 1. On the other hand, based on the size and persistence of the gap between actual and potential GDP exhibited in figure 1, one may question whether such a transition might have been faster with appropriate macroeconomic policies. After all, while economists often assume that, no matter where potential GDP might be, actual GDP will eventually move to it, convergence can also be in the reverse direction, with potential GDP growth falling to meet actual growth. For example, losses associated with prolonged periods of significant output gaps, for example, labor de-skilling, foregone research and development (R&D) efforts, and resource idleness could become permanent effects that are also known as “hysteresis effects.”

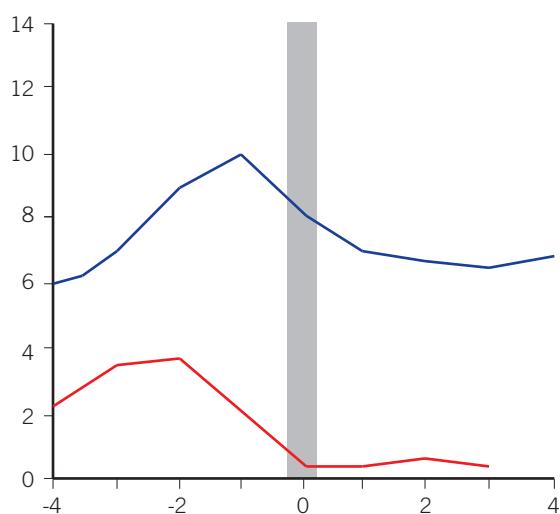
ure 1. On the other hand, based on the size and persistence of the gap between actual and potential GDP exhibited in figure 1, one may question whether such a transition might have been faster with appropriate macroeconomic policies. After all, while economists often assume that, no matter where potential GDP might be, actual GDP will eventually move to it, convergence can also be in the reverse direction, with potential GDP growth falling to meet actual growth. For example, losses associated with prolonged periods of significant output gaps, for example, labor de-skilling, foregone research and development (R&D) efforts, and resource idleness could become permanent effects that are also known as “hysteresis effects.”

A “One-Handed” Policy Response

Kose, Loungani, and Terrones (2013) point out that the recovery in advanced economies may well reflect peculiarities of the policy mix adopted in response to the recent economic crisis, compared to those implemented during previous financial crises. While fiscal and monetary policies implemented in tandem in the same countercyclical direction were successful in promoting recovery in past recessions, this time such policies have been ineffective.

Monetary policy has been very accommodative. As policy interest rates approached the zero lower bound, some central banks, most notably the U.S. Federal Reserve, headed by a chairman well versed in the mistakes made on the monetary policy front during the Great Depression, expanded its balance sheets rapidly and followed other unconventional monetary policies (Canuto 2013a). Figure 2, which compares short-term interest rates during previous economic down-

Figure 2. Short-Term Interest Rates during Global Recessions and Recoveries for Advanced Economies (%)



Source: Kose, Loungani, and Terrones 2013, 34.

Note: Zero is the global recession year. Each line shows the PPP-weighted average of the countries in the advanced economies. The red line refers to recovery from the Great Recession; the blue line refers to the average of previous recessions (1975, 1982, 1991) and the grey vertical line refers to the global recession year.

turns and the most recent episode (the “Great Recession”), illustrates the extremely accommodating nature of monetary policy.

Conversely, while previous recoveries were supported by expanded public spending, this time fiscal policy has moved in the opposite direction (figure 3). This shift was made despite the low costs of borrowing, which would presumably have allowed large-scale public investment projects with higher returns than initial costs. The fiscal stimulus implemented in the United States at the outset of the downturn was reversed not long after, followed by fiscal contraction. In the eurozone, fiscal austerity policies were implemented as financial havoc morphed into fiscal unsustainability among its crisis-ridden members. Austerity has also been favored in the United Kingdom.

Why has the fiscal and monetary policy mix been so different this time round? On the fiscal policy side, as shown by Kose, Loungani, and Terrones (2013), public debt levels in advanced economies were much higher than in past macroeconomic downturns. Public deficit levels had soared in the run-up to the recession, given the scale of financial support measures and substantial revenue losses. However, the use of austerity as a policy option was exercised: in the cases of the United States and the United Kingdom, financial markets were not signaling the need for the short-term fiscal retrenchment that was adopted. Likewise in the eurozone, some fiscal adjustment was unavoidable in crisis-ridden members, yet its pace could have been more measured had higher financial support from outside been made available. Furthermore, core

eurozone countries had far more room for fiscal expansion than they ultimately used.

This new policy mix no doubt contributed to the current sluggish postcrisis recovery. In crisis conditions, and in situations where fiscal retrenchment is employed in a synchronized manner, fiscal multipliers tend to be much higher than usual (IMF 2012). Fiscal retrenchment, therefore, is likely a contributing factor to the currently slow recovery.

But what about monetary policy? There is no doubt that the early and sharp reductions in interest rates helped. However, once the zero lower interest rate bound was reached, central bankers were forced to rely on more unconventional monetary policy measures. These measures certainly helped, and the U.S. Federal Reserve has, for example, estimated that interest rates fell along the yield curve in the wake of its balance sheet expansion. But the size of the effects of such policies is “very limited and uncertain” (Blanchard 2013).

Moreover, the scope for engaging in a long period of quantitative easing (QE) is limited, because QE expands central bank balance sheets to levels that are risky and may lead to political resistance, while the availability of appropriate instruments for purchase is limited. This means that ongoing QE could begin to dominate, rather than just influence, some private sector markets; short-term QE can only achieve so much. As Summers argued (2013b), “whereas you can keep the federal funds rate at a low level forever, it’s much harder to do extraordinary measures beyond that forever, but the underlying problem may be there forever.”

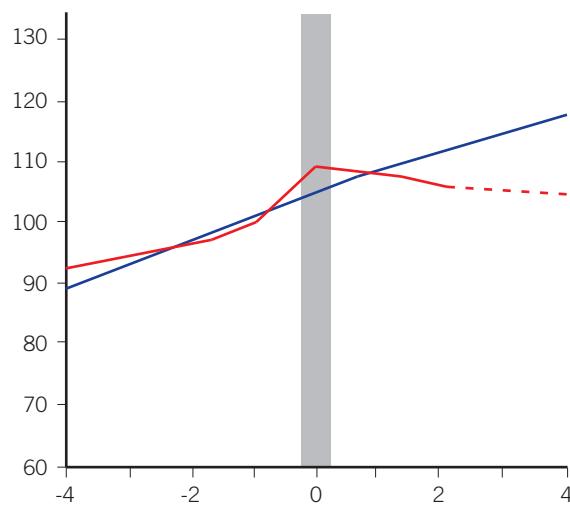
What If a “Secular Stagnation” Trend Has Been at Play? Which One?

The role of asset bubbles in pulling up the precrisis growth trajectory depicted in figure 1 is now widely acknowledged. In the case of the United States:

The liquidity-generating machine inflated U.S. asset values and fed the exuberant growth of U.S. household spending. U.S. consumers have accounted for more than one-third of the growth in global private consumption since 1990. Increasingly, their spending was made possible by the wealth effect generated by the rising prices of housing and household financial assets and stocks, whose values were in turn expected to more than outstrip those of household debt. It was this upswing in consumption by U.S. households and others as debt-based consumers-of-last-resort in the global economy that essentially made possible the extraordinary structural transformation and productivity increases experienced by some manufacturing exporters and commodity producers among developing economies (Canuto 2009).

A similar bubble-led growth process was found within the eurozone, beginning with the downward convergence of

Figure 3. Real Primary Expenditure of Advanced Economies (index, PPP weighted)



Source: Kose, Loungani, and Terrones 2013, 33.

Notes: Dashed lines denote World Economic Outlook forecasts. Figures are indexed to 100 in the year before global recession. Zero is the global recession year. Each line shows the PPP-weighted average of the countries in the advanced economies. The red line refers to recovery from the Great Recession; the blue line refers to the average of previous recessions (1975, 1982, 1991) and the grey vertical line refers to the global recession year.

perceived risks and interest rates throughout the zone after the introduction of the new common currency. Countries that are currently under stress were able to sustain domestic absorption much above domestic production capacities for a long period, easily financing the difference because of fallen-from-heaven domestic asset value appreciation. The underestimation of fiscal risks can also be seen as a manifestation of such euphoria. Asset-price dynamics are now considered a key area to be addressed by policy makers, and macroprudential policies are now a component of the macroeconomic stabilization toolkit (Canuto 2013b).

However, enhancing the policy framework by revamping financial regulation and supervision and combining monetary and prudential policies to ensure both financial and macroeconomic stability may not be enough if some underlying secular trend of stagnation is at play. If the precrisis growth trend in figure 1 was inextricably dependent on the overspending induced by the financial frenzy—credit and house bubbles—running its course, avoiding future asset price booms and busts might simply lead to stability around low growth rates. This view underlies the possibility of a “secular stagnation” trend, as raised by economists Krugman (2013b) and Summers (2013c):

Manifestly unsustainable bubbles and loosening of credit standards during the middle of the past decade, along with very easy money, were sufficient to drive only moderate economic growth. (...) short-term interest rates are severely constrained by the zero lower bound: real rates may not be able to fall far enough to spur enough investment to lead to full employment (Summers 2013c).

Under secular stagnation, and at the zero lower bound, flexible wages and prices may not help because they may end up exacerbating real debt burdens, which are already high for debtors, while falling prices can lead to postponement of purchases, further undermining demand. Summers (2013a) categorizes this world as one in which resources become increasingly concentrated in the hands of those with high propensities to save and low propensities to invest, such as very rich individuals and reserve-accumulating foreign governments.

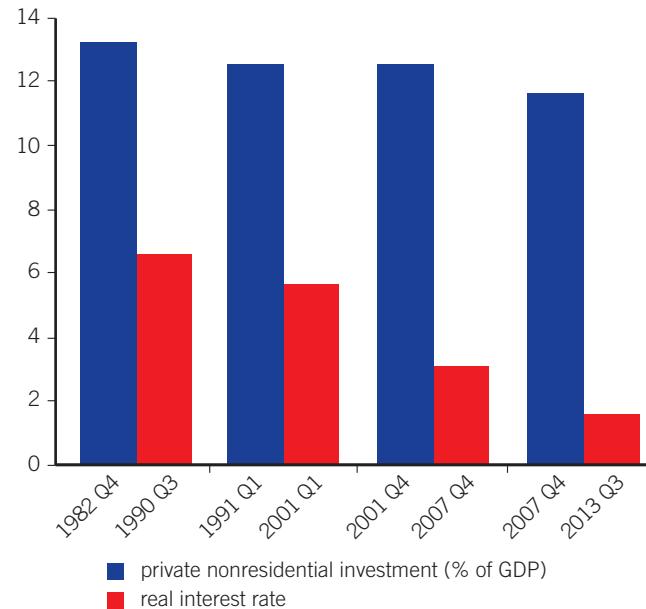
Krugman, Summers, and others—referred to here as “Keynesian”—economists have suggested an array of possible reasons for the U.S. economy and other advanced economies’ demonstrated propensity for aggregate demand shortfalls, in the sense that, as a result of structural conditions, aggregate spending would be enough to ensure full employment and use of potential output capacity only in the presence of negative real interest rates. Such an “investment drought”—or, on the flipside, a “savings glut” as measured by levels of nonconsumption expenditures required to sustain income at full em-

ployment—could be seen as underlying the evolution shown in figure 4.

Wolf (2013) offers a detailed account³ of why the Summers hypothesis may make sense. Wolf agrees that the financial excesses prior to the crisis masked structural weaknesses that are now obvious in the postcrisis world. The structural weaknesses are, according to Wolf: (i) the global savings glut (figure 5) and, relatedly, (ii) global imbalances. The global economy has generated more savings than businesses wish to use, even at very low interest rates, which would usually tend to stimulate such investment. The global savings glut, or its counterpart, the investment dearth, has low real interest rates as its counterpart. Relatedly, the large current account surpluses of some East Asian emerging economies, including China (although to a lesser extent than before the crisis), as well as several high-income countries such as Germany and large oil exporters, has meant that these economies became net suppliers of savings to the rest of the world. Prior to the recent crisis, the United States absorbed most of these global savings, albeit in investments that were often unproductive, as evidenced by the precrisis housing and investment bubbles. The fact that desired investment has fallen in the wake of the crisis only exacerbates the effects described by Summers (2013c).

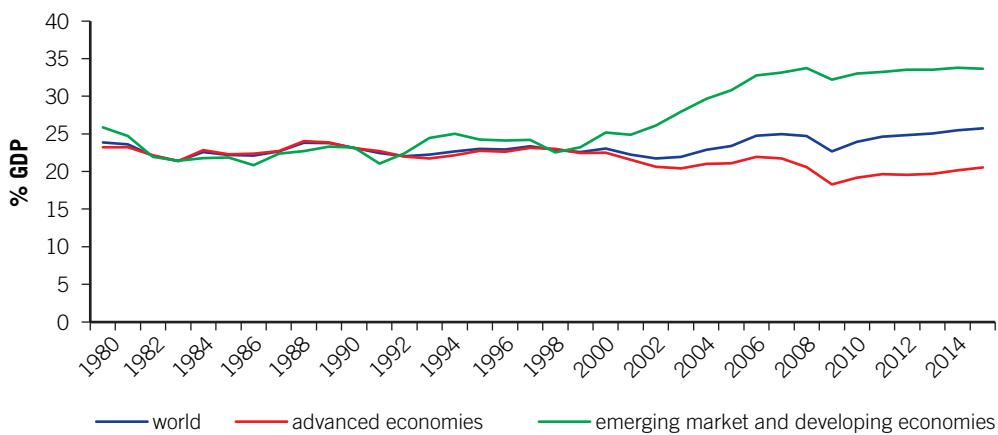
Fatás (2013b), in a recent blog post, also considers the savings glut and investment dearth and argues that that the only way to validate the savings glut hypothesis was if the investment curve was shifting inwards, as in figure 6. This is consistent with the fact that investment fell rather than rose, as would have been the case if a rightward shift of the savings

Figure 4. U.S.–Private Nonresidential Investment and Real Interest Rates



Source: Fatás 2013a.

Figure 5. Global Savings as a Percentage of GDP

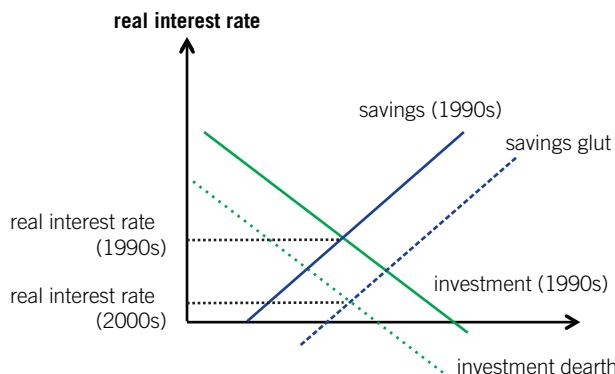


Source: IMF World Economic Outlook (WEO) Database, <http://www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.aspx>, accessed February 21, 2014.

curve was the main explanatory factor. Indeed, Fatás shows that the aggregate investment rate as a percentage of GDP for advanced economies exhibited a clear downward trend from 1980 to 2012. This also helps explain why growth and labor market performance have been sluggish since 2000 in some advanced economies.

Echoing these arguments, Drum (2013a) contends that there “simply aren’t enough promising real-world investments available at current interest rates.” Some of the reasons reviewed by Drum for the lack of investment opportunities include Krugman’s view of demographics, the increased automation view (Drum’s 2013b) in which machines take over more work, resulting in fewer available jobs and less disposable income; Cowen’s (2011) theory of the great stagnation;⁴ rising income inequality (CEPR 2013) that squeezes the middle class and their economic ability to fuel the consumer economy (given that rising shares of income accruing to capital and the very wealthy tends to lead to underconsumption); and Bernstein’s (2013) view that the culprit is the financialization⁵ of the United States and the world.

Figure 6. The Savings Glut and Investment Dearth



Source: Fatás 2013b.

Krugman (2013c) invokes Hansen (1939), who, as a key architect of the secular stagnation hypothesis, suggested that slowing population growth would mean low investment and lower growth. While Hansen did not foresee the baby boom that ultimately resulted in the U.S. labor force growing at an average of 2.1 percent annually⁶ over 1960–85, accompanied by full employment and sustained investment, Krugman suggests that “this time around the slowdown is here, and looks real.” He notes that the working-age population in the United States is projected to grow at an annual rate of just 0.2 percent annually between 2015 and 2025, reflecting slower overall population growth as well as population aging, and suggesting a new equilibrium in which both investment and growth are both lower. Krugman (2013c) posits that the decline in population growth may have reduced the natural rate of interest by an equal amount and that the secular stagnation in Japan may well have resulted from its shrinking working-age population.

Summers (2014) argues that “our economy is held back by lack of demand rather than lack of supply. Increasing capacity to produce will not translate into increased output unless there is more demand for goods and services.” He strongly recommends establishing “a commitment to raising the level of demand at any given level of interest rates through policies that restore a situation where reasonable growth and reasonable interest rates can coincide.” If the argument proposing increased demand as key to economic recovery is correct, then the prevailing postcrisis policy mix has been inappropriate. Instead of relying single-handedly on ultra-loose monetary policy, the retrenchment of public spending—on infrastructure, energy, and others—should be reversed where there is fiscal space. At the same time, pro-active public policies to ignite private investment spending should also be implemented.

Summers (2014) cites three approaches to help avoid secular stagnation:

- The first approach targets the *supply side* of the economy—the skills of the workforce, firms' capacity for innovation, structural tax reform, and sustainable entitlement programs. This approach focuses on the long-term health of the economy and, despite its clear merits, is unlikely to achieve anything significant in terms of generating higher growth over the next five years or so. Moreover, in the short term, there is the problem of insufficient demand, and Summers (2014) cautions that raising supply “could have the perverse effect of magnifying deflationary pressures,” which brings with it debt deflation problems, as already mentioned.
- The second approach is to continue with the current policy of *lowering relevant interest rates* and capital costs as much as possible and relying on prudent regulation to ensure financial sustainability. Several central banks, such as the U.S. Federal Reserve and the Bank of Japan have employed QE to further lower the real interest rate and generate new investment demand. But, as noted, the scope for sustained QE is limited.
- Summers most favors the third approach, which involves the *commitment to raise the level of demand* at any given level of interest rates. He calls for expansionary fiscal policy to take advantage of the current slack in the economy and low borrowing rates and to renew and rebuild critical infrastructure. Increased demand would spur private investment, and Summers cites the untapped energy sector as an example of an area that could benefit from private investment in fossil fuels and renewables.

This third approach is also what De Long (2014) termed the first best solution in attacking the underlying market failures that have brought about secular stagnation. De Long first outlines the “very different fiscal policy” favored by Summers (2014), in which the U.S. government would take advantage of the global savings glut to borrow and spend, and in combination with the significant economic slack and low borrowing costs that exist, resulting in the government successfully rebalancing its long-term finances and lowering its debt burden.⁷ However, as acknowledged by De Long (2014) as well as Krugman (2013c), the political will is not there, so the second best alternative needs to be sized up.

The second best alternative, termed “Blanchardist” by De Long (2014) and “the solution that cannot be named”⁸ by Avent (2013b), focuses on setting and aiming for a higher inflation target. Since 2010, Blanchard, Dell’Ariccia, and Mauro (2010) have argued on the merits of a higher inflation target to help alleviate the impact of the zero interest lower bound: it is much easier to generate negative real interest rates at higher inflation. They also question whether the costs of inflation are really much higher at, say, 4 percent than they are at the current target range.

Ball (2013) examines the implications of a 4 percent inflation target and concludes that such a rate would ease the constraints on monetary policy arising from a zero lower bound and ameliorate economic downturns. Indeed, Ball (2013) estimates that had central banks targeted a 4 percent inflation rate in the early 2000s, average unemployment over 2010–13 could have been lowered by a full 2 percentage points. Ball also reviews eight recessions in the United States since 1960 and suggests that of the three recessions that began with inflation rates between 2 and 3 percent, the lower bound on interest rates was much more binding compared to the remaining recessions that began with inflation above 4 percent. He suggests that an initial inflation rate of 2 percent will produce a bound of -1 percent on the real interest rate.

Krugman (2013b) addresses two of the main arguments against a higher inflation target, but dismisses both. First, to those that contend “events like the current crisis almost never happen,” Krugman responds that the costs are so huge, that they warrant different policies. Furthermore, the liquidity trap was on the horizon in the last three recessions, promulgated by private sector overreach and not U.S. Federal Reserve tightening. The most recent recession, Krugman argues, was similar to what has now become a regular pattern, not an unexpected exception. The second argument against a higher inflation target is a credibility problem—the central bank announces a higher target and suddenly it’s a “slippery-slope” issue. Ball (2013) finds no evidence for this fear, and Krugman (2013b) concludes that “the conventional 2 percent target is a prejudice, nothing more.”

But the argument for a higher inflation target is highly controversial, even among those that believe something should be done to address the secular stagnation. Indeed, De Long (2014) contends that undermining central banks’ track records on price stability by increasing the inflation target risks undermining governments’ reputations, which could generate further financial instability. Kaminska (2014), in agreement with De Long,⁹ cautions against even modest increase in inflation and underscores the importance of preserving trust in fiat currencies. According to Kaminska, it behooves the central bank to do its job well and guard against the slippery slope of inflation.¹⁰ Both Bernanke (2010) and Mishkin (2011) also subscribe to the slippery slope theory. Bernanke suggests that inflation would become more volatile above 4 percent, and inflation expectations would likely become less stable. In a similar vein, Mishkin (2011) noted that inflation tends to keep on rising once it goes above 3 percent. Wolff (2014) brings an international dimension into the policy options. Beyond advocating improved investment conditions, Wolff argues for a better integrated international financial system. He also suggests that emerging market investment demand may be part of the solution. For instance, the more China and India are integrated into the global economy, the

more they should increase global investment demand, thus helping to alleviate secular stagnation.

Not Without Its Critics: The “Schumpeterian” View

On the other side of the debate, there are those—called here “Schumpeterian”—economists who have offered supply side-based hypotheses of a long-run stagnation trend already on course for some time. Like Schumpeter, they emphasize the role of growth in a process of “creative destruction” in which obsolete forms of resource allocation and wealth—jobs, fixed capital assets, technologies, and balance sheets—are replaced by higher-value forms. Although accepting the eventual role of monetary policies in avoiding systemic financial meltdowns, these economists tend—also like Schumpeter—to be more skeptical of fiscal or other types of countercyclical stimuli if designed in ways that impede the process of creative destruction. As for the postcrisis policy mix, even if it is acknowledged that fiscal policy may have moved prematurely to contraction, ultimately public policy action to prop up aggregate demand is not considered to be a key component in the fight against stagnation under the Schumpeterian view: “If you are postulating a stagnation across the longer run, ultimately it will have to boil down to supply side deficiencies” (Cowen 2013). The evolution of declining investments in the context of lower interest rates, as shown in figure 4, would be stemming from disadvantageous rates of return not related to the pace of aggregate demand expansion.

Gordon (2014) has for some time now proposed the hypothesis that technological evolution can lead to stagnation trends. Nevertheless, his arguments regard the low productivity-raising features of current technological trajectories rather than their supposedly dampening implications for aggregate demand. Cowen (2011) has in turn approached stagnation as an outcome of the exhaustion of a significant set of “low-hanging fruits” reaped in recent history, namely one-off supply side opportunities associated with postwar reconstruction; trade opening; diffusion of new technologies in power, transport, and communications; educational attainments; and others. Other supply side stagnation possibilities recently suggested are associated with features of resource allocation—for example, the oversizing of financial activities, as discussed by Canuto (2013c).

As outlined by Rajan (2012), speculation on stagnation trends along this line suggests that:

The advanced countries’ precrisis GDP was unsustainable, bolstered by borrowing and unproductive make-work jobs. More borrowed growth—the Keynesian formula—may create the illusion of normalcy, and may be useful in the immediate aftermath of a deep crisis to calm a panic, but it is no solution to a fundamental growth problem. If this diagnosis is correct, ad-

vanced countries need to focus on reviving innovation and productivity growth over the medium term, and on realigning welfare promises with revenue capacity, while alleviating the pain of the truly destitute in the short run.

Not Without Its Critics: More Views on Secular Stagnation

Beyond the Schumpeterian critiques, there are other valid criticisms of the secular stagnation hypothesis. Although Taylor (2013) is in agreement with Summers and others about the weak postcrisis recovery, he is not convinced that a low equilibrium real rate of interest is at fault. Taylor contends that bad policy decisions, rather than secular stagnation, are holding back the economy. He argues that lax enforcement of financial regulations before the crisis caused major problems. And, during and since the crisis, Taylor argues that new and complex regulations, such as the Dodd-Frank act, and failed temporary stimulus packages, such as cash for clunkers, along with higher federal debt and a highly discretionary monetary policy, have generated distortions and uncertainty, which are holding back economic growth.

Cowen (2013) casts doubt on the assumption that the equilibrium real rate of return is negative. He argues that, although real rates held on certain government securities, positive rates still held on many other investments in the United States. In Cowen’s view, a very negative real rate of return would not be a “natural” rate, and instead would be associated with negative economic growth and other problems. Looking further ahead, he argues that capital obsolescence, which requires new investment, would pull the economy out of secular stagnation over time. Cowen does, however, allow for the fact that the real rate of return on capital could be positive, but low, which would require very negative borrowing rates to reflate the economy, given the high risk premium.

Where Does This Leave Us?

Postcrisis recovery has been unusually sluggish. This partly reflects the implementation of a poor policy mix—one overly reliant on a monetary policy that had run into the zero lower bound, and one that eschewed large-scale publicly funded investments financed at historically low interest rates.

But this sluggish growth may also reflect something deeper. Larry Summers recently invoked the secular stagnation hypothesis as a key reason for the unusually slow postcrisis growth rebound in the United States and other advanced economies. In doing so, he dusted off a theory that first rose to prominence in the late 1930s, associated with Alvin Hansen. Is secular stagnation likely to hold sway in the 21st century? If this theory is correct—that the equilibrium real interest rate could well be negative due to large savings (associated with population aging) and a dearth of investment demand—this is a new danger.

The secular stagnation hypothesis has its critics. Most notably, so-called Schumpeterian economists maintain that supply side constraints explain sluggish growth, rather than demand side factors, and that reliance on stimulus measures—such as higher public investment—is not a recipe for success. Keynesian and Schumpeterian hypotheses of stagnation trends are based on not directly observable factors. Therefore, the struggle for the hearts and minds of the public and policy makers will likely remain unsettled.

However, what if there is merit to the secular stagnation view? What does this imply for policy? Policy prescriptions for such stagnation are either slow in bearing fruit—such as structural reforms to address supply side constraints—or do not garner sufficient political backing, such as open-ended QE or fiscal stimuli concentrated on public investment. And the remaining policy approach—increasing the official inflation target to reduce the impact of the zero interest rate lower bound—has few proponents.

Even within these constraints, however, policy makers could make improvements at the margin. First, regardless of the size of public outlays, public action and spending should be designed in ways that “maximize the bang for the buck” in terms of overcoming obstacles to both secular stagnation and the process of creative destruction. Take the case of Japan: the third arrow of Abenomics—on structural reforms of the services sectors and others—will be necessary to achieve successful results from its fiscal and monetary arrows. In the Euro-zone, timely restructuring/consolidation of “zombie” balance sheets and companies, with a more pro-active stance taken by monetary and financial authorities, should also facilitate the trek out of the current stagnation. Second, regardless of whether advanced economies are facing a demand or supply side stagnation trend, a major bet for the global economy to escape depends on the developing world’s economic transformation as a source of growth (Canuto 2011). However, for that to happen, developing countries themselves need to face their own country-specific agendas of structural reform (Canuto 2013d).

If Summers and other secular stagnation theorists are correct, the issues facing Japan over the past decades could offer a glimpse of what lies ahead for many of the advanced economies around the world. Certain policies can maximize the “bang for the buck,” allowing relief to flow from emerging market economies; however, relying on both these arrows may, in the end, fall short of what is needed.

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Notes

1. Secular stagnation was introduced into the literature in the late 1930s by Alvin Hansen, who suggested that population growth would lead to low investment demand and low growth.
2. The loosening of credit standards and the unsustainable bubbles in financial and housing markets in the precrisis period were associated with moderate growth at best, pointing to a weak, underlying sustainable growth trend.
3. These factors have already been detailed in this note. Wolf (2013) summarizes these as: (i) weak growth despite expansionary monetary policies, referencing the U.S. economy's third quarter rate in 2013 that was just 5.5 percent bigger than its precrisis peak and the continuing decline in U.S. real GDP relative to the precrisis trend; (ii) the bubble economy, fed by rapid increases in leverage by the household and financial sectors that did not translate into above trend growth and/or inflation; and (iii) despite strong global economic growth prior to the crisis, long-term real interest rates remained low, referencing the yield on UK long-term, index-linked government liabilities (gilts) falling from close to 4 percent to about 2 percent after the Asian financial crisis, and then to negative levels after the financial crisis. U.S. Treasury inflation-protected securities (TIPS) followed a similar course, albeit later.
4. Related to this, steep declines in the costs of durable goods—especially those associated with information and communication technology and/or outsourcing—would mean less spending associated with investment plans out of corporate savings. Furthermore, the trajectories of technological evolution currently unfolding would not carry an array of high-return investment opportunities comparable to those in the past.
5. Defined as the “relative growth of the finance sector.” (Bernstein 2013)
6. Reflecting maturing baby boomers and increasing numbers of women entering the labor force.
7. As Krugman (2013b) notes, servicing the debt by stabilizing the ratio of debt to GDP, in an environment of persistently negative real interest rates and positive, albeit moderate, growth, has no cost.

8. Although as Krugman notes, "Actually, I've named it repeatedly; so have many others" (<http://krugman.blogs.nytimes.com/2013/11/19/monetary-and-fiscal-implications-of-secular-stagnation/>).

9. De Long (2014) cites a hypothetical example in which a random investment bank (Schiff Medici Pomponius), in the face of an increased inflation target (5 percent per year), decides to become involved in a liquid-safe-store-of-value business. The bank will then construct a basket of durable, storable commodities to mimic the price level, fill containers with these, and store them. Then they will set up their own cryptocurrency and begin to trade in this, and thus take the seigniorage business away from the 5 percent per year inflation governments.

10. "If the store of value is based on a consumable or usable commodity or good, however, it's going to be much harder to control the incentive to create ever more of it when the price goes up" (Kaminska 2014).

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