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The Economic Hokum of 'Secular Stagnation'

by John B. Taylor
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The evidence continues to mount that government policy has been to blame for the disappointing economic performance in recent years. Yet many don't want to hear it, and they offer a series of alternative explanations including most recently the re-emergence of a chestnut, "secular stagnation."

When it became clear that the recovery from recession—which officially ended in mid-2009—was unprecedentedly weak, policy makers found an excuse in the depth of the financial crisis. Treasury Secretary Tim Geithner argued in August 2010 that "recoveries that follow financial crises are typically a hard climb. That is reality." This argument is put forth frequently by government officials, and it's loosely based on a popular 2009 book by Carmen Reinhart and Kenneth Rogoff, "This Time Is Different."

A careful look at American history by Michael Bordo of Rutgers and Joseph Haubrich of the Cleveland Federal Reserve Bank has blown holes in the argument. Recoveries from deep recessions with financial crises have been stronger, not weaker, than recoveries following shallower recessions. These strong recoveries averaged about 6% real GDP growth per year, compared to only 2% per year in this recovery. The current recovery should have been much stronger.

Five years into a sluggish recovery, this explanation has worn ridiculously thin. The credit crunch and financial disruptions due to crisis have long since been resolved. Residential investment picked up more than two years ago, so the "weak housing market" excuse is gone.

Yet the overall economy has failed to rebound strongly as it did so often in the past. At 52 months and counting, the recovery is already longer than the 33-month average of all U.S. recoveries. Yet the gap between real GDP and its potential based on population and productivity trends has yet to close appreciably. The fraction of the population employed is still below what it was at its start.

And now comes a new excuse, emerging like a vampire from the crypt. Though it has been quietly gestating for some time, a new-old idea, "secular stagnation," has received a great deal of attention since former Treasury secretary and White House adviser Lawrence Summers made the case at a Brookings-Hoover conference in October, and then again at an International Monetary Fund conference in November. A similar hypothesis was famously espoused by Alvin Hansen, "the American Keynes," in the late 1930s to explain America's poor economic performance.

Hansen claimed, rather ludicrously in retrospect, that technological innovation and population growth had played out, depressing investment—and that only government deficit spending could keep employment up. According to the modern version, secular stagnation began 10 years ago when the rate of return on capital—or what Mr. Summers called in his IMF speech the "real interest rate that was consistent with full employment"—fell well below normal levels experienced since the end of World War II. The decline, say to -2 or -3%, continues today and will likely continue into the future, he said. The low rate of return is due to a supposed glut of saving and dearth of investment opportunities.

What it means is that firms need an extra-low interest rate—even a negative interest rate—to be induced to invest. With interest rates at or near zero and inflation low, it is hard to get real interest rates down enough to provide these incentives. Hence, the economy stagnates, and there are unavoidable adverse side effects due to the distortions resulting from heavy government interventions, such as the Fed's quantitative easing and forward guidance, as policy makers try to respond to the secular decline.

There are many problems with this neo-secular stagnation hypothesis. First, it implies that there should have been slack economic conditions and high unemployment in the five years before the crisis, even with the very low interest rates—especially in 2003-05—and the lax regulatory policy.

But it was just the opposite. There were boom-like conditions, especially in residential investment, as demand for homes skyrocketed and housing price inflation jumped from around 7% per year from 2002-03 to near 14% in 2004-05 before busting in 2006-07. The unemployment rate got as low as 4.4%—well below the normal rate and not a sign of slack. Inflation was rising, not falling. During the years 2003-05, when the Fed's interest rate was too low, the annual inflation rate for the GDP price index doubled to 3.4% from 1.7%.

Moreover, there is little direct evidence for a saving glut. During this recovery, the personal saving rate is well below what it was during the 1980s rapid recovery from a deep recession: 5.5% now versus 9.2% then. In my 2009 book on the crisis, "Getting Off Track," I examined the claim that there was a global savings glut and found evidence to the contrary: In the past decade global savings rates fell below what they were in the 1980s and 1990s. The U.S. has been running a current account deficit, which means national saving is below investment.

In the current era, business firms have continued to be reluctant to invest and hire, and the ratio of investment to GDP is still below normal. That is most
likely explained by policy uncertainty, increased regulation, including through the Dodd Frank and Affordable Care Act, about which there is plenty of evidence, especially in comparison with the secular stagnation hypothesis.

I suppose the emergence of the secular stagnation hypothesis shouldn't be surprising. As long as there is a demand to pin the failure of bad government policies on the market system or exogenous factors, there will be a supply of theories. The danger is that this leads to more bad government policy.

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