Three, Four... Many Secular Stagnations!

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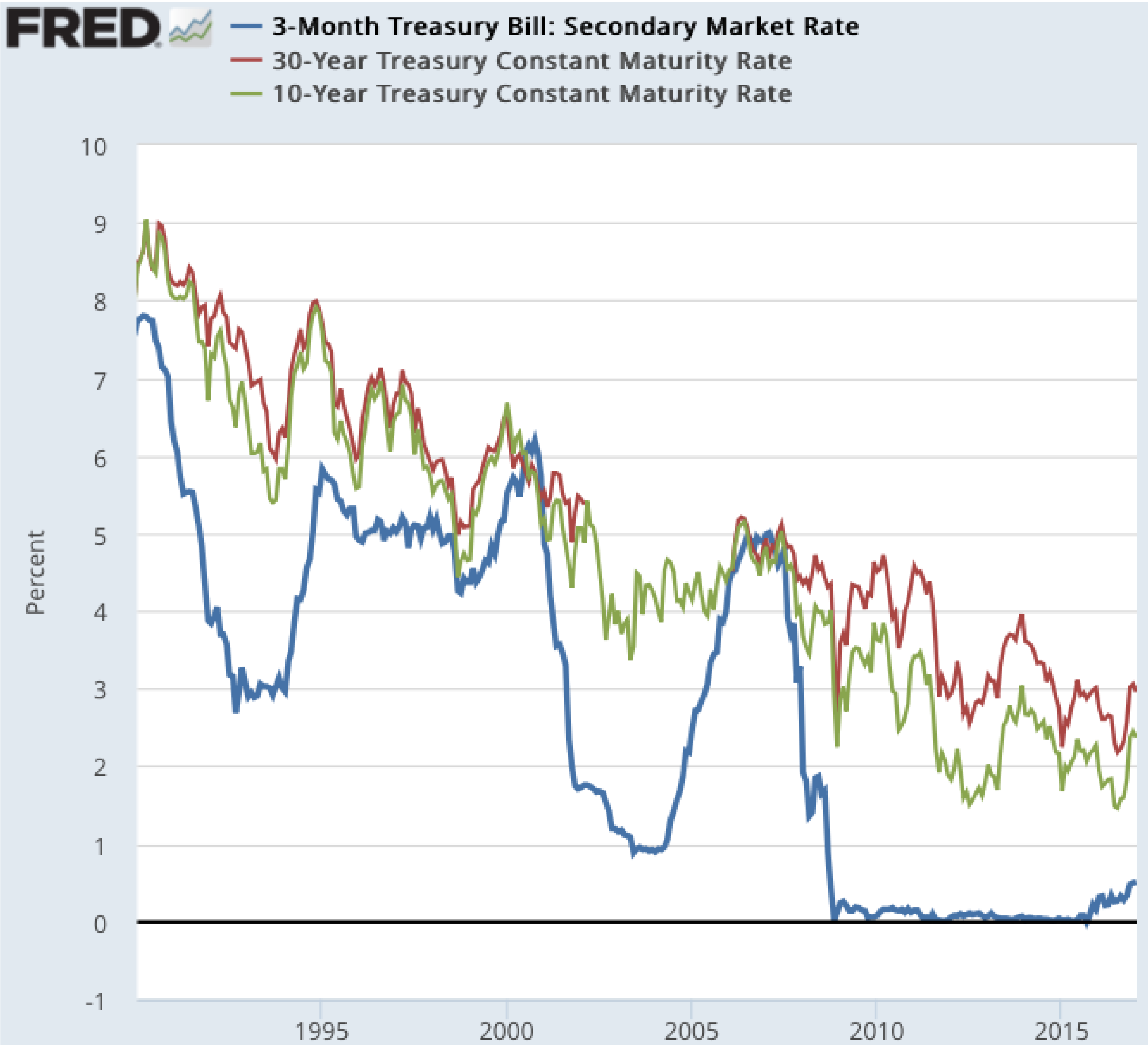
I. The Third Coming of John A. Hobson

In my view, the current debate about “secular stagnation” started by Larry Summers is best thought of as the third coming of John A. Hobson.



The first coming of John A Hobson was, of course, Hobson (1902): *Imperialism: A Study*. In Hobson’s schema, unequal income distribution combined with the limited physical capacity to consume of the rich meant that anything like full employment could be maintained only with a growing share of output devoted to government purchases and investment. But where were there vents for additional investment? Abroad, in the growing empire:

> *Investors who have put their money in foreign lands, upon terms which take full account of risks connected with the political conditions of the country, desire to use the resources of their Government to minimize these risks, and so to enhance the capital value and the interest of their private investments. The investing and speculative classes in general also desire that Great Britain should take other foreign areas under her flag in order to secure new areas for profitable investment and speculation…*

Moreover, the military apparatus necessary to conquer and to defend what had been conquered soaked up productive capacity that would otherwise have been idle. As Winston Churchill put it with respect to Great Britain's naval construction plans for the year 1909: "The Admiralty had demanded six [Dreadnought-class] battleships: the economists offered four: and we finally compromised at eight." Thus governments that embarked on imperialism and armaments found their domestic economies in relatively good shape with respect to employment, capacity utilization, and profits; while governments that minded their knitting did not. And even though imperialism and militarism were humanitarian and cost-benefit disasters, governments that pursued them tended to remain in office. And this pushed Europe toward World War I.

It is conventional among economists to not understand Hobson's "underconsumptionist" argument. As Ben Bernanke commented in 2013:

> *As I pointed out… [when] Larry first raised the secular stagnation argument… it's hard to imagine that there would be a permanent dearth of profitable investment projects. As Larry's uncle Paul Samuelson taught me in graduate school at MIT, if the real interest rate were expected to be negative indefinitely, almost any investment is profitable. For example, at a negative (or even zero) interest rate, it would pay to level the Rocky Mountains to save even the small amount of fuel expended by trains and cars that currently must climb steep grades. It's therefore questionable that the economy's equilibrium real rate can really be negative for an extended period…*

This, of course, misses the point that risk-bearing capacity is an essential factor of production needed for private-sector business investment, and risk bearing capacity must be mobilized and paid for—and paid for very handsomely given the adverse selection and moral hazard problems in financing private investment. A very healthy average risky rate of profit is perfectly consistent with a short-term safe real rate of interest less than the negative of the rate of inflation.

For Hobson, of course, the solution was progressive tax and transfer (and perhaps predistribution?) policies to end the Gilded Age and create a reasonable distribution of income, in which fortunes would not be in the hands of those whose stomachs were small and whose narrow eyes were not much bigger, and who would thus hoard rather than spend their incomes.

The second coming of John A. Hobson was, of course, Alvin Hansen (1939). Secular stagnation was "sick recoveries which die in their infancy and depressions which feed on themselves and leave a hard and seemingly immovable core of unemployment…" We were "rapidly entering a world in which we must fall back upon a more rapid advance of technology than in the past if we are to find private investment opportunities adequate to maintain full employment…" For Hansen, the solution was either (a) more investment in research and development to speed technological progress, or (b) public investment "in human and natural resources and in consumers' capital goods of a collective character…"

In some sense Hobson's fears became true and more than true: World War I, and what followed. And when the world economy reoriented itself after World War II we were no longer in a Gilded Age but, rather, in an Age of

Social Democracy with a much more equal income distribution—and so Hobson's unequal income distribution and resulting underconsumptionist worries were no longer relevant.

Alvin Hansen's worries were similarly obsolete as the post-World War II order formed itself. We got the greater public investment, both in research and development to spur more rapid technological progress—DARPA—and in the Cold War arms race.

The Wheel Has Turned Again

The Longer Depression: But now the wheel of history has turned once again. We have a Second Gilded Age. We have had what looks to have been either the second-largest or the largest adverse financial business-cycle shock in history. We have had an economic downturn followed by a very slow recovery that has produced and will produce a cumulative output gap vis-a-vis potential that will rival and may well exceed the Great Depression itself as a multiple of the economy's productive potential.

But it is not just what people call "the Great Recession" and should call "the Longer Depression". It is the long, steady decline in safe interest rates at all maturities since 1990: the decline in short-term safe real interest rates from 4% to -1.5%, and the decline in long-term safe real interest rates from 5% to 1%.

B. Larry's Core Worry: And so now we have Larry Summers (2013), reacting to the collapse of the short-term safe nominal Wicksellian "neutral" rate of interest consistent with full employment and with central banks' ability to hit their inflation targets.

We are handicapped because there is not one place in which Larry has developed his argument: it is evolving. But the debate Larry has started seems to me, as I wrote, "the most important policy-relevant debate in economics since John Maynard Keynes's debate with himself in the 1930s."

Summers's core fear is that the global economy—or, at least, the North Atlantic chunk of it—will be stuck for a generation or more in a situation in which, if investors have realistically expectations, then even if central banks reduce interest rates to accommodate those expectations and even if governments follow sensible but not extravagant fiscal policies, private financial markets will still fail to support a level of investment demand compatible with full employment.

Thus economic policymakers will find themselves either hoping that investors form unrealistic expectations—prelude to a bubble—or coping with chronic ultralow interest rates and the associated risks of stubbornly elevated unemployment.

III. Causes of Secular Stagnation III

Such "badly behaved investment demand and savings supply functions," as Martin Feldstein called them when he taught this stuff to me at Harvard back in 1980, could have seven underlying causes:

1. High income inequality, which boosts savings too much because the rich can't think of other things they'd rather do with their money. (Hobson)
2. Technological and demographic stagnation that lowers the return on investment and pushes desired investment spending down too far. (Hansen)
3. Non-market actors whose strong demand for safe, liquid assets is driven not by assessments of market risk and return but rather by political factors or by political risk. (Bernanke)
4. A broken financial sector that fails to mobilize the risk-bearing capacity of society and thus drives too large a wedge between the returns on risky investments and the returns on safe government debt. (Rogoff)
5. Very low actual and expected inflation, which means that even a zero safe nominal rate of interest is too high to balance desired investment and planned savings at full employment. (Krugman, Blanchard)

6. Limits on the demand for investment goods coupled with rapid declines in the prices of those goods, which together put too much downward pressure on the potential profitability of the investment-goods sector.
7. Technological inappropriateness, in which markets cannot figure out how to properly reward those who invest in new technologies even when the technologies have enormous social returns—which in turn lowers the private rate of return on investment and pushes desired investment spending down too far.

A. Other Economists' Views as Partial: The first thing to note is that other economists who have been worrying at related issues have views all of which appear to be a subset of Summers-style secular stagnation concerns. Hobson saw income inequality as the root—that's number 1 on the list. Hansen saw demographic and technological stagnation—that's number 2, and today this point of view is echoed by Gordon. Bernanke, the former Federal Reserve chairman, says we have entered an age of a "global savings glut" because of mercantilism and political risk in emerging markets—that's number 3 on the list. Kenneth Rogoff of Harvard points to the emergence of global "debt supercycles" that have broken the ability of financial markets to do the risk transformation on a large enough scale—that's number 4. CUNY's Paul Krugman warns of the return of "Depression economics" and seeks central banks that will "credibly promise to be irresponsible", while Olivier Blanchard called for a 4%/year inflation target—that's number 5. And numbers 6 and 7 have not yet made their appearance in the policy-macroeconomic debate. But they should.

Larry Summers is all of the above: all seven.

B. Against Partial Explanations: And his major concern is to argue against those who think that it is just one of the seven that is the problem—that there is a quick fix, which will either come of itself relatively soon or could be brought forward in time via a simple, clever policy move. Thus Summers on Bernanke:

> *Ben… suggest[s]… the savings glut is a relatively transitory phenomenon that will be repaired. Perhaps in the fullness of time… [but] it is very difficult to read market judgments about real interest rates as suggesting that that is likely…. For the relevant medium-term policy horizon (as I have no useful views about 2040 or 2050) the challenge of absorbing savings in productive investment will be the overriding challenge for macroeconomic policy…*

And Summers on Rogoff:

> *Ken Rogoff argues… that the current weakness is the temporary result of over-indebtedness…. The debt super-cycle view does not have a ready explanation for the low level of real interest rates, nor does it have a ready explanation for the fact that real interest rates have fallen steadily…. Ken suggests an alternative hypothesis for explaining the low level of real interest rates… a generalized increase in the level of risk…. [But] you would… expect [that] to lead to a decline, rather than an increase, in asset values, given that it was those assets that had become more risky. You would expect it to manifest itself in a measurable and clear increase in implied volatilities, as reflected in options markets. You would expect it to reflect itself in a dramatic increase in the pricing of out-of-the-money puts. But the opposite has occurred…. The length of time that markets are forecasting low real interest rates makes the stagnation fairly secular or the debt super-cycle very long, at which point the distinction blurs.*
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> *And what is the temporary debt-overhand induced headwind that is thought to be present in a major way today but that will be gone in three years? Corporate balance sheets are flush. The spread between LIBOR and other yields are low. Debt service ratios are at abnormally low levels. Whatever your indicator of repair from the financial crisis, it has mostly happened. And yet with interest rates of zero, the United States is still likely to grow at only two percent this year. I do not see a good reason to be confident that that situation will be significantly better three years from*

> *now….*
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> *Any debt overhang would itself be endogenous. Why did we have a vast erosion of credit standards by 2005? Why were interest rates in a place that enabled such bubbles? Because that was what was necessary to keep the economy going with adequate aggregate demand through that period. So even if a debt overhanging were occurring it would in a sense be a mechanism through which secular stagnation or over-saving produces damage. It is not an alternative to the idea of secular stagnation…*

Summers's rejection of the Krugman-Blanchard higher-inflation-is-the-solution position as a sufficient and quick fix seems to me more subtle. I do not think he has set it out clearly. But what Summers is thinking—or at least what the Larry Summers emulation module I have running on my own wetware is thinking—is this:

There are worthy private risky investment projects and unworthy ones. Worthy risky projects have a relatively low elasticity with respect to the required real yield—that is, lowering interest rates to rock-bottom levels would not induce much more spending. In contrast, unworthy risky investment projects have a high elasticity. Thus, when safe interest rates get too low, savers who should not be bearing risk nonetheless reach for yield—they stop checking whether investment projects are worthy or unworthy.

Put it another way: there are people who should be holding risky assets and there are people who should be holding safe assets. The problem with boosting inflation so that the central bank can make the real return on holding safe assets negative is that it induces people who really should not be holding risky assets to buy them.

I would speculate that, deep down, Summers still believes in one tenet of inflation economics: that effective price stability—the expectation of stable 2 percent inflation—is a very valuable asset in a market economy. It should not be thrown away.

C. Seeking Not a Cure But Palliatives: For Summers, secular stagnation does not have one simple cause but is the concatenation of a number of different structural shocks un- or only loosely-connected with each other in their origin that have reinforced each other in their effects pushing the short-term safe nominal Wicksellian "neutral" rate down below zero. But even though there is no one root cause, there are two effective palliatives to neutralize or moderate the effects.

Thus Summers calls for two major policy initiatives:

1. Larger and much more aggressive progressive tax and transfer (and predistribution?) policies to end the Second Gilded Age.

2. A major shift to an investment-centered expansionary fiscal policy as the major component of what somebody or other once called "a somewhat comprehensive socialisation of investment… [as] the only means of securing an approximation to full employment… not exclud[ing] all manner of compromises and of devices by which public authority will cooperate with private initiative…"

I think he has a very, very strong case here.

D. Achieving Potential: The standard diss of Larry was that even though his promise was immense—he was brilliant, provocative, creative, and so willing to think outside-the-box that you sometimes wondered whether he knew where the box was or even if there was a box—there was no great substantive contribution but only a bunch of footnotes to lines of inquiry that really "belonged" to others.

I think this is the contribution.
