As surprising as the recent financial crisis [1] and recession were, the behavior of the world's industrialized economies and financial markets during the recovery [2] has been even more so.

Most observers expected the unusually deep recession 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 [3]'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 [4]. Had the American economy performed as the Congressional Budget Office fore-cast 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 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. With appropriate caveats about the complexities of drawing inferences from indexed bond markets, it is fair to say that inflation for the entire industrial world is expected to be close to one percent for another decade and that real interest rates are expected to be around zero over that time frame. In other words, nearly seven years into the U.S. recovery, markets are not expecting "normal" conditions to return anytime soon.

The key to understanding this situation lies in the concept of secular stagnation [5], 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 propensity to save and a decreasing propensity 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. 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).

Other explanations for what is happening have been proposed, notably Kenneth Rogoff's theory of a debt overhang, Robert Gordon [6]'s theory of supply-side headwinds, Ben Bernanke's theory of a savings glut [7], and Paul Krugman's theory of a liquidity trap. All of these have some validity, but the secular stagnation theory offers the most comprehensive account of the situation and the best basis for policy prescriptions. The good news is that although developments in China [8] and elsewhere raise the risks that global economic conditions will deteriorate, an expansionary fiscal policy by the U.S. government can help overcome the secular stagnation problem and get growth back on track.

STUCK IN NEUTRAL

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. Following the Swedish economist Knut Wicksell, it 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. Secular stagnation occurs when neutral real interest rates are sufficiently 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. Absent 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, reductions in the ability to borrow (especially against housing), and a greater accumulation of assets by foreign central banks and sovereign wealth funds. 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).

Perhaps most important, the new economy [9] tends to conserve capital. Apple and Google, for example, are the two largest U.S. companies and are eager to push the frontiers of technology [10] forward, yet both are awash in cash and are under pressure to distribute more of it to their shareholders. Think about Airbnb’s impact on hotel construction, Uber’s impact on automobile demand, Amazon’s impact on the construction of malls, or the more general impact of information technology on the demand for copiers, printers, and office space. And in a period of rapid technological change, it can make sense to defer investment lest new technology soon make the old obsolete.

Various studies have explored the impact of these factors and attempted to estimate the extent to which they have reduced neutral real interest rates. The most recent and thorough of these, by Lukasz Rachel and Thomas Smith at the Bank of England, concluded that for the industrial world, neutral real interest rates have declined by about 4.5 percentage points over the last 30 years and are likely to stay low in the future. Together with the current price of long-term bonds, this suggests that the kind of Japan-style stagnation that has plagued the industrial world in recent years may be with us for quite some time.

DIFFERENTIAL DIAGNOSIS

Not all economists are sold on the secular stagnation hypothesis. Building on the monumental history of financial crises he wrote with Carmen Reinhart, for example, Rogoff ascribes current difficulties to excessive debt buildups and subsequent deleveraging. But although these surely contributed to the financial crisis, they seem insufficient to account for the prolonged slow 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 decried by Rogoff as not simply exogenous events but rather the consequence of a growing excess of saving over investment and the easy monetary policies necessary to maintain full employment.

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.

For a decade, 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.

Krugman and some others have sought to explain recent events and make policy recommendations based on the old Keynesian concept of a liquidity trap [11]. As Krugman has emphasized, this line of thinking is parallel to the secular stagnation one. 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.

Perhaps the most comforting alternative view is that secular stagnation may have indeed occurred in the past but is no longer operating in the present. With the unemployment rate down to five percent and the Fed embarked on a tightening cycle, the argument runs, indicators will start returning to earlier, higher growth trends. Perhaps. But markets are betting that the Fed will not be able to tighten monetary policy nearly as much as it expects, and if another recession starts in the next few years, cuts will soon bring interest rates back down to the zero lower bound.

LET'S GET FISCAL

Up to the 1970s, most economists believed that if governments managed demand properly, their countries' economies could enjoy low unemployment and high output with relatively modest inflation. The proper task of macroeconomists, it followed, was to use monetary and fiscal policy to manage demand well. But this thinking was eventually challenged from two directions—in theory, by Milton Friedman [12], Robert Lucas, and others, and in practice, by the experience of high inflation together with high unemployment.

The emergence of such "stagflation" in the late 1970s [13] led to general acceptance of the natural-rate hypothesis, the idea that abnormally low unemployment causes inflation to accelerate. According to this view, since policymakers would not accept permanently rising rates of inflation, economies would tend to fluctuate around a natural rate of unemployment, determined by factors such as labor flexibility, the availability of benefits, and the effectiveness of hiring and job searches. By skillfully managing demand, policymakers could aspire to reduce the amplitude of the fluctuations—and although they could determine the average rate of inflation, they could not raise the average level of output.

By the mid 1980s, once inflation had been brought down from double-digit levels, a consensus on macroeconomic policy emerged. The central objective of policy, most mainstream economists believed, should be to achieve a low and relatively stable rate of inflation, since there were no permanent gains to be had from higher inflation. This could best be accomplished, it was thought, by firmly establishing the political independence of central banks and by setting inflation targets in order to control expectations. Fiscal policy, meanwhile, was not considered to have a primary role in managing demand, because it was slow acting and might push interest rates up and because monetary policy could do what was needed.

Seen through the lens of the secular stagnation hypothesis, however, all these propositions are problematic. If it were possible to avoid secular stagnation, then it would indeed be possible to increase average levels of output substantially, raising the stakes for demand management policy. The danger in monetary policy, moreover, lies not in politicians eager to inflate away problems but in bankers refusing to generate enough demand to bring inflation up to target levels and permit reductions in real interest rates. And fiscal policy, finally, takes on new significance as a tool in economic stabilization.

As of yet, none of these principles has been fully accepted by policymakers in the advanced industrial world. It is true that central banks have sought, through quantitative easing, to loosen monetary conditions even with short-term interest rates at rock bottom. But they have treated these policies as a short-term expedient, not a longer-term necessity. More important, these policies are running into diminishing returns and giving rise to increasingly toxic side effects. Sustained low rates tend to promote excess leverage, risk taking, and asset bubbles.

This does not mean that quantitative easing was mistaken. Without such policies, output would likely be even lower, and the world economy might well have tipped into deflation. But monetary-policy makers need to acknowledge much more explicitly that neutral real rates have fallen substantially and that the task now is to adjust policy accordingly. This could include setting targets for nominal GDP growth rather than inflation, investing in a wider range of risk assets, making plans to allow base rates to turn negative, and underscoring the importance of avoiding a new recession.

When the primary policy challenge for central banks was establishing credibility that the printing press was under control, it was appropriate for them to jealously guard their independence. When the challenge is to accelerate, rather than brake, economies, more cooperation with domestic fiscal authorities and foreign counterparts is necessary.

The core problem of secular stagnation is that the neutral real interest rate is too low. This rate, however, cannot be increased through monetary policy. Indeed, to the extent that easy money works by accelerating investments and pulling forward demand, it will actually reduce neutral real rates later on. That is why primary responsibility for addressing secular stagnation should rest with fiscal policy. An expansionary fiscal policy can reduce national savings, raise neutral real interest rates, and stimulate growth.

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. Other structural policies that would promote demand include steps to accelerate investments in renewable technologies that could replace fossil fuels and measures to raise the share of total income going to those with a high propensity to consume, such as support for unions and increased minimum wages. 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.

TO HANGZHOU AND BEYOND

If each of the countries facing secular stagnation today were to confront it successfully on its own, the results would be very favorable for the global economy. But international focus and coordination have crucial additional roles to play.

Secular stagnation, after all, increases the contagion from economic weakness. In normal times, if the rest of the world economy suffers, the United States or any other affected economy can offset the loss of demand and competitiveness through monetary easing. With monetary policy already at its lower limit, however, additional easing is impossible (or at least much more difficult), and so each country's stake in the strength of the global economy is greatly magnified.

Secular stagnation also increases the danger of competitive monetary easing and even of currency wars. Looser money, starting with near-zero capital costs, is likely to generate demand primarily through increases in competitiveness. This is a zero-sum game, since currency movements switch demand from one country to another rather than increase it globally. Fiscal expansions, in contrast, raise demand on a global basis. International coordination is thus necessary to avoid an excessive and self-defeating reliance on monetary policy and achieve a mutually rewarding reliance on fiscal policy to address problems.

Movements in commodity prices in recent months have shown that events in emerging markets, especially China, can have significant impacts globally. It now appears likely that more capital will flow out of emerging markets and less will flow in than has been the case in recent years. These capital outflows and the consequent increases in net exports will further reduce demand and neutral real rates in the developed world, thereby exacerbating secular stagnation. Policies that help restore confidence in emerging markets, therefore, will also strengthen the global economy.

These issues were recognized at the successful G-20 summit in London in April 2009 (although the problems were misdiagnosed as cyclical and temporary rather than secular and enduring). The common commitments undertaken there to engage in fiscal expansion, strengthen financial regulation, resist trade protection, and enhance the capacity of international financial institutions to respond to problems in emerging markets were effective in halting the collapse of the global economy. Unfortunately, subsequent G-20 summits returned to their traditional lethargy and misguided preoccupation with fiscal austerity, monetary normalization, and moral hazard, ending up missing opportunities to accelerate the recovery.

This year, the Chinese will host a G-20 summit in September. If China chooses to recognize how important global growth is for its economy, and how important its economy is for global growth, it could perform a great service by reinvigorating international economic cooperation. The key priority in Hangzhou—as it was in London back in 2009—should be increasing global demand and making sure that it picks up particularly in those countries where there is the most economic slack.

In this regard, China's decisions about its own economic affairs will be crucial. To date, the international community has joined Chinese financial officials in urging China's political leadership to pursue financial liberalization. This is surely correct for the long run. But it may well be in China's and the global interest that the liberalization process proceed more gradually than is currently envisioned, so that capital outflows from China do not threaten China's own financial stability and spread weakness to the global economy at large.

As the euro has declined sharply, meanwhile, any recovery that Europe has achieved has come largely from increases in competitiveness that reduce growth elsewhere. Germany now leads the world with a trade surplus equal to a whopping eight percent of GDP. The global community should encourage Europe to generate domestic demand as it seeks to expand its economy.

One more priority in Hangzhou should be promoting global infrastructure investment. In this regard, the Chinese-led Asian Infrastructure Investment Bank [14] is a valuable step forward, and it should be strongly supported by the global community, even as it is encouraged to respect international norms and standards relating to issues such as environmental protection and integrity in procurement. And efforts to support infrastructure investment elsewhere, such as the Obama administration's Power Africa initiative, should be carried forward.

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 more dire 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.

Links
[1] https://www.foreignaffairs.com/reviews/2015-02-16/can-economists-learn
[2] https://www.foreignaffairs.com/reviews/review-essay/second-great-depression
[3] https://www.foreignaffairs.com/articles/united-states/2012-04-23/all-presidents-central-bankers
[4] https://www.foreignaffairs.com/articles/united-states/2011-06-29/america-s-weak-recovery
[5] http://www.economist.com/blogs/graphicdetail/2014/11/secular-stagnation-graphics
[6] https://www.foreignaffairs.com/reviews/review-essay/2016-01-28/innovation-over
[7] http://www.brookings.edu/blogs/ben-bernanke/posts/2015/04/01-why-interest-rates-low-global-savings-glut
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