Secular Stagnation, Coalmines, Bubbles, and Larry Summers

Paul Krugman

***The New York Times*, November 16, 2013**

I'm pretty annoyed with Larry Summers right now. His presentation at the IMF Research Conference is, justifiably, getting a lot of attention. And here's the thing: I've been thinking along the same lines, and have, I think, hinted at this analysis in various writings. But Larry's formulation is much clearer and more forceful, and altogether better, than anything I've done. Curse you, Larry Summers!

OK, with professional jealousy out of the way, let me try to enlarge on Larry's theme.

1. *When prudence is folly*

Larry's formulation of our current economic situation is the same as my own. Although he doesn't use the words "liquidity trap", he works from the understanding that we are an economy in which monetary policy is de facto constrained by the zero lower bound (even if you think central banks could be doing more), and that this corresponds to a situation in which the "natural" rate of interest – the rate at which desired savings and desired investment would be equal at full employment – is negative.

And as he also notes, in this situation the normal rules of economic policy don't apply. As I like to put it, virtue becomes vice and prudence becomes folly. Saving hurts the economy – it even hurts investment, thanks to the paradox of thrift. Fixating on debt and deficits deepens the depression. And so on down the line.

This is the kind of environment in which Keynes's hypothetical policy of burying currency in coalmines and letting the private sector dig it up – or my version, which involves faking a threat from nonexistent space aliens – becomes a good thing; spending is good, and while productive spending is best, unproductive spending is still better than nothing.

Larry also indirectly states an important corollary: this isn't just true of public spending. Private spending that is wholly or partially wasteful is also a good thing, unless it somehow stores up trouble for the future. That last bit is an important qualification. But suppose that U.S. corporations, which are currently sitting on a huge hoard of cash, were somehow to become convinced that it would be a great idea to fit out all their employees as cyborgs, with Google Glass and smart wristwatches everywhere. And suppose that three years later they realized that there wasn't really much payoff to all that spending. Nonetheless, the resulting investment boom would have given us several years of much higher employment, with no real waste, since the resources employed would otherwise have been idle.

OK, this is still mostly standard, although a lot of people hate, just hate, this kind of logic – they want economics to be a morality play, and they don't care how many people have to suffer in the process.

But now comes the radical part of Larry's presentation: his suggestion that this may not be a temporary state of affairs.

2. *An economy that needs bubbles?*

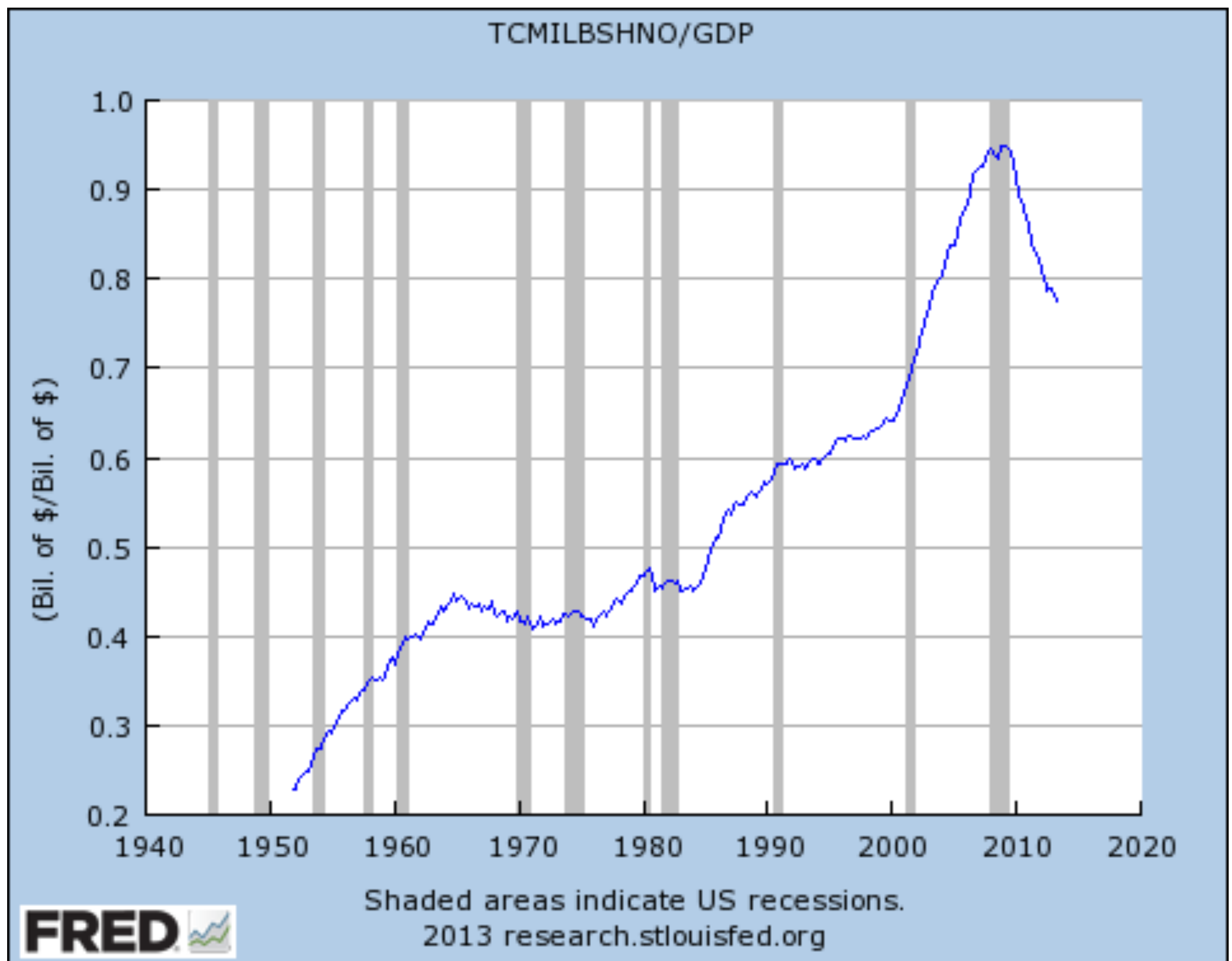
We now know that the economic expansion of 2003-2007 was driven by a bubble. You can say the same about the latter part of the 90s expansion; and you can in fact say the same about the later years of the Reagan expansion, which was driven at that point by runaway thrift institutions and a large bubble in commercial real estate.

So you might be tempted to say that monetary policy has consistently been too loose. After all, haven't low interest rates been encouraging repeated bubbles?

But as Larry emphasizes, there's a big problem with the claim that monetary policy has been too loose: where's the inflation? Where has the overheated economy been visible?

So how can you reconcile repeated bubbles with an economy showing no sign of inflationary pressures? Summers's answer is that we may be an economy that needs bubbles just to achieve something near full employment – that in the absence of bubbles the economy has a negative natural rate of interest. And this hasn't just been true since the 2008 financial crisis; it has arguably been true, although perhaps with increasing severity, since the 1980s.

One way to quantify this is, I think, to look at household debt. Here's the ratio of household debt to GDP since the 50s:



Ratio of household debt to GDP

There was a sharp increase in the ratio after World War II, but from a low base, as families moved to the suburbs and all that. Then there were about 25 years of rough stability, from 1960 to around 1985. After that, however, household debt rose rapidly and inexorably, until the crisis struck.

So with all that household borrowing, you might have expected the period 1985-2007 to be one of strong inflationary pressure, high interest rates, or both. In fact, you see neither – this was the era of the Great Moderation, a time of low inflation and generally low interest rates. Without all that increase in household debt, interest rates would presumably have to have been considerably lower – maybe negative. In other words, you can argue that our economy has been trying to get into the liquidity trap for a number of years, and that it only avoided the trap for a while thanks to successive bubbles.

And if that's how you see things, when looking forward you have to regard the liquidity trap not as an exceptional state of affairs but as the new normal.

3. *Secular stagnation?*

How did this happen? Larry explicitly invokes the notion of secular stagnation, associated in particular with Alvin Hansen (pdf). He doesn't say why this might be happening to us now, but it's not hard to think of possible reasons.

Back in the day, Hansen stressed demographic factors: he thought slowing population growth would mean low investment demand. Then came the baby boom. But this time around the slowdown is here, and looks real.

Think of it this way: during the period 1960-85, when the U.S. economy seemed able to achieve full employment without bubbles, our labor force grew an average 2.1 percent annually. In part this reflected the maturing of the baby boomers, in part the move of women into the labor force.

This growth made sustaining investment fairly easy: the business of providing Americans with new houses, new offices, and so on easily absorbed a fairly high fraction of GDP.

Now look forward. The Census projects that the population aged 18 to 64 will grow at an annual rate of only 0.2 percent between 2015 and 2025. Unless labor force participation not only stops declining but starts rising rapidly again, this means a slower-growth economy, and thanks to the accelerator effect, lower investment demand.

By the way, in a Samuelson consumption-loan model, the natural rate of interest equals the rate of population growth. Reality is a lot more complicated than that, but I don't think it's foolish to guess that the decline in population growth has reduced the natural real rate of interest by something like an equal amount (and to note that Japan's shrinking working-age population is probably a major factor in its secular stagnation.)

There may be other factors – a Bob Gordonesque decline in innovation, etc.. The point is that it's not hard to think of reasons why the liquidity trap could be a lot more persistent than anyone currently wants to admit.

4. *Destructive virtue*

If you take a secular stagnation view seriously, it has some radical implications – and Larry goes there.

Currently, even policymakers who are willing to concede that the liquidity trap makes nonsense of conventional notions of policy prudence are busy preparing for the time when normality returns. This means that they are preoccupied with the idea that they must act now to head off future crises. Yet this crisis isn't over – and as Larry says, "Most of what would be done under the aegis of preventing a future crisis would be counterproductive."

He goes on to say that the officially respectable policy agenda involves "doing less with monetary policy than was done before and doing less with fiscal policy than was done before," even though the economy remains deeply depressed. And he says, a bit fuzzily but bravely all the same, that even improved financial regulation is not necessarily a good thing – that it may discourage irresponsible lending and borrowing at a time when more spending of any kind is good for the economy.

Amazing stuff – and if we really are looking at secular stagnation, he's right.

Of course, the underlying problem in all of this is simply that real interest rates are too high. But, you say, they're negative – zero nominal rates minus at least some expected inflation. To which the answer is, so? If the market wants a

strongly negative real interest rate, we'll have persistent problems until we find a way to deliver such a rate.

One way to get there would be to reconstruct our whole monetary system – say, eliminate paper money and pay negative interest rates on deposits. Another way would be to take advantage of the next boom – whether it's a bubble or driven by expansionary fiscal policy – to push inflation substantially higher, and keep it there. Or maybe, possibly, we could go the Krugman 1998/Abe 2013 route of pushing up inflation through the sheer power of self-fulfilling expectations.

Any such suggestions are, of course, met with outrage. How dare anyone suggest that virtuous individuals, people who are prudent and save for the future, face expropriation? How can you suggest steadily eroding their savings either through inflation or through negative interest rates? It's tyranny!

But in a liquidity trap saving may be a personal virtue, but it's a social vice. And in an economy facing secular stagnation, this isn't just a temporary state of affairs, it's the norm. Assuring people that they can get a positive rate of return on safe assets means promising them something the market doesn't want to deliver – it's like farm price supports, except for rentiers.

Oh, and one last point. If we're going to have persistently negative real interest rates along with at least somewhat positive overall economic growth, the panic over public debt looks even more foolish than people like me have been saying: servicing the debt in the sense of stabilizing the ratio of debt to GDP has no cost, in fact negative cost.

I could go on, but by now I hope you've gotten the point. What Larry did at the IMF wasn't just give an interesting speech. He laid down what amounts to a very radical manifesto. And I very much fear that he may be right.