

The Scary Debate Over Secular Stagnation

Hiccup... or Endgame?

BY J. BRADFORD DELONG

The first principle of success in practically any endeavor is to move not toward where the ball is, but where it is going to be. Economists, as a rule, ignore this principle, indulging in the likely-to-be-vain hope that policies that would have worked yesterday will still work tomorrow.





SPENCER/HINES
Properties

AVAILABLE
(864) 583-1001

UNSAFE



SECULAR STAGNATION

But now there is hope that economists will do better, a hope based on the near-consensus that the modes of thought of the past two generations are obsolete. Ben Bernanke, the former Federal Reserve chairman, says we have entered an age of a “global savings glut.” Kenneth Rogoff of Harvard points to the emergence of global “debt supercycles.” Princeton’s Paul Krugman warns of the return of “Depression economics.” And former Treasury Secretary Lawrence Summers calls for broad

Without governments willing to deal with the structural problems, we are doomed to oscillate between asset bubbles and depression.

structural shifts in government policy to deal with “secular stagnation.”

All of these experts are expecting a future that will be very different than the second half of the 20th century, or even the so-far, not-so-good third millennium. But they are influenced by different inclinations – toward optimism or pessimism, toward cautious repairs or an abrupt break with policy as usual – to diagnose the malady and prescribe the treatment.

The debate over secular stagnation is, I believe, the most important policy-relevant debate in economics since John Maynard Keynes’s debate with himself in the 1930s, which transformed him from a monetarist to the apostle of active fiscal policy. I think Summers is largely right – but then, I would, since

J. BRADFORD DELONG is an economist at the University of California, Berkeley and creator of the blog “Grasping Reality.” He was deputy assistant secretary of the Treasury in the Clinton administration.

I have been losing arguments with him since I was 20. What’s needed here, though, is not a referee’s decision, but a guide to the fight.

The immediate macroeconomic problem is how to cure the hangover from the housing bubble in the middle of the first decade of the 21st century – the still-incomplete recovery in the United States and the non-recovery in Europe. But even a straightforward success that restored the growth rate experienced in the 1990s would not restore the world as we thought we knew it.

Do we also suffer from Bernanke’s global savings glut, produced by ill-

coordinated national policies toward recovery? His prescription is reform that gives governments better incentives to pull together in harness. Or is it the hangover from Rogoff’s supercycle of imprudent debt accumulation that can only be remedied by painful deleveraging while building an effective macroprudential regulatory framework to prevent a repeat performance? Or, as Krugman counsels, is the deeper problem our reluctance to use the full panoply of monetary policy and fiscal tools that Keynes and his disciples developed? Or, à la Summers, are our problems more fundamental, requiring a paradigm shift in the means and ends of economic policy?

Successful management of the business cycle, Summers argues, will also require governments to reduce wealth inequality, stimulate more productive societal investment and bear more of the risk that now weighs heavily on households and businesses. Without governments willing to deal with the structural problems, he says, we are doomed to oscillate



CITY COUNCIL BOPROW W.P.A. AND GET PROSPERITY UNDER WAY

A JOB FOR EVERY WORKER

W.P.A. PROJECT FOR THE HOTEL INDUSTRY

REPEAL THE PHI SALES-TAX

WE MADE Philco OWE US OUR JOBS

CITY COUNCIL WANTS WORK ON W.P.A.

Money for Education, Not War

Money for Education, Not War

Such

WAR

JOB FOR ALL PUBLIC WORKS NOW

STUDENTS FREE EDUCATION

OCCUPY UNIVERSITY

EXERCISE YOUR RIGHT TO THE CITY

JOB FOR ALL



between asset bubbles in which much investment is wasted and growth is below sustainable potential, and depression, in which unemployment is high and output is below sustainable potential.

Many other economists have contributed to this debate – notably, Martin Feldstein, Richard Koo, Lars Svensson and Olivier Blanchard. However, with Bernanke, Rogoff, Krugman and Summers, we are already juggling four balls, and that is more than enough.

CAN ECONOMISTS LEARN FAST ENOUGH?

It is a truth too often ignored that economic models and rules of thumb have the functional lifespan of fresh fish on a hot day. Approaches that help us to understand (and would have successfully managed) the business cycle in the past are more likely than not useless, or even worse than useless, for man-

aging the cycle in the future.

Pre-World War I trust in the gold standard, combined with the conviction that business confidence with “her magic wand” (in the words of Alfred and Mary Marshall) must be the highest priority of policy, was disastrous in the changed environment of the interwar years. The tool kits built in the 1930s during the Great Depression focused on the importance of decoupling national economies from an unstable world market, the utility of work-sharing and the potential benefits of cartelization in making businesses viable. They had no application during the long post-World War II boom. And policymakers who viewed those golden years as confirmation of Keynesian fine-tuning as the fix for all seasons left themselves deeply vulnerable in the face of the adverse supply, productivity and expectative shocks of the 1970s.

Everybody, it seems, is inclined to fight today's battle with yesterday's stratagem. Think of the economists who came of age in the 1970s. Ever since then, they have seen inflation, currency debasement, low productivity growth and excessive government deficits lurking at every turn. They have had nothing constructive to offer since 1990.

And what of those who took the long, stable boom of 1984-2006 as an indication that the macroeconomy had undergone a "Great Moderation" and could be managed with a very light policy and regulatory touch? They were blindsided by 2007 and thereafter. Why have economists' business-cycle theories almost invariably been wrong? Well, why should their theories be right?

Inertia and hubris drive economics (and so many other disciplines). Because they were successful in answering past questions, economists place heavy bets at unfavorable odds on the proposition that the major shocks will be of the same type and that changing insti-

tutions will not materially change the way economic shocks are propagated. Of course, the bettors almost always crap out.

Finally, however, there are signs that economists (the smart ones, anyway) are learning that past shocks doesn't tell us much about future ones. They are instead painting possible "if these trends continue" scenarios of major transformations.

Thus, Thomas Piketty of the Paris School of Economics speculates about a scenario in which wealth inequality brings about the end of the social democratic era that began at the start of the 20th century. Robert Gordon of Northwestern looks toward the likely end of the buoyant GDP growth brought on by the second industrial revolution in the late 19th

century and Eric Brynjolfsson of MIT projects a future in which our principal economic problem is not scarcity, but finding useful and meaningful work to do.

THE DEBATE OVER SECULAR STAGNATION

Economists worth listening to are not just saying the future is likely to be different from the past; they are staking out turf as to how it will be different. Of these, the most controversy has been generated by Summers's secular-stagnation thesis.

Summers's analysis is not, however, the right place to start. His interpretation is easier to understand as the most recent in a string of new approaches. The debate really started back in the late 1990s with Krugman's book, *The Return of Depression Economics*. But that puts the cart before the horse. Let's start with what "Depression economics" really replaced.

What might be called "inflation economics" was born of the stagflation of the 1970s and

Why have economists' business-cycle theories almost invariably been wrong? Well, why should their theories be right?

early 1980s and focused on two goals. The first was keeping expectations of inflation low. A central bank that sought to avoid inflation – and all central banks sought to avoid inflation – needed to either keep expectations of inflation low or incur the heavy cost of engineering sufficient unemployment to lower those expectations. Second, subject to that expectations-management constraint, central banks sought to manage interest rates to keep them in the sweet spot where inflation was contained and the gap between actual and

SECULAR STAGNATION

potential output was minimal.

Why manage interest rates? Why couldn't a central bank simply set a neutral monetary policy? Because nudging interest rates to the level at which investment equals savings at full employment is what a properly neutral monetary policy really is. Over the decades, many have promised easier definitions of neutrality, along with a rule for thumb for maintaining it. All had their day: advocates of the gold standard, believers in a stable monetary base, devotees of a constant growth rate for the (narrowly defined) supply of money and believers in a constant growth rate for broad money and credit aggregates. All of those theories were tried and found wanting.

The inflation-economics school of thought paid all due respect (and more) to free markets. First, adherents thought that government distorted markets and caused collateral damage if policymakers pursued goals other than maintaining inflation credibility and,

subject to that, finding the aforementioned sweet spot for interest rates. Second, and in particular: monkeying with spending and taxes to try to balance the economy was asking for trouble. Indeed, double trouble, if the government sought to accomplish its goals by running large deficits that could produce an unsustainable debt burden.

Third, once central banks became the credible guardians of low inflation and learned to manage interest rates to sustain full employment, there was little reason for maintaining the Depression-inspired straitjacket on financial markets. Financial innovation ought to be welcomed—after all, it wasn't the job of government to play nanny to consenting capitalists.

In broad terms, inflation economics defined the worldview shared by three chairmen of the Federal Reserve, Paul Volcker (1979-87), Alan Greenspan (1987-2006) and at least the pre-2009 version of Ben Bernanke (2006-14). Indeed, that was the consensus view of most economists and financiers of influence during



the 1985-2007 period of the Great Moderation.

Across that period, global financial markets bobbed around like rubber ducks in a kiddie pool – remember the 1987 stock market crash, the 1990 savings and loan crisis, the 1994 Mexican crisis, the 1997 East Asian crisis, the 1998 Long Term Capital Management collapse and the 2001 dot-com collapse? Yet the faithful execution of the rule of inflation economics generated solid overall economic performance.

BEN BERNANKE'S GLOBAL SAVINGS GLUT

Although Krugman's warnings of trouble ahead came first, Bernanke's diagnosis in the mid-2000s precedes it in logical sequence. In a series of speeches back in 2005 about the "global savings glut," Bernanke, then a Fed governor (he had yet to be promoted), argued that there was one blemish on the picture of balanced growth of the U.S. economy: the large trade- and current-account deficits. This wasn't a version of your boring uncle's

platitudes on being neither a borrower nor a lender. Bernanke saw a variety of drawbacks in an economy in which, on net, more than one dollar in 20 spent was borrowed abroad.

First, developing economies ought to have been investing their wealth at home, rather than in the United States, in order to boost their own productivity and wages. Second, by depressing interest rates and making Americans feel richer, the incoming torrent of capital boosted both home construction and household consumption and reduced domestic savings that might have financed investment in business productivity. Third, the capital inflow pushed American workers out of export manufacturing, even as it increased U.S. international debts that could only be serviced in the long run by exporting more manufactured goods.

The global savings glut, in Bernanke's view, was driven by multiple factors. For one thing, the aforementioned financial crises that rattled the developing world in the 1980s and





1990s had induced emerging-market countries to borrow less abroad and to park their assets in stable climes. By the same token, financial instability had led the governments of developing economies to conclude they needed much larger liquid reserves. And the natural place to park those assets was the United States, the country with the deepest, most liquid capital markets.

As of the mid-2000s, Bernanke appeared confident that this shift in economic structure was on the whole unfortunate, but not overwhelmingly damaging – and in any event, would be temporary. In a matter of years rather than decades, he suggested, emerging-market governments would acquire the liquid reserves they wanted. Then, international capital flows, and with them asset prices and interest rates, would return to their natural equilibrium.

Bernanke was, of course, wrong in 2005 in his belief that the forces driving hyper-low interest rates were transient. The interaction of

the global savings glut with the deregulated structure of Wall Street and the American housing bubble on the one hand, and the rigid structure of the Eurozone and the wash of capital from Northern to Southern Europe on the other, led to a crash and the Great Recession that may prove to be more damaging than the Great Depression.

Yet today, as the North Atlantic economy is still groping its way forward seven years after the crash, Bernanke continues to hold for the most part to his global savings glut diagnosis of 2005. There is one difference. Back in 2005, Bernanke saw the problem as driven by emerging-market economies attempting to accumulate liquid assets. Today, he writes of falling current-account surpluses in these countries (the good news) offset by growing surpluses in Eurozone countries that reflect Europe's self-destructive determination to stick to fiscal austerity.

He's acknowledged, moreover, that one tenet of inflation economics – that the risk of a disorderly adjustment in financial global markets really does necessitate effective macro-



prudential regulation of finance – was wrong. But other than that, he’s not changed his diagnosis. The global economy, he seems to be saying, suffers from a medium-run distortion in global capital flows and thus of elevated asset prices and depressed interest rates. This distortion could be fixed quickly if surplus countries would adopt more sensible policies. Moreover, even if it is not fixed, it can still be managed.

Bernanke’s diagnosis thus falls into a standard pattern for center-right economists. In his view, if only market prices were not distorted, things would be good. But the government-caused distortions can be dealt with by creating a global political-economic environment that gives the Europeans incentives to play nice.

KRUGMAN CHANNELS KEYNES

Paul Krugman’s analysis differs from Bernanke’s in a number of ways. He sees the problems of the Great Moderation-era economy not as easily correctable missteps but as major structural problems that expose different and very

dangerous vulnerabilities that predate those of the 1970s and 1980s. He views the policies that created Bernanke’s savings glut as rational, given the requisites of successful development. Moreover, unlike Bernanke, he is very worried about the consequent fall in interest rates because it undermines the power of conventional monetary policy. Accordingly, his prescription varies from Bernanke’s appeal of collective reason; what’s needed, he says, is a revival of old-style Keynesian fiscal intervention.

One root of the problem, Krugman argues convincingly, is that that central banks succeeded too well in anchoring inflation expectations. The folks who brought us inflation economics are thus in the position of the dog that caught the car. By inflicting a short but sharp depression on the North Atlantic economy from 1979 to 1984, central banks convinced nearly all economic actors that they would offer zero tolerance for even moderate inflation. And they had subsequently reinforced



the hard line by pursuing policies that pushed inflation to 2 percent or less.

That success created a new vulnerability. With 2 percent inflation, the nominal interest rate consistent with full employment would be about two percentage points higher (4 percent). Now suppose some adverse economic shock – the bursting of a housing bubble and a financial crisis, say – temporarily pushed the interest rate consistent with full employment down by six percentage points. Then the central bank would find it impossible to lower interest rates enough to maintain full employment because the nominal rate couldn't fall below zero. The economy would find itself in what Keynes dubbed a “liquidity trap” – a situation dismissed in the postwar years as a theoretical curiosity – with no obvious levers a central bank could use to boost demand back to full employment.

Way back in 1992, in the wake of the mild 1990-91 recession, Summers and I warned against central bankers' hubris with their success at inflation-expectations management:

Can [monetary] austerity be overdone? ... The relaxation of monetary policy seen over the past three years in the United States would have been arithmetically impossible had inflation and nominal interest rates both been three percentage points lower in 1989. Thus a more vigorous policy of reducing inflation to zero in the mid-1980s might have led to a recent recession much more severe than we have, in fact, seen.

It is difficult to read the macroeconomic history of the past decade as anything other than vindication of DeLong/Summers-as-Cassandra. A similar reading of events lies be-

hind the calls by, among others, the IMF's chief economist, Olivier Blanchard, for an inflation target as high as 4 percent.

If the policy announcement is credible, a two percentage point increase in the inflation target would have the same stimulus effect as a further two percentage point reduction in interest rates. A second unorthodox route to that end: mammoth “quantitative easing,” in the form of massive purchases of long-term government and government-guaranteed securities with the goal of narrowing the gap between long- and short-term interest rates. With that in mind, back at the start of the 1990s, Summers was willing to trust that technocratic central banks under loose political reins could guard against both the inflationary dysfunctions of the 1970s and the depression-prone dysfunctions of the 1930s.

Live and learn. The consensus has become that quantitative easing works, but only weakly. Reliance on monetary policy as an adequate tool for macroeconomic management thus

Larry Summers was willing to trust that technocratic central banks under loose political reins could guard against both the inflationary dysfunctions of the 1970s and the depression-prone dysfunctions of the 1930s.

required that the central bankers could talk the public into raising its expectation of inflation. And because he feared that they couldn't, Krugman believed that Depression economics, complete with the liquidity trap, had returned.

Krugman is not as alone in his fears. For while the economics profession may still be relatively sanguine about the Fed's prospects for guiding us back to full employment, it is

SECULAR STAGNATION

difficult to find many economists who are optimistic about the ability of a central bank to boost a deeply depressed economy operating at the zero lower bound on interest rates by changing inflation expectations.

Central bankers are chosen from among those who are deeply averse to abandoning what they see as the expensive success (in terms of the excess unemployment) of reducing expected inflation to 2 percent. Raising that anchor, they fear, would return us to the bad old days of the 1970s, when relatively small missteps might trigger an inflationary spiral that required a deep and prolonged recession to untangle.

Market observers know that central bankers love their inflation anchors. Thus, as Krugman put it, bankers “promising to be irresponsible” are unlikely to be believed. From Krugman’s perspective, then, Bernanke’s global-savings-glut assessment is much too optimistic. Krugman has recommended aggressive use of expansionary fiscal policy to get economies out of the liquidity trap once they fall in. He also favors vigorous use of exchange-rate and nonstandard monetary policies in these circumstances, though with less confidence than he has in fiscal policy. And he has called for higher inflation targets to create more maneuvering room to prevent a fall into a liquidity trap in the first place.

But when he wrote the book, in 1998, he had little confidence in the ability of these policy shifts to eliminate the dangers of Depression economics. And with hindsight, it appears that he was 100 percent right.

ROGOFF’S SUPERCYCLE OF DEBT

Rogoff’s diagnosis, the third in the logical sequence (after Bernanke’s and Krugman’s), was originally conceived as a critique of Krugman’s interpretation of Japan’s lost decades of

no growth and no inflation. The problems Krugman described were transitory, Rogoff thought, at least in the medium-run sense. They could have been avoided when they occurred and could be avoided in the future by appropriate macroprudential regulation to avoid the buildup of excessive debt. Once the crisis hit, Rogoff argued, policies to rapidly deleverage economies could reduce the trauma but not eliminate it. In large measure, the situation simply needed to be toughed out.

Rogoff has consistently viewed what Krugman sees as a long-term vulnerability to Depression economics as the temporary consequences of failures to properly regulate debt accumulation. Eventually, a large chunk of debt thought of as relatively safe is revealed to be risky, and financial markets choke on the lump. As the riskiness of the debt structure is revealed, interest rate spreads go up – which means that interest rates on assets already known to be risky go up, and interest rates on assets still believed to be safe go down.

It is the debt-accumulation cycles, Rogoff argues, that cause the stagnation problem. They inevitably end in a morass of distressed loans, which is what creates the economy’s vulnerability to the zero-bound problem. The consequences look like those of Krugman’s Depression economics, but the cause is simply too much risky debt. Deleveraging can be helped along by government-enforced debt write-downs and other heterodox policies. But it cannot be avoided.

Rogoff argues that this “debt supercycle model matches up with a couple of hundred years of experience.” There is, in his view, nothing new or unusual in the post-2008 reaction to the financial crisis. Debt accumulation, the consequent enormous rise in risk spreads and a long depressed slog while the overhang poisons investment and aggregate demand are simply par for the course.

Rogoff's assessment comes with an implicit prediction that interest rates will now rapidly normalize. In his view, the Fed is, if anything, behind the curve in postponing its first hike in the interest rates until the end of 2015. By this reckoning, the Fed's big problem in two years is more likely to be incipient inflation than rising unemployment.

If Bernanke's policy recommendations are a combination of macroprudential financial regulation and exhortation of governments to play by the rules, and Krugman's policy recommendations are a return to Keynesian reliance on expansionary fiscal policy at the zero lower bound for interest rates, Rogoff's recommendations for policy are more complex – and a bit muddled.

Rogoff calls for a higher inflation target, along with a willingness to break the pattern when circumstances change, for he believes that “central banks were too rigid with their inflation target regimes” when the crisis hit. And he calls for aggressive debt write-downs – both private and public – along with aggressive macroprudential policies to prevent a repeat performance.

But Rogoff seems confused (or at least inconsistent) on the role of fiscal policy when the economy is in a liquidity trap. He sounds like Krugman when he says that fiscal policy “was initially very helpful in avoiding the worst of the crisis, but then many countries tightened prematurely.” And he still sounds like Krugman when he acknowledges that, “With low real interest rates, and large numbers of unemployed (or underemployed) construction workers, good infrastructure projects should offer a much higher rate of return than usual.”

But he hedges, wondering whether the ballooning risk spreads that make safe debt such a bargain and infrastructure investment so tempting reflect economic conditions accu-

rately. “In a world where regulation has sharply curtailed access for many smaller and riskier borrowers, low sovereign bond yields do not necessarily capture the broader ‘credit surface’ the global economy faces,” he says.

I have a difficult time untangling Rogoff's analysis. Surely if good public investments are even better deals in a crisis, mediocre public investments cross the line to acceptable deals. Surely there is little to fear when interest rates are low and the central bank has

Market observers know that central bankers love their inflation anchors. Thus, as Krugman put it, bankers “promising to be irresponsible” are unlikely to be believed.

the power to print money to pay off the debt, if necessary, to avoid a rollover crisis.

And you may point out: extraordinary foreign demand today for dollar-denominated securities as safe, liquid stores of value are not just the consequence of a supercycle of excessive debt issue. They reflect the insane austerity and secular stagnation in Europe. They also reflect the global imbalances caused by China's rapid export-led growth and potential political instability.

If you were to say all that, you would not be Ken Rogoff, but Paul Krugman. And you would be well on the road toward agreeing with Summers.

SUMMERS'S LEAP

“Secular stagnation” was a bad phrase for Summers to have chosen to label the position

SECULAR STAGNATION

he has staked out. He wanted to evoke association with Keynes's disciple, Alvin Hansen, who in the wake of World War II worried that declining population and productivity growth would reduce the rate of profit and the incentive to invest, and so create an economy that was trapped in Krugman-style Depression economics by a permanent insufficiency of investment to sustain full employment demand. But the mechanisms that Summers points to are different from those of Hansen. He should, at the least, have called it "Secular Stagnation II."

Summers's core worry is not about the immediate aftermath of a crisis. Nor is it just about the medium run of the unwinding of a debt supercycle or of Bernanke's government-reserve accumulation that produces a glut in savings. It 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 low expectations, central banks reduce interest rates to accommodate those expectations and governments follow sensible fiscal policies, the private financial markets will lack sufficient appetite for risk 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. 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 six underlying causes:

1. Technological and demographic stagnation that lowers the return on investment and pushes desired investment spending down too far.

2. 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.

3. 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.

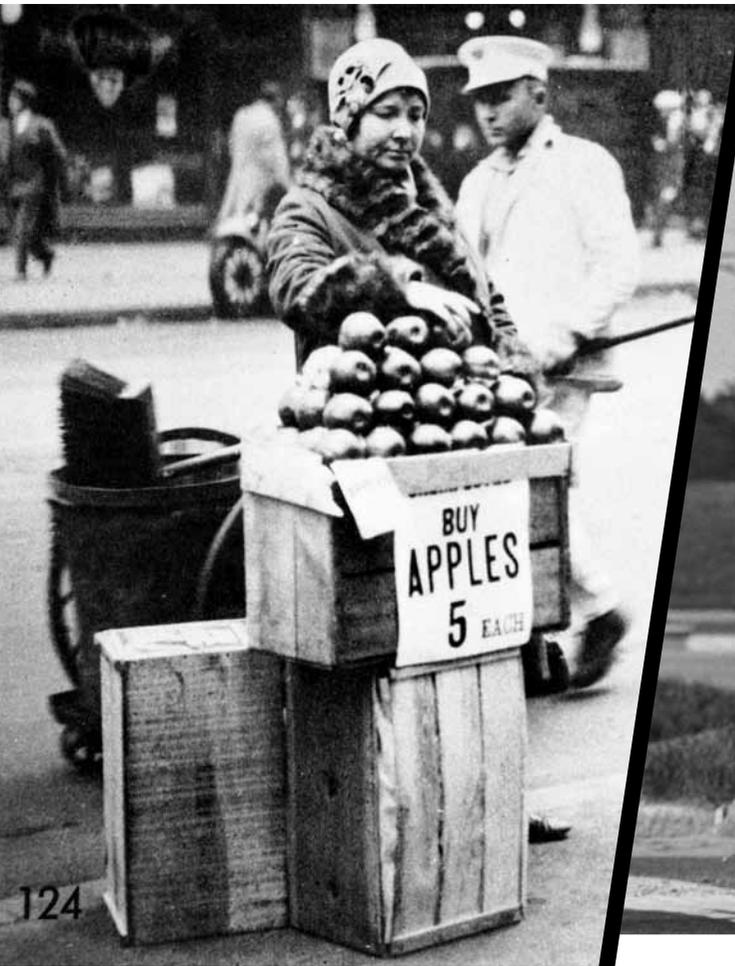
4. High income inequality, which boosts savings too much because the rich can't think of other things they'd rather do with their money.

5. Very low 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.

6. 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.

Hansen focused on cause-one; Rogoff focuses on cause-six, in the form of his debt supercycle; and Krugman focuses on five and six. Summers has, at different moments, pointed to each of the six causes.

It is to Summers that we have to look to see why this confluence of Depression economics symptoms has emerged now – and why it is turning out to be such a deep and stubborn problem. For it is not just one or many of Feldstein's causes – or for that matter, Bernanke's badly behaving governments that don't qualify for the list – that lie at the root of the problem. It is that historical trends right now are driving all of these potential causes together, and are driving them in the same direction.



LEFT: ©HERITAGE IMAGE PARTNERSHIP LTD/ALAMY. RIGHT: ©VESPASIANI/ALAMY

Thus Summers seeks to dive deeper. The policy changes he has in mind are different from standard supply-side measures or demand-side reliance on temporary expansionary fiscal policy or raising the inflation target.

Summers dismisses the largely Republican focus on “deep supply-side fundamentals: the skills of the workforce, companies’ capacity for innovation, structural tax reform and ensuring the sustainability of entitlement programs,” which he calls “unlikely to do much” in any reasonable time frame. He also dismisses the fix of higher inflation targets that would allow central banks to push real interest rates into negative territory via conventional monetary policy: “A growth strategy

that relies on interest rates significantly below growth rates for long periods virtually ensures the emergence of substantial financial bubbles and dangerous buildups in leverage.” Moreover, he asserts that the idea macroprudential regulation would “allow the growth benefits of easy credit to come without cost is a chimera.”

Instead, he wants the government to step up to the plate across a very broad range of initiatives. Why does it have to be the government? Is it really the case that there aren’t enough good private investment opportunities in America? Or would it be better to say that there aren’t enough good *relatively safe* private investment opportunities in America? Or would it be better to say that there is now a large-scale

SECULAR STAGNATION

systematic failure to mobilize the economy's risk-bearing capacity? Yes, yes and yes.

The government should thus be taking advantage of the global savings glut to borrow and spend, Summers argues.

The [approach] that holds the most promise is 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 ... ending the disastrous trends toward ever-less government spending and employment each year and taking advantage of the current period of economic slack to renew and build out our infrastructure.

What's more, he says, "If the federal government had invested more over the past five years, the U.S. debt burden relative to income would be lower; allowing slackening in the economy has hurt its long-run potential."

In this view (which I share), more of the risk-bearing and long-term investment-planning and investing role needs to be taken over by governments. We strongly believe that governments with exorbitant privilege that issue the world's reserve currencies – notably, the United States – can take on this role without any substantial chance of loading future taxpayers with inordinate debt burdens. But the government should be doing more to prevent stagnation.

- It needs to take aggressive action to reduce income and wealth inequality in order to get money into the hands of those who will spend it rather than save it.

- It needs to invest more in research to supplement the pace of privately driven technological progress.

- It needs to curtail the power of NIMBY (not-in-my-backyard) interests that make some productive investments unprofitable.

The reason for government investment is not your garden-variety, the-benefits-exceed-

the-costs rationale, but because full employment depends on it. Thus, for example, Summers calls for very active environmental regulation. Full employment requires finding something expensive to invest in, and fighting global warming is the most useful thing that is likely to be expensive enough to make a difference.

Some say that investments to fight global warming should be made slowly, postponed until better science gives us a better handle on the problem. Summers finesses this argument, pointing out that the cost of the resources invested would be very low as long as the economy is stuck below full-employment equilibrium. Thus he sees a need for carbon taxes to accelerate the phaseout of coal power, which need to be much more than offset by spending to accelerate the buildup of renewable energy sources and other carbon-sparing energy technologies.

In Summers's view, the experience of the last two decades – the oscillation between a dangerously depressed economy and a dangerously bloated bubble economy, with seemingly no ability to find or maintain the sweet spot – is not inevitable. But the problems are deeper than the market and political dysfunctions diagnosed by Rogoff and Bernanke, and not as easily cured by pure demand-management policies as one might conclude from Krugman.

That does leave a loose end. Why would a higher inflation target – one that would allow monetary policy to pack a bigger punch – not be sufficient? Summers's explanation is a tad esoteric.

In his view, 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

Full employment requires finding something expensive to invest in, and fighting global warming is the most useful thing that is likely to be expensive enough to make a difference.

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. And with the right sorts of government intervention discussed above, there is no need to sacrifice it. A mix of income redistribution, mobilization of the economy’s entrepreneurial risk-bearing capacity and an infrastructure-oriented fiscal policy could do the job.

Is there a strong argument against Summers’s reading of the situation or his recommended policies? The alternatives offered above, a nudge in the global adjustment process à la Bernanke or Rogoff (in the hope that “secular stagnation” isn’t secular after all) or a Krugman-style fix that relies on more aggressive monetary and fiscal intervention don’t convince me.

NIHILISM IS NOT A POLICY

A better case against Summers’s policy recommendations is rooted in general skepticism about his reliance on increased government intervention. The argument isn’t that more spending by a competent government would not work, but rather that the government isn’t sufficiently competent or is too encumbered by interest groups to make it work. By this reckoning, additional government investment is worse than useless in a contemporary free-market democracy for the same reasons that

government investment in, say, hopelessly inefficient steel mills or railroads to nowhere was worse than useless in the crony-Socialist environment of the Soviet Union.

The view that any expansion of the government’s role in the economy is bound to make us worse off certainly has its supporters among public-choice economists as well as among red-meat Republican conservatives. But I agree with Summers that the public-choice economists have taken solid explanations for government failure and driven them “relentlessly towards nihilism in a way that isn’t actually helpful for those charged with designing regulatory institutions,” or, indeed, “making public policy in general.”

Nihilism grounded in theoretical first principles is simply not a useful guide to policy. We will not know the limits of government action to remove the structural impediments that have produced our vulnerability to secular stagnation until we try them. 