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Washington must not settle for secular stagnation

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By Lawrence H. Summers

We may, as I argued last month in the Financial Times, be in a period of "secular stagnation" in which sluggish growth and output, and employment levels well below potential, might coincide for some time to come with problematically low real interest rates.

Since the start of this century, annual US gross domestic product growth has averaged less than 1.8 per cent. The economy is now operating nearly 10 per cent – or more than \$1.6tn – below what was judged to be its potential as recently as 2007. And all this is in the face of negative real interest rates for terms of more than five years and extraordinarily easy monetary policy.

It is true that even some forecasters who have had the wisdom to remain pessimistic about growth prospects for the past few years are coming around to more optimistic views in 2014 – at least in the US. This is encouraging but should be qualified by the recognition that, even on optimistic forecasts, output and employment will remain well below previous trend for many years. More troubling, even with today's high degree of slack in the economy, and with wage and price inflation slowing, there are signs of eroding credit standards and inflated asset values. If we were to enjoy years of healthy growth under anything like current credit conditions, there is every reason to expect we would return to the kind of problems we saw in 2005-07 long before output and employment returned to trend or inflation picked up again.

So the secular stagnation challenge is not just to achieve reasonable growth but to do so in a financially sustainable way. There are, essentially, three approaches.

The first would emphasise what is seen as the deep supply-side fundamentals – labour force skills, companies' capacity for innovation, structural tax reform and assuring the long-run sustainability of entitlement programmes. All of this is appealing – if politically difficult – and would indeed make a great contribution to the economy's health in the long run. But it is unlikely to do much in the next five to 10 years. Apart from obvious delays – it takes time for education to operate, for example – our economy is held back by lack of demand rather than lack of supply. Increasing our capacity to produce will not translate into increased output unless there is more demand for goods and services. Training programmes or reform of social insurance may, for instance, affect which workers find jobs but they will not affect how many find jobs. Indeed, measures that raise supply could have the perverse effect of magnifying deflationary pressure.

The second strategy, which has dominated US policy in recent years, is lowering relevant interest rates and capital costs as much as possible and relying on regulatory policies to assure financial stability. The economy is far healthier now than it would have been in the absence of these measures. But a strategy that relies on interest rates significantly below growth rates for long periods of time virtually guarantees the emergence of substantial bubbles and dangerous build-ups in leverage. The idea that regulation can allow the growth benefits of easy credit to come without the costs is a chimera. It is precisely the increases in asset values and increased ability to borrow that stimulate the economy that are the proper concern of prudential regulation.

The third approach – and the one that holds 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. This means ending the disastrous trend towards ever less government spending and employment each year – and taking advantage of the current period of economic slack to renew and build up our infrastructure. If the government had invested more over the past five years, our debt burden relative to our incomes would be lower: allowing slackening in the economy has hurt its potential in the long run.

Raising demand also means seeking to spur private spending. There is much that can be done in the energy sector to unleash private investment on both the fossil fuel and renewable sides. Regulation that requires the more rapid replacement of coal-fired power plants will increase investment and spur growth as well as helping the environment. And in a troubled global economy it is essential to ensure that a widening trade deficit does not excessively divert demand from the US economy.

Secular stagnation is not an inevitability. With the right policy choices, we can have both reasonable growth and financial stability. But, without a clear diagnosis of our problem and a commitment to structural increases in demand, we will be condemned to oscillating between inadequate growth and unsustainable finance. We can do better.

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