Are advanced economies stagnating?: a quick guide

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This Quick Guide provides a brief overview of the current debate about whether advanced economies are caught in a period of protracted slow growth or if there are grounds to be more optimistic.

What is ‘secular stagnation’?

Robert Solow has defined ‘secular stagnation’ as ‘a persistent tendency for a national economy (or group of them) not only to grow slowly but more particularly to find it difficult or impossible to use fully its productive potential’.

The notion of secular stagnation is not new: it can be traced back to American economist Alvin Hansen writing on the eve of World War II. Hansen argued the Great Depression was not a temporary downturn, rather ‘we are passing, so to speak, over a divide which separates the great era of growth and expansion of the nineteenth century’ from a new unknown era. His particular concern was that slower population growth, a shortage of new lands to settle and blockages to technical progress would mean investment would not be sufficient to achieve full employment of America’s resources. The risk was secular stagnation, the essence of which is ‘sick recoveries which die in their infancy and depressions which feed on themselves and leave a hard and seemingly immovable core of unemployment’.

That things did not turn out as Hansen predicted does not necessarily debunk the idea of secular stagnation. World War II and the immediate post-war era provided enormous stimulus to the American economy, which Hansen could not have foreseen. Hansen’s underlying idea that secular ‘headwinds’ may be sufficiently strong at times to cause economies to experience a protracted period of slow growth remains a possibility.

Interest in secular stagnation was famously revived by Larry Summers at the International Monetary Fund’s research conference in November 2013. He posed the question of whether the idea of secular stagnation might not be ‘profoundly important in understanding Japan’s experience in the 1990s, and may not be without relevance to America’s experience today’.

Why are people concerned about secular stagnation?

More than six years after the onset of the Global Financial Crisis (GFC) the global economy has yet to shake off its malaise. The Bank for International Settlements (BIS) has argued that the slowness of the recovery is not surprising because financial crises generally cause deeper and longer recessions than ordinary business cycle recessions and are followed by much slower recoveries. Nevertheless, there remains considerable concern about the medium to long-term growth prospects of the advanced economies and the spectre of secular stagnation.

Part of the concern is what a protracted period of slower growth would mean for future living standards. Andrew Haldane notes that economic growth remains the single most important determinant of rising societal living standards. Given this he argues the current debate about economic growth is one of the ‘key issues of our time’.

Summers argues secular stagnation raises the possibility that it may be impossible for an economy to ‘achieve full employment, satisfactory growth, and financial stability simply through the operation of conventional monetary policy’. In response to a negative demand shock one would normally expect interest rates to fall until savings and...
investment are once again in balance at full employment. However, if the real interest rate is already low it is possible the rate needed to achieve full employment is negative and not consistently achievable.

Further, Summers argues even if the real interest rate consistent with full employment is positive it may be so low as not to be compatible with financial stability. He observes that low interest rates increase risk-taking on the part of investors, promote irresponsible lending practices and make Ponzi financial structures look relatively attractive.

Paul Krugman has flagged the possibility the US economy may have been trending towards negative interest rates for some time, arguing that in recent decades periods of economic expansion have been largely driven by repeated ‘bubbles’.

So how can you reconcile repeated bubbles with an economy showing no signs of inflationary pressures? Summer’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.1

**What are some of the possible causes of secular stagnation?**

Several possible explanations have been advanced as to why growth among the advanced economies continues to be disappointing and may prove difficult to revive in a sustained way.

One explanation is that demand is not sufficiently strong to achieve the full employment of advanced economies’ resources. To be credible as an explanation of secular stagnation arguments along these lines have to be able to explain why demand consistently falls short of what is required to ensure an economy achieves its long-run growth potential and is not simply a temporary aberration.

- One possible explanation is growing income inequality within advanced economies. Stephanie Lo and Kenneth Rogoff note this headwind implies that over time the relative spending power of low-income households, which have a high propensity to consume, may have declined.

- A further possible explanation is that there has been a decline in the long-run growth potential of advanced economies. This line of reasoning focuses attention on the supply-side and in particular changes in the growth of productive inputs and how efficiently they are combined to produce outputs. Here a number of potential headwinds may be relevant, including:
  - The argument innovation may be slowing has attracted much attention and is discussed separately below. To the extent this is the case the technological frontier may no longer be expanding as fast as it once did. Lo and Rogoff note this would mean productivity growth, ‘the ultimate engine of per capita output growth, may be fading’.
  - Increasing income inequality is also relevant to the supply side. Haldane points out rising income inequality potentially erodes both social and human capital. Increasing income inequality may undermine those relationships, institutions, shared norms, values and understandings that help facilitate trust, cooperation and social cohesion so essential to a well-functioning modern economy. It may also erode human capital for example by dampening investment in education by poorer households.
  - Some argue advanced economies have not invested sufficiently in education and training and infrastructure. In relation to infrastructure Haldane notes in advanced economies ‘public investment has been on a gently downwards path for the past three decades’. Barry Eichengreen points out that while the empirical literature on infrastructure, education and economic growth is less than fully conclusive ‘intuitively we know that there is something here; we just don’t know how much’.
  - Haldane raises the interesting possibility that ‘short-termism’ may be on the rise, which could work against the patient accumulation of all types of capital. He posits the information revolution may have come at the cognitive cost of shorter attention spans. As well as being detrimental for capital accumulation it could also reduce creativity, with potentially negative flow-on effects for research and innovation.

Robert Gordon argues headwinds are ‘uniquely country specific’. For example, his work on the US suggests the list includes the effects of demographic shifts; challenges relating to education; increasing inequality; and high levels of household and government indebtedness.

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Are there other possible explanations for why growth has yet to bounce back?

Secular stagnation is only one possible explanation for why slow growth persists across many advanced economies. Lo and Rogoff have provided a useful summary of other possible causes including: slowing population growth; heightened policy uncertainty; the effects of policy errors made in response to the GFC; and the effects of the remaining post-GFC debt ‘overhang’ (i.e. the persistence of significant pockets of private, external and public debt). It is possible some combination of these influences may be at work.

Having reviewed the evidence Lo and Rogoff argue the most likely explanation for why growth has taken so long to normalise is there remains a significant debt overhang. In the years prior to the GFC there was a significant build-up of public and private sector debt in many advanced economies. This has yet to fully unwind and is a drag on growth. Moreover there is the potential for countries to get trapped in a vicious cycle: slower growth makes deleveraging more difficult, which in turn feeds back into continued slow growth. The authors observe that deleveraging post-GFC has been a common experience across advanced countries and the tightening of fiscal policy in response to debt may be important in understanding the subsequent slowdown in growth.

What about innovation and technological change?

Even if there are secular ‘headwinds’ detracting from growth it is possible technological change could still drive a sustained increase in economic growth. What matters is the pace of technological change and its potential to spur stronger productivity growth. This is a keenly contested dimension of the broader growth debate.

At one extreme are the ‘ techno-optimists’ who argue we are on the verge of an inflection point in history and the pace of technological change will accelerate from here. Joel Mokyr argues, for example, that technological advances in areas such as computing, materials and genetic engineering will prove the growth pessimists wrong. Among other things Mokyr contends past scientific advances have equipped us with tools which have enormous potential. Indeed, he argues that in the long-run the indirect effects of science on productivity through these tools may end up dwarfing the direct effects.

Compared to the tools we have today for scientific research, those of Galileo and Pasteur look like stone-age tools. Yes, we build far better microscopes and telescopes and barometers today, but digitalisation has penetrated every aspect of science. It has led to the re-invention of invention. It is not just ‘IT’ or ‘communications’. Huge searchable databanks, quantum chemistry simulation, and highly complex statistical analysis are only some of the tools that the digital age places at science’s disposal. Digital technology is everywhere, from molecular genetics to nanoscience to research in medieval poetry. Quantum computers, still quite experimental, promise to increase this power by orders of magnitude.²

Mokyr considers the interplay between science and technology creates a self-reinforcing or auto-catalytic process that ‘seems unbounded’. As science moves into new areas and solves new problems, waiting in the wings are the inventors, engineers and entrepreneurs ready to turn the new knowledge into useful things.

At the other extreme are the ‘techno-sceptics’ such as Robert Gordon. He argues it is useful to think of the innovation process as a ‘series of discrete inventions followed by incremental improvements which ultimately tap the full potential of the initial invention’. He notes that while the Second Industrial Revolution ran from only 1870 to 1900 in terms of epochal inventions (the electric light bulb; running water and sewers; and the internal combustion engine), exploiting the full potential of these inventions helped power growth through to 1972. In contrast Gordon contends the Third Industrial Revolution associated with the computer and internet revolution that began around 1960 has already largely run its course. He observes:

Invention since 2000 has centred on entertainment and communication devices that are smaller, smarter, and more capable, but do not fundamentally change labour productivity or the standard of living in the way that electric light, motor cars, or indoor plumbing changed it.³

Looking ahead Gordon is sceptical about claims we are about to see a rapid acceleration in technological change. His take on the data is that technological change seems to be slowing down not speeding up. Moreover, he rejects arguments the future of technology cannot be forecast and examines the likely potential of several technologies commonly cited as future game changers: medical advances, small robots, 3-D printing, big data and artificial

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intelligence. He questions whether these technologies will have the same productivity effects of previous transformative inventions.

Gordon is not arguing that there won’t be further technological advances but that in the case of the US the positive growth effects from future innovation will not be sufficiently strong to offset the negative effects of the growth headwinds. Consequently, Gordon is forecasting US growth over the next 20 to 50 years will be markedly slower than its long-run average through to 2007.

**What are the implications for public policy?**

There is sufficient uncertainty about the advanced economies’ future growth prospects to take seriously the possibility of a protracted period of slow growth. Haldane observes:

> Today, the growth picture is foggier. We have fear about secular stagnation at the same time as cheer about secular innovation. The technological tailwinds to growth are strong, but so too are the sociological headwinds. Buffeted by the cross-winds, future growth risks becoming suspended between the mundane and the miraculous.⁴

Even if it turns out that at some point we are able to look back at this debate as nothing more than a bad case of GFC-induced ‘hypochondria’ it may still have served a useful purpose to the extent it has highlighted that continued growth cannot be taken for granted. Lo and Rogoff point out that understanding the individual drivers of the slowdown in economic growth is likely to be crucial to evaluating potential policies. In this regard, Robert Gordon’s work suggests that while there may be some commonality advanced economies are likely to have to put in place policies to address their own particular set of headwinds.

In trying to synthesise the current debate Coen Teulings and Richard Baldwin distinguish between policies they argue unquestionably support long run growth and other areas of policy requiring a rethink. Among the former are reforms to improve the education system, investing in physical infrastructure, removing barriers to labour mobility, increasing incentives for low skilled workers to participate in the labour market and applying anti-monopoly policies to reduce the profit margins of new IT industries.

More controversially, Teulings and Baldwin call for a rethink of the conduct of monetary and fiscal policies; the retirement age; and public pensions and health care insurance systems.

Lo and Rogoff also acknowledge there are a wide range of views on how public policy should be calibrated, observing that while there are ‘some areas of broad agreement, including the need for greater public spending on high-return infrastructure projects and on improving the quality of education at all levels’ there is far less agreement about ‘debt restructuring, fiscal stimulus, redistribution and structural reform’.

If it turns out it is largely a story about the lingering effects of the debt overhang, the policy challenges are still large. Lo and Rogoff argue ‘exploring ways to continue advancing private sector deleveraging, without excessively eroding the capacity of the public sector to backstop the system and handle catastrophes, remains an important challenge in restoring growth’.

If Gordon and others are right and a broader set of constraints are at play what is likely to separate the stronger performing advanced economies from the rest over coming decades will be policies that seek to maximise the productivity pay-off from technological change and ensure they suffer less from the growth headwinds. From a fiscal policy perspective Paulo Mauro emphasises the need to refocus public spending in ways which are pro-growth while ensuring overall spending remains affordable in a lower growth environment. He sees this challenge as ‘one of the defining policy challenges of the next decade’.

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