Sluggish Future

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YOU are reading this because of the long, steady decline in nominal and real interest rates on all kinds of safe investments, such as US Treasury securities. The decline has created a world in which, as economist Alvin Hansen put it when he saw a similar situation in 1938, we see "sick recoveries… die in their infancy and depressions… feed on themselves and leave a hard and seemingly immovable core of unemployment…" In other words, a world of secular stagnation. Harvard Professor Kenneth Rogoff thinks this is a passing phase—that nobody will talk about secular stagnation in nine years. Perhaps. But the balance of probabilities is the other way. Financial markets do not expect this problem to go away for at least a generation.

Eight reinforcing factors have driven and continue to drive this long-term reduction in safe interest rates:

1. ***Higher income inequality,*** which boosts saving too much because the rich can't think of other things to do with their money;

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

3. ***Nonmarket actors*** whose strong demand for safe, liquid assets is driven not by assessments of market risk and return, but by political factors;

4. ***A collapse of risk-bearing capacity*** as a broken financial sector finds itself overleveraged and failing to mobilize savings, thus driving a large wedge between the returns on risky investments and the returns on safe government debt;

5. ***Very low actual and expected inflation,*** which means that even a zero safe nominal rate of interest is too high to balance desired investment and planned saving at full employment;

6. ***Limited demand for investment goods, coupled with rapid declines in the prices of those goods,*** which puts too much downward pressure on the potential profitability of the investment-goods sector;

7. ***Market failure in the information economy***—which means markets cannot properly reward those who invest in new technologies, even when the technologies have enormous social returns—which lowers the private rate of return on investment and pushes desired investment spending down too far;

8. ***Increasing technology- and rent-seeking-driven obstacles to competition,*** which make investment unprofitable for entrants, and market cannibalization possible for incumbents.

The result is that with rates so close to zero, central banks can no longer easily and effectively act to maintain full employment by cutting interest rates in recessions. Central banks typically—and powerfully—operate by buying and selling bonds for cash to encourage investment spending by leading the value of assets in the future to be higher and encourage consumption spending by making people feel richer. But when there is little room for cutting rates central banks are reduced to using novel, uncertain, and much weaker tools to try to guide the economy.

The magnitude of this decline in safe rates since 1990 is demonstrated by US Treasury securities. The short-term annual interest rate has fallen from 4 percent to 1.2 percent in real (inflation-adjusted) terms and from 8 to 0.5 percent in nominal terms, with long-term rates following them down.

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The natural response to this secular stagnation is for governments to adopt much more expansionary tax and spending (fiscal) policies. When interest rates are low and expected to remain low, all kinds of government investments—from bridges to basic research—become extraordinarily attractive in benefit-cost terms, and government debt levels should rise to take advantage of low borrowing costs and provide investors the safe saving vehicles (government bonds) they value. Harvard's Lawrence Summers argues that interest rates are so low that the inability of central banks to conduct effective monetary policy has become a chronic condition. He says that there is no sign we will emerge from this state for a generation, and so we should adopt appropriate fiscal policies that provide for expansionary investment the private sector is reluctant to undertake.

Critics of Summers's secular stagnation thesis miss the point. Each seems to focus on one of the eight factors driving the decline in interest rates and then say that factor either will end soon or is healthy for some contrarian reason.

Since the turn of the century, the North Atlantic economies have lost a decade of what we used to think of as normal economic growth, with secular stagnation the major contributor. Only if we do something about it is it likely that in nine years we will no longer be talking about secular stagnation. ■