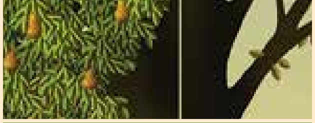

Policy Is the Problem

John B. Taylor

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SECULAR stagnation has been the subject of much debate ever since 2013, when Lawrence Summers proposed the hypothesis "that the economy as currently structured is not capable of achieving satisfactory growth and stable financial conditions simultaneously."

Speaking at a recent conference, Summers posited that for the past decade and a half, the economy had been constrained by a "substantial increase in the propensity to save and a substantial reduction in the propensity to spend and invest," which were keeping equilibrium interest rates and economic growth low.

Few dispute that the economy has grown slowly in recent years, especially when the financial crisis is taken into account. But secular stagnation as an explanation for this phenomenon raises inconsistencies and doubts.

Low policy interest rates set by monetary authorities, such as the US Federal Reserve, before the financial crisis were associated with a boom characterized by rising inflation and declining unemployment—not by the slack economic conditions and high unemployment of secular stagnation. The evidence runs contrary to the view that the equilibrium real interest rate—that is, the real rate of return required to keep the economy's output equal to potential output—was low prior to the crisis. And the fact that central banks have chosen low policy rates since the crisis casts doubt on the notion that the equilibrium real interest rate just happened to be low. Indeed, in recent months, long-term interest rates have increased with expectations of normalization of monetary policy.

For a number of years going back to the financial crisis, I and others have seen a more plausible reason for the poor economic growth—namely, the recent shift in government economic policy. Consider the growth in productivity (output per hour worked), which along with employment growth is the driver of economic growth. Productivity growth is depressingly low now—actually negative for the past four quarters. But there is nothing secular about this. Indeed, there have been huge swings in productivity in the past: the slump of the 1970s, the rebound of the 1980s and 1990s, and the current decline.

These shifts are closely related to changes in economic policy—mainly supply-side or structural policies: in other words, those that raise the economy's productive potential and its ability to produce. During the 1980s and 1990s, tax reform, regulatory reform, monetary reform, and budget reform proved successful at boosting productivity growth in the United States. In contrast, the stagnation of the 1970s and recent years is associated with a departure from tax reform principles, such as low marginal tax rates with a broad base, and with increased regulations, as well as with erratic fiscal and monetary policy. During the past 50 years, structural policy and economic performance have swung back and forth together in a marked policy-performance cycle.

To see the great potential for a change in policy now, consider the most recent swing in productivity growth: from 2011 to 2015 productivity grew only 0.4 percent a year compared with 3.0 percent from 1996 to 2005.

Why the recent slowdown? Growth accounting points to insufficient investment—amazingly, capital per worker declined at a 0.2 percent a year clip from 2011 to 2015 compared with a 1.2 percent a year increase from 1996 to 2005—and to a decline in the application of new ideas, or total factor productivity, which was only 0.6 percent during 2011–15 compared with 1.8 percent during 1996–2005.

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To reverse this trend and reap the benefits of a large boost to growth, the United States needs another dose of structural reform—including regulatory, tax, budget, and monetary—to provide incentives to increase capital investment and bring new ideas into practice. Such reforms would also help increase labor force participation and thus raise employment, further boosting economic growth.

While the view that policy is the problem stands up to the secular stagnation view, the ongoing debate suggests a need for more empirical work. The recent US election has raised the chances for tax, regulatory, monetary, and perhaps even budget reform, so there is hope for yet another convincing swing in the policy-performance cycle to add to the empirical database. ■