A silver lining of Covid: the demise of the secular stagnation hypothesis?

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1. Introduction

For more than a decade now, the advanced countries have operated with ultra-low interest rates, even negative in the Eurozone, Denmark, Switzerland and, for a while, Sweden. Central banks have tried hard to raise inflation to their stated targets but many failed. This has been a strange world where lenders pay borrowers to accept their monies and central banks find that inflation is too low and yet are unable to lift it up.

A sizeable economics literature has been devoted to explaining the phenomenon. The most generally thesis is that the advanced economies have entered a long-lasting period of secular stagnation, characterized by low growth, minimal inflation and very low interest rates. This hypothesis carries very important implications.

One implication is that interest rates will remain low. It matters a great deal for the conduct of monetary. Permanently low interest rates cut the room for maneuver of central banks when they face a cyclical slowdown. With interest rates stuck at the effective lower bound – slightly above or below zero – they have resorted to Quantitative Easing (QE), flooding the financial markets with liquidity in the hope of encouraging private borrowing but the response has been largely disappointing. The combination of ultra-low interest rates and abundant liquidity has resulted in high stock prices. Indeed, stock prices are meant to measure the present value of future dividends, discounted by the interest rate. As the interest rate goes to zero, the present value goes to infinity! In addition, flush with liquidity and facing near-zero returns on bonds, the financial markets have invested heavily in stocks.

More generally, investors have looked for higher returns than now low-yielding bonds. In addition to stocks, they have channeled large amount resources to risky assets, including in emerging market economies. Large capital flows to these countries have been a boon and fueled growth. However risk-taking occasionally results in disasters, especially if investments are financed by borrowing. Should the secular stagnation hypothesis proved wrong, financial stability could resurface. If interest rate in the advanced countries rise again, capital stands to flow out of the emerging market economies, spreading hardship there.

Another important implication is that monetary policy will not play the macroeconomic stabilization role that it has performed with great effectiveness before the decline in interest rates. We have grown accustomed to central banks taking responsibility for dealing with business cycles as they were anchoring inflation to their stated targets. Fiscal policy instead was seen as too complicated as a macroeconomic stabilization instrument. Its effectiveness was sometimes considered as weak because some research concluded that the famed fiscal multiplier was low and sometimes even negative (Alesina et al., 2019). The ability to use this instrument was in doubt given the importance of political considerations that shape budgets. In fact, in many countries, there is evidence that fiscal policy has often been used in a procyclical way, amplifying fluctuations rather than moderating them, or at best acyclical, with no impact (Alesina et al. 2011; Jaimovich and Panizza, 2007; Fatas, 2019, Gootjes and de Haan, 2021).

Finally, the prospect of a long period of low interest rates has led Blanchard (2019) and others to argue that public borrowing can be expanded securely. At a time when public debts have reached high levels, this policy prescription is disquieting.

This paper wonders whether the secular stagnation hypothesis is valid and proposes an alternative explanation of the era of low interest rates (Section 2). It suggests an alternative explanation (Section 3) and shows that the post-Covid recovery may allow us to pass judgment on the alternatives (Section 4). It then examines how we will know (Section 5).

2. The secular stagnation hypothesis

2.1 The hypothesis in a nutshell

The case for secular stagnation has been made forcefully by Summers (2015). Initially proposed by Hansen (1939) in the wake of the Great Depression this theory posits that savings are too large, or consumption is too low. Weak demand limits growth, which eliminates inflation pressure. Excess savings depress interest rates. Productive investment is not buoyed by low borrowing costs because of slow growth. Hansen emphasized a declining demography, which would lead people to raise savings to provide for old-age retirement as fewer young people would provide for their late years. While also mentioning demography, Summers and others list a lnumber of causes.

One reason for higher savings is that new financial regulation adopted after the Global Financial Crisis has forced banks and other financial institutions to restrict lending. This, in turn, reduces consumption and investment spending. Regulation has also led financial institution, including insurance companies, to acquire large amounts of safe assets, which are in insufficient supply, leading to low interest rates (Caballero et al., 2017). Another reason is that rising wealth inequality has transferred purchasing to the rich, who save much more than the poor (Mian et al., 2029). Summers (2015) also observes that the cost of technology-driven productive investments has declined. This means that firms need to spend less on this kind of investment to produce a given volume of goods or services.

2.2 Testing the hypothesis requires time

Secular stagnation is a hypothesis. It has been widely accepted as a description of the current situation. The reason seems to be that it matches some stylized facts, but so do other hypotheses. The problem is that formal testing is nearly impossible because many things may be happening at the same time. For example, it is true that the price of productive equipment

that heavily uses information technology has declined because innovations keep lowering the costs of production while performance is rising (think of computer chips). However, in the past, such technological advances have triggered an acceleration of growth, which was sustained over decades. Examples of these innovations include the steam engine, electricity and the combustion engine, which produced the industrial revolution. In fact, Gordon (2012) has recently warned us that the current "IT revolution" is no match to these previous innovations and that its poor contribution to technological advances explains lower growth. Thus, two opposite hypotheses purport to explain the same phenomenon. In order to test one hypothesis against the other, we need a much longer observation period, unfortunately.

Much the same can be said about the impact of declining demography. Recent work by Goodhart and Pradhan (2020) argue the opposite. Old people will be more numerous and they dissave. The decades of low inflation are the result of a large effective increase in labor supply as China and Eastern Europe broke from economic isolation and joined the global economy, cutting wage growth. Lower future labor supply, in this view, will provoke more dynamic wage growth. It may take a couple of decades to find out.

Other disquieting issues arise. For instance, the presumed decline in savings does not appear in data for the advanced countries, where secular stagnation is presumed to be taking place. It is true, however, that savings have risen globally over the last decade or two. The proponents of secular stagnation correctly argue that, in this day and age of financial globalization, this is the correct measure. However, the increase in global savings is down to one country, China. It is explained by a host of policy choices such as income distribution that favors firms at the expense of households, financial repression, poor welfare policies (health, retirement) or central controls that encourage productive investments. These choices can be reversed, and are likely to be reversed because they slow growth down.

2.3 Doubts about the hypothesis

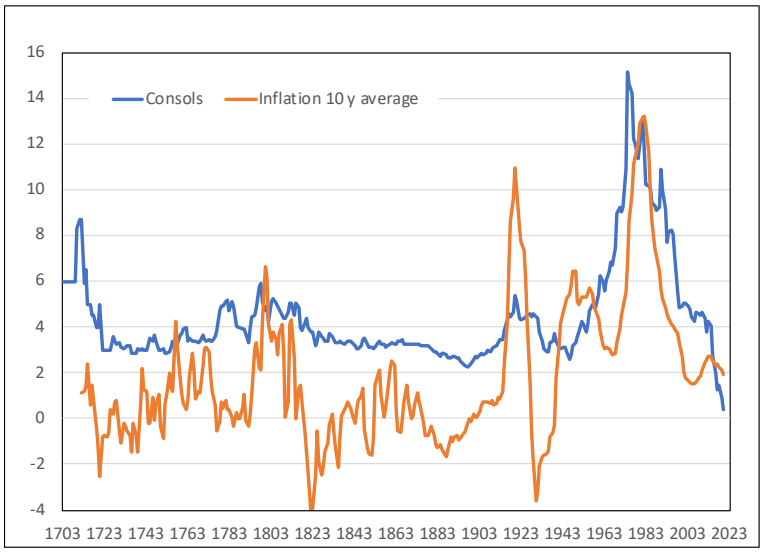
A major reason to be skeptical about this hypothesis is the data. Nearly all the papers that develop it provide the evidence of sharply declining interest rates since the 1980s. But this is the period when inflation reached a climax in most developed countries, pushing interest rates up. Central banks then shifted their policies toward bringing inflation down, and they succeeded. As inflation receded, so did the interest rates.

The problem with this evidence is that it ignores what happened before. Figure 1 displays the interest rate on UK consols since 1703, probably the series that goes furthest back in time. It clearly shows that the 1980s saw a historical peak. The sharp fall that came after the peak marked a return to normality, not any new phenomenon. If anything, the interest rate stabilized in the early 2000s at a level above the historical average. However, the further decline, following the Global Financial Crisis, brought the rate to a historical low.

Figure 1 also displays the inflation rate. Given the high volatility of inflation over the 18th and 19th century, the figure presents its average over 10 years. It confirms that the peak of the interest rate during the 1980s and its subsequent decline is related to the evolution of inflation.[1] It may also be noted that the rise of global savings due to China's emergence occurred in the 2000s, long after the interest rate peaked.

[1] The previous high inflation episode corresponds to World War I.

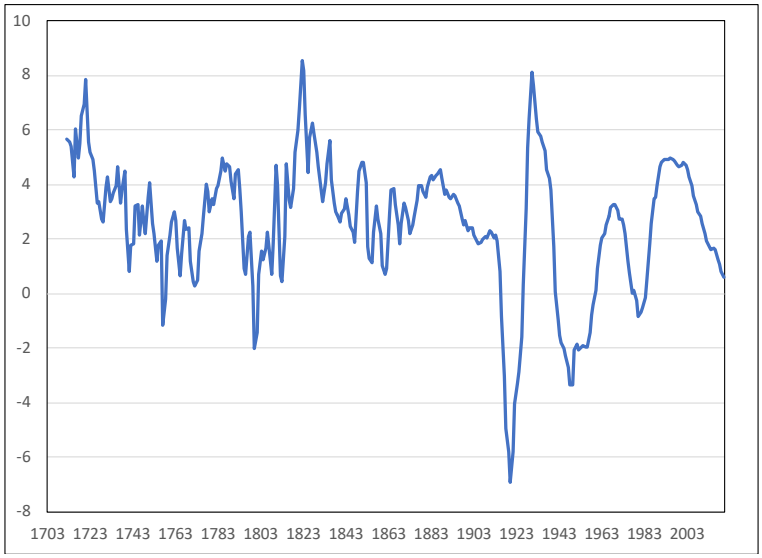
Figure 1. Interest rates on UK consols (perpetual bonds) and inflation (10 year average) 1703-2020



Source: FRED, Federal Reserve Bank of Saint-Louis

An important caveat is in order. What matters for borrowers and lenders is not the nominal interest rate shown in Figure 1. Because inflation erodes the value of assets, they care about the difference between the nominal interest rate and the inflation rate, the real interest rate. It is displayed in Figure 2, using the same data as in Figure 1, after averaging the annual numbers over the previous ten years because the real rates were highly volatile until the 19th century. Because the interest rate has declined alongside inflation since the 1980s, the much-vaunted decline in the real rate is smaller than that of the real interest rate and the level reached in 2020 is not the lowest ever, far from it. In comparison with the decline in 1930s – the period that prompted Hansen to formulate the secular stagnation hypothesis – the recent experience looks trivial.

Figure 2. Real interest rate on UK consols (10 year average) 1712-2020



Source: FRED, Federal Reserve Bank of Saint-Louis

3. Two theories of ultra-low interest rates

3.1 Secular stagnation

Secular stagnation predicts that interest rates are low because savings exceed productive investments, for a variety of possible reasons explained above. It may well be that, then, there is no positive interest rate that brings savings exceed investments to the same level so that interest rates must actually be negative. This, in turns, force central banks to keep interest rates low or even negative.

3.2 Monetary policy in a vicious cycle

A very different interpretation of why interest rates are currently low emphasizes the role of monetary policy (Borio et al. 2019). It comes in two steps. The first step is the elimination of inflation in the 1980s. With prices rising in some countries at double-digit rates in the 1970s, central banks changed their strategies. They recognized that inflation cannot increase without monetary policy acquiescence, a point made much earlier by Milton Friedman. Therefore, they decided to focus on bringing inflation down. They cut sharply the rate of growth of the money supply, accepting whatever interest rate it may take, which explains the peaks of the early 1980s. As inflation receded, so did interest rates. By the late 1980s, central banks could declare victory. Then, one after another, the central banks adopted the inflation targeting strategy that still dominates even though it has been adjusted subsequently. The strategy consists in steering the short-term interest rate to achieve the inflation target, whatever it means for the money supply.

The second step starts with the Global Financial Crisis of 2008. Facing a sharp recession, which possibly could lead to a 1930s style depression, central banks slashed their interest rates all the way to the effective lower bound around zero. At the same time, they recognized their responsibility regarding financial stability and resorted to QE, both to provide financial markets with abundant liquidity and thus alleviate stress on the financial markets. They also intended to supplement the effect of ultra-low interest rates in support of growth. Furthermore, they sought to buttress the credibility of this approach by committing to keep the interest rates low for long. In so doing, they also tried to lower longer-term interest rates. These efforts were largely successful.

Unfortunately, in the developed countries, the governments focused on their budget deficits because they had allowed their public debts grow fast in the wake of the Global Financial Crisis. This was a premature withdrawal of fiscal policy support. It had a negative impact on growth and consequently on inflation. The central banks, therefore, were led to keep interest rates low for much longer than they initially intended. While the Fed finally raised its interest rates, still to relatively low levels, the ECB never did so, mainly because of the need to offset widespread fiscal austerity.

The result is that central banks have found themselves caught in a vicious circle, previously seen in Japan. Having reached the effective lower bound or remained close to it, they had lost the use of their key instrument, the policy interest rate. In order to counteract the perception that they run out of ammunitions, they had to reaffirm their commitment to low for long interest rates. When the Covid crisis occurred, they were largely out of the game, except that they restarted QE, primarily to prevent a financial crisis to occur on top of the health crisis. They claimed that QE was an effective substitute for the interest rate. QE may have helped a

bit to stabilize the economy, but not much (Kempf and Pastor, 2020). Fortunately, fiscal policies took over.

It seems implausible that monetary policy does not explain, partly at least, the low interest rate phenomenon. There is no dispute that central banks control the short-term interest rate and that the low-for-long commitment – plus Japanese-style interventions along the yield curve – has also strongly influenced longer-term interest rates. These interpretations well explain the evolution of interest rates after the peak of the early 1980s as well as the further decline after the Covid crisis. The question is whether we need the secular stagnation hypothesis to complement the monetary policy interpretation. At this stage, we do not have enough evidence to answer that question. It may well that the Covid crisis will provide the needed evidence.

4. The Post-Covid test

The proponents of the secular stagnation hypothesis maintain that the interest rates will remain low and growth subdued for the indefinite future. The alternative interpretation, which emphasizes monetary policy, opens up the possibility that interest rates rise and that growth solidifies at higher levels. The likely end of the health crisis – when the coronavirus remains active but on a small scale – may tell us which interpretation is correct, or not.

The monetary interpretation rests on the observation that fiscal policies have not been used to stabilize the economy, in effect forcing central banks to carry that responsibility. During the Covid crisis, fiscal policies have promptly shifted. Budget deficits have reached scales unprecedented in peace time. They were mostly aimed at protecting people and firms during lockdowns and other social distancing measures. As these measures end, will budget deficits be promptly reduced? The risk that the economic recovery is weak or, more likely, not sustained beyond the initial bounce back, suggests that fiscal policy could remain strongly supportive of growth for an extended period, in contrast of the quick scaling-down that followed the Global Financial Crisis.

According to the secular stagnation hypothesis, these considerations are largely moot. After the initial spurt of post-pandemic growth, interest rates will remain ultra-low. If the secular stagnation hypothesis is invalid, we can distinguish four cases. They show that, in the end, it is the stance of fiscal policy, not monetary policy, that will determine what the judgment about the secular stagnation hypothesis will be. The reason is that the monetary policy interpretation presented above concerns the period after the Great Financial crisis during which governments refrained from using fiscal policy as a macroeconomic stabilizing tool, in effect forcing the hands of central banks.[2]

4.1 Expansionary fiscal and monetary policies.

In this case. both governments and central banks are keen to make sure that the recovery from the Covid crisis is sustained. They will keep fiscal and monetary policies supportive of growth and accept some inflation. The central banks will keep their policy rates low, raising them by less than inflation to keep real interest rates down and quite possibly negative. Even if central banks still pledge low for long policy rates, longer-term interest rates will rise because they are set by the financial markets, which will be concerned by inflation.

[2] This relationship between fiscal and monetary policies is developed at length in Bartsch et al. (2021).

Fast growth along with higher inflation and longer-term interest rates will disprove the secular stagnation hypothesis.

4.2 End of fiscal expansion, continuing monetary policy laxity.

If instead governments shift their attention to containing inflation and change the stance of their policies, firms and wage-earners could well be concerned that the recovery will be soon weakening, and they will keep wage and price increases at bay. This will be a remake of the 2010s, with moderate growth and low interest rates.

The secular stagnation hypothesis will live on, even if it is incorrect.

4.3 Expansionary fiscal policy, monetary policy moves to tightening.

If it is the central banks that move to raise the interest rates while fiscal policies remain expansionary, the outcome will be high interest rates. Depending on how far central banks tighten, growth may be sustained. Even if tight monetary policies bring the recovery to an end, high interest rates will be high.

In both instances, the secular stagnation hypothesis will be disproved.

4.4 End of fiscal expansion, monetary policy tightening.

Finally, if both policies cease to support the economy, growth will be slow and interest rates will remain ultra-low. This will provide support to the secular stagnation hypothesis, even if it is incorrect.

5. When and how will we know the answer?

5.1 The rise in inflation: temporary or permanent?

Inflation is already rising, chiefly because primary commodity prices and transport costs are recovering from the very low levels reached at the height of the pandemic. This is not a source of concern because it represents a return to the status quo that prevailed before the crisis. Much the same may happen for a range of goods and services, the production of which requires intermediary products that are slow to recover from the pandemic slump. Shortages will cause the corresponding prices to rise but these shortages are likely to be temporary. If all these prices stabilize and nothing else happens, we will have seen a spike in inflation rates that will soon disappear. Central banks currently claim that they do not need to take action precisely because this is their central forecast.

This benign scenario is not the only possibility, however. Inflation may rise durably for a number of related reasons. First, even a temporary inflationary spike may trigger longer-lasting inflation. As prices rise, wage-earners see their purchasing power decline and ask for wage increases. As firms face higher costs, they will need to raise their prices. This is the so-called wage-price spiral. The spiral is more likely to occur if the recovery from the Covid crisis is strong. In that case, firms will need to rapidly expand their labor forces, which will put them in a weak position to resist demands for higher wages. At the same time, facing strong demand for the products, they will be reassured that they can recoup higher costs by raising prices.

5.2 The fiscal policy stance

The key question for the post-Covid test concerns the stance of fiscal policies over the next couple of years. The debate is under way in Europe. The NextGenerationEU program adopted by the European Union represents a major institutional change but, spread as it is over several years, it is unlikely to be sufficient should growth peter out. Some governments are currently thinking about adding more national fiscal policy support.

In the US, this debate is settled. The current administration is intent on carrying out substantially increased levels of spending over the next couple of years. Two programs, one adopted in February and one currently in the process of approval, mobilize large amounts that will definitely boost growth. Another debate is whether this initial boom will raise inflation temporarily or permanently. Part of the answer to this question rests with the Federal Reserve. Under its traditional practice, the Fed should soon raise its interest rate to pre-empt a permanent increase in the inflation rate above the 2% target. However, the new monetary policy strategy of the Fed, average inflation targeting, explicitly calls for keeping inflation above target to make up for the undershooting of recent years. No one, including the Fed itself, knows how this strategy will play out.

A plausible outcome is that described in Section 4.1: years of inflation overshooting, fueled by strongly expansionary fiscal policy and accommodating monetary policy, a combination not seen since the inflationary years in the 1970s. It seems unlikely, however, that the Fed will tolerate the return to the inflation rates seen during these years. In order to prevent such an outcome, it will have to raise its interest rate, strongly and durably. That scenario, which corresponds to Section 4.3, would likely bring to an end the era of ultra-low interest rates in the US. Both scenarios stand to invalidate the secular stagnation hypothesis since they involve continuing fiscal expansion.

5.3 Transmission from the US

The next question is whether this change would be limited to the US. The short answer is: probably not. The US economy is the largest in the world, so a rapid expansion there has a wide impact. In addition, its financial markets dominate the global financial situation. There is much evidence that interest changes in the US affect worldwide interest rates. Finally, the US combination of large budget deficits, tightening monetary policy and rapid growth is known to generally result in exchange rate appreciation. For other countries, that means an exchange rate depreciation, which tends to raise the inflation rate. Central banks elsewhere are likely to respond by raising their own interest rates, signaling the end of ultra-low interest rates.

5.4 Central banks and public debts

It is highly possible, therefore, that central banks are about to normalize their interest rates, returning them to historical levels as shown in Figures 1 and 2. This normalization will not come without risks, though. For instance, a rapid increase of interest rates, stands to complicate the situation of highly indebted governments that have enjoyed a long period of cheap borrowing and debt service. With public and private debts historically high in many advanced countries, pressure on central banks to show restraint is bound to grow. This could result in inflation rates significantly above the 2% norm. In that case, interest rates would still increase in nominal terms but remain low in real terms. In fact, the combination high inflation

rates and relatively low real interest rates has historically been the implicitly chosen way of eroding large public debts.

Although they are independent (in the developed countries, at least), central banks will not want to be blamed for higher taxes or even public or private debt crises. They could also be concerned that raising the interest rate may provoke a sharp fall in stocks and that a strong appreciation of the exchange rate could hurt exports. The coalition of government, financial markets and exporters is formidable.

But then, keeping interest rates low while the economy expands fast will allow inflation to rise and therefore lead to low, quite possible negative, real interests, which will a boon to highly indebted governments. While this may be seen as a vindication of the secular stagnation hypothesis, it is not, since it depends entirely on central bank decisions. Yet, in that case, both camps may claim victory.

6. Conclusion

The long period of very low interest rates during which central banks have been unable to bring inflation up to their chosen target can be explained by the reluctance of governments to use fiscal policy as a macroeconomic instrument. This reluctance was largely driven by large public debts but also by the view that the fiscal instrument is not effective. This led central banks to assume alone the task of macroeconomic stabilization. In the wake of the Global Financial Crisis, they brought their interest rates down to the effective lower bound. At that stage, they had lost most of their macroeconomic firepower and inflation lingered below target.

When the Covid pandemic, nearly all governments forcefully stepped in. Arguably, they were foremost motivated by the need to absorb the shock that social distancing measures were creating. Paradoxically, perhaps, they may have recovered the taste for taking responsibility for macroeconomic stabilization even though their indebtedness has risen to new highs. If the governments continue support the economy, the central banks will have an opportunity of escaping the effective lower bound trap.

The advanced countries entered the Covid crisis with the pessimistic outlook of an indefinite continuation of secular stagnation. Although the pandemic has been a huge disaster in many dimensions, it will be a silver lining if, indeed, we escape this pessimistic outlook. The US seem well poised to reach that outcome. If they do, the rest of the world could well follow suite.

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