Secular stagnation and the euro area

SUMMARY

Several years after the Great Recession began, the euro area is still far from fully recovered. The international economic and financial crisis has pushed down investment levels within the EU by about 15% from their peak in 2007. Even though the near-term prospects seem brighter, high unemployment persists in many Member States. Some experts argue that the euro area, alongside Japan and the United States, is facing 'secular stagnation', a long-term economic stagnation characterised by a shrinking work force, low demand, excess savings and low investments, despite low interest rates and deflationary tendencies.

The complexity of the ongoing crisis and the diverging economic situations of the Member States participating in the euro area make it difficult to predict future developments, as there is no common cure for long-term stagnation. Some believe that if the demand side is spurred, it would help boost the economy. In this context, the European Commission launched a number of measures in 2015, among which the European Fund for Strategic Investments (EFSI), with the aim of mobilising at least €315 billion worth of investments in the real economy by 2017. But it is also important to improve the supply side, which shapes the investment environment.

Furthermore, in December 2015 the European Central Bank (ECB) extended its quantitative easing programme (in particular, the asset purchase programme (APP)) until at least March 2017 as a way to provide further liquidity and stability to Member States' financial markets.

In this briefing:

EPRS | European Parliamentary Research Service
Authors: Gustaf Gimdal and Cemal Karakas, Graphics: Christian Dietrich
Members' Research Service
PE 573.972

Glossary

Economic bubble: Such a bubble appears whenever the prices of securities or other assets rise so sharply and at such a sustained rate that they exceed valuations justified by fundamentals, making a sudden collapse likely (at which point the bubble 'bursts').

GDP gap: The difference between what an economy is producing and what it can produce, i.e. between real and potential GDP.

Inflation rate: A general increase of prices for goods and services. The inflation rate is generally indexed year-on-year, as is the case with the harmonised index of consumer prices (HICP) used by the ECB. A low inflation rate is synonymous with price stability.

Nominal, real and equilibrium interest rate: Central banks set a short-term nominal interest rate, which then forms the basis for other interest rates charged by banks and financial institutions; this rate does not take inflation into account. The real interest rate is the nominal interest rate minus the inflation rate. The equilibrium interest rate (or natural interest rate) is the estimated real interest rate that keeps output at its potential and inflation stable under full employment, which means the economy is in equilibrium.

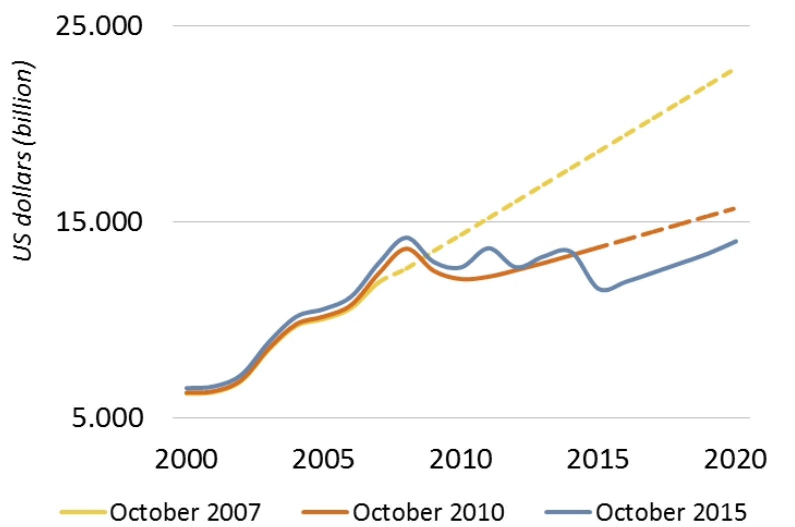
Zero Lower Bound (ZLB): The lowest percentage of owed principal that a central bank can set. In monetary policy, the use of a 0% nominal interest rate means that the central bank can no longer reduce the interest rate to decrease credit costs and thereby boost investments, consumption and economic growth. As the interest rate approaches the zero bound, the effectiveness of monetary policy as a macroeconomic tool is reduced.

Background: stagnation in the euro area

The euro area has not yet fully recovered from the Great Recession. The global financial crisis has resulted in a drop in the level of investment in the European Union of about 15% from its peak in 2007. Despite near-term forecasts looking brighter, many Member States are facing high unemployment. Several forecasts predict GDP growth of 1.6% (2016) to 1.9% (2017) for the euro area. However, given the downward shift in GDP forecasts by the year 2020 (see Figure 1), it will be hard to make up for the output losses incurred since the crisis began and return to the pre-crisis growth path. This will prove even more difficult as long as investments remain inadequate.

In connection with the ongoing stagnation in the euro area, Japan and the United States, economists have been debating whether or not they are facing secular stagnation. The debate was initiated by former US Treasury Secretary, Lawrence Summers in a speech delivered at an International Monetary Fund (IMF) conference in 2013, where he revived an idea put forward by US economist Alvin Hansen in 1938 (see Box 1). Several experts, including Summers himself, suggest that Europe and the euro area are at

Figure 1 – IMF 2007, 2010, 2015 forecasts for the euro area GDP



Source: IMF. Dashed lines are own estimates, based on the three-year simple moving average.

bigger risk of plunging into secular stagnation than the USA, and that there is a risk of a Japan-style lost decade, or 'Japanification' (see Box 2).

Box 1 – Alvin Hansen on secular stagnation

'Not until the problem of full employment of our productive resources from the long run, secular standpoint was upon us, were we compelled to give serious consideration to those factors and forces in our economy which tend to make business recoveries weak and anaemic and which tend to prolong and deepen the course of depressions. This is the essence of secular stagnation—sick recoveries which die in their infancy and depressions which feed on themselves and leave a hard and seemingly immovable core of unemployment.'

Economic Progress and Declining Population Growth, Alvin H. Hansen, *The American Economic Review*, Vol. XXIX, No 1, Part I, March 1939, pp. 1–15.

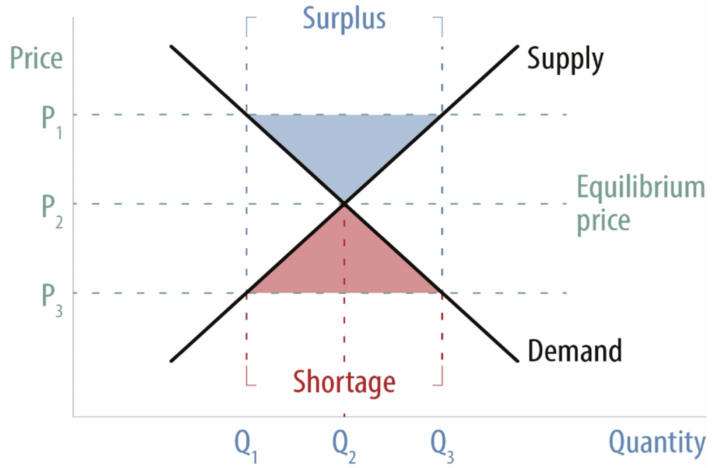
Box 2 – Japanification

At the beginning of the 1990s, Japan went into recession with the bursting of its 'bubble economy', built on stock and real estate bubbles. The Japanese economy has since been characterised by low demand, excess savings, deflationary tendencies and an ageing and shrinking workforce. Some commentators such as Paul Krugman fear a similar future for the euro area, which manifests comparable features: slow growth, deflationary pressures, an ageing society, and interest rates at the Zero Lower Bound. According to Richard Koo, another similarity with Japan is that Europe is facing a 'balance sheet' recession, where businesses and consumers prefer to save and pay off their debts, rather than spend and invest, even at very low interest rates.

Economic assumptions in theory

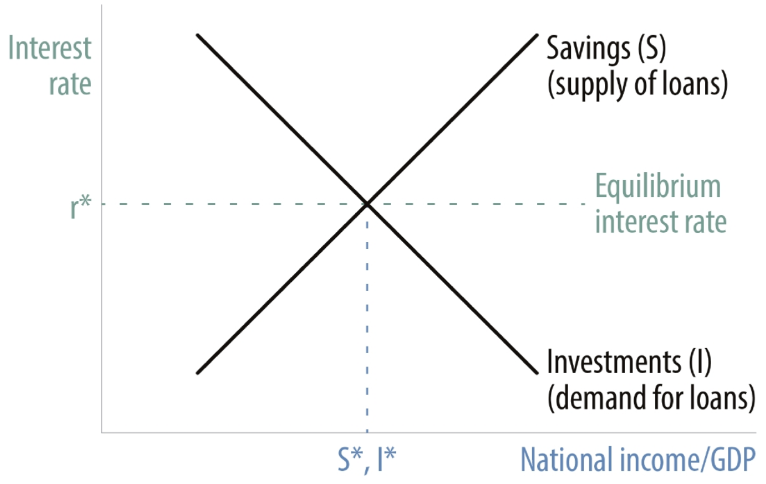
The relationship between demand and supply, and price and quantity, is one of the major pillars of economic theory. Demand describes the need for a good, credit or service by buyers. Supply refers to the amount the producer (or market) can offer. According to popular market economy theories, the demand and supply mechanism will allocate resources in the most efficient way possible.[1] This mechanism (Figure 2), works in two ways: the higher the price, the lower the quantity consumers' demand,[2] and the higher the price, the higher the quantity producers supply. The demand pattern can be translated into a downward sloped curve; the supply relationship curve shows an upward slope. The equilibrium price (P_2) would balance out the supply and demand of quantity (Q_2). A price higher than the equilibrium price (P_1) would increase the supply of goods and lead to a surplus of supply as the demand would decrease due to higher prices (Q_1). A decrease in prices (P_3) would lead to an increase in demand (Q_3), and would bring about a shortage (of supplied goods).

Figure 2 – Supply and demand curve



The fundamental mechanism of demand and supply also applies to financial and capital markets, among others, as well as to the amount of a central bank's money and to investments and savings. The interest rate serves as the price for investments (demand for loans) and savings (supply of loans), it determines national income and GDP respectively (see Figure 3). At an interest rate r*, both savings and investments would be in equilibrium and financial resources would be allocated in the most efficient way. In theory, changes in the interest rate would not only have an impact on the monetary base in an economy, but also on investments, consumption and savings.

Figure 3 – Investments and savings curve



Countries going through economic stagnation or recession have, in general, at least four means to cope with these challenges. Two of them – cutting or increasing public expenditure and cutting or raising taxes – are of a fiscal nature. The other two – increasing or decreasing interest rates, and direct expansion or contraction of money supply, for instance through the issue/redemption of bonds and securities – are monetary instruments. The theory of Monetarism accentuates the relevance of a steady increase in money supply for sustainable economic growth, as well as of price stability – a key element for confidence and investment. The theory of Keynesianism on the other hand lays emphasis on the demand side of the economy and its relevance for production, consumption and employment. For Keynesians, rather than austerity, countercyclical state interventions through deficit spending (such as economic stimulus packages or the increase of wages to strengthen purchasing power) are important tools for addressing recession and achieving market equilibrium.[3]

Lawrence Summers' new secular stagnation hypothesis

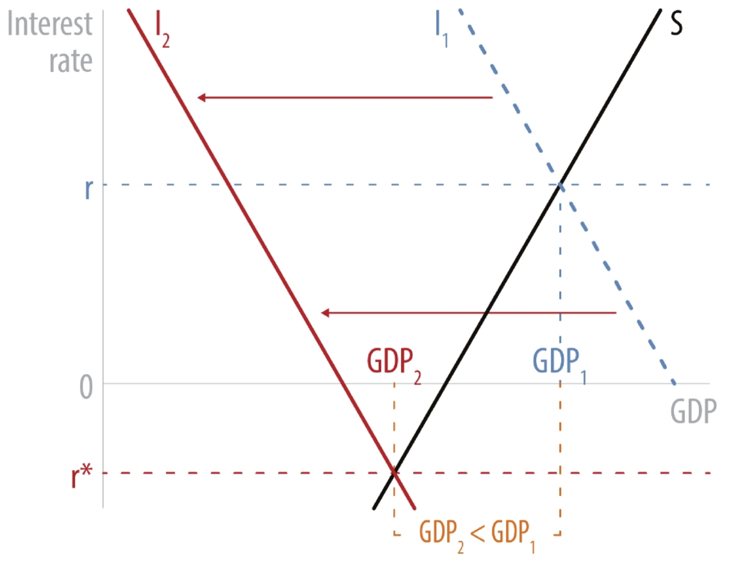
Since the start of the international financial and economic crisis, many of the conventional theoretical assumptions have come into question. It seems that the supply/demand mechanism is not allocating resources in the most efficient way, and that monetary and fiscal policies aimed at countering stagnation have shortcomings.

In his 2013 speech, Summers presented his take on the puzzling situation in the United States: four years after the financial panic had subsided, the country's GDP was still falling further and further behind potential. In a paper from 2014, Summers holds that even though the economy had grown and employment had increased since the trough of the recession in 2009, the GDP gap compared to 2007 projections was still 10% (or 5% compared to the 2013 downward revision of forecast GDP). Also, only a small portion of the drop in the employment ratio had been recovered.

Another point Summers makes is that, prior to the downturn in 2007 related to the housing bubble, the economy had been growing at a satisfactory rate, with no substantial acceleration of inflation and with capacity utilisation and employment at satisfactory levels. Furthermore, the period before the stock market bubble burst in 2001 had been characterised by strong economic performance. Pointing out that the bubbles had led to full employment but not to overheating of the economy, Summers argues that this was related to the decline in the equilibrium interest rate – the rate associated with full employment of resources – and to a 'chronic problem of desired savings relative to investment'.[4]

This forms the basis of Summers' new secular stagnation hypothesis. In general, a market-based economy affected by secular stagnation is characterised by low or absent economic growth, low inflation and low interest rates. In such an environment, desired savings exceed desired investments, leading to declining levels of per capita income, and to declining productivity numbers.

Figure 4 – Secular stagnation in the loanable funds model



Low inflation (for example, around 1% per annum) accompanied by a drop of the equilibrium rate of interest into substantially negative territory and a nominal interest rate approaching the ZLB, causes serious problems for policy-makers and central bankers. Such circumstances would make it impossible to achieve a sufficiently low real interest rate to equate savings and investments at full employment, that is, to make the real interest rate r coincide with the equilibrium rate r* (see Figure 4). Growth would remain sluggish and the economy would continue to operate below potential (GDP_2 is smaller than GDP_1), 'leading to disinflation and leaving output and unemployment gap open.'[5]

According to Summers, there are several reasons to believe that the United States' equilibrium interest rate has declined and that it is facing secular stagnation:

- reductions in demand for debt-financed investment, due to deleverage and greater restriction on financial intermediation;
- a declining population growth rate;
- changes in the distribution of income and an increase in inequality (in income and wealth), leading to an increase in the level of savings; and
- a substantial downward shift in the relative price of capital goods.

According to Summers, as a consequence of disinflation, the pre-tax real interest rate needs to be lower now than it was before. Central banks have started accumulating reserves in which safe assets, in particular US government securities ('treasuries'), feature at a disproportionately high rate.

Summers indicates three possible options to deal with secular stagnation. The first involves remaining patient and seeing how things evolve over time. In a way this is how Japan has been tackling its decades-long sluggish growth, that some qualify as a sort of secular stagnation. The second involves reducing the real rate of interest, which is difficult to do in the context of ZLB. Moreover, it creates a risk of bubbles in connection with markets considered as 'safe havens', such as the stock market and the housing market. The third – raising the level of demand – is Summers' preferred option. This could be done by regulatory or tax reforms that boost private consumption by promoting exports or by assigning a more substantial role to public investments.

Responses to Summers' hypothesis and evidence for the euro area

On his blog, former US Federal Reserve Chair, Ben Bernanke, voices his scepticism regarding secular stagnation, and maintains that the US economy is on track to full employment. Contrary to Summers, he believes that the achievement of full employment during recent decades has not required the presence of financial bubbles.[6] As for the recent slow growth in the United States, he attributes it to the slow recovery of the housing sector and the government's restrictive fiscal policies. His alternative to the secular stagnation hypothesis is what he calls the 'global savings glut', or the unprecedented hoarding of savings that occurred during the weak recovery of 2002-2006. At that time, the excessive global savings which flowed into the United States contributed to keeping longer-term interest rates persistently low. A stronger dollar led to a very large trade deficit, that is, to domestic demand being diverted to imports. Bernanke holds that this may explain why the United States' economy did not overheat. He claims that Summers is focusing on individual countries or regions. According to Bernanke, Summers considers the frailty of capital investment to be caused by fundamental factors, for instance slow population growth, low capital needs, and a downward shift in the relative price of capital. So, while secular stagnationists advocate public investments and an expansionary fiscal policy, Bernanke's policy response would be to overturn the policies that engender the savings glut, for instance by easing international capital flows.

In response to Bernanke, Summers emphasises that the secular stagnation hypothesis also takes on a global perspective, and that in a world where capital markets are integrated, 'real rates anywhere will depend on conditions everywhere'. He maintains that there will be a global shortage of demand if there are more countries with a tendency for excess saving than countries with a tendency for excess investment.

Similar to the US, the situation in the euro area is difficult to interpret. Forecasts point to low GDP growth in the mid-term (see Figure 1). Inflation has gone from around 3% in 2011 to an estimated 0.4% in January 2016. Since early 2009, the European Central Bank's (ECB) main interest rate has been 2% or lower and is now 0.05%, with the deposit facility rate at -0.30%. Economist Marie-Hélène Duprat enumerates a number of aspects of the euro area economy that are in line with the secular stagnation hypothesis: inadequate investment and aggregate demand; excessive saving; a natural interest rate that may well have fallen into negative territory; and difficulties in obtaining results via conventional monetary policy, especially since 'responsibility for fiscal policy remains in the hands of each national member government.'[7] She maintains that if the secular stagnation hypothesis is correct, a long period of under-performance in the euro

Box 3 – Helicopter money

'Helicopter money' has been proposed as a way to boost demand, raise inflation and kick-start an economy that is running below potential. The basic idea is that a central bank increases the money stock permanently and provides the new money to households and businesses. This could be done for instance by making transfers to households and firms via tax cuts or by dropping the money directly into their bank accounts. The idea originates in an article by Milton Friedman, 'The Optimum Quantity of Money'. Economists such as Ben Bernanke and Willem Buiter have seen it as a possible policy choice. Mario Draghi pointed out to the European Parliament's Committee on Economic and Monetary Affairs that helicopter money could be a potential policy instrument, but that its consistency with the Treaties needed to be examined. Critics of the idea state that its implementation would create serious practical and political difficulties, that consumers could choose to save the money instead of increasing their consumption, and that the idea is more than 'erroneous'.

area economy can be expected.

Nicholas Crafts (University of Warwick) distinguishes two types of secular stagnation: short-term, related to the need for negative real interest rates in order to increase demand, and long-term, where failure to create or use technological innovations suppresses demand. He holds that continuing fiscal consolidation is likely to be deflationary, and speaks of 'helicopter money' (see Box 3), as an unconventional monetary and fiscal measure to create stimulus. He maintains that medium-term growth prospects in the euro area are not as bad as the secular stagnation thesis implies, but that supply-side policies are needed: 'If secular stagnation of whatever flavour is the outcome for the Euro Area, it should be clear that it is not inevitable but will be the result of policy mistakes.'[8]

In an economic paper, Karl Pichelmann from the European Commission's Directorate-General for Economic and Financial Affairs (DG ECFIN), maintains that the new secular-stagnation hypothesis does not have a solid theoretical and empirical basis, but that enduring lack of demand and persistent periods of weak growth cannot be ruled out: 'Anaemic growth could become the new, dismal normal of the euro area'.[9] According to the author, trade integration, foreign direct investment and free capital movement are important to overcome the global saving-investment imbalances. To tackle the secular stagnation elements and increasing inequalities, action would be needed on the demand side as well as on the supply side of the European economy.

Outlook

The euro area may be threatened by secular stagnation. The complexity of such a crisis and the different economic situations in the Member States that make up the euro area make it difficult to predict future developments, as there is no panacea for long-term stagnation.

Economic theory proposes different approaches to tackle an economic slump. One suggestion to boost the economy is to stimulate the demand side. In this context, the Commission has, amongst other measures, launched the European Fund for Strategic Investments (EFSI). It aims to mobilise investments in the real economy of at least €315 billion over three years (2015-2017). At the same time it is also important to improve the supply side, which shapes the investment environment. That would encourage innovation, improve efficiency and boost employment. According to the above-mentioned DG ECFIN paper, vulnerable countries in the euro area might consider shifting activities from non-tradable to tradable sectors, and creditor countries could remove the structural obstacles (for example through fiscal reforms) to stronger domestic demand, in order to further balanced growth in the euro area. In addition, controlled migratory flows might alleviate the pressures from worrying demographic developments and a shrinking workforce.[10]

The ECB is also reacting. In December 2015, it extended its quantitative easing programme (in particular, its asset purchase programme (APP)) in order to provide further liquidity and stability to the EU markets. The monthly purchases of €60 billion under the APP are now intended to run until the end of March 2017, 'or beyond, if necessary,' as Mario Draghi pointed out. The aim is to achieve inflation rates close to 2% (annual average) over the medium term. In the Monetary Dialogue with the European Parliament, Draghi stated that economic recovery is proceeding, albeit at a moderate pace: 'While growth has been mainly supported by private consumption in recent quarters, we now see encouraging signs that private investment is also picking up, which underlies our expectation that the economic recovery should broaden.'

Main references

Euro Zone: In the Grip of 'Secular Stagnation'?, Marie-Hélène Duprat, Econote, Société Générale, 2015.

On secular stagnation: Larry Summers responds to Ben Bernanke, Lawrence H. Summers, Ben Bernanke's blog, Brookings 2015.

Secular Stagnation: Facts, Causes and Cures, Coen Teulings and Richard Baldwin (eds.), Centre for Economic Policy Research (CEPR), 2014.

Speech at the IMF Fourteenth Annual Research Conference in Honor of Stanley Fischer, Lawrence H. Summers, 3 November 2013.

U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound, Lawrence H. Summers, Business Economics, Vol. 49, No. 2, 2014

When 'Secular Stagnation' meets Piketty's capitalism in the 21st century. Growth and inequality trends in Europe reconsidered, Karl Pichelmann, European Commission, 2015.

Why are interest rates so low, parts 1–4, Ben Bernanke's blog, Brookings 2015.

Endnotes

[1] For an overview of the main concepts behind economics, see N. Gregory Mankiw, *Macroeconomics*, Worth Publishers, New York, 2012.

[2] Sometimes, however, the 'snob effect' can be observed. Where this is present, the demand for a product from a high-income segment varies inversely with the demand from a lower-income segment. Nevertheless, exceptions prove the rule.

[3] N. Gregory Mankiw, *Macroeconomics*, Worth Publishers, New York, 2012.

[4] Larry Summers, 2015.

[5] Monetary Policy, Fiscal Policy, and Secular Stagnation at the Zero Lower Bound. A View on the Eurozone, Mitja Kleczka, MPRA Paper No 67228, Leibniz University Hannover, 30 September 2015, p. 19.

[6] Bernanke makes reference to a study by Hamilton et al, who have performed a quantitative analysis of the equilibrium real rate. They emphasise their scepticism about the secular stagnationists' view – which they call exaggerated pessimism – that for many years to come, the equilibrium rate would stay close to zero. They also conclude that their analysis gives little support to the claim that asset bubbles were essential to attaining full employment in recent business cycles.

[7] Marie-Hélène Duprat, 2015, p. 15.

[8] Is Secular Stagnation the Future of the Eurozone?, Nicolas Crafts, The CAGE-Warwick in Brussels Series, No 1, March 2015, p. 9.

[9] Karl Pichelmann, 2015, p. 3.

[10] Ibid., p. 14.

Disclaimer and Copyright

eprs@ep.europa.eu
http://www.eprs.ep.parl.union.eu (intranet)
http://www.europarl.europa.eu/thinktank (internet)
http://epthinktank.eu (blog)