
Secular stagnation: US hypochondria, European disease?

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After the Great Depression, secular stagnation turned out to be a figment of economists' imaginations. This chapter argues that it is still too soon to tell if this will also be the case after the Great Recession. However, the risks of secular stagnation are much greater in depressed Eurozone economies than in the US, due to less favourable demographics, lower productivity growth, the burden of fiscal consolidation, and the ECB's strict focus on low inflation.

The first time around, 'secular stagnation' was a hypothesis famously articulated by Alvin Hansen in his Presidential Address to the American Economic Association in Detroit in December 1938 (Hansen 1939). Hansen argued that the US economy faced a crisis of underinvestment and deficient aggregate demand, since investment opportunities had significantly diminished in the face of the closing of the frontier for new waves of immigration and declining population growth. It was as if the US was faced with a lower natural rate of growth to which the rate of growth of the capital stock would adjust through a permanently lower rate of investment.

As we all know, these fears were completely without foundation – the delusions of a hypochondriac rather than the insightful diagnosis of a celebrated economist. Trend growth in the US regained or even exceeded its pre-Depression rate in the following decades that were characterised by full employment (Ben-David et al. 2003). The US economy delivered a rapid rate of TFP growth building on the technological prowess that it had established prior to the Depression (see Table 1), and this sustained a high

level of investment while population growth revived under the auspices of the ‘baby boom’. Moreover, the textbook antidote for secular stagnation in a depressed economy at the zero lower bound for nominal interest rates – namely, to cut real interest rates dramatically by credibly committing to higher inflation – had already been shown to work by Roosevelt’s New Deal, which delivered a strong recovery in the years after 1933 (Eggertsson 2008).

Table 1 Contributions to labour productivity growth in US (% per year)

	K/HW growth	HK/HW growth	TFP growth	Y/HW growth
1906-19	0.51	0.26	1.12	1.89
1919-29	0.31	-0.06	2.02	2.27
1929-41	-0.19	0.14	2.97	2.92
1941-48	0.24	0.22	2.08	2.54
1948-73	0.76	0.11	1.88	2.75

Note: Estimates are for private non-farm economy. K/HW = capital per hour worked; HK/HW = human capital per hour worked; Y/HW = real GDP per hour worked.

Source: Derived from Field (2013).

The rediscovery of secular stagnation in the context of a sluggish recovery from the financial crisis of 2008-9 has similar foundations. Forecasts of US economic growth over a medium- to long-term horizon have been revised down in recent times as the growth of labour inputs decreases and questions are raised about the future (post-ICT-revolution) rate of technological progress (Gordon 2014), with the result that investment opportunities are curtailed. Models have been devised in which, faced with shocks of this kind, it would be necessary to find a way to have a lengthy period of negative real interest rates to avoid a prolonged slump (Eggertsson and Mehotra 2014). Aggressive use of fiscal stimulus might be appropriate in this scenario.

It must be said that once again, this could well turn out to be hypochondria rather than far-sighted prediction. Even after downward revisions, mainstream projections for growth over the next ten years or so in the US cluster around 2.1% per year for GDP and 1.6% per year for labour productivity. This productivity growth rate would basically be a continuation of the average performance of the last 40 years (Fernald 2014), with

the main headwind being diminished growth of labour inputs in the face of adverse demographic trends. The future rate of TFP growth is, of course, quite uncertain and techno-optimists such as Brynjolfsson and McAfee (2014) imagine a much rosier future. Be that as it may, it is not obvious why an economy with a steady-state growth rate of more than 2% per year should have a permanent shortfall in demand or a need for a permanent negative real rate of interest.

However, the threat of secular stagnation may be much more real for Europe. Although relatively little attention seems to have been given to this possibility, Europe is surely much more vulnerable, especially in the Eurozone. There are four obvious reasons for this, two stemming from economic performance and two from policy responses:

- European demographics are less favourable
- Productivity growth in Europe will underperform whatever US achieves
- Fiscal consolidation in the context of a high public debt ratio will bear relatively heavily on Europe
- In a depressed economy, the Fed is more likely to take appropriate policy action than the ECB

Table 2 reports OECD growth projections for 2014-2030. In the context of ageing populations, Eurozone employment growth is projected at 0.2% per year compared with 0.5% for the US, and for most European countries the demographics are relatively unhelpful.

It is clear from Table 2 that pre-crisis productivity growth in Europe generally failed to match that in the US, as was widely noted at the time. A major reason for this in many countries was the relatively slow exploitation of the potential of ICT (Oulton 2012). More generally, productivity growth in European countries was frequently held back by weak competition, excessive regulation and shortfalls in human capital that particularly undermined productivity performance in marketed services, where the single market has been ineffective (Crafts 2013a). Europe relies heavily on the US for new technology

and its track record suggests that this will diffuse more slowly in Europe. As Table 2 reports, the OECD (2014) is hopeful that future European productivity growth will generally better the dismal pre-crisis outcome, presumably because supply-side policy will improve. However, this does seem to favour hope over experience, given the protectionist and anti-market responses that the economic history of the 1930s suggests are likely to be nurtured by prolonged stagnation.

Table 2 Pre-crisis growth and OECD long-term growth projections (% per year)

	Real GDP, 1995-2007	Employment, 1995-2007	GDP/worker, 1995-2007	Real GDP, 2014-30	Employment, 2014-30	GDP/worker, 2014-30
Eurozone	2.3	1.3	1.0	1.7	0.2	1.5
USA	3.2	1.2	2.0	2.4	0.5	1.9
France	2.2	1.1	1.1	2.2	0.3	1.9
Germany	1.6	0.4	1.2	1.1	-0.5	1.6
UK	3.3	1.0	2.3	2.6	0.6	2.0
Greece	3.9	1.3	2.6	2.2	0.2	2.0
Ireland	7.2	4.3	2.9	2.3	1.2	1.1
Italy	1.5	1.2	0.3	1.5	0.3	1.2
Portugal	2.4	1.0	1.4	1.4	0.3	1.1
Spain	3.7	3.6	0.1	1.5	0.9	0.6

Sources: 1995-2007: The Conference Board Total Economy Database; 2014-30: OECD (2014, Ch. 4).

In the aftermath of the financial crisis, many European countries have high public debt-to-GDP ratios and for those in the Eurozone extended periods of severe fiscal consolidation lie ahead if they are to comply with the fiscal rules agreed in 2012. For example, the OECD (2013) calculates that for every year from 2014 to 2023, Greece will have to maintain a primary budget surplus of about 9% of GDP, Italy and Portugal about 6% of GDP, and Ireland and Spain about 3.5% of GDP. Dealing with the debt legacy of the crisis in this way will clearly be quite painful and is likely to undermine growth. If fiscal stimulus is required to combat secular stagnation, these countries are not well placed. Moreover, it is noticeable that, at high levels of debt, restoring fiscal sustainability typically entails cuts in both public investment and education spending (Bacchiocchi et al. 2011). The strong likelihood that post-crisis fiscal consolidation will

undermine these expenditures does not bode well for the growth prospects of highly indebted EU countries.

The ECB was designed to be a highly independent central bank mandated to achieve a low inflation target. It has been reluctant to embrace quantitative easing and relatively content with a rate of inflation close to zero. By contrast, the Fed has been far more willing to undertake unconventional monetary policy and has a ‘dual mandate’ that requires weight to be given to employment as well as inflation. It may be that neither central bank is well placed to make a credible commitment to raising inflation to deliver negative real interest rates, but the ECB is surely much the less likely to pursue the monetary policies that the secular stagnation scenario would demand.

If adequate monetary and fiscal responses to a threat of secular stagnation in Europe are not forthcoming, then that leaves supply-side reform, which might crowd in private investment and/or consumer expenditure, as well as increase productivity in the long run, as the only game in town. Such a strategy was successfully pursued in 1980s Britain with the relaxation of credit rationing, and the relaxation of land-use planning rules could play a similar role in Britain now (Crafts 2013b). OECD economists have quantified the possible effects of structural reforms in European economies on productivity and in many cases they are quite sizeable, as can be seen in Table 3. Moreover, such reforms need not be fiscally expensive. Unfortunately, however, in practice this is unlikely to be a feasible way to address a threat of secular stagnation, partly because the impacts are slow to come through, but more importantly because they are politically very difficult to implement effectively.

Table 3 Potential impact on real GDP per person of structural policy reforms (%)

	Labour market	Taxation	Product market regulation	Education	R & D incentives	Total
Moving to OECD average						
USA	0.3	1.4	0.0	2.5	0.0	4.2
France	4.5	10.9	2.2	2.1	1.5	21.2
Germany	6.1	9.9	0.0	0.0	0.0	16.0
UK	1.1	0.0	0.0	4.6	0.0	5.7
Greece	6.0	10.1	22.0	5.8	0.0	43.9
Ireland	6.8	0.9	9.7	0.0	0.0	17.4
Italy	0.3	10.8	0.3	5.4	0.2	17.0
Portugal	7.3	0.7	8.5	21.8	1.3	39.6
Spain	3.5	4.6	0.0	6.3	1.4	15.8

Source: Barnes et al. (2011).

In sum, it is too soon to tell whether secular stagnation is going to materialise in the OECD economies. But it does seem clear that Europeans should be much more afraid than Americans. The depressing effects of slower growth of productive potential will probably be felt more keenly in Europe and economic policies to address such problems will probably be less effective there than in the US.

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