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Stagnation In A Historical Perspective

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Abstract

The paper focuses on the recent resurfacing of the question of secular stagnation. Prompted as it appears from the severity and continuing effects of the financial crisis and the 2008-2009 recession the paper argues that this is a good example of how the history of economic ideas is indispensable to understand current issues.

Introduction

Underneath much of the discussion of the crisis there seems to be the idea of a resumption of growth based on a "return to normal" scenario. That overlooks the exceptional character of the crisis. It implies to look at the last ten years as there had been no crisis, but only a severe downturn. The problem is instead the pattern of growth on which industrialized economies settle in and whether it creates the conditions for an expansive transformation. The likely alternative is stagnation.

There is little sign that this perspective is penetrating economists' thinking and the solutions offered by the mainstream. We have observed however the return to the fore of the question of "secular stagnation" after Lawrence H. Summers comments at the 2013 IMF conference in honor of Stanley Fisher. The topic has attracted enough attention among mainstream economists to be the subject of a panel at the 2015 conference of the American Economic Association, with contributions by Robert Gordon (2015), Barry Eichengreen (2015) and Summers (2015a).

It is open to discussion whether Summers really elaborates on the issue of secular stagnation. Indeed much of the original argument put forward by Alvin Hansen in the 1930s seems sourly missing. He is certainly trying to convince his audience that modern macro theory does not have much of a clue on what is happening and that a change in perspective is needed. Summers seems to say that: a) the crisis is not over and stagnation is a

clear possibility; b) a dramatic change in policy is necessary; c) the central issue is investment, private and public.

The first section of the paper outlines the background of the most recent evolution of the crisis. Section two examines Summer's argument and quotes extensively his words. That is to provide the textual evidence of the reasons, the key concepts and analytical constructs of the rejuvenation of a concept that is decisively outside the domain of mainstream macroeconomics, indeed a "heresy" in macroeconomics as pointed out by Backhouse and Boianosky.

The third section of the paper examines the evolution of the notion of secular stagnation in the history of economic analysis following the recent work by Backhouse and Boianosky (2016). That is very helpful to understand what they label the "new secular stagnation hypothesis" and the association with Keynesian economics. At the end of their article they point out the politically sensitive nature of the discussion of stagnation that brings together economic analysis and political views. In this light the last section presents the comprehensive analysis by Palley (2012). Based on what Palley labels Structural Keynesian theory he argues that the crisis is inevitably leading to a long-term stagnation. Ideology and policy are fundamental to understand the abandonment of the Keynesian virtuous cycle. That is why Neoliberalism is breeding stagnation.

1. The pattern of the crisis

Despite being "technically" over the recession that lasted in the US from the fourth quarter 2007 to the third quarter 2009, has been followed by an uncertain and overall relatively weak recovery.

At the beginning the crisis was mainly financial. It started in 2007 with the subprime crisis, but it did not explode until the late summer 2008 with the collapse of Lehman Brothers. The downturn was marked by the collapse of the stock market that reached its lowest point around March 2009. The most urgent task appeared to be the prevention of a complete collapse of the banking system. Meanwhile the credit crunch began. That appears to be the channel though which the crisis was transmitted to the real sector.

The generalized debt and liquidity crisis originating in the private financial sector prompted the Federal Reserve, together with other central banks, and US Treasury to massively intervene, setting aside worries about deficit and inflation.[1] At the peak of the crisis in 2009 the amount of toxic

[1] There was a short-lived but dramatic reversal of the policy stance that had argued against government intervention and supported an increasing deregulation of financial markets.

assets, potentially worthless securities and bonds, on the balance sheets of financial institutions was unclear. Nobody knew exactly the value of the portfolios they held. Uncertainty and a collapse of confidence had created a situation in which nobody was willing to lend, while firms'internal resource were drained by decreasing sales and a worsening outlook. That brought the private sector to a virtual halt.

The Fed made money easily available by lowering interest rates to unprecedented levels. That did not prevent the economy from falling into a severe recession, but it did avoid the collapse of the financial system. [2]The priority became then supporting a failing economy by means of a fiscal stimulus to avoid a collapse of investment and employment. In Europe, where the financial crisis hit a little later, there was a similar call for government intervention directed at saving the financial system and also supporting the real economy. But that was only for a short time. In the US the stimulus was more forceful.

In January 2009 the news of the "Obama New Deal" (the president himself drew a parallel with Roosevelt) referred to the new administration's plan to get the economy out of the recession. [3]Worth approximately $ 800 billion the American Recovery and Reinvestment Plan was a combination of tax cuts (for households and firms) and Government investment. Broadly defined the spending would be concentrated in energy, health and education, with a focus on public works in infrastructure. Its implementation helped to shorten the recession, but it certainly did not end the crisis, as the recovery was weak and uncertain.

The crisis entered a new phase in 2010. It became the crisis of public debt. In the presence of a massive government intervention, including the fiscal stimulus, in 2010 the problem became the rising deficits of governments. Obviously not just more spending but also the standstill of the real economy drove the rapid expansion of public debt. Indeed, the debt crisis continued through what was at best a weak recovery.

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[2] Indeed, financial markets have recovered (although uncertainties persist and there have been periodical corrections). The influx of government money saved the financial institutions, but rather than lending to the private sector they have returned to speculating on financial markets (the Goldman Sachs case might be the best example) and restoring their profit margins at pre-crisis levels. Efforts to regulate the sector have been notoriously weak, raising serious doubts about the regulatory framework ability to prevent another financial crisis. Furthermore, the response to the crisis facilitated a dramatic consolidation of the banking and financial sector, so that a few major player became even fewer.

[3] The last act of the Bush administration, the Paulson plan to save the banks (September 2008, approximately $ 750 billion) had not helped to restart the real economy.

In Europe the crisis of sovereign debt became the common currency crisis. The circumstances were all in place to trigger a wave of speculation against government issued bonds. Financial markets more aggressively targeted, and Central Banks provided almost unlimited liquidity, especially the countries worse hit by the crisis of the real economy in the periphery of the Eurozone. The so-called PIGS (Portugal, Ireland, Italy, Greece, Spain) are indeed the weakest economies of the Eurozone and had large deficits. Some had also large public debt.[4] In July 2011 the crisis in the Eurozone appeared deadlocked. Not only speculation continued unabated but it was fueled by the slow and uncertain response by the European institutions. That in turn reflected the conflicting interest of national economies manifested in the lack of agreement between national governments. The point appears to be that the common currency, praised as the decisive step towards integration and consequently towards prosperity across Europe became the straitjacket making the PIGS countries perfect targets for speculation. If they were to stay within the common currency they had to cut deficits and debt, otherwise they would be punished by the international financial markets.

It became increasingly clear that European institutions lacked the means or the political will to address the causes of the debt, entangled as they were in the underlying conflicts of national government. At the same time it became clear that getting out of the common currency was an event that nobody had considered, and for which there were no clear rules or institutional arrangements. Thus the uncertainty and the postponement of decisions while PIIGS countries further precipitated into the crisis. The liquidity pumped into the system by the ECB was not sufficient to contain the unfolding of the sovereign debt crisis. While pursuing the same kind of monetary policy of the Fed, it did not have the same power, and the ECB policy was less effective because the Euro zone had no political unity behind it. That called into question the very existence of the common currency with an up and down of crises and rebounds as the EU insisted on austerity measures as a condition to have access to European rescue funds.[5]

The EU governments have rapidly moved from stimulus to fiscal austerity, cutting public spending, with the usual corollary of structural adjustment policies. A well-known scenario often advocated for developing economies by the IMF during the 1990s was finally landing into "developed" Europe. But austerity can be hardly a strategy for the resumption of economic growth. It simply started what we can call the debt trap, which is likely to

[4] But similar deficits and deteriorating economic growth did not have the same dire consequences for wealthier EU economies like the UK and France.

[5] First Greece then Ireland and Portugal asked the EU for aid in 2011. In June 2012 Spain asked for European support in the effort to address the financial fragility of its banks.

have long-term consequences. The debt trap has two sides. On the one hand, weak growth inflates deficits that then require rescue efforts. These come at the price of reinforced austerity measures. On the other hand, speculators anticipating that austerity measures will have negative effects on the economy, at least in the short run, raise the cost of borrowing to the troubled countries, thereby exacerbating the fiscal problem.

The speculative attacks on sovereign debt and the common currency shifted the focus for a time from the US to Europe and from private to public debt. But the issue of the government deficit was making a rapid comeback in the US. In June 2010 the US government expressed its concern that austerity may result in a new depression. The administration however also faced mounting pressure from Republicans in Congress to reduce the deficit. A striking – and somewhat novel – development in the US is the commitment of the Federal Reserve to fight persisting high employment.[6] The Chairman and other top officials defended a strong and continuing expansionary monetary policy and dismissed worries about inflation as unwarranted in the current economic circumstances.

The US appeared to be the "Keynesian of last resort". Still the stimulus was much less than much less that what was needed, as Paul Krugman has repeatedly pointed out, and there was no serious debate about how government policies - particularly as regards public investment could help re-start the economy.

Amid weak signs of recovery, and some positive data about employment, in April 2011 the confrontation over the government budget led to a last minute deal averting a government shutdown. The agreement included severe spending cuts that destroyed the prospects for a new fiscal stimulus. The tentative budget compromise, with $ 38 billion in cuts, was sharply criticized by the IMF.[7] It sealed for a time a precarious balance of power in the run-up to the 2012 presidential campaign.

In 2012 it was unclear whether after growth rates around 2% in 2010 and 2011 the US recovery was consolidating or loosing steam. In Europe the

[6] "…On its current economic trajectory the United States runs the risk of seeing millions of workers unemployed for many years …As a society, we should find that outcome unacceptable:" [since] "the ultimate purpose of economic growth is to deliver higher living standards at home" (Federal Reserve Chairman Ben S. Bernanke, *The New York Times*, November 19, 2010, p. B1-B2)

[7] " The US lacks credibility on debt, says the IMF" (*Financial Times*, April 13, 2011). The IMF argued "the US was the only advanced economy to be increasing its underlying budget deficit in 2011 at a time when its economy was growing fast enough to reduce borrowing." The same day the President delivered a radio message stating that budget cut will not break the "basic social contract" underlying programs such as Medicaid and Medicare, that are being cut under the budget deal, and will have to combined with a rise of taxes for the rich.

economic scenario was dominated by simultaneous austerity measures of national governments. The stall of Eurozone was such that a new recession and a further rise of unemployment became a possibility. The new factor was the European Central Bank determination to save the common currency. In July 2012 Chairman Mario Draghi stated that the currency would be saved "Whatever it takes". That was a not so veiled indication that the central bank would buy if necessary directly the sovereign debt issued by the weakest economies, despite the fact that it was arguably forbidden by the European Treaties. The worst of the speculative attacks on sovereign debt were stopped and financial speculation tamed. Meanwhile severe austerity measures went into effect. Such policies were put in place in several rounds in the PIGS country, and again in 2012 in Italy and Spain, but they are in fact the dominant trait of economic policy in the entire Euro-zone. Austerity was combined with renewed calls for revamping economic growth. But with stagnant private consumption and investment where is the growth to come from?

We reach then a third phase: The debt crisis is developing into a deflationary scenario. US modest growth rates and the crisis in Southern Europe, and notably the case of Greece in 2015, illustrate how deeply rooted the problem is. Austerity measures may lead to marginal improvement public finances, but did not and could not revamp growth prospects.[8]

The fundamental change occurred again at the level of the monetary policy. At the beginning of 2015, four years after the FED, the ECB finally put into effect the Quantitative Easing policy. Still Mario Draghi in September 2015 admitted that the growth prospects in the Eurozone were not encouraging. In other words the change of monetary policy the celebrated "bazooka" was not giving the Eurozone economy the expected lift.

That might have changed in the most recent years together with the stronger growth in the US. The overall outlook on the macroeconomy seems improved and the general notion that the crisis is behind us prevails. How much that signals a definite move out of a stagnation perspective and an indication that the causes of the crisis have been removed is much in doubt. The admittedly oversimplified contours of these last ten years suggest that the main questions are still there: The real economy is still much in trouble and the financial markets are still the main "engine" of expansion. The sovereign debt and debt in general are left hanging over a weak expansion. How far that can go is very serious

[8] Italian Prime Minister Mario Monti in the Summer of 2012, argued that it was understood that the immediate effect of austerity would be deflationary, but expansion would soon follow.

question, complicated by the not so rosy picture of the world economy and international relations.

In particular nothing is said about the absence of a growth scenario driven by private investment, which is arguably the most serious problem posed by the crisis. Stagnation is to be linked to the lack of an investment drive capable of launching a new phase of transformation and the exhaustion of the previous sources of dynamism. (Gualerzi, 2010, 2013) [9]

2. Secular stagnation?

2.1 The IMF Fourteenth Annual Research Conference in Honor of Stanley Fischer

The issue of stagnation found its way into the discussion on the crisis thanks to Lawrence H. Summers who first introduced the idea of secular stagnation in his comments at an IMF conference in honor of Stanley Fisher.[10]

At the beginning of his speech Summers agrees with Ben Bernanke, Stan Fischer and Ken Rogoff on “the importance of providing liquidity decisively; the importance of not allowing financial problems to languish; the importance of erecting sound and comprehensive frameworks to prevent future crises.” He then defines a special role for his comments. “Were I a member of the official sector, I would discourse at some length on each of those themes … But, I’m not part of the official sector, so I’m not going to talk about any of that. I’m going to talk about something else that seems to me to be profoundly connected, and that is the nagging concern that finance is all too important to leave entirely to financiers or even to financial officials. Financial stability is indeed a necessary condition for satisfactory economic performance but it is, as those focused on finance sometimes fail to recognize, far from sufficient.”

So while there is no doubt “that a remarkable job was done in containing the 2007-2008 crisis”[11] the tone of his comments change when looking at the real economy issue. “Yet, in the four years since financial normalization, the share of adults who are working has not increased at all

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[9] See also a collection of essays (De Juan, Febrero, Marcuzzo, 2011) where competing explanations are combined with sectoral and national perspectives.
[10] The notion, according to Summers, was rejected in Stanley Fischer's monetary theory class at MIT.
[11] He mentions the fact that despite statistical indicators suggested a macroeconomc picture worse than that of 1929 the results were quite different. The panic was rapidly overcome and financial conditions normalized. The phantom of the Great Depression is evoked but then dismissed.

and GDP has fallen further and further behind potential, as we would have defined it in the fall of 2009." He argues that Japan is presenting a much similar picture. "Japan's real GDP today in 2013 is little more than half of what we at the Treasury or the Fed or the World Bank or the IMF predicted in 1993."

He then introduces the idea of secular stagnation in two steps. First he recalls that both classical models and Keynesian models are about stabilization of fluctuations around a given mean. But we are looking for something else than having less volatility. "I wonder if *a set of older and much more radical ideas…that went under the phrase secular stagnation are not profoundly important in understanding Japan's experience in the 1990s, and may not be without relevance to America's experience today."*

Although firmly rejected by Stanley Fisher these ideas are according to Summers important to explain the experience of the crisis. Why?

Despite the consensus that in the economy prior to the crisis there was "Too much easy money, too much borrowing, too much wealth", there was no great pressure on capacity utilization, unemployment was not particularly low and inflation was not a problem. Thus "even a great bubble wasn't enough to produce any excess in aggregate demand".

To get the point across he relies on a comparison with a power failure. When that is solved and electricity production restored there would be a rush in the economy to recuperate what had been lost because of lack of electricity. In a similar way when the temporary failure of the financial system was fixed up the economy should accelerate its pace simply because it had lost ground. "So, you'd actually expect that once things normalized, you'd get more GDP than you otherwise would have had, not that four years later, you'd still be having substantially less than you had before. So, there's something odd about financial normalization, if panic was our whole problem, to have continued slow growth."

The key concept in Summers's argument about stagnation is the interest rate. "So, what's an explanation that would fit both of these observations? Suppose that the short-term real interest rate that was consistent with full employment had fallen to -2% or -3% sometime in the middle of the last decade. Then, what would happen? Then, even with artificial stimulus to demand coming from all this financial imprudence, you wouldn't see any excess demand. And even with a relative resumption of normal credit conditions, you'd have a lot of difficulty getting back to full employment."

Monetary policy can still support demand when the short-term interest rates are zero, argues Summers, but not when "natural and equilibrium interest rates have fallen significantly below zero. … we all seem to agree that whereas you can keep the federal funds rate at a low level forever, it's

much harder to do extraordinary measures beyond that forever; but, the underlying problem may be there forever."

That is why Summers concludes "it does seem to me that four years after the successful combating of crisis, since there's really no evidence of growth that is restoring equilibrium, one has to be concerned about a policy agenda that is doing less with monetary policy than has been done before, doing less with fiscal policy than has been done before, and taking steps whose basic purpose is to cause there to be less lending, borrowing, and inflated asset prices than there were before." This policy agenda concerns what he regards as the fundamental issue, that is to manage "an economy in which the zero nominal interest rate is a chronic and systemic inhibitor of economic activity holding our economies back below their potential."

2.2 Speech at Julius-Rabinowitz Center, Princeton University, 2015.

Summers has returned to the question of secular stagnation several times suggesting that his comment at the IMF conference was not just a casual reference to an important question, but rather a pressing concern. To identify the core of his argument we can compare the comments at the 2013 IMF conference with his Reflections on Secular Stagnation, one of the most recent speeches delivered at Princeton University in February 2015. (Summers, 2015b)

The reflections concern the "profound macroeconomic challenge of the next 20 years in the industrial world, and that is a problem of what I like to call secular stagnation, following Alvin Hansen." Summers articulates his argument in six points. "I'm going to talk about why we're talking about secular stagnation, the dismal performance of the industrial world in recent years. I'm going to talk about the secular stagnation hypothesis, as Hansen framed it. Talk about what's the central element in that, the low level of real interest rates. Reflect on some of the challenges that have been posed to the hypothesis, and then discuss what is it to be done."

The problem is that there has be no decisive catch up in the US economic performance with respect to the situation prior to the 2007-2009 crisis. "The GDP gap is indeed smaller than it was in 2009, but that is entirely because our judgments about potential has been revised downwards, in the face of dismal performance. If anything, the picture is worse… Europe today looks very much like Japan did seven or eight years post-bubble. Demographically challenged, incipiently deflating with severe financial strains, with dysfunctional politics, and ineffective decision-making."

The picture of the crisis he argues is largely worse that expected and inconsistent with the dominant descriptions" that fall within the framework of what I would call financial network failure theory." That goes back to

power failure analogy. Yes, the financial collapse was avoided, but that is only part of the story. The rest goes beyond “a traditional business cycle”. To explain why “we need to think of something that’s further outside the conventional sandbox” Summers recalls again that before the crisis an (excessively) expansionary fiscal and “the mother of all housing bubbles” did not result in a spectacular economic performance, nor were inflation pressures strong. More to the point an adequate economic performance was combined with an unsustainable growth of debt to disposable income.

Looking further back we find the Internet bubble and then the 2001 recession. So Summers asks the question: “How long has it been since the American economy enjoyed reasonable growth, from a reasonable unemployment rate, in a financially sustainable way?” The answer is that is has been really quite a long time, certainly more than half a generation. *That’s why it seems to me that one has to contemplate macroeconomic theories of a very different kind than suggested by the conventional business sector theory.”*

Indeed “something profound has happened.” The evidence on falling inflation, diminishing expected inflation over the long term, even deflation suggests “we should probably think of it as at least being substantially related to demand factors”. That is confirmed by the decline of expected interest rates in the last five years. “Some of that was because, despite the recovering economy, expected inflation has come down substantially. More of it is because of market judgment about the real interest rate has come down substantially.”

According to Summers: “Alvin Hansen prophesied, or addressed, this kind of problem in the late 1930s when he spoke about secular stagnation” and quotes Hansen definition of the problem: “Sick recoveries which die in their infancy and depressions which feed on themselves.”

Hansen was obviously wrong in the sense that what followed was not secular stagnation. “But, it has always seemed to me, and this is a good example, that economists have a tendency to suppose that because the world equilibrates and is stable, that that means they must operate with models that equilibrate and are stable. That’s fine if their model captures every aspect of the world, but their model should not have capture the Second World War, should not have captured the immense financial repression that took place during the Second World War, could not have reasonably been expected to capture the various features – the baby boom, the post-war housing boom, and more – that drove the economy forward. So, whether the experience invalidated Hansen’s model, or reflected the fact that variables that were exogenous in Hansen’s model changed very substantially seems to me to be a quite open question.” What seems clear however is that “dynamics stochastic general

equilibrium is kind of irrelevant… *What you need is a theory of a big, bad, protracted thing."*

The problem is that when the interest rate is constrained – for whatever reason – the normal operation of the market will not lead to a restoration of full employment. "One can draw the picture in a different way by envisioning that investment is a function of the interest rate, and savings are a function of the interest rate. The point at which they balance at full employment, is an unattainably negative level of the nominal interest rate, and so the adjustment has to take place through a reduction in income that inhibits savings." Although not rigorously micro-founded relating the level of investment and the level of savings to the rate of interest highlights that "there has been a pronounced increase in private savings, suggesting an increase in the savings propensity, at the expense of a diminution in the investment, and also an increase in private savings, and a decrease in the level of investments."

We can therefore say that *"Secular stagnation is the phenomenon that the equilibrium level that savings are chronically in excess of investment, at reasonable interest rates."* But what are the reasons behind the change in savings and investment propensities? Summers highlights a few factors, among them demography ("This is what Hansen emphasized"), declining capital requirements ("savings can buy much more capital than it used to"), the developing world accumulating reserve in safe assets ("pushing down yields")", inflation tax interactions (putting downward pressure on the level of nominal rates).

All the above concerns the demand side. A supply side explanation of stagnation "seems hard to relate to a period of declining inflation, and a period where much of the industrial world is actually experiencing something quite close to deflation." Except for the productivity slow-down that mean less demand for investment.

Concluding Summers singles out a particular role policy might have. "Past fears of secular stagnation have indeed proven to be unfounded, but as I already tried to explain, that is largely because exogenous variables changed. It is certainly possible that exogenous variables will change in the future. Indeed and I hope that they will. In an important respect, that is the task of economic policy."

He favors "structural reforms" over monetary policy. The latter has a role to play but "I believe the case is much stronger for structural measures to promote private investment, and for expansionary fiscal policy." He strongly argues for infrastructure investment both for the possibility of taking advantage of low borrowing cost and the impact on GDP. These changes appear warranted since *"the most important arguably market price in our economy, the real rate of interest, is going to be substantially*

lower than most of us have been accustomed to." Underneath are the fundamental forces of savings and investment and the need to restore stronger economic performance through a more appropriate investment and saving path. [12]

2.3 Why secular stagnation

Summers returns to the policy implications of a general view of the global economy for the next decade. "Real forward rates over the 2020 to 2025 period, which should clearly be after the hangover of the financial crisis, are negative in Japan and the Euro area and barely positive for the United States. The so-called five-year indexed bond yields are negative or barely positive. And nowhere in the G7 is market-expected inflation over a 10-year period likely to reach the two percent target."

The discomforting conclusion is that although we are more and more moving away from the crisis "market pricing (interest rates nominal, inflation rates) has actually moved in all the directions you would expect if you thought that there was a chronic excess of savings over investment." All indicators confirm that the financial crisis was overcome "And yet with interest rates of zero the United States is still likely to grow at only two percent this year. I do not see a good reason to be confident that that situation will be significantly better three years from now."

If the fundamental challenge is to absorb the savings in the global economy then policy must be redirected. "The first priority for policy should not be financial engineering in either the private sector or the public sector, but should be *a* concerted effort to identify and find the means of financing the most productive investment opportunities globally."

3. Stagnation: A "heresy" in macroeconomics

3.1 The history of an idea

Summers fundamental purpose seems that of getting through a few important points. First, The crisis is not over and it poses questions that go beyond financial panic. Second: there is something we can hardly explain in the crisis. It is a different "beast" than that dealt with my modern macroeconomic modeling. It forces to reconsider a number of issues, and possibly some ideas that have long lost relevance in the debate.

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[12] Summers contrasts the secular stagnation viewpoint with the debt super-cycle view put forward by Ken Rogoff and Ben Bernanke's savings glut hypothesis. He regards them as overlapping "but insofar as their nuances of difference, I prefer the secular stagnation view. "

Secular stagnation has a history and indeed a rich one. Very recently two historians of economic thought Backhouse and Boianosky (2016) have pointed out the oscillating and ultimately declining popularity of the term, measured by the number of articles on the topic. Since Alvin Hansen first introduced it in 1938 the term was frequently used until the 1950s to then decline steadily with modest resurgences in the 1960s and the 1970s. It never completely disappeared and was back into the economic debate in 2012-2015.

But “concealed within the graph are the changes in the way the term was used.” (p.2) From the 1950s the term was used primarily in economic history, development economics and the history of economic thought being virtually pushed out from the theoretical discourse because of the spread of “competitive equilibrium theorizing”. (p.3). In fact the problem of stagnation (or stagflation) returned to the fore but because it was an issue concerning Europe and later Japan, and not the United States that dominate the field of economics, it had to be explained “in terms of factors specific to these regions rather than prompting any reappraisal of economic theory.” (p.3)

The reemergence of the “heresy” in macroeconomics is linked to the 2007-2008 financial crisis that made the worldwide stagnation a distinct possibility. Backhouse and Boianovsky do not want to enter the debate: “As historians of economic, our role is not to adjudication the current controversy, which hinges as much as on the interpretation of contemporary data as on economic theory…Our concern is with the history of the idea.” In any case they argue that the reasons why the question almost disappeared from the economic discourse go beyond the fact that after the 50s the economy entered a period of unprecedented growth. “It is not just a story of a disproved theory disappearing from sight.“

Their reconstruction is very useful as a guide to the debate on the causes of stagnation and the evaluation of Summers comments.

3.2 The stagnation idea and its evolution

Backhouse and Boianovsky see at the roots of Hansen original formulation of the stagnation hypothesis the question of the frontier, thus the point of view of historian Frederick J. Turner according to which “the existence of an area of free land its continuous recession and the advance of American Settlement western, explain American development.” In his early work Cycles of prosperity e depression (1921) Hansen centered its analysis on the role of money and credit to later focus on “fluctuations in investment, driven by population changes and waives of innovation, as the root cause of the cycle.” It is the decline of population however becoming the central point of his views. In 1939 he argued: “We

are rapidly entering a world in which we must fall back upon a more rapid advance of technology than in the past if we are to find private investment opportunities adequate to maintain full employment." (Hansen, 1939, p.12)

Public investment had a role to play but it could only partially compensate the fall of private investment. Private Investment is the central concern. After the frontier the rise of technology in the form of motor vehicles and electricity had sustained demand in the 1920s. "The Great Crash of 1929 may have originated in finance and the collapse of speculation, but its consequences were severe because the stimulus from these industries was at the end. " (Backhouse and Boianovsky, p.7)

Hansen defined the "essence of secular stagnation" as "sick recoveries which die in their infancy and depressions which feed on themselves and leave a hard and seemingly immovable core of unemployment:" (ibid.) The roots of the concept are in the Mill's formulation of the stationary state as a low-investment bur high-consumption economy. Except the classics "were wrong in assuming that the price system could also ensure a propensity to consume compatible with this investment situation so as to produce full employment." (Hansen, 1939, p. 288)

A crucial question in the reconstruction of the secular stagnation idea is its relationship to Keynes. Hansen argued that Keynes focused on the psychological and institutional aspects of investment, while disregarding real or objective factors. Keynes took for granted the real factors behind the marginal efficiency of capital. Therefore he "did not associate Keynes with the stagnation thesis" (Backhouse and Boianovsky, p.9). The point can be illustrated by the distinction between movements along the marginal efficiency curve and movements upward of the curve, due to population growth and technical progress. Hansen argued that underemployment equilibrium (a notion that he increasingly identified with secular stagnation) was not so much the result of an elastic liquidity preference schedule. It depended on "limited investment opportunities (technical progress, etc.) combined with a marginal efficiency schedule which is not very highly elastic" (Backhouse and Boianovsky, p.10)

According to Backhouse and Boianovsky "The doctrine of secular stagnation originated in Hansen's analysis of the specific, perhaps unique, circumstances of the United States in the 1930s: the end of the frontier, declining population growth and the problem of a mature economy." They therefore quite interestingly note that under different circumstances the post-war problem of maintaining sufficient investment to absorb rising savings, led Domar to shift the attention to "a general analysis of the problem of economic growth." (Backhouse and Boianovsky, p.15).

The debate around the issue of stagnation involved major figures in the history of economics, such as Samuelson and Harrod. The point is that

the changing meaning and theoretical framework of reference progressively associated stagnation with Keynesian theory. There is a passage that occurs early in the debate that needs to be emphasized with respect to the rejuvenation of secular stagnation by Summers. It was Pigou (1943) who first argued that Hansen's stationary state with unemployment featured a negative equilibrium full-employment rate of interest (Wicksell's natural rate) (Backhouse and Boianovsky, p.8) In order to account for a negative natural rate Pigou assumed that savings are made also for other motives (such as the "desire of possession as such ") which are inversely related to real cash balances. (p.9) Later Klein (1947) "picked up the negative natural rate of interest and turned into a main feature of Keynesian economics." This is why by the end of the 1940s secular stagnation "was increasingly associated with Keynes, not specifically with Hansen."(p.19) Consequently "once secular stagnation was interpreted in terms of a negative natural rate of interest and discussed in the context of the Pigou effect it could become detached from the institutionalist-continental European theoretical framework in which Hansen had defended the doctrine and be linked to Keynes." (ibid.)

To understand the span and complication involved in the concept we can notice that Hansen himself (1954) reviewing Steindl (1952) argued that there were in fact three different categories of stagnation hypothesis. He characterized his own as driven by exogenous factors, that of Schumpeter being focused on the "arterial sclerosis of capitalism", that of, and that presented by Steindl linked to the rise of Oligopoly. [13]

3.3. The stagnation idea today

The debate spurred by Summers should then be seen against a quite complex set of propositions and theories. "Summers has defined secular stagnation as a negative natural rate of interest, a concept he ascribed to Hansen…" (Backhouse and Boianovsky , p.27) although it was really the results of the elaboration by Keynesians such as Klein. On the other hand the zero lower bound to nominal interest rates preceded this debate. When the zero bound problem is made into a permanent and not just transitory feature we have secular stagnation in the sense used by Summers. This is the new secular stagnation hypothesis.

Backhouse and Boianovsky argue that the refutation of the possibility of stagnation by the (positive) economic trends of the post-war period does

[13] Backhouse and Boianovsky recall that the evolution of the concept must be seen in light of the changing notion of "mature economy" that lies behind the reconsideration of the concept by the theorist of the stages of development, Rostow. They also refer to the changing of the concept when applied to the case of Japan and after the 2007 to Europe and the US.

not tell the story of the concept. The debate around stagnation was intertwined with the discussion of the role of the private sector, the excessive concentration of economic power and the federal policy towards debt and state intervention. “Secular stagnation was thus highly political from the start.” (p.29) Indeed proving or disproving the stagnation hypothesis “depended critically on how the idea was interpreted.” (p.30) In particular it might be true that stagnation could reemerge “should the role of government be reduced.” (ibid.)

What killed the idea among academic economists was the competitive equilibrium that came to dominate macroeconomics. There is thus an overwhelming lesson to be learnt from the history of the idea: “its future will depend as much on political factors as on specific economic arguments.” (ibid.)

4. The stagnation tendencies imbedded in Neoliberalism

4.1 The Neoliberal macroeconomic model

It is quite interesting to contrast this last observation with the analysis of the Neoliberal model (Palley, 2012). Stagnation is the necessary result of the policies pursued since the 1980s and that have brought us to the 2007 crisis. A fundamental role is played by “bad ideas”, which are located in political philosophy as much as in economic theory and define modern Neoliberalism. Hayek and Milton Friedman have displaced basic Keynesian theory. This is the story of the last thirty years since the Reagan – and Thatcher- “revolution”.

The financial crisis was the result of the “faulty US macroeconomic paradigm that has its roots in neoliberalism which has been the dominant intellectual paradigm.“ (p.4) Part of this paradigm is the Neoliberal growth model combined with a model of engagement with the global economy. The exhaustion of both underlies the crisis. Lacking a fundamental change of paradigm the crisis and the recession are going to drive the Great Recession.

The shift to the neoliberal model of growth follows the dismissal of the classic Keynesian virtuous circle of growth. (p.34) It meant the abandonment of the commitment to full employment, an exclusive focus of controlling inflation (well beyond the employment-inflation trade off), thus severing the productivity-wage link. “In place of wage growth as the engine of demand growth, the new model substituted borrowing and assets inflation. “(ibid.) The pressure on wages was both internal (policies against unions) and external (off-shoring of production and rise of cheap imports).

“These features” argues Palley have been visible in every US business cycle since 1980.” (p.35) They have consistently shown a weak recuperation of employment giving rise to the phenomenon of “jobless recoveries”.

The fundamental problem is the dismantling of US manufacturing in favor of cheap imports combined with the off-shoring of production and the stagnation of wages. Successful as it was this strategy has undermined the system of generation of demand and destroyed the prospects of shared prosperity. In fact the implementation of the model destroyed the Keynesian virtuous circle in favor of a bubble economy. And yet it did work for a number of years. “Although prone to instability (boom and bust) the neoliberal growth model might have operated successfully for quite a while longer were it not for a US economic policy that created a flawed engagement with the global economy.” (pp. 43-44) Its most unsustainable aspects were the erosion of households’income and the piling up of unproductive debt. That is why “The model would likely have eventually slumped because of its internal dynamics” but “the policy triumph of corporate globalization (the model of globalization lobbied for by corporations) accelerated this process and transformed it into a financial crash.” (p. 44)

In other words, the flaws of the model of US engagement with the global economy is the key factor in the crisis. That shows in the negative effects of the trade deficit that shows prominently in Palley explanation. In the same way the development of finance accounts for the form taken by the crisis, which at the onset was primarily a financial crisis.

The Trade policy especially of the two Clinton administrations created the trade deficit that became a growing and permanent aspect of the US economy. It must be seen in a larger policy scheme. “The United States would import from East Asian and other developing economies, provide FDI to those economies, and run large deficits that would provide the demand for the new supply. In return, developing countries would accumulate financial obligations against the United States, principally in the form of Treasury securities. This would provide them with foreign exchange reserves and collateral that was supposed to make investors

feel secure. China was to epitomize the new arrangement." (p.52) This picture implied however three forms of leakages for the US economy: loss of spending going to imports, loss of jobs driven by corporate globalization, and loss of new investment.

The crisis was the result of the undermining of the economy and indeed the manifestation that the model was unsustainable. Without a change of paradigm argues Palley the structural weaknesses of the US macroeconomic model imply that there is no escape from the pull of stagnation (p.56)

4.2 The role (and paradox) of finance

Although put in place in the 1980s and 1990s the flawed macroeconomic model fully displayed its negative consequences during the 2001-2007 expansion. It relied on debt and asset price inflation to sustain demand growth. That in turn highlights the particular role of finance and the dynamics of the financial crisis.

Financialization and the raise of financial capital are the characteristic of the neoliberal model. In many accounts they are the explanation of the crisis. According to Palley finance "plays a critical part in explaining why the contradictions of the neoliberal model took so long to surface and why they surfaced in the form of a financial crisis." (p.57)

The finance-fed expansion of the last decade hides the erosion and dismantling the "demand-generating process" that was put in place since the New Deal. Finance then has a peculiar role in the interpretation of the crisis. Finance evolved as a form of compensation, to fill a demand-gap that was the most evident shortcoming of the neoliberal growth model centered on the compression of wages. It became the substitute for wage and investment growth.

Although the model of financial markets is itself "flawed" financialization prevented to an extent the crisis imbedded in the neoliberal model. It had a "positive' effect with respect to the fundamental causes of the crisis (the erosion of the real economy), at the cost of an increasing financial fragility (debt) and inflated asset prices (the bubbles). So finance is not at the roots of the crisis but its development imposed the path to the crisis.[14]

The financial sector did so according to different modalities during the three decades since the emergence and establishment of the neoliberal

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[14] The erosion of the real economy is essentially that of the "manufacturing base and of the process of income and demand generation…That created a growing demand shortfall relative to the demand needed to sustain full employment, and this shortfall was filled via financial markets." (p.58)

growth model. Deregulation (Palley focuses on four pieces of legislation in 1980, 1982, 1994 and 1999) operated to increase the elasticity of supply of finance. It was combined with financial innovation. "In sum, the combination of a constant stream of innovations and deregulation, changing psychology and belief, and changing business and regulatory culture created what seemed to be a perpetual-motion financial machine." (p. 66)

As opposed to these developments that cover the three decades before the financial crisis of 2008 stands the "mechanics of the Crash" that concerns the flaws of the financial system and the causes of the financial crisis. The channels of transmission of the crisis to the global economy complete the picture of the dead-end in which the economy is, with an additional paradox. If indeed finance was the engine of demand growth, regulating the sector implies that it could no longer operate in that direction. That is a further reason why the model has nothing to offer except for the prospects of stagnation.

4.3 The law of unintended consequences

But the functional role of finance was not planned. Palley maintains that: "it reflects the law of unintended consequences." (p. 75)

Neoliberal economists such as Greenspan and Summers did not think that finance were to play the role of filling the demand-gap resulting from paradigm shift and the ensuing economic policy. "…they believed the model would promote economic efficiency and freedom." (ibid.) Following the theory of efficient markets deregulated financial markets would increase saving and investment.

"That was the thinking that drove policy. However, the way it actually worked was completely different, reflecting the law of unintended consequences." (ibid.) Through debt expansion and repeated assets bubbles neoliberal policies unintentionally created "a mechanism that temporarily papered over the profound flaws of their growth model." In the end that "pushed the economy into the worst financial crisis since the great Depression and now the economy confronts an even more profound and prolonged stagnation." (p.76)

Concluding remarks

Years after the end of the recession a prominent figure such as Lawrence Summers takes some time and effort to argue that we should take seriously the notion of stagnation. He does so within a theoretical scheme Palley calls mainstream Keynesianism. It is not surprising then the

emphasis on the interest rate and the identification of secular stagnation with a negative interest rate.

However the understanding of the nature of the crisis should not be underestimated. He recognizes that a negative interest rate is the result of an excess of saving over investment, although saying very little about what may lay behind this situation. That remains confined to the domain of the “exogenous forces”. And yet directing policy on a new path involves dealing with these forces. What else could be behind the “a concerted effort to identify and find the means of financing the most productive investment opportunities globally”?

His argument is quite different from that of Alvin Hansen He recalls the declining population factor, but not the causes of stagnation discussed by Hansen. It is also silent on what Backhouse and Boianovsky call the political nature of the discussion on stagnation. That involves at a very fundamental level the question of fiscal policy and government intervention. Could government action prevent stagnation?

Palley argues that the problem is neoliberal macro model that dictated the US policy economic policy of the last thirty years. The crisis signals that it was finally caught by its own internal contradictions and is no longer sustainable. In the circumstances of the ongoing crisis there is no escape from the prospects of stagnation. Policy is a key issue. Stagnation may ultimately be the result of bad ideas but they certainly were put in action by a set of deliberate policies.[15]

According to Palley Summers is one of the architects of Neoliberalism, therefore of the policies leading in his view to stagnation. Today Summers insists on a change of policy, although is rather vague on how it could be accomplished. It certainly has at its center investment, both private and public.

The two perspectives although clearly conflicting have some important similarity, it concerns the nature of the crisis and what it says. It signals a persistent, long-term phenomenon, not a short run disturbance. Meanwhile stagnation seems the appropriate way to describe a situation of long-term decline punctuated by brief recoveries and a progressive erosion of standards of living of a large part of the population.

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[15] “Economic policy played a critical role in generating and shaping the new growth model.” (Palley, p.37)

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