SHOULD WE FEAR LOW INTEREST RATES OR "SECULAR STAGNATION"?

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WHAT IS SECULAR STAGNATION?

Possible meanings include:

- Low nominal interest rates
- Low real interest rates
- Hysteresis / Reverse Say's Law
- Slow productivity growth
- Slow population growth (Alvin Hansen)
- Persistently slack labor markets

What does Summers mean by secular staganation?

Mostly: Low nominal and/or real interest rates

(Slow population growth and possibly slow productivity growth are among the causes of low rates.)

(Secular stagnation interacts negatively with hysteresis.)

The term “secular stagnation” is a victory for marketing over clarity.

Should we fear low interest rates?

My answers:

Low *nominal* rates are dangerous... but the problem is easy to mitigate.

It's unclear whether low *real* rates are dangerous... and it's unclear what policy can do about low real rates.

The danger from low nominal rates arises from the zero lower bound:

From 1945 through 2007, the Fed responded to recessions by reducing rates sharply, which produced V-shaped recoveries.

Over 2008-2015, the zero bound impeded recovery from the Great Recession.

In the future, the zero bound is likely to constrain policy frequently:

Peek et al.: $i^* = 2.875$

To offset a typical recession, the Fed needs to reduce i by 5.0 - 6.0

There have been eight recessions since 1960, or one every 7.4 years.

We have seen that a zero-bound episode can last 7 years ...

So, going forward, we should expect that the zero bound will often constrain policy.

When that happens, the real interest rate will exceed its neutral level and the economy will be stuck with underemployment.

The Pernicious Interaction Between the Zero Bound and Hysteresis

Recession → i hits zero bound

→ $Y < Y^*$

→ hysteresis drags down Y^*

→ new equilibirum with $Y = Y^*$ at lower level

→ Fed starts raising i toward 2.875, until the next recession...

Over time, the path of Y^* ratchets down repeatedly.

What can be done about the zero bound??

Increase inflation. For example, if the Fed raises its inflation target from 2 to 4, i* rises from 2.875 to 4.875.

Will it happen?

When Blanchard mentioned a higher target in 2011, mainstream policymakers rejected the idea out of hand (e.g., Bernanke at Jackson Hole).

As the zero-bound episode dragged on, it became OK to discuss the idea at conferences.

Today, many people are edging toward endorsements of higher inflation.

> Summers, June 2018: Monetary policy "should have the property that in normal times the federal funds rate will exceed 4 percent."
>
> Peek et al.: The Fed may need to "build a larger monetary buffer."

It may take another zero-bound episode or two, but eventually policymakers will accept the need for higher inflation. That will greatly reduce the problem of low nominal interest rates.

But... safe real interest rates may still be low.

Is that dangerous? What should be done?

Two possible dangers of low real rates:

1) Persistent underemployment

2) Financial instability (excessive risk-taking, bubbles, ...)

Hansen's (1939) worry: persistent underemployment resulting from S>I.

In today's textbooks, r always adjusts to ensure S=I. But Hansen does not trust that mechanism:

> "Few believe that in a period of investment stagnation an abundance of loanable funds at low rates of interest is alone adequate to produce a vigorous flow of real investment... The prospective rate of profit on new investment is the active, dominant, and controlling factor..."

Summers sometimes appears to endorse this view.

In textbook terms, the IS curve becomes vertical at low interest rates. Therefore, if IS shifts to the left, there may be no interest rate that produces the full-employment level of output. [SEE GRAPH]

I don’t know...

Is there evidence for the secular stagnation view?

Many discussions confuse shifts in the IS curve with the slope of the IS curve.

From history, we know that IS is far from vertical in the relevant range when $r^*=2.0$. Is the slope so different when $r^*=0.9$?

A hypothesis: Interest-sensitive spending exists always and everywhere... e.g., people at the margin for buying a new car, firms at the margin for investment projects.

Do low safe interest rates cause problems in the financial system?

Some possible dangers....

Profit squeezes at financial institutions: banks, insurance companies, and money market funds.

These problems arise primarily from low nominal rates, not low real rates (?)
... so cured by higher inflation.

Low interest rates → reach for yield: Miscellaneous thoughts:

- A relationship between safe real rates and risk spreads does not jump out of the data (e.g., Baa-Treasury spread).

- Lian and Ma find that reach for yield depends mainly on nominal rates, not real rates.

- Is it bad if people make riskier investments? The equity premium suggests that people take on too little risk. Jeremy Siegel hopes that his *Stocks for the Long Run* "will fortify those who will inevitably waver when pessimism once again grips economists and investors."

- One possible cause of low safe rates is increased demand for safe assets after the 2008 crisis revealed tail risk (e.g., Kozlowski et al. 2018). In that case, it doesn't make sense to worry that low safe rates will cause excessuve risk-taking.

Low interest rates → asset price bubbles?

What is the mechanism? Most discussions are cryptic.

What is the evidence? The role of low rates in the 2000s housing bubble is debatable... Are there other relevant episodes?... International data do not suggest a relationship between $i<1.0$ and booms in real estate or stock prices (Posen, 2003).

Policies to raise real interest rates?

Summers (2014): actions to improve “long-run supply-side fundamentals such as policy measures that ensure the sustainability of entitlement programs, provide for tax reform, and facilitate investments in labor force skills and innovation.” Such policies “can contribute to confidence and thereby boost demand.”

These are wonderful goals, but easier said than done.

Summers (2016): increased government spending. “An expansionary fiscal policy can reduce national savings, raise neutral real rates, and stimulate growth.”

That is not what I learned in school.

The U.S. economy is dynamically efficient (Abel, Mankiw, Summers, and Zeckhauser, 1989). Therefore, a decrease in national savings would retard growth.

Summers advocates government spending on infrastructure investment (e.g., Kennedy Airport). This might be a good idea, but only if the benefits outweigh the costs: crowding out of private capital plus deadweight loss from taxation.