What Market Failures Underlie Our Fears of "Secular Stagnation"?

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<https://www.icloud.com/pages/0BsJmiTdZ3AemMxTHK7uBdRQg>
<https://github.com/braddelong/public-files/blob/master/paper-secular-stagnation-market-faiures-2014.pdf>

3785 words

2014-01-09

I. The Lesson

A. Lawrence Summers

The first part of our lesson for today consists of a piece based on his AEA presentation by Lawrence Summers: Strategies for sustainable growth:

> Last month I argued that the U.S. and global economies may be in a period... in which sluggish growth and output, and employment levels well below potential... coincide... with problematically low real interest rates…. Even with the high degree of slack in the economy and with wage and price inflation slowing, there are signs of eroding credit standards and inflated asset values. If the United States were to enjoy several years of healthy growth under anything like current credit conditions, there is every reason to expect a return to the kind of problems of bubbles and excess lending seen in 2005 to 2007 long before output and employment returned to normal trend growth or inflation picked up again...

Having identified the problem, Summers then writes:

> There are, essentially, three approaches:
>
> (1) Emphasize… deep supply-side fundamentals: the skills of the workforce, companies' capacity for innovation, structural tax reform

> and ensuring the sustainability of entitlement programs. This is appealing.... But this approach is unlikely to do much in the next five to 10 years….
>
> (2) Lower relevant interest rates and capital costs as much as possible and relying on regulatory policies to ensure financial stability. No doubt the economy is far healthier now than it would have been in the absence of these measures. But a growth strategy that relies on interest rates significantly below growth rates for long periods virtually ensures the emergence of substantial financial bubbles and dangerous buildups in leverage. The idea that regulation can allow the growth benefits of easy credit to come without cost is a chimera. The increases in asset values and increased ability to borrow that stimulate the economy are the proper concern of prudent regulation....
>
> (3) The [approach] that holds the most promise is a commitment to raising the level of demand at any given level of interest rates through policies that restore a situation where reasonable growth and reasonable interest rates can coincide... ending the disastrous trends toward ever less government spending and employment each year and taking advantage of the current period of economic slack to renew and build out our infrastructure. If the federal government had invested more over the past five years, the U.S. debt burden relative to income would be lower: allowing slackening in the economy has hurt its long-run potential. Raising demand also means spurring private spending. Much could be done in the energy sector to unleash private investment toward fossil fuels and renewables... more rapid replacement of coal-fired power plants... mak[ing] sure that a widening trade deficit does not excessively divert demand from the U.S. economy…

And Summers then concludes:

> Secular stagnation is not inevitable. With the right policy choices, the United States can have both reasonable growth and financial stability. But without a clear diagnosis of our problem and a commitment to structural increases in demand, we will be condemned to oscillating between inadequate growth and unsustainable finance. We can do better…

B. Ryan Avent

The second part of our lesson for today is a gloss on and critique of same by Ryan Avent:

> **Secular stagnation: Why is stagnation bubbly?**: Imagine a world, [Summers] said, in which resources are increasingly concentrated in the hands of those with high propensities to save and low propensities to invest: reserve accumulating foreign governments... the very rich....

> The real rate of interest that... balances savings and investment [at high employment]... could fall to and remain at very low levels….
>
> The central bank would need to keep its policy rate near zero... asset prices would soar... a dangerous rise in financial instability.... The market-clearing interest rate could fall below zero, leaving the central bank unable to move... and trapping the economy in a prolonged slump. The evidence of our senses, and the judgment of bond markets, appears to strongly support this story….
>
> Summers' preference would be to close the gap between investment and saving through direct fiscal stimulus... a hefty programme of public investment[:]... if now—with the economy slumping and the government able to borrow at negative real rates—is not the time to fix JFK airport in New York City, when is?... If one runs a large, 5-year fiscal stimulus plan through the Federal Reserve's basic economic forecasting model, one gets a debt-to-GDP ratio several decades down the road that is lower than in the absence of stimulus, because of the costly nature of a prolonged slump, even if one assumes that production resulting from stimulus is tossed in the ocean and generates zero productivity gains for the economy.
>
> There is another possibility... what I called "the solution that cannot be named"... temporarily raise inflation.... Mr Summers dismissed this possibility. He argued that clearing the market by raising inflation would simply encourage more private investment and reduce saving.... Full employment generated that way would simply lead to increased financial instability: more bubbles. This left me a bit puzzled as to what his story about stagnation actually is…

And here Ryan registers both disagreement and a failure to follow the logic of the argument:

> We're talking about two very different phenomena! We have the... zero lower bound prevents the central bank from generating adequate demand. And... we have... savings pile up, generating a dangerous hunt for yield.... Why would we think that solving the first problem would exacerbate the second? Mr Summers seems to be arguing that more demand would simply mean more investment, and because we lack sufficient good (private) investment opportunities already (which is why long-term real rates are low) adequate demand just means more foolish investment.... But... are we really arguing that there aren't enough good private investment opportunities in America?...

And he endorses, instead, the *inflationista* position of Olivier Blanchard:

> Olivier Blanchard responded to Mr Summers' take on secular stagnation by arguing that policymakers should target higher inflation to generate adequate demand and then use macroprudential policies to

> rein in financial instability.... There are many sources of excess saving. Macroprudential policies might very effectively filter out some of them (like inward capital flows from reserve-accumulating foreign governments) while leaving other savings perfectly free to scale up investment and boost the economy….
>
> I whole-heartedly agree with Mr Summers that seizing the opportunity now offered by bond markets to make lots of useful public investments is a win-win-win idea. Probably win-win-win-win. But the evidence strongly suggests that a higher inflation target would in fact make life much easier…

C. The Questions

Now let me proceed to my commentary, in which we will see if I can untangle this analytical Gordian knot: What is (are) the underlying market failure(s) here? What would be the first-best solution to compensate for them? What are the possible second-best solutions, and what are the benefits and costs of each?

That is the economist's analytical catechism, and it is—I think—a good one to apply here.

II. The Blanchardist Critique

A. The Summersian Position

Start with what I will call the *Summersian* position. As I understand it, it begins the chain of its analysis by focusing on three perhaps-independent root factors:

(1) A **concentration of wealth**—due to earnings from commodity exports and surpluses from pursuing industrial-policy strategies of undervaluing currencies in order to generate the social learning promoted by export-led manufacturing growth—in the hands of sovereign wealth funds and other political actors that seek not to maximize risk-adjusted return but instead some other objective that we can think of as "safety of nominal principal". This is a market failure: they are not properly responding to real economic incentives.

(2) A **concentration of wealth**—due to other factors making for increasing wealth inequality—that concentrates savings in the hands of the rich who seek not to maximize risk-adjusted return but instead to preserve their principal as they guard against large-scale political risks. This makes the following market failure crucial:

(3) The **zero nominal bound** on safe interest rates keeps the return on safe savings above its free-market equilibrium price.

B. The Natural Response

What seems to me the natural response to the Summersian argument's assertion of is then made by IMF Chief Economist Olivier Blanchard. It goes thus:

Political actors value not real wealth and risk-adjusted return but rather nominal safety and liquidity? Then you can provide what they want at a lower resource cost by having a higher inflation target—5% per year or so rather than our current target of less than 2% per year.

The rich seek safety, and are unwilling to bear the risks of enterprise and so the real rate of interest that clears the market for safe bonds is less than zero? Here too the answer is a 5% per year inflation target: that lifts the constraint imposed by the zero nominal lower bound, and allows the market to clear.

Thus, what I will call the *Blanchardist* position argues, there is no insoluble problem, only a units-of-account problem and thus opportunity. This can be easily solved:

- The problem is that the government has pegged the return on safe assets at a real return of -1% when the free-market equilibrium real return is -3%, and, given our institutions, a higher inflation target is the best way to release this distortionary price floor.

- The opportunity is that the non-market political actors can be satisfied at lower resource costs under a higher inflation target. So why not do so?

These arguments appear very strong. But they are not convincing to Summers.

What else is he thinking besides (1), (2), and (3)? And why?

III. Greenspanite Considerations

A. What Inflation Targets Are Sustainable?

One argument—the argument that Paul Volcker, Alan Greenspan, and (I believe) Ben Bernanke would make—is that a 2% per year inflation target is sustainable over the long run, but that a 5% per year target—even a 3% per year target—is not, or is not easily sustainable.

A 5% per year inflation target, this argument I will call *Greenspanite* goes, demonstrates to investors everywhere that effective price stability is really not high on the central bank's list of priorities. Emergencies and politics will pressure the central bank, and if effective price stability is not the highest priority it will succumb to the temptation to relax its inflation target.

Thus a central bank that has been happy with a 5% per year rate of inflation last year will be willing to tolerate a 7% per year rate of inflation next year.

Thus if past inflation has been 5% per year, expected inflation will be 7% per year—and the central bank will either watch inflation creep up until it escapes from all control and 1982 is required again to re-anchor expectations again, or the central bank will have to perennially target an unemployment rate higher than the natural rate in order to keep actual inflation at 5% per year below expected inflation at 7% per year, with enormous resulting economic losses.

This Greenspanite argument is, I think, relatively strong within the community of central bankers.

I recall one very, very senior monetary policymaker telling me in the late 1990s that Greenspan had in fact pushed the envelope hard in defining a

2% per year inflation target as "effective price stability", and that had been a gutsy loose-money move for someone in his position.

B. A Corollary

A corollary to this Greenspanite argument is that the government derives seigniorage from being in the liquid-safe-store-of-value business, and that the public derives utility from having the liquid-safe-store-of-value business run by a very patient organization with a very long time horizon.

Suppose that the central bank does establish and maintain a 5% per year inflation target. At some point it will strike the investment bank of Schiff Medici Pomponius that it can get into the liquid-safe-store-of-value business as well. They will turn loose their quants to construct the optimal basket of durable, storable commodities to mimic the overall price level; fill containers with those commodities; park the containers—along the Hudson, the Thames, in Tokyo Bay, and in Singapore Strait, or wherever — guard them; set up their own cryptocurrency; announce that they stand ready to buy and sell their cryptocurrency for any other currency at its current commodity value; and so take the seigniorage business away from the 5% per year inflation governments.

Thus as long as Schiff Medici Pomponius remains long-term greedy, the real commodity value of SchiffMediciPomponiusCoin will remain stable. But it will not have the resources to be a proper stabilizing central bank; tying up capital in commodities and containers is a reduction in social wealth; and the containers will actually be full of commodities only as long as Schiff Medici Pomponius remains long-term greedy.

When it stops being so, watch out! Thus there is an inverse-Gresham's Law process at work here: short-term good money will drive out less-good money in the medium run, but in the long run the fact that investment banks are likely to have shorter horizons and definitely have less resources than governments will be the cause of enormous trouble.

I have not found anybody else who makes their corollary argument, so I will call it the *DeLongian* corollary. The question is: where does this corollary—and the original Greenspanite argument—start to apply? It is pretty clear to me that 2% per year is a sustainable inflation rate over the long run. It is pretty clear to me that 10% per year is not. Greenspan, I think, believes that 3% per year is not sustainable. I think it is. I think 5% per year is probably sustainable, but I admit to having little basis for my belief. And I do not think anybody really knows.

This §III, however, has been for the most part a digression. These Greenspanite and DeLongian corollary arguments are, I think, important and weighty. But they do not appear to be the reasons that the Summersian position rejects the Blanchardist proposal for a 5% per year inflation target.

IV. Low Interest Rates and Financial Stability

A. Implications for Fiscal Policy

Let's parse Larry Summers's anticipatory rebuttal to the Blanchardist higher-inflation target proposal. Summers expicitly calls not for a higher inflation target but, instead, for:

> a commitment to... policies that restore a situation where reasonable growth and reasonable interest rates... coincide... ending the disastrous trend towards ever less government spending and employment... taking advantage of the current period of economic slack to renew and build up our infrastructure.... In the energy sector... unleash[ing] private investment on both the fossil fuel and renewable sides.... requir[ing] the more rapid replacement of coal-fired power plants... ensur[ing] that a widening trade deficit does not excessively divert demand from the US economy…

The first best, for the Summersian position, thus seems to involve a very different fiscal policy. The government should be taking advantage of the global savings glut to borrow-and-spend—and, given how low its borrowing costs are and how large is the economic slack produced by too-tight fiscal policy, borrow-and-spend would be an effective way of rebalancing the long-term finances of the government and lowering debt burdens as well.

The first best, for the Summersian position, also involves very different environmental regulation: carbon taxes to accelerate the phase-out of coal power and the buildup of first non-carbon energy, second closed-carbon-cycle energy, and third natural gas energy, with its release of the energy from the transformation of four rather than two carbon-hydrogen to carbon-oxygen bonds for each molecule of global warming carbon-dioxide created; and, failing carbon taxes, the regulatory stick to require the investments in energy we would be making if the Pigovian carbon-tax carrot were working properly.

And the government should be making sure that non-market wealthholders' demand for dollars does not push U.S. exports and manufacturing production below their first-best levels.

Thus, the Summersian position appears to go, the current stance of fiscal policy is very, very wrong: government purchases and government investment are too low, environmental regulation is too hesitant and insufficient, and U.S. trade policy does not properly compensate for the distortionary harm inflicted on U.S. export and import-competing manufacturing by the market failure of so much global wealth being controlled by political actors. We should, therefore, move immediately to the first-best fiscal policy. Were we to do so, we would find that we had a much stronger economy, a lower prospective long-term debt burden, and no requirement to raise the inflation target in order to clear the market at the first-best price of the real return on safe 98766debt.

OK. That makes a lot of sense. I am 100% behind this aspect of the Summersian position...

B. The Existence of Republicans Constrains Fiscal Policy

But we are not going to get to this first-best fiscal policy, absent the complete destruction of Republican legislative power, plus the recognition by both the Rubin wing of the Democratic Party that now is the time to spend more, and the recognition by the Very Serious

People who have been the debt-scold caucus that they have been barking up the wrong tree, plus the conversion of Obama to the belief that in his attachment to the debt-scold caucus he has served America poorly.

So, the Blanchardists might argue, isn't a higher inflation target then the second-best? Given fiscal dysfunction, isn't that the best we can do? And the Summersian position still says: "No". Summers somewhat elliptically writes against:

> the... strategy... [of] lowering relevant interest rates and capital costs as much as possible, and relying on regulatory policies to assure financial stability.... A strategy that relies on interest rates significantly below growth rates for long periods of time virtually guarantees the emergence of substantial bubbles and dangerous build-ups in leverage. The idea that regulation can allow the growth benefits of easy credit to come without the costs is a chimera. It is precisely the increases in asset values and increased ability to borrow that stimulate the economy that are the proper concern of prudential regulation...

The argument seems to be thus: Yes, we could have a higher inflation target and so lower real rates on safe bet well below zero, and with a constant risk premium thus lower required yields on real assets low enough and boost real asset prices high enough to induce enough private investment and private consumption to get us to full employment. But we also need to guard against bubbles and financial instability. And macroprudential regulation works by putting barriers in the way of the wrong people holding risky investments and thus works by raising the spread between the real safe rate of return and the required risky yield. What we do to stimulate investment via a higher inflation target at the zero nominal bound we undo by macroprudential regulation that raises spreads, and thus leaves the required real yield where it was: too high to induce enough private investment (and consumption) to get us to properly full employment.

The Blanchardist response to this is well-put by Ryan Avent:

> There are many sources of excess saving. Macroprudential policies might very effectively filter out some of them (like inward capital flows from reserve-accumulating foreign governments) while leaving other savings perfectly free to scale up investment and boost the economy.... Lots of useful public investments is a win-win-win.... But the evidence strongly suggests that a higher inflation target would in fact make life

> much easier...

How much wiggle room there is in fact to boost private investment without triggering private financial instability by give us via lowering real safe interest rates below zero while taking away the macro prudential regulation that pushes unworthy risk bearers out of the market? That is a complicated and understudied question. I cannot deal with it here.

C. The Underlying Market Failure Argument

What I do want to do is make explicit the underlying Summersian argument: the required real yield on private investments low enough to induce enough investment to balance savings at full employment is too low a yield to properly discourage bubbles and overleverage. The argument appears to be:

- There are "worthy" private risky investment projects and "unworthy" ones.
- "Worthy" risky investment projects have a relatively low elasticity of supply with respect to the required real yield.
- "Unworthy" ones have a high elasticity of supply.
- When safe real interest rates get too low savers who should not be bearing risk do so by reaching for yield—they stop checking whether investment projects are "worthy" or "unworthy", and so sell unhedged puts in the hope that everything will come out all right.

This is what provokes Ryan's despairing plea that:

> are we really arguing that there aren't enough good private investment opportunities in America?…

Yes. We are.

Or, perhaps, we are arguing that there aren't enough good *relatively safe* private investment opportunities in America. Or, perhaps, we are arguing that there has been a large-scale systematic failure to mobilize the economy's risk-bearing capacity so that when additional risky private investment opportunities are launched the risks are carried by intermediaries that really should not be carrying them.

The argument seems to be that there are people who should be holding risky assets, that there are people who should be holding safe assets, and that lowering the real return to safe assets induces people who really should not be holding risky assets to go and try to hold them. Thus we need an alternative mechanism to boost the desired supply of capital to fund risky private investment projects than lowering safe real interest rates.

V. The Punt

That seems to me, at bottom, to be the Summersian argument. That appears to me to be the reason why a higher inflation target does not even get us to an acceptable proper second-best, given fiscal dysfunction. The market failure is that some of the demand for risky assets is provided by institutions that have no business holding risky assets.

What is the proper, politically-attainable second-best, then? Ah. Here I am stuck.

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