

The secular stagnation equilibrium

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The economic state of slow growth and underemployment, coupled with low inflation or even deflation, has recently been widely discussed, in particular by [Larry Summers](#), under the label of “secular stagnation”. The hypothesis of secular stagnation was expressed for the first time in 1938 in a speech by A. Hansen, which was finally [published in 1939](#). Hansen was worried about insufficient investment and a declining population in the United States, following a long period of strong economic and demographic growth.

In a [Note by the OFCE \(no. 57 dated 26 January 2016 \[in French\]\)](#), we studied the characteristics and dynamics of a secular stagnation equilibrium.

A state of secular stagnation results when an abundance of savings relative to demand for credit pushes the “natural” real interest rate (what is compatible with full employment) below zero. But if the real interest rate permanently remains above the natural rate, then the result is a chronic shortage of aggregate demand and investment, with a weakened growth potential.

To counter secular stagnation, the monetary authorities first reduced their policy rates, and then, having reached the zero lower bound (ZLB), they implemented non-conventional policies called quantitative easing. The central banks cannot really force interest rates to be very negative, otherwise private agents would have an interest in keeping their savings in the form of banknotes. Beyond quantitative easing, what other policies might potentially help pull the economy out of secular stagnation?

To answer this crucial question, the model developed by [Eggertsson and Mehrotra](#) in 2014 has the great merit of clarifying the mechanisms behind a fall into long-term stagnation, and it is helping macroeconomic analysis to update its understanding of the multiplicity of equilibria and the persistence of the crisis. Their model is based on the consumption and savings behaviour of agents with a finite lifespan in a context of a rationed credit market and nominal wage rigidity. As for the monetary policy conducted by the central bank, this is set at a nominal rate using a [Taylor rule](#).

According to this approach, secular stagnation was initiated by the 2008 economic and financial crisis. This crisis was linked to high household debt, which ultimately led to credit rationing. In this context, credit rationing leads to a fall in demand and excess savings. Consequently, the real interest rate falls. In a situation of full employment, if credit tightens sharply, the equilibrium interest rate becomes negative, which leaves conventional monetary policy toothless. In this case, the economy plunges into a lasting state of underemployment of labour, characterised by output that is below potential and by deflation.

In the model proposed by Eggertsson and Mehrotra, there is no capital accumulation. As a result, the underlying dynamic is characterized by adjustments without transition from one steady state to another (from full employment to secular stagnation if there's a credit crisis, and vice versa if credit doesn't tighten much).

To extend the analysis, we considered the accumulation of physical capital as a prerequisite to any productive activity ([Le Garrec and Touzé, 2015](#)). This highlights an asymmetry in the dynamics of secular stagnation. If the credit constraint is loosened, then capital converges on its pre-crisis level. However, exiting the crisis takes longer than entering it. This property suggests that economic policies used to fight

against secular stagnation must be undertaken as soon as possible.

There are a number of lessons offered by this approach:

- To avoid the ZLB, there is an urgent need to create inflation while avoiding speculative asset “bubbles”, which could require special regulation. The existence of a deflationary equilibrium thus raises the question of the appropriateness of monetary policy rules that are overly focused on inflation.
- One should be wary of the deflationary effects of policies to boost potential output. The right policy mix is to support structural policies with a sufficiently accommodative monetary policy.
- Cutting savings to raise the real interest rate (e.g. by facilitating debt) is an interesting possibility, but the negative impact on potential GDP should not be overlooked. There is a clear trade-off between exiting secular stagnation and depressing potential GDP. One interesting solution could be to finance infrastructure, education or R&D (higher productivity) through government borrowing (raising the real equilibrium interest rate). Indeed, an aggressive investment policy (public or private) funded so as to push up the natural interest rate can meet a dual objective: to support aggregate demand and to develop the productive potential.