



# Secular stagnation: Evidence and implications for economic policy

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# Definition of secular stagnation

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- **Prolonged demand weakness undermines potential output and growth via labour hysteresis and discouraged investment**
- **Demand weakness is partly due to the inability of monetary policy to stimulate demand sufficiently given problems with lowering real interest rates below their neutral levels [  $r^*_t < (i_t - \pi_t)$  ]:**
  - **Especially if neutral rates have turned negative**
  - **Zero bound on nominal interest rates**
  - **Low inflation due to large economic slack**



# Outline

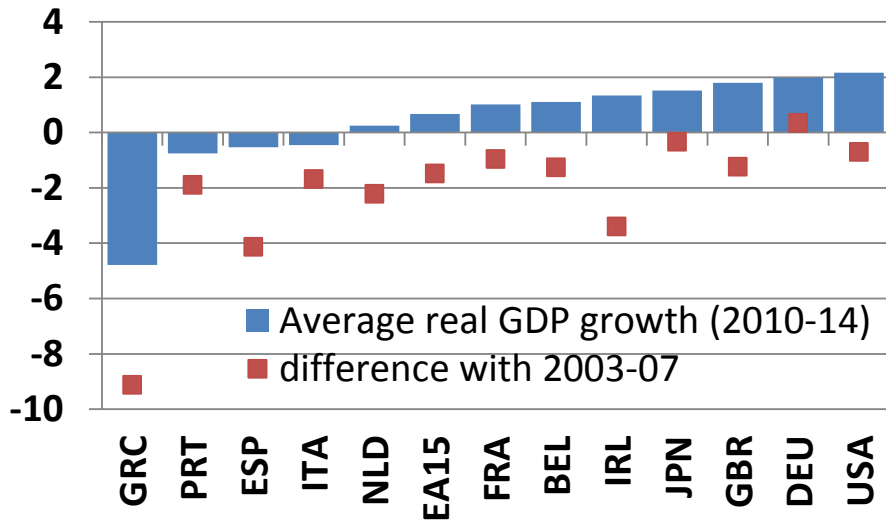
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- **Evidence about secular stagnation**
  - **Stagnation**
  - **Economic slack and crisis-related reduction in potential output**
  - **Disinflation**
  - **Neutral real interest rates**
- **Policy and other considerations**

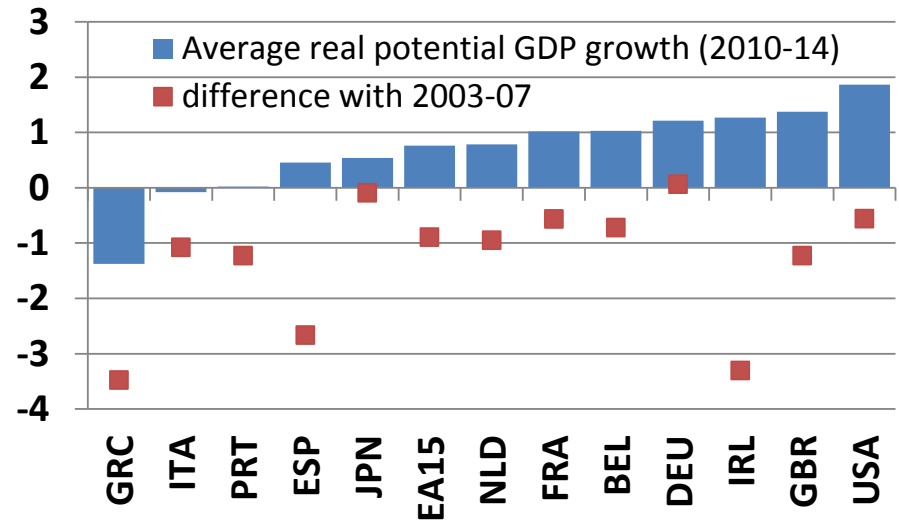


# Evidence – stagnation

## Real GDP growth



## Real potential GDP growth

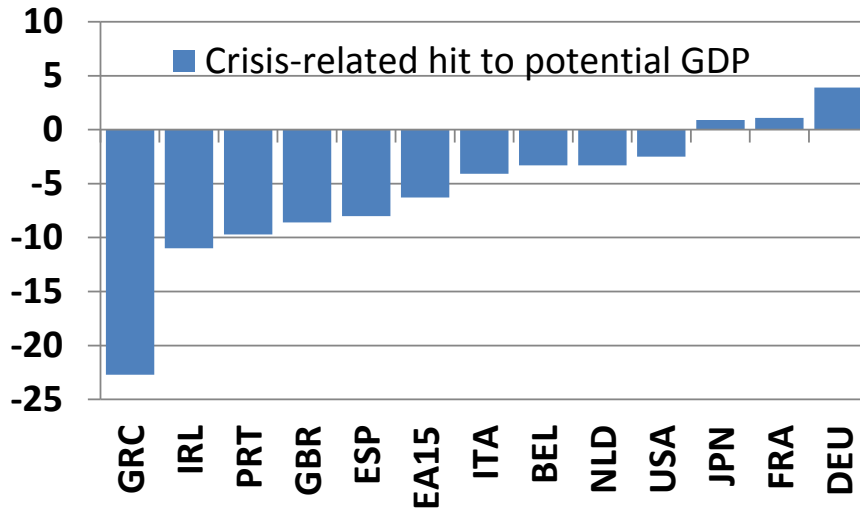


Source: November 2014 Economic Outlook

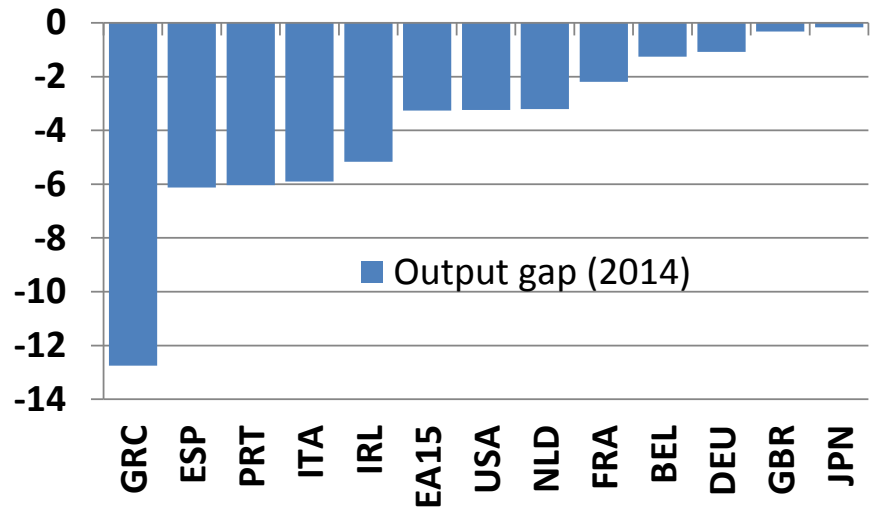


# Evidence – hit to potential & economic slack

### Crisis-related hit to potential GDP



### Output gap in 2014



Source: November 2014 Economic Outlook and Ollivaud and Turner (2014), “The Effect of the Global Financial Crisis on OECD Potential Output”, *OECD Economics Department Working Papers*, No. 1166, OECD Publishing.



## Evidence – limited disinflation

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- **The insensitivity of inflation to the level of slack has played a key stabilising role in recent years and has helped ward off worse outcomes:**
  - Low inflation rates in advanced economies may have made downward nominal rigidities more binding as workers are reluctant to accept nominal wage cuts.
  - The apparent weak impact of domestic demand pressure on inflation was evident well before the crisis:
    - Greater credibility of central banks' medium-term inflation targets
    - Globalisation might have reduced the sensitivity of inflation to domestic conditions



## Evidence – Neutral real interest rates

- A neutral interest rate conventionally refers to a theoretical short-term real interest rate that would prevail with a closed output gap and stable inflation
- Unobservable time-varying neutral interest rates are estimated in a small-scale macroeconomic model:

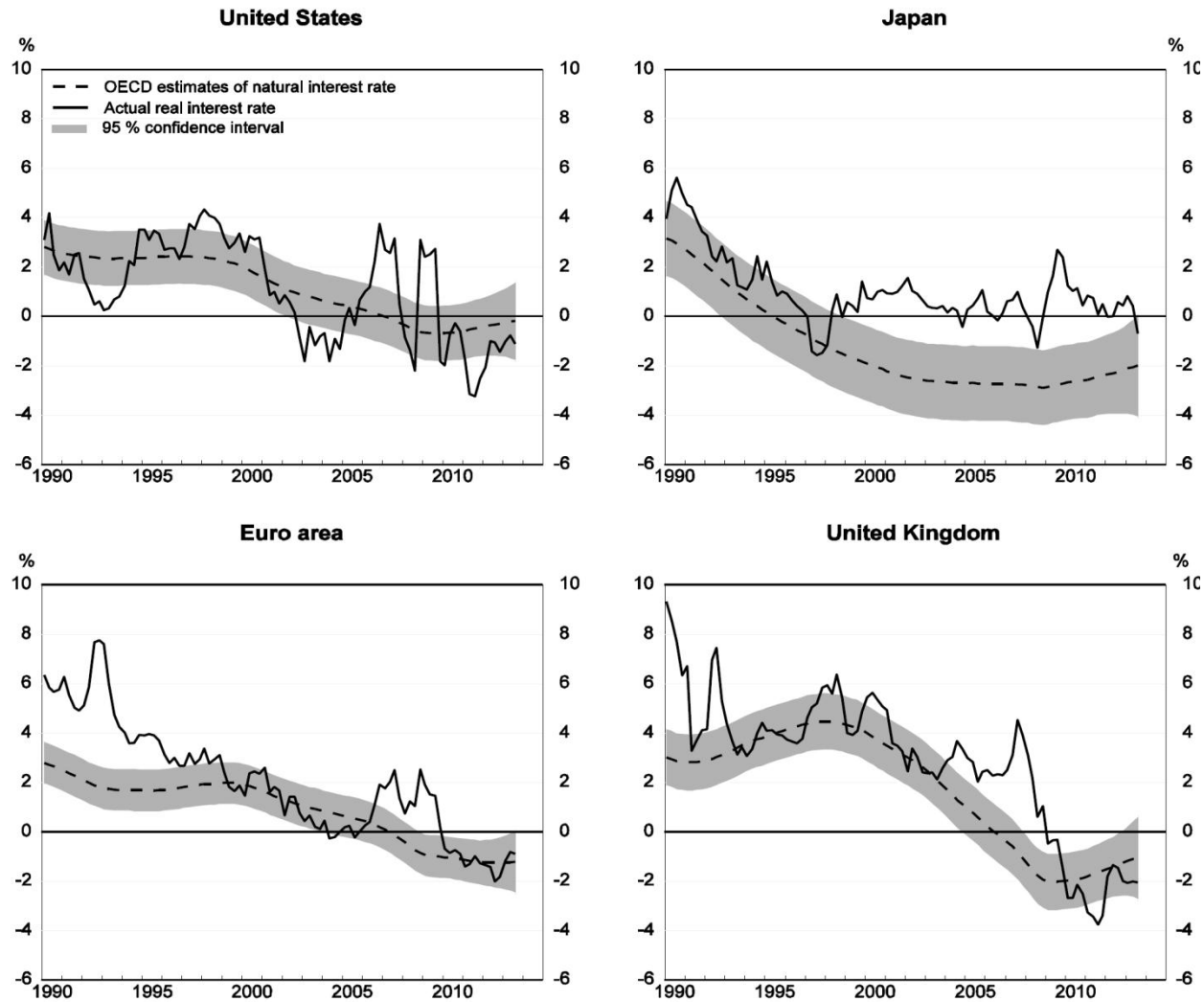
$$r_t^* = \mu_r + \theta(g_t - \mu_g)$$

$r_t^*$	neutral real interest rate at time $t$
$\mu_r$	unconditional average of neutral interest rate
$g_t$	real potential GDP growth
$\mu_g$	sample average of real potential GDP growth
$\theta$	inverse of the inter-temporal elasticity of substitution in consumption (relative risk aversion)

- Monetary policy stimulus:  $r_t^* > (i_t - \pi_t)$



# Evidence – Neutral real interest rates



Source: Rawdanowicz et al. (2014).





## Evidence – Summing up

- ***Euro area:*** the crisis-related hit to potential output has been significant and the fall in the neutral interest rate implies that the decline in interest rates to close to zero may not be giving sufficient stimulus. Ensuing actual and potential growth dynamics has been mediocre and slack remains large, especially in the labour markets. These secular stagnation features have been particularly strong in the vulnerable countries.
- ***Japan:*** hysteresis effects since the Great Recession have been absent but, already long before the crisis, GDP growth was sluggish and deflation persisted. Estimated neutral rates have been well below actual rates for almost two decades, suggesting that the zero-interest-rate policy failed to provide any support to demand though monetary policy has become supportive since the introduction of quantitative and qualitative monetary easing (QQME) in 2013.
- ***United States:*** hysteresis effects have been present but muted compared with elsewhere, and the neutral interest rate is likely to have fallen though monetary policy has still provided stimulus to aggregate demand through unconventional measures. Consequently, average GDP growth has been not far from historical averages, even if economic slack still persists.
- ***United Kingdom:*** hysteresis effects appear to have been strong and neutral rates have fallen though monetary policy has succeeded in providing stimulus through unconventional measures, boosting GDP growth recently.
- The worst has been avoided thanks to sustained positive, even if low, inflation due to the apparent insensitivity of inflation to the level of slack throughout the OECD area.



# Policy implications

- **Secular stagnation necessitates a comprehensive stimulus package: more monetary and fiscal stimulus should be accompanied by structural reforms that boost potential growth and neutral interest rates**
- **The presence of hysteresis effects strengthens the case for accommodative policies, with potentially beneficial longer-term implications for economic activity**
- **However, large uncertainty about the size and persistence of hysteresis and risks associated with certain measures poses policy dilemmas:**
  - **Monetary policy: only unconventional but with potential diminishing marginal returns**
  - **Fiscal policy: fiscal stimulus could be self-financing in theory but in practice involves risks**
  - **Structural policies: Structural reforms can boost potential output in the longer term but risk widening output gaps from already high levels in the short run**



# Policy implications

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- **Euro area:**

- Further unconventional monetary accommodation is needed
- Finalise the repair of bank balance sheets
- The pace of structural fiscal adjustment could be slowed in some countries if this is in line with EU fiscal rules and does not undermine market confidence
- Structural reforms are needed to boost potential output growth but they should be designed so as to have the least negative impact on demand

- **Japan:**

- No scope for fiscal stimulus
- Sustained monetary policy stimulus
- Implementing specific measures based on the government's revised growth strategy, and carrying out bolder reforms of product markets, including greater international openness, and reducing labour market dualism



## Other considerations

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- **OECD does not foresee secular stagnation to continue, but there are risks that the recovery may be delayed**
- **Secular stagnation trap is not predetermined – it depends on policies**
- **Secular stagnation could be also due to a gradual slowing of potential growth rates due to growing income and wealth inequality, especially in the United States, population ageing, lower returns from education and possibly slower technological progress**



# References

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- Rawdanowicz, Ł., R. Bouis, K. I. Inaba and A. K. Christensen (2014b), “Secular Stagnation: Evidence and Implications for Economic Policy”, [\*OECD Economics Department Working Papers, No. 1169\*](#), OECD Publishing.
- Teulings, C. and R. Baldwin (eds) (2014), *Secular Stagnation: Facts, Causes and Cures*, A VoxEU.org. [eBook](#), Centre for Economic Policy and Research Press.