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Will secular stagnation return? The stakes for current economic debates and fiscal policy

By Asha Banerjee and Josh Bivens • August 4, 2022

Close followers of macroeconomic debates have likely noticed a profound change in recent years in what is most worrying policymakers. In the 2010s, there was much consternation about the Federal Reserve consistently undershooting its 2% inflation target, despite years of near-zero interest rates meant to spur growth (Bernanke 2015a; NBER 2019). Over the past 18 months the worry has been the prolonged spell of inflation well over the Fed's 2% target. Heightening this worry is the fact that the Fed has already raised rates rapidly and is under pressure to do more.

There is obviously good reason for this shift: Inflation is real and has been a big problem for the past year and a half. But policymakers' pre-pandemic concerns about slow growth should not be jettisoned. In that pre-pandemic debate, experts recognized that chronic weakness in aggregate demand (spending by households, businesses, and governments) was keeping too much of the economy's productive capacity idled, and unemployment higher than it needed to be over long periods. The focus was on keeping interest rates near-zero just to try to spur spending and approach closer to full employment (and thus keep inflation from constantly *decelerating).* The chronic weakness had arguably persisted for decades. It seems worth asking—even in the face of today's (justified) worries about too-fast inflation—if this weakness and the associated deflationary pressures have really completely evaporated, leaving policymakers safe to strike them from their list of concerns going forward. We think not. Instead, policymakers should strongly consider secular stagnation (the shorthand term for what is described here) in their decisions in the coming years.

Drawing on a recent paper by Banerjee and Bivens (2022), this policy memo makes the following points:

- **Secular stagnation is real.** The existence of a chronic shortfall in aggregate demand relative to the economy's productive capacity—often short-handed as "secular stagnation"—prior to the COVID-19 pandemic has been extremely well-documented.

- **Inequality and other causes of secular stagnation have not disappeared.** Secular stagnation in the U.S. economy very likely was *not* driven by a one-off policy mistake or economic influence. Almost every plausible candidate for its appearance has deep structural roots that will likely persist well past the economic shock of the pandemic.
    - One of the most important likely drivers of secular stagnation is the very large upward redistribution of income occurring over decades. As Banerjee and Bivens (2022) found, from 1979 to 2007, 10% of total national income moved from less affluent households (who spend a higher share of their incomes) to more affluent households, those in the top 1% (who spend a lower share, and who already were securing a disproportionate share of national income. The effects of the Great Recession and financial crisis moved this figure down a bit, but even as of 2018 the share of income held by the top 1% was nearly 8% higher than in 1979. As Banerjee and Bivens (2022) show, shifting greater shares of income to affluent households (whose savings rates far eclipse lower-income households' savings rates) drags on household spending growth.
- **The structural forces behind secular stagnation would likely serve as a future break on inflation.** Given the high likelihood that the structural drivers of secular stagnation persist throughout the pandemic business cycle, any inflationary pressure driven by excess demand growth should face stiff headwinds before too long, and thus should be easier to tame than during previous periods of demand-driven inflation.
- **The structural forces behind secular stagnation would likely fortify a recession springing from excessive anti-inflation measures.** At the same time, given the likelihood that the structural drivers of secular stagnation persist throughout the pandemic business cycle, any recession caused by a too-aggressive stance in fighting inflation (say, by the Fed raising interest rates too fast and too high) will be quite stubborn and will require aggressive expansionary policy to rapidly recover from (Bivens 2022b).
- **Social insurance expansion and public investment spending financed by progressive taxes would help combat secular stagnation.** Long periods when aggregate demand lags the economy's productive capacity mechanically generate larger budget deficits. This fact—and secular stagnation generally—suggests at least one potential policy response to combatting secular stagnation: Raise taxes on higher-income households to finance an increase in federal spending on social insurance and public investment. This combination of progressive taxes and spending not only would reduce inequality (which lowers demand in turn helps drive secular stagnation), but also would apply a modest "balanced budget multiplier" to support aggregate demand growth. There is enormous potential scope to raise progressive revenue: Even as the top 1% saw their share of total national income rise by almost 8 percentage points between 1979 and 2018, their average effective tax rate actually fell by a meaningful amount.

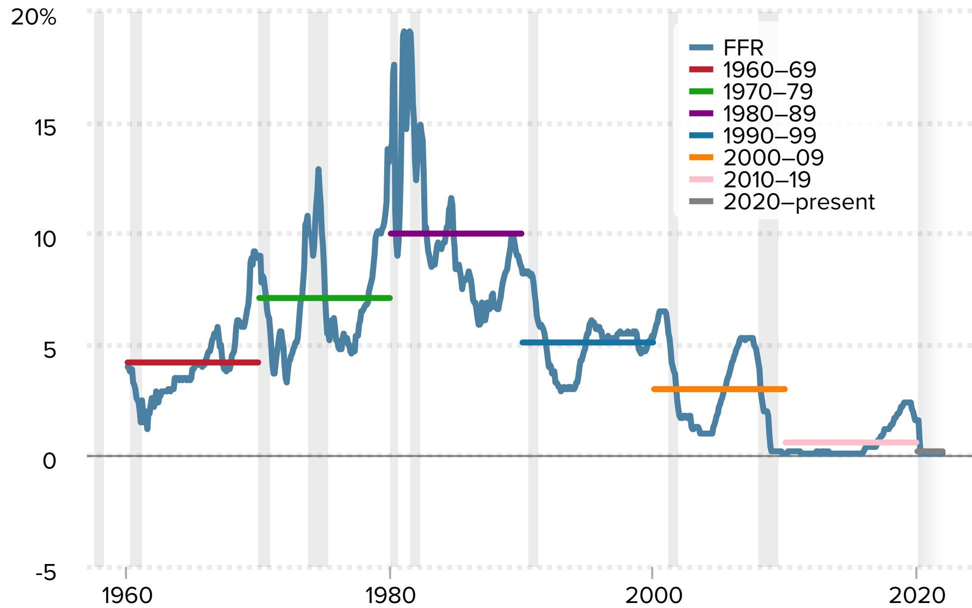
Secular stagnation is real and important

The most intuitive evidence that the United States has experienced a chronic and growing

Figure A

Slowing demand means that lower and lower Interest rates have been needed over time

Effective federal funds rate, actual and decade averages, 1960–2021



Notes: Data are monthly averages. Horizontal lines are averages over dates indicated. Shading indicates recessions.

Source: Authors' analysis of Effective Federal Funds Rate data from the Federal Reserve (FRED 2021).

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shortfall of aggregate demand relative to the economy's productive capacity is probably the behavior of the Federal Reserve's policy interest rates in recent decades. **Figure A** shows the business cycle average of this policy interest rate over time. A steady downward trend since at least the 1980s is apparent. What this figure shows us is that a lower and lower policy interest rate is needed over time to meet the Fed's stabilization goals of acceptably low unemployment and low inflation. If more and more monetary stimulus (via lower and lower policy interest rates) is needed over time to meet a common goal, this by definition means other influences on economywide spending are pushing demand down.

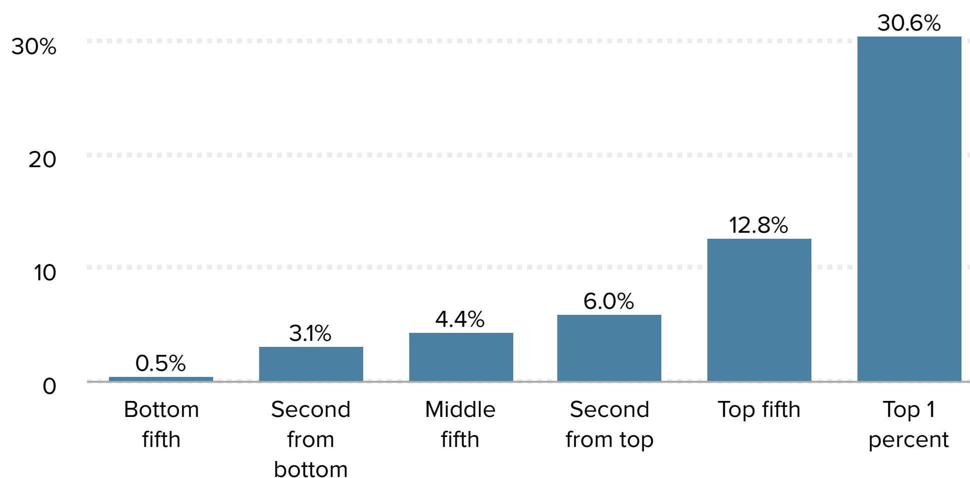
Roots of secular stagnation are likely deep and will outlast pandemic recession

As shown in Banerjee and Bivens 2022, an obvious candidate for driving a large and growing shortfall of demand is the large upward redistribution of income that characterized the post-1979 years in the U.S. economy. Between 1979 and 2018, for example, the share of pre-tax income claimed by the top 5% of households rose by just under 10 percentage points. (For the top 1% , the share of income claimed was nearly 8%

Figure B

The top 1% of the income distribution saves over 60 times as much as the bottom 20%

Net savings rates by income group (2007–2018 pooled data average)



Notes: Savings rates are a measure of net new assets acquired by households, which are grouped according to distribution of income after government taxes and benefits.

Source: Data on personal savings and income shares from the Federal Reserve Board (FRB 2021a, 2021b) and household income data from the Congressional Budget Office (CBO 2021).

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higher than in 1979.

It is generally assumed that higher-income households save a higher share of their income than low- and moderate-income households. The intuition is simply that higher-income households are able to both enjoy a high level of consumption and save money for wealth-building. Conversely, most low- and moderate-income households can barely afford a decent level of consumption, and certainly cannot afford spending to meet their needs and engaging in much savings. Put another way, low- and moderate-income households must spend nearly everything they earn just to get by. **Figure B** from Banerjee and Bivens (2022) shows how large the differentials in savings rates between income classes really are. Depicting savings rates as a share of income for households at different points of the income distribution, the figure shows that the top 1% of the income distribution saves over 60 times as much (as a share of income) as the lowest 20%.

These large differences in savings rates mean that the large upward redistribution of income seen since 1979 can have large macroeconomic effects. Say that by 2018 there was a 7.5 percentage-point increase in the share of total income claimed by the top 1% that came directly from the bottom 80% of households (see Figure A in Banerjee and Bivens 2022). Say as well that households in the top 1% save roughly 30% of their income while those in the bottom 80% only save 5% on average. This means that overall spending out of this 7.5 percentage-point chunk of income that has been redistributed will fall by 25% (pre-redistribution, 95%—or 1 minus the 5% savings rate of the bottom 80%—would have

been spent rather than saved; post-redistribution, only 70%—1 minus the 30% savings rate of the top 1%—is spent). This leaves a spending shortfall caused by the redistribution of 7.5 percentage points multiplied by 25%, or 1.9% of total national income. While 1.9% might sound modest, in the 74 years since 1947, only two have seen output declines as large as 1.9% (U.S. BEA 2022. In short, this is a big (albeit building gradually over time) effect relative to baseline rates of economic growth

If inequality was (as we think) a prime driver of secular stagnation, the economy will only be free and clear of this growth drag if inequality begins to stabilize or even reverse. Further, other influences that have been highlighted as potential drivers of secular stagnation are at least as deep-seated and unlikely to change as the rise in inequality (Teulings and Baldwin 2014; Eichengreen 2015). For example, some experts have argued that demographic change is behind secular stagnation, with demand depressed by an older population looking to save more to finance retirement (Gottfries and Teulings 2015). Others have argued that the "global savings glut" is a prime driver. The global savings glut is a large surplus of desired savings over planned investment, most particularly in East Asian countries like China and wealthy resource-rich economies like the Gulf states (Bernanke 2015b). Given that these national savings imbalances are fundamental parts of the economic development strategies of these countries, it is hard to simply assume they will evaporate once the pandemic economic shock relents. Other researchers have posited that secular stagnation is in part driven by technological change that has made key investment goods (computers and related equipment, in particular) cheaper over time (Basso and Jimeno 2019). The reasoning behind this theory is that because less and less money is needed to finance a given amount of real investment, a mismatch arises between the financing firms need for these investments and the desired savings of households looking to build wealth. Again, simply assuming a long-run technological trend will reverse and making plans based on this assumption seems unwise.

In short, the roots of secular stagnation are deep and unlikely to have evaporated due to the pandemic economic shock.

Secular stagnation's headwind to demand growth should make controlling inflation easier

The precise sources of inflation over the last 18 months are still contested. In our view, the claim that this inflation is overwhelmingly caused by a simple excess of aggregate demand (spending by households, businesses and governments) relative to the economy's ability to produce goods and services is far from proven (Bivens 2022b; 2022c). But, for the sake of argument, if the rise in inflation were driven by excess aggregate demand growth, then the steady downward pressure secular stagnation places on aggregate demand growth should be a powerful headwind that would help slow inflation.

In turn, the headwind to inflation should allow the Fed to take a more measured approach to the pace and level of interest rate hikes made in the name of tamping down inflation. Once the large temporary boosts to demand work through the economy, the headwind of secular stagnation should start to meaningfully decelerate the pace of demand growth

going forward. And indeed, the main temporary boost to demand—the large fiscal relief provided in early 2021—has worked its way through the economy (Bivens 2022b).

Secular stagnation's headwind also would heighten the cost of a policy mistake leading to recession

In recent months, the Federal Reserve has faced increasing pressure to increase the pace of interest rate increases to tamp down inflation. But some Fed watchers also recognize that a more-aggressive pace of rate hikes could end up causing a recession. In our opinion, too many voices in this debate are too unconcerned about the damage that would be done by launching a recession in the name of tamping down inflation (Bivens 2022a).

And the influence of secular stagnation makes this risk even larger. If the forces driving secular stagnation begin reasserting themselves more visibly in the form of depressed demand growth in the next year, any economic downturn over this period will be more stubborn and harder for policymakers to reverse.

For most of the decade before the pandemic struck, unemployment was unambiguously too high and inflation too low (relative to the Fed's 2% target). This meant that there was no real trade-off to be made in monetary policy: The evidence from both unemployment and inflation pointed to a common policy recommendation of keeping interest rates low.

But now, the traditional trade-off has reasserted itself: Inflation is clearly too high, and, yet moves to fight it with higher interest rates come with a large potential cost in higher unemployment. All else equal, the presence of secular stagnation should make the Federal Reserve more willing to take on inflation risk than to risk excess unemployment.

Progressive taxes and more public spending can neutralize secular stagnation

If it is true that secular stagnation reasserts itself after the current inflationary period, an obvious policy response would be to raise progressive taxes and increase federal spending on social insurance and public investments (Blair and Bivens 2020). This policy mix would help address secular stagnation in the U.S. along at least two dimensions.

First, this policy mix would reduce post-tax income inequality. Higher taxes on high-income households combined with spending and investments that disproportionately benefit low- and middle-income households could significantly redistribute income away the already-rich. **Given that rising inequality has likely been a prime cause of secular stagnation in the United States, reducing inequality through this mix of fiscal policies would attack the root driver.**

Second, this policy mix would provide a modest boost to aggregate demand growth.

Because high-income households spend less of each marginal dollar of income they receive, raising taxes progressively provides only a modest drag on aggregate demand growth. Social insurance and public investment programs that provide progressive (or even income-neutral) benefits would boost the resources available to low- and middle-income households, and these households are far more likely than high-income households to spend these additional marginal dollars.

Of course, the main criterion to judge the worth of undertaking expanded social insurance and public investment spending is whether such expansions would help meet pressing social needs. Providing greater insurance to U.S. households for health care, retirement, and to weather periods of joblessness could constitute such a pressing social need. And there is room to grow this spending, as the U.S. fiscal system is currently quite stingy on social insurance compared with most of our advanced economy peer countries (EPI 2022). Additionally, much research suggests that public investment is inefficiently low in the United States, and that the country is missing out on large potential productivity gains as a result (Park 2019; Bivens 2012; Moss, Nunn, and Shambaugh 2020) .

But the degree to which providing these needed expansions to social insurance and public investment also helps address the decades of chronic shortfalls of aggregate demand before the pandemic adds to their value.

In current debates around a mix of tax increases and increased spending proposed by the Biden administration, there occasionally surface fears that this policy mix could stoke near-term inflation. We would make two observations about that. First, fiscal policymakers making decisions about these proposed policies should keep an eye on the medium and long term implications. In the short run, it is the Federal Reserve that has been tasked with adjusting the level of aggregate demand in the name of inflation control. In the medium and longer terms—when the full effects of fiscal policies are likely to materialize—secular stagnation, not inflation, is quite likely to be the bigger challenge. Second, if fiscal policymakers think the proposed mix of taxes and spending is smart for the medium and long run but have genuine, good-faith issues with potential inflationary effects in the near term, they could just call for front-loading tax increases rather than entirely balking on the proposals

Conclusion

For decades after World War II, the primary problem of macroeconomic stabilization was often thought to be inflation control. For a number of reasons—mostly an equitable distribution of national income—aggregate demand generally grew quite strongly and didn't need large ongoing boosts from fiscal or monetary policy. Recessions obviously happened, but they were generally short and recoveries happened quite quickly.

Starting in the 1990s, recoveries took longer and longer and interest rates needed to be kept lower and lower even outside of recessions. It took a while, but by the 2010s many macroeconomists believed that the primary problem of economic stabilization had shifted to sustaining strong aggregate demand.

In 2021, the economy experienced a temporary respite from the chronic problem of weak aggregate demand, both through the extreme shock of the COVID-19 pandemic and the historically aggressive fiscal boost used to aid recovery from the pandemic recession. But, given the deep roots of secular stagnation, it would be unwise to assume a one-off shock even one as large as the COVID-19 pandemic—could render it forever tamed. This memo urges policymakers to ensure that future policy debates at least entertain the possibility that the forces behind secular stagnation will soon reassert themselves and thus consider fiscal policies that address the root driver of secular stagnation, income inequality.

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