Secular stagnation or self-inflicted malaise?

By Hans-Werner Sinn

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Almost exactly eight years ago, the Lehman Brothers collapse plunged the global economy into recession. The interbank market collapsed, and the entire industrialized world was thrown into the worst crisis since the end of World War II. Though central banks have maintained ultra-low interest rates, the crisis hasn't yet been fully overcome. On the contrary, numerous economies, such as the southern European countries and France, simply aren't making any headway. And Japan has been on the ropes for a quarter-century.

Some economists believe that this is evidence of "secular stagnation," a phenomenon described in 1938 by the American economist Alvin Hansen, who drew on Karl Marx's Law of the Tendency of the Rate of Profit to Fall. Owing to the gradual exhaustion of profitable investment projects, according to this view, the natural real interest rate has continued to fall. Stabilizing the economy thus is possible only by an equivalent decline in policy interest rates.

In view of the huge credit bubble that preceded the crisis in Japan, the United States, and southern Europe, and the aggressive policies pursued by central banks over the last few years, I doubt that this theory is correct. In fact, I find it plausible that a very different mechanism lies behind the post-2008 stagnation, which I refer to as "self-inflicted malaise."

This hypothesis is best understood in the context of the economist Joseph Schumpeter's theory of the business cycle. Faulty expectations on the part of market participants regularly cause credit and asset-price bubbles. Investors, expecting prices and incomes to rise, purchase residential and commercial properties, and they take chances on new business ventures. Real-estate prices start to rise, a construction boom occurs, and a new phase of rapid expansion begins, partly sustained by the revitalization of the domestic economy, including services. The growth in incomes increasingly emboldens borrowers, which further heats things up.

Then the bubble bursts. Investment collapses and real-estate prices fall; businesses and banks go bankrupt; factories and residential buildings are vacated; and employees are laid off. Once prices and wages have fallen, new investors step in with new business ideas and establish new firms. After this "creative destruction," a new phase of rapid expansion sets in.

In the current crisis, however, monetary policy preempted the creative destruction that could have formed the basis for a new upswing in growth. Asset holders talked central bankers into believing that Schumpeter's economic cycle could be overcome by large-scale bond purchases financed via the printing press, and by corresponding interest-rate reductions.

To be sure, these measures stopped the fall in asset prices halfway and thus saved much wealth. But they also prevented sufficient numbers of young entrepreneurs and investors from risking a new start. Instead, established firms remained in place, keeping themselves afloat but lacking the wherewithal for new investments. In Japan and Europe, in particular, large numbers of such zombie firms and banks survived, and they are now blocking would-be competitors able to drive the next upswing in growth. The resulting economic ossification looks like the secular stagnation that Hansen described; in fact, the malaise is self-inflicted.

And, because low interest rates have reduced asset managers' returns, some central banks – and the European Central Bank, in particular – have relied on successive interest-rate cuts in an effort to engineer ersatz value gains for assets.

The economy is thus caught in a trap, forcing the ECB to engage in ever more radical monetary-policy measures. Its current program of quantitative easing is meant to double the money supply in a very short period. Further guns are being moved into position, such as successively more negative nominal interest rates or so-called helicopter money.

The only way out of the trap is a hefty dose of creative destruction, which in Europe would have to be accompanied by debt relief and exits from the eurozone, with subsequent currency devaluations. The shock would be painful for the incumbent wealth owners, but, after a rapid decline in the dollar values of asset prices, including land and real estate, new businesses and investment projects would soon have room to grow, and new jobs would be created. The natural return on investment would again be high, meaning that the economy could expand once again at normal interest rates. The sooner this purge is allowed to take place, the milder it will be, and the sooner Europeans and others will be able to breathe easy again.

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