real-world economics review, issue no. 78
subscribe for free

Can Trump overcome secular stagnation?

James K. Galbraith[1] [LBJ School of Public Affairs, University of Texas, USA]

Copyright: James K. Galbraith, 2017
You may post comments on this paper at
https://rwer.wordpress.com/comments-on-rwer-issue-no-78/

Could the economic program of President Donald Trump, if enacted, overcome secular stagnation? This essay addresses part of that question, focusing on the effects of a changing macroeconomic policy mix and thrust in the present US national and global context. A separate essay will address considerations on the supply side.

The phrase "secular stagnation" is usually attributed to the early post-war Harvard economist Alvin Hansen, one of the first American disciples of John Maynard Keynes, who used it to argue that the American economy would return to the Great Depression once the Second World War ended. *Today,* secular stagnation is defined by Lawrence Summers, who defines it as the condition of a "low real neutral rate of interest", or in Fed-speak a "low R* world". A neutral rate of interest ("R*") is said to be the one that neither increases nor restrains the economic growth rate. If such a rate exists and if it is close to zero, then monetary policy cannot spur growth, and a big-deficit fiscal policy is required.

For this reason, it is argued, the great recession-cure of "Quantitative Easing", so highly touted a few years back, proved to be mostly a dud. But fiscal policy would have better luck, whether through increased public spending or tax cuts, although only so long as the fiscal push is not offset by higher interest rates. If interest rates rise, in a "low R* world" then the fiscal expansion will fail. This tension between fiscal and monetary forces is of great importance just now, as Donald Trump assumes the presidency on a program of infrastructure spending and tax cuts, while interest rates are starting to rise.

So, what do economists who argue along the lines described by Summers – a group that includes Paul Krugman, Ben Bernanke and other substantial figures – say that they think governs the interest rate? One might say: it's obvious, Janet Yellen and Stanley Fischer decide the interest rate. But this is not what our leading economists appear to believe. Instead, they appear to believe – or anyway, they argue – that a panoply of natural and social forces lie behind the interest rate. And therefore, if interest rates rise to block the Trump expansion, it will be because those stars are aligned against him.

---

[1] James K. Galbraith holds the Lloyd M. Bentsen Jr. Chair in Government/Business Relations at the LBJ School of Public Affairs, The University of Texas at Austin. His 2014 book, *The End of Normal: The Great Crisis and the Future of Growth*, addresses these issues. His most recent books are *Inequality: What Everyone Needs to Know* and *Welcome to the Poisoned Chalice: The Destruction of Greece and the Future of Europe*. He thanks Lance Taylor, Geoffrey Harcourt, Jason Furman, Grzegorz Kolodko, Mike Lind, Steve Cohen and Robert Skidelsky for comments on drafts.

Since you're here …

… we've got a small favour to ask. More economists and other professionals are reading the *Real-World Economics Review* than ever. But because our journal **is not kept behind a paywall nor owned by a corporate giant nor funded by the one-percent** it needs voluntary financial support from its readers. You can provide that support by paying a voluntary membership fee or making a contribution to the World Economics Association.

Pay membership fee → Make a contribution →

We have seen this movie before, in the early 1980s, when interest rates rose dramatically in advance of the Reagan tax cuts. Those high interest rates – reaching twenty percent briefly, and sustained at high levels for two years, generated a deep recession. They destroyed much of heavy industry in the Mid-west and of the trade union movement, previously the backbone of the Democratic Party. They were, in their way, the forebear of the economic conditions that have brought Donald Trump to power now.

In this paper I will first explore the intricate doctrines of the interest rate which are still circulating among high-profile economists, and which have the effect of obscuring a basic reality. The reality is that in the modern world of integrated global finance, the central bank of the largest economy determines the core financial conditions for the United States and also for the world at large. Whether a change in those conditions will serve, or undermine, the Trump program is the question.

To straighten the matter out, it is necessarily to plumb a number of rabbit-holes in the deep history of economic thought. Investigating, one finds especially the ghosts of two academic scribblers: Knut Wicksell of the late 19th century and Dennis Robertson of the early 20th century. Wicksell, a Swede, advanced the doctrine of a “natural rate of interest”, while Robertson, of Cambridge University, is associated with a “loanable-funds” theory of the actual interest rate. Both doctrines appear prominently in recent attempts by leading economists to explain themselves on the question of the interest rate.

According to the loanable funds theory, the actual interest rate is set in something called the “capital market”, by a balancing between household savings and business investment. A recent report from the Council of Economic Advisers states this bluntly: “The interest rate settles at the level that equates the supply of saving with the demand for investment.” This is pure Robertson, which is perhaps not surprising, given that the CEA Report is by (at least in part) my 1975 King’s College (Cambridge) contemporary Maurice Obstfeld, the international economist at the Obama White House.

So what determines the supply of savings and investment demand? Evidently, “loanable funds” is today a global theory. In a recent Federal Reserve paper cited by Summers as “thoughtful,” John C. Williams of the Federal Reserve Bank of San Francisco gives the “underlying determinants” as “the global supply and demand for funds, including shifting demographics, slower trend productivity and economic growth, emerging markets seeking large reserves of safe assets, and a more general global savings glut.” In other words it’s a grab bag, based loosely on reports from the Council of Economic Advisers, the International Monetary Fund and leading lights of MIT and elsewhere. One can search the pudding for a theme, in vain. Except possibly in the perception that if interest rates are governed by obscure global forces, they cannot also be anything so banal as the decision of a committee sitting at the Board of Governors of the Federal Reserve System, on Constitution Avenue in Washington, DC.

To compound the confusion, leading mainstream economists are often unclear as to what it is, exactly, that the supply of savings and investment demand are supposed to determine. For Obstfeld, to judge by the quote above, supply and demand apparently determine the actual rate of interest. Specifically, this would be the rate of interest paid by private banks for funds, as they draw on Chinese savings and compete with the Russians or the Indians for a safe reserve asset. In this model of the world, it would appear, the central bank of the United States plays no role at all.

But for Summers, supply-and-demand govern the *neutral* rate – not the rate of interest actually paid by banks for funds, but a notional benchmark rate, a characteristic of the world economy, a standard against which actual rates are measured to judge whether they are likely to be contractionary or expansionary in effect. The neutral rate is not something that you can actually observe. Against the neutral rate, the central bank sets a *policy rate.* Again, if the policy rate is below the neutral rate, then policy is expansionary; otherwise it's contractionary.
The natural rate – yet another notional benchmark rate – is something else. Simple and clear by comparison, it stipulates a larger equilibrium of financial *and physical* forces, driven by the prevailing "marginal product of the capital stock". As with the neutral-rate theory, an actual rate below the natural one is a disequilibrium, which will (it is said) stimulate investment, by making new capital more profitable than its physical productivity would justify. The CEA report, co-authored by Obstfeld, links the natural rate directly to the concept of productivity, and explains why (in this theory) the actual rate should be influenced by the natural rate over the long run:

> "A high return on investment should trigger a reallocation of resources from consumption toward capital accumulation, driving down the marginal product of capital and the real interest rate over time. Similarly, a low return on investment should induce consumers to increase current consumption and reduce capital investment, eventually driving up the real interest rate. Such economic forces should limit extremely high or extremely low real interest rates and work to push the rate back to intermediate levels" (p. 1).

In other words, the world is constructed in an orderly way, such that the state of economic development progresses on a path determined by the role of capital in the country. If the country is capital-rich, the rate of interest will fall, and if it is capital-poor, the rate of interest will rise. This view of things, firmly rooted in the eighteenth and nineteenth centuries, tells one a great deal about the idle mentality of the economists at the Obama White House, just at the moment when dark forces were building in the depressed heartland, preparing to sweep the vestiges of liberal America into the dustbin of history.

Reference to the marginal product of capital raises another ugly little issue from the history of economic thought: namely, the specter of capital theory and the Cambridge-Cambridge capital controversies. This topic, now obscure, was very hot back at Cambridge in 1975 – although it seems that Obstfeld missed it, or he could never have signed off on a paragraph like the one quoted. As far back as 1966, the MIT neoclassical Paul Samuelson had already conceded that the underlying theory was, in point of mathematics, wrong. A larger "amount" of capital (whatever that means) or an increase in capital accumulation over time does *not* necessarily lead to a lower "marginal product" or to a lower "natural" rate of interest. Nor would a reduction in later capital investment lead to a rise in the natural rate, even in the long run. *In short, there is no such thing as a "natural rate of interest".*

If there is no *natural* rate, and if Summers were right that the *neutral* rate is governed by world financial forces, then (as he argues) the force of monetary policy is governed by the relationship of the actual rate and the neutral rate. In that argument, the actual rate is set by Yellen and Fischer after all. It is the cost of funds to banks, established by the Federal Open Market Committee of the Federal Reserve System, at their meetings every six weeks, and known to the world as the rate on "federal funds". In this concept, the apposition is not between deep technological factors and financial market factors, but rather between financial market factors on one side and the will of the policy-makers on the other.

But this is also nonsense. The apposition requires that saving, and the supply of funds, be governed by the decisions of households, and that it be wholly separate from the decisions of government. But what is the Federal Reserve if not a central bank? And what does a central bank do, if it does not supply funds? If the Federal Reserve is not in position to supply funds, if it is not a participant in the "loanable funds" market in which the "neutral rate" is determined, then what the devil are open-market operations, and what is Quantitative Easing, the principal tool of monetary policy for the past decade?

Of course the Federal Reserve supplies funds. "QE" is nothing more than large-scale purchases by the Federal Reserve of long-term securities for cash. On the short end of those same markets, funds are something which the Federal Reserve can create at will. It has done so, in recent years, to the tune of trillions, in order to put and keep the short-term policy rate where it is. Therefore, separating the policy rate from a supposed neutral interest rate determined by the supply of household saving and the demand for loanable funds makes no sense.

What then? It is difficult to say, exactly, whether the prevalent confusions are the result of sloppy thinking, an incoherent textbook pedagogy, or a deliberate desire to cover for the Federal Reserve and to obstruct potential criticism of the independent central bank. As a next step, let us ask: is there a better theory of interest rates out there, somewhere in the great work of the economists?

In the CEA paper, as in most of this so-called literature, the 20th century British economist John Maynard Keynes is not cited. Yet it is a fact that Keynes did write an influential book with the word "Interest" in the title. It was called *The General Theory of Employment Interest and Money,* published in 1936. In which Keynes states, of the classical theory of interest – that theory of loanable funds overlying a natural rate – that his own analysis "will have made it plain that this account of the matter must be erroneous" (p. 177). Perhaps it is worthwhile to seek Keynes's counsel at this point?

Keynes's theory of interest does not rest on the capital stock. And in Keynes as in the real world, there is no "capital market" that equates household saving with business investment.

Instead, Keynes's theory of interest is about the *market for money* – a market that definitely does exist in the real world. He wrote: "The rate of interest is not the 'price' which brings into equilibrium the demand for resources to invest with the readiness to abstain from consumption. It is the 'price' which equilibrates the desire to hold wealth in the form of cash with the available quantity of cash" (p. 167). In other words, interest rates are a portfolio issue. They are determined in the money markets, by how – *in what form* – people with wealth choose, at any given time, to hold that wealth. You pay interest, in order to get people to hold their wealth in less-liquid forms, such as bonds – and this is what provides firms with a secure source of financing, which then permits them to invest.

Keynes's theory of interest is the pure common sense of how financial markets work. So why is it treated, by our leading liberal economists, as though it didn't exist? Why all this confusing folderol about natural and neutral rates? The apparent answer is damning. In the theories our economists like, a technical theory of interest creates a technical theory of income distribution, since interest rates govern the incomes of creditors against debtors, of the rich against the poor, of profits against wages. Thomas Piketty's recent book is a nice instance of this point, with its argument that the great inequalities of capitalism are due to interest rates

higher than the rate of economic growth. If interest somehow reflects the physical productivity of the capital stock, then the consequences may be unfortunate – but they are inevitable and not something of which it is proper to complain.

Keynes's theory offers no such bloodless rationale for profits, maldistribution and gross inequalities. If you accept Keynes, as for Marx before him, distribution is political. For that reason above all, Keynes and his ideas on this theme had to be forgotten. (Otherwise, among other things, the Democratic Party's current alliances with Wall Street would be seen too clearly for what they are.) And the upshot is that Trump, as his Federal Reserve – especially if augmented by numerous hard line appointments – drives interest rates up, will be able to hide behind a bipartisan phalanx of academic obfuscation.

Keynes's theory isn't the last word. In the period of the gold standard and just afterward, there was a certain definiteness to the "available quantity of cash". Cash was what the government could print up and make available to banks on short notice. But financial markets have changed since the 1930s.

Today, we live in a world of what is called "fiat money", backed by nothing except the legal-tender declaration and the taxing power of the state. Moreover, most money is created outside the state itself; it is bank money, created through explicitly- or implicitly-insured electronic bank balances. These can be increased by private bankers at will. And so in our time government can create (or guarantee) liquidity as much as it likes, and governments with control of their monetary systems do exactly that, since they don't want the banks to run dry. And so there is (or can be) as much liquidity around as anyone – anyone with funds to trade, that is – would like to have.

This is the world in which we have all lived since the demise of the Bretton Woods monetary system in 1971, which broke the last link of the dollar to gold. In this world, the base rate of interest is the policy rate, nothing more or less. It is what it seems: the decision of the central bank. And so, we're back to ordinary common sense: the Federal Reserve does control the money-market dollar interest rate, as surely as OPEC used to control the price of oil. Today, the price of cash, which is the rate of interest in the overnight money markets, is an administered cost of funds. It's called the Federal Funds rate or, in England, Bank Rate. This is the price the central bank sets for a bank wishing to obtain cash on short notice; the US Federal Open Market Committee sets it, normally, at meetings once every six weeks.

This interest rate can be set at any level, and the level at which it is set, at any given time, is the object of competing political and economic pressures. For a long time, thanks to the crisis, it was set at or nearly at zero, giving banks access to funds, to meet their reserve requirements, at close to no cost. To determine the rates that banks charge customers, of course, other factors come in: a markup covering bankers' cost, the alleged risk of the loan, and what the market will bear. But that is another matter; monetary policy in the first instance focuses on the short-term cost of funds to banks.

Long-term rates are, of course, what matters to business borrowers and homeowners, among many others. But once one has a clear understanding of the administered character of short-term rates, then the trajectory of *long-term* interest rates also becomes much easier to understand. As even the CEA paper admits, long rates are a function (in large part) of the expected sequence of short rates. Short rates are policy rates. And so as the prevalence of low short rates became the norm, through persistence of policy over time, low-risk long rates

followed them down. Simple as that. This is a process which has been going on since the early 1980s, and although I and other dissidents have been following it for decades, according to a new paper by Jason Furman, chair of the CEA under Obama, the economic mainstream seems only just to have noticed.

In this light the entire problem of “secular stagnation” can be radically simplified. There is no natural rate, and no neutral rate independent of policy. The fear of risk has risen. The desire to borrow, for all purposes including to invest – except perhaps in cheap imported electronics – has declined. That is all that is necessary. The supposed physical productivity of capital and the supposed global supply of savings have nothing to do with it. Low realized rates of growth, of productivity, and high liquidity are effects, not causes, of a general climate of fear and reluctance to borrow and invest. So too is a high markup on a slim volume of new loans. So too is the proliferation of intermediaries who obscure who exactly is bearing the risk. Against these forces, the inability of a low cost of funds to produce robust economic growth is no surprise; in the absence of borrowers, low short policy rates are weak tea.

In this simplified world, even with no “neutral rate” to act as a fulcrum, it is still very easy to see why raising rates is dangerous. Rising interest rates are not a sign of a stronger economy. They are not a market response to stronger investment demand or a shortage of funds. They are an action of the central bank. But the Federal Reserve acts immediately on the short-term rate, not the long-term rate.

Normally, long-term rates lie above short-term rates, thanks to liquidity preference. But as short rates rise, this relationship, which is called the yield curve, flattens out. Soon enough it will invert, as short rates rise above sluggish long-term rates. In financial markets, this provokes a rush to cash. Often an inverted yield curve provokes a financial crash, and from that, follows a recession.

So now the economy is Trump’s problem, and what does he propose? On the fiscal side, there will be tax cuts, especially for business, and (we are told) vast new public-private spending, especially for infrastructure. In other words, if the fiscal program is for real it will resemble the American Recovery and Reconstruction Act, Obama’s early stimulus program. Tax cuts and public spending work; if there is a large fiscal stimulus then the economic growth rate will rise. But Trump promises to reinforce the “inflation hawks” – the high-interest-rate caucus – at the Federal Reserve. Taken together, so far as the broad outlines are concerned, and so far as we know now, Trump proposes to repeat the Reagan formula. And the question becomes, what will happen if he does?

As with Reagan, higher interest rates – especially if they come before the fiscal effects kick in, will play havoc with credit-dependent sectors of the economy. Here at home, the pinch may fall largely on corporate borrowing and on automobile and student loans. The net depends on scale and timing: under Reagan the recession came first, because the monetary shock was very strong and it hit before the tax cuts and military spending boom took effect. This pattern could be repeated, even though the level of nominal interest rates need not approach the extremes of the early 1980s. But an equally or more important effect could come from the consequences of this policy mix for a price that Trump and his team do not directly control: the exchange rate of the US dollar.

Expected higher interest rates have already raised the value of the dollar. Higher interest rates will drive it up even more. As in the early Reagan years, this will hurt exports and import-

competing traded goods, offsetting the benefits of fiscal expansion for manufacturing. Only the most severe and sustained protection, which Trump in his inaugural did promise, can mute or reverse this effect. But such protection would bring inflation, product shortages, unemployment in the distribution and retail sectors, a massive decline in real consumption – since new production facilities would have to be established on a vast scale to replace the disappeared plants of the older manufacturing sector, and this takes time. Much more likely, there will be a wide expectation that the policy cannot last, and so there will be little gain, under the policy we're going to get, in manufacturing jobs. Symbolic gestures apart, industrialists are not going to invest in factories to make shirts and shoes, when they know very well that a future government can reopen trade and bankrupt them all, in a matter of days.

So where will the money go? Where will private investors, seeking low taxes on quick profits, want to invest? The answer seems clear enough: real estate. Infrastructure spending, after all, is not only or even necessarily in support of production. Most of it, whether in roads, bridges, water systems or airports, supports household consumption and offices and – therefore – land values. A high dollar attracts foreign capital. A low corporate profits tax rate diverts loose funds from other countries. Real estate – practically alone – can turn these factors into capital gains in a fairly short time. Trump of course knows this; he's a real estate man.

It is darkly amusing that the entire US economy may be run in such a way that so well serves the personal interests of the President, of his children, his son-in-law and his friends. Those who voted for him to make America great again – by restoring manufacturing jobs – will be disappointed. And those who may lose many other benefits they now receive, including health insurance and perhaps parts of Social Security, Medicare, Medicaid and other programs, will be unhappy. Trump and his team may not care very much, for as a good businessman, he and his team will know when to cash out. But to the extent that they wish to survive politically, they must be relying on the obvious fact that the Democratic Party has had no strategy for the Mid-west since the 1960s, that it has become a bicoastal party of professionals, with no plan to earn back the votes that carried Wisconsin, Michigan, Pennsylvania and Ohio for Obama in 2008 and 2012. That's probably a safe bet for at least the next four years.

References

Council of Economic Advisers, "Long Term Interest Rates: A Survey," Executive Office of the President: July 2015. At https://obamawhitehouse.archives.gov/administration/eop/cea

Furman, Jason, "The New View of Fiscal Policy and Its Applications, Conference: Global Implications of Europe's Redesign, New York, October 5, 2016.

Galbraith, James K. *Created Unequal*. New York: Free Press, 1998.

Galbraith, James K.,*The End of Normal: The Great Crisis and the Future of Growth*, New York: Free Press, 2014.

Keynes, John Maynard, *The General Theory of Employment Interest and Money*, New York: Harcourt Brace, 1936.

Levhari, David and Paul A. Samuelson, "The Nonswitching Theorem is False", *The Quarterly Journal of Economics* (1966) 80 (4): 518-519 doi:10.2307/1882912

Summers, Lawrence, "The Age of Secular Stagnation: What it is and what to do about it", *Foreign Affairs*, February 2016.

Taylor, Lance, "The 'Natural' Interest Rate and Secular Stagnation: Loanable Funds Macro Models Don't Fit Today's Institutions or Data", manuscript for *Challenge*, October 2016

Varoufakis, Yanis, *The Global Minotaur,* Economic Controversies, 2011.

Williams, John C. "Monetary Policy in a Low R-Star World" *FRBSF Economic Letter*, August 15, 2016, http://www.frbsf.org/economic-research/publications/economic-letter/2016/august/monetary-policy-and-low-r-star-natural-rate-of-interest/

Author contact: galbraith@grandecom.net

SUGGESTED CITATION:
James K. Galbraith, "Can Trump overcome secular stagnation?", *real-world economics review*, issue no. 78, 22 March 2017, pp. 20-27, http://www.paecon.net/PAEReview/issue78/Galbraith78.pdf

You may post and read comments on this paper at https://rwer.wordpress.com/comments-on-rwer-issue-no-78/