Economists and politicians have long discussed the danger of a prolonged period of very weak economic growth. They see this kind of “secular stagnation” as a particular threat in Europe and Japan due to their rapidly aging and shrinking populations.

The fact is that growth of the world economy, and above all economic growth in Western countries, is lagging behind pre-crisis growth rates. The same applies to the U.S. economy, which was averaging 3–3.5 percent annual growth until 2007, but which has seen much lower rates since then. Growth in the euro area is also weaker than before the crisis at slightly over 1.5 percent, and Japan’s economy has been stagnant for many years now.

This may be surprising given the extremely expansionary macroeconomic policy. Eight years after the Western financial system crisis broke out and more than six years after the escalation of the sovereign debt crisis in the euro area, central bank interest rates are at a historically low level of around zero percent—or even in negative territory. At the same time, public budget deficits are still considerably high in Western countries, and public debt levels the highest seen in peacetime.

The majority of the economic establishment, supported by international institutions such as the International Monetary Fund and the OECD, sees the cause of weaker growth rates as insufficient aggregate demand. For instance, the International Monetary Fund’s October 2016 World Economic Outlook was entitled “Subdued Demand: Symptoms and Remedies.” The central banks’ ultra-loose monetary policy is set to continue, supplemented by additional fiscal stimulus. The European Commission

Joachim Starbatty is a member of the European Parliament and professor emeritus at the University of Tübingen. Jürgen Stark is a former Member of the Executive Board of the European Central Bank.
American economists Lawrence Summers and Paul Krugman are particular proponents of this “new” theory of secular stagnation. The theory originates from the doyen of American Keynesianism, Alvin Hansen, who diagnosed the threat of an enduring period of economic stagnation, or secular stagnation, in the United States following the Great Depression at the end of the 1930s. He argued that the solution was to stimulate demand by way of government investment through higher public budget deficits and increased debt.

Summers and Krugman are currently calling for the ultra-loose monetary policy to be continued even after economic recovery begins, in order to stimulate inflationary expectations and thereby reach a higher rate of inflation. This should also serve to reduce real interest rates further. They say that the equilibrium real interest rate has already been negative for some time, but because of low inflation, not yet negative enough to generate higher aggregate demand. In a situation like the present one, the central bank needs to “creibly promise to be irresponsible,” as Krugman put it back in 1988.

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“CREATIVE DESTRUCTION”—A REQUIREMENT FOR SUSTAINABLE GROWTH

It is precisely this irresponsibility of the central banks and constant bolstering of aggregate demand via government debt that caused the ongoing stagnation in the eyes of Joseph Schumpeter, the polar opposite economist to John Maynard Keynes in the twentieth century. In his “Theory of Economic Development” (1912), Schumpeter first of all established the principles underlying bubble formation: many things float on the wave of a prolonged period of prosperity without a driving force of their own, and if speculative anticipation acquires a causal significance, the symptoms of prosperity themselves finally become, in the well-known manner, a factor of prosperity. In other words, the whole world invests or buys companies or shares in companies without checking closely whether it is worth it in the long term, according to his theory.

What Schumpeter means is that these exaggerations cause undesirable developments in the macroeconomic production structure. In the event of an unavoidable economic demise, such misinvestments would have to be eliminated from the production process. He says that the unharnessed production factors are raw materials for subsequent periods of prosperity, which are primarily driven by product and process innovations. This selection process is of course perceived as painful, because values and wealth are destroyed and unemployment created, but it would be wrong to overlook the positive effects associated with it, according to Schumpeter. He later described this period as “creative destruction.”

A policy aimed at hampering this process with “the cheapest money” and government demand stimulus in the hope of such weakness being eliminated in an economic upturn assumes that the existing production structure can also meet future needs. However, this is the main misconception—a policy that aims to rescue the viable as well as preserve the unviable prevents a national economy from moving towards a sustainable growth path.

This is exactly what has happened following the bursting of various bubbles since the beginning of this century. In the short term, the necessary national economic adjustments have been prevented by ever-lower interest rates, more liquidity, and increasing public debt.

KEYNES’ RICARDIAN VICE

It is easy to imagine from the outlined interpretation of boom and bust how Schumpeter reacted to the publication of John Maynard Keynes’ “The General Theory of Employment, Interest and Money” (1936). It is not wide-
accept this invitation because he pleads everywhere for a
definite policy, and on every page the ghost of that policy
looks over the shoulder of the analyst, frames his assump-
tions, and guides his pen. In other words, Schumpeter said

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that Keynes’ policy recommendations were not based on
his theory, but that he had sought a fitting theory for his
policy recommendations. He said that Keynes’ recommen-
dations may be suitable for England, but that this was no
“general theory.”

We would like to take a close look at Keynes’ meth-
odological approach, as this point is the focus of current
discussion and policy. Schumpeter accused Keynes of
Ricardian vice, that is, retreating into a hypothetical struc-
ture, accumulating assumptions, constructing constant
relationships between them, and then drawing political
conclusions from them. It is remarkable that Keynes ac-
cussed Ricardo of the same, of creating a hypothetical world
void of experience, as if it were the real world, in order
to permanently live in it. In so doing, Keynes reverted to
his criticism of the Ricardian method in his 1933 essay on
Robert Malthus, stating that it was Ricardo’s more fascinat-
ing intellectual construction rather than that of Malthus that
“constrained the subject for a full hundred years in an artifi-
cial groove” by turning its back on Malthus’ idea of “effec-
tive demand.” And Keynes considered himself the econo-
mist who would push the train back onto the right track.
Schumpeter in turn said of Keynes that he set the course in
the wrong direction, as the method of his “General Theory”
was just as Ricardian in spirit and intention. “The same
method is used of skirting problems by means of artificial
definitions which, tied up with highly specialized assump-
tions, produce paradoxical-looking tautologies.” He said
that Keynes’ central assumptions, “marginal propensity to
consume,” “liquidity preference,” and “marginal efficiency
of capital” would inevitably lead to the assumption of long-
term unemployment. Schumpeter wrote in 1936 that this
discovery has no greater practical importance “than a proof
that motor cars cannot run in the absence of fuel.”

In particular, Keynes’ determination of lacking prof-
itability of future investments went against the grain for
Schumpeter, as there was not a single line of reasoning for
this in “General Theory.” Monetary and financial policy
based on Keynes clearly assumes that there are now and will
be in the future too few profitable investments. This kind of
assumption would have appeared absurd to Schumpeter.
His response to contemporary economists would be that
precisely because they are halting the recovery process,
they are preventing a process of creative destruction which
forms the basis for any sustainable economic growth.

The Japanese economy is a prime example of this. The
Bank of Japan’s cheap money policy has enabled banks
to keep zombie companies alive through liquidity injec-
tions until lacking profits cause them to become zombie
banks themselves, reliant on the central bank’s drip feed.
Moreover, government debt has risen from around 60 per-
cent of GDP in 1989 to a current 250 percent, without the
Japanese economy being able to return to a sustainable
growth path.

**IRRESPONSIBLE MONETARY POLICY**

This example shows that the Summers-Krugman formula
is a cause for concern. Interest rates the world over are
already too low according to the Bank for International
Settlements—the central bank of central banks—in Basel.

**The Bank of Japan’s cheap money**

**policy has enabled banks**

**to keep zombie companies alive**

**through liquidity injections.**

But even so, European central banks and the Bank of Japan
introduced negative interest rates on bank deposits. This hap-
pened at the same time as the creation of ever more liquidity,
quantitative easing of monetary policy via purchases of gov-
ernment and corporate bonds, and in the case of Japan, the
purchase of shares. Deposits with central banks are intended
to become unattractive. Banks are to be pushed to grant loans
and assume higher risks. However, if banks were to follow
the intentions of the central banks, this behavior could not be
guaranteed and would also be highly risky. Because nega-
tive interest rates affect the banks’ earning power, they can
react by granting fewer loans. So the whole thing would be
rather counterproductive. At the same time, negative interest
rates are gradually becoming interwoven and are affecting
customers. It is increasingly evident that the traditional saver
is sustaining considerable real losses.

A further market intervention by the central bank or
governments may be impending to prevent evasion attempts
such as hoarding cash, and to aid the supposed effectiveness
of monetary policy: limiting cash transactions or even elimi-
nating cash altogether, as American economists declare. Or
we remember the option of “helicopter money,” whereby
the central bank distributes money to individuals in order to
boost consumption. Economist Milton Friedman’s thought
experiment aimed at demonstrating the effect of money
highlights the extent to which the central bank should get
involved, and takes monetary policy to the absurd.

Interventions of this kind gradually undermine the
credibility of the central bank. Trust is lost because the
effectiveness of measures is questioned, and the “uninten-
tended consequences” of this policy—to which the Bank
for International Settlements has been referring for several
years now—are increasingly recognizable. The central
bank policy causes financial instabilities and new market
excesses, as the interest rate has lost its steering and signal
function. Central bank policy is no longer part of the solu-
tion but is becoming part of the problem. The economy is at
threat of zombification. Necessary corrections to bank and
company balance sheets are being delayed, unproductive
companies are remaining on the market, and banks without
sufficient capital or sustainable business models continue
to exist. All of this means a considerable economic burden
and causes a significant decline in productivity.

REFORM AGENDA

The macroeconomic production structure needs to be cor-
corrected to enable sustainable growth. Overcapacities stem-
ming from before the crisis and excessive debt need to be
decreased in order to release productive forces.

The euro area countries and Japan have long reform
agendas, and little on them has been implemented thus far.
This is also because central bank intervention has lifted the
pressure to reform from the governments.

The reforms needed naturally differ from country to
country. The priority in many European countries is re-
structuring of the banking sector. The familiar problems
have been allowed to slide for too long. The banking
systems now need to be quickly consolidated and restruc-
tured. Bad loans need to be outsourced, and banks—where
necessary—recapitalized. National economies need to gain
flexibility in order to reduce structural imbalances and in-
crease production potential. Investment in education and
vocational training, in research and development, and in
infrastructure are key policy areas. Budget policy is in need
of credible consolidation strategies to guarantee the long-
term sustainability of public finances and regain trust in the
solidity of government finances. This is not least necessary
in order to confront impending sovereign insolvencies in a
more normal interest rate environment.

Secular trends are clear, particularly demographic
change with an aging and shrinking population. However,
these do not in themselves pose the risk of secular stag-
nation. These trends have blended together with the con-
sequences of the systemic financial and debt crises, and it
only makes sense to tackle this matter via the supply side.

NO MORE KEYNES

The Keynesian formula is not part of the solution to the
problems; it is only aimed at short-term effects. In the me-
dium term, it leads to new excesses and exacerbates cri-
ses developing in public finance and the negative conse-
quences of the currently excessively loose monetary policy.
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Keynes and his disciples and turn their gaze towards the

It is time for economists to emancipate
themselves from Keynes and
his disciples and turn their gaze towards
the Austrian School.

Austrian School and reflect on the insights of its most im-
portant representatives: Carl Menger, Eugen von Böhm-
Bawerk, Joseph Schumpeter, Ludwig von Mises, and
Friedrich August von Hayek.

We will therefore leave the last word to Ludwig von
Mises: “The task of economics is to foretell the remoter
effects, and so to allow us to avoid such acts as attempt to
remedy a present ill by sowing the seeds of a much greater
ill for the future.”

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