Discussion of "A Contagious Malady: Open Economy Dimensions of Secular Stagnation"

by Eggertsson, Mehrotra, Singh and Summers

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Cambridge and CEPR

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Whatever I say, does not reflect the views of the Bank of England

Great paper

- high impact
- controversial
- many insights, but not exhaustive

Outline

1. The question
2. The transmission mechanism
3. Expanding on a missing dimension: real exchange rates
4. A New-Keynesian rejoinder
5. Policy

Larry Summers

"Secular stagnation occurs when neutral real interest rates are sufficiently low that they cannot be achieved through conventional central-bank policies. At that point, desired levels of saving exceed desired levels of investment, leading to shortfalls in demand and stunted growth."

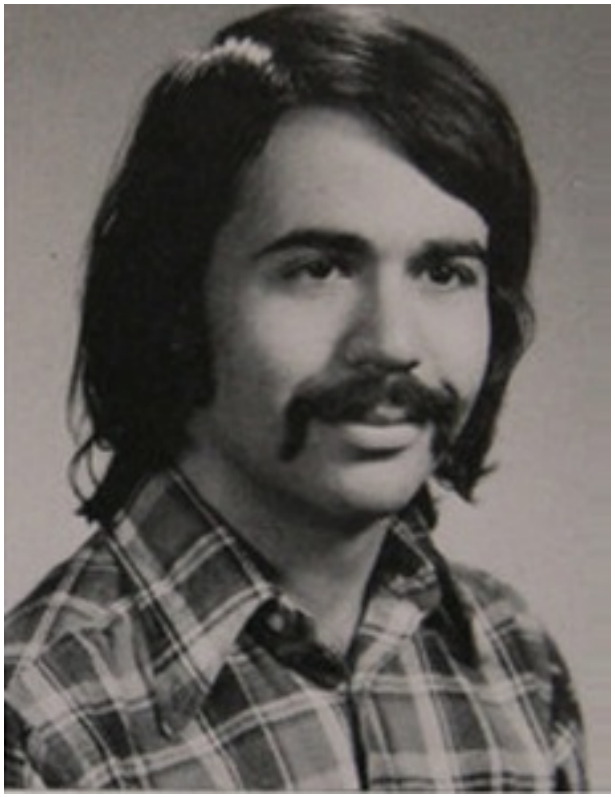
Secular stagnation

- Neutral rates are negative: $r^n < 0$
  - Demographics, productivity ...
  - Financial frictions
- but conventional monetary policy cannot lower real rates as much as needed: $r > r^n$
  - (Downward nominal rigidities)
  - Policy framework: low inflation target too low, Effective Lower Bound (ELB) too high
- Monetary stance is endogenously and permanently contractionary: Equilibrium savings cannot be absorbed at full employment underemployment in steady state

This paper

- Study how secular stagnation spreads globally via net capital flows—'dumping a country excess savings abroad'
  - Role of Bernanke's *global savings glut* hypothesis
- Conditions for a country to 'escape global secular stagnation'
  - Negative spillovers from higher domestic inflation cum exchange rate depreciation, competitiveness-enhancing reforms (generating savings); positive spillovers from fiscal (absorbing savings);
- Role of financial market integration
  - Does it raise vulnerability?

Ben Bernanke



- Global Saving Glut reducing the world interest rate
- to be blamed?

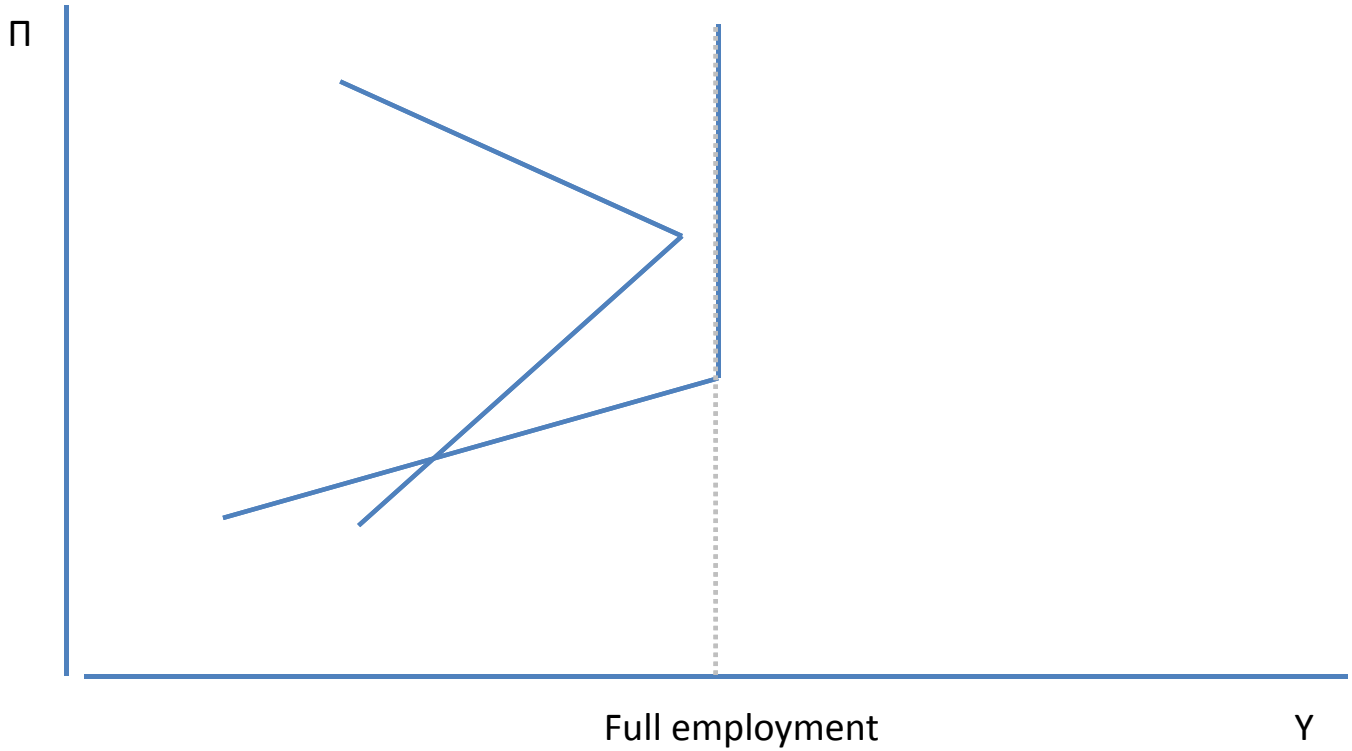
2. To be clear: the root of the problem same in closed and (small and large) open economies

1. Target $\bar{\Pi}$ low relative to *neutral rate*, policymakers cannot control inflation because of ZLB:
   equilibrium at low (negative) inflation, high rates and insufficient demand
2. With downward nominal wage rigidities, the Phillips curve

$$Y = \begin{cases} Y^f, & \text{if } \Pi \geq \left(\frac{Y^f}{Y_{t-1}}\right)^{\frac{1-\alpha}{\alpha}} \\ \left[\gamma \frac{Y_{t-1}^{\frac{\alpha-1}{\alpha}}}{\Pi_t} + (1-\gamma) Y_f^{\frac{\alpha-1}{\alpha}}\right]^{\frac{\alpha}{1-\alpha}}, & \text{otherwise} \end{cases}$$

   can generate steady state stagnation if prices drop too fast relative to wage adjustment

Secular stagnation equilibrium



The key open-economy "dimension" in the paper: inflow of foreign savings lower neutral rates

- With market segmentation, country-specific real rate still respond to global determinants:
  capital inflows (foreign savings), private or public (international reserves), lower r^n and may cause ZLB to bind

$$1 + r_t = \frac{1+\beta}{\beta} \frac{(1+g_t)D_t}{Y_t - D_{t-1} + \frac{1-\omega_{t-1}}{\omega_{t-1}} \frac{1+\beta}{\beta} (K^* + IR_t)}$$

The key open-economy "dimension" in the paper: inflow of foreign savings lower neutral rates

- With perfect integration only global excess savings matter

$$1 + r_t^W = \frac{1+\beta}{\beta} \frac{\omega(1+g_t)D_t + (1-\omega)(1+g_t^*)D_t^*}{\omega Y_t + (1-\omega)Y_t^* - \omega D_{t-1} - (1-\omega)D_{t-1}^*}$$

- Insightful result: a stagnation equilibrium in one country (lowering output) raises r^W:
  asymmetric equilibria are possible
  $\Pi_t = \bar{\Pi}$ with $i_t \geq 0$,
  $\Pi_t^* < 1$ and $i_t^* = 0$

Nominal exchange rates and inflation

- In an asymmetric steady state, exchange rate must accommodate inflation differentials:

$$\frac{S_t}{S_{t-1}} = \frac{\bar{\Pi}}{\Pi_t^*} > 1$$

  to insulate domestic economy from foreign deflationary drift
- Home full employment incompatible with fixed exchange rate (forcing symmetry)
- Currency "war" only in the sense that if $\bar{\Pi}^* = 1$, Foreign must be in stagnation—but this is self-inflicted by policy!

3. Bigger role of exchange rates: demand, income and valuation effects

- Key idea: real depreciation
  - raises demand and employment
  - lowers income (value of output in consumption units) hence may *reduce excess savings*
  - may directly affect borrowing constraint
- The following draws on work at the Bank of England
  "Step away from the zero lower bound: Small open economies in a world of secular stagnation", joint with Eleonora Mavroeidi, Gregory Thwaites, and Martin Wolf (CMTW)
- expands on EMSS: SOE taking world real rate as given, but facing a downward sloping demand for its goods

In a global secular stagnation, the SOE can be in one of two Steady States

Secular Stagnation

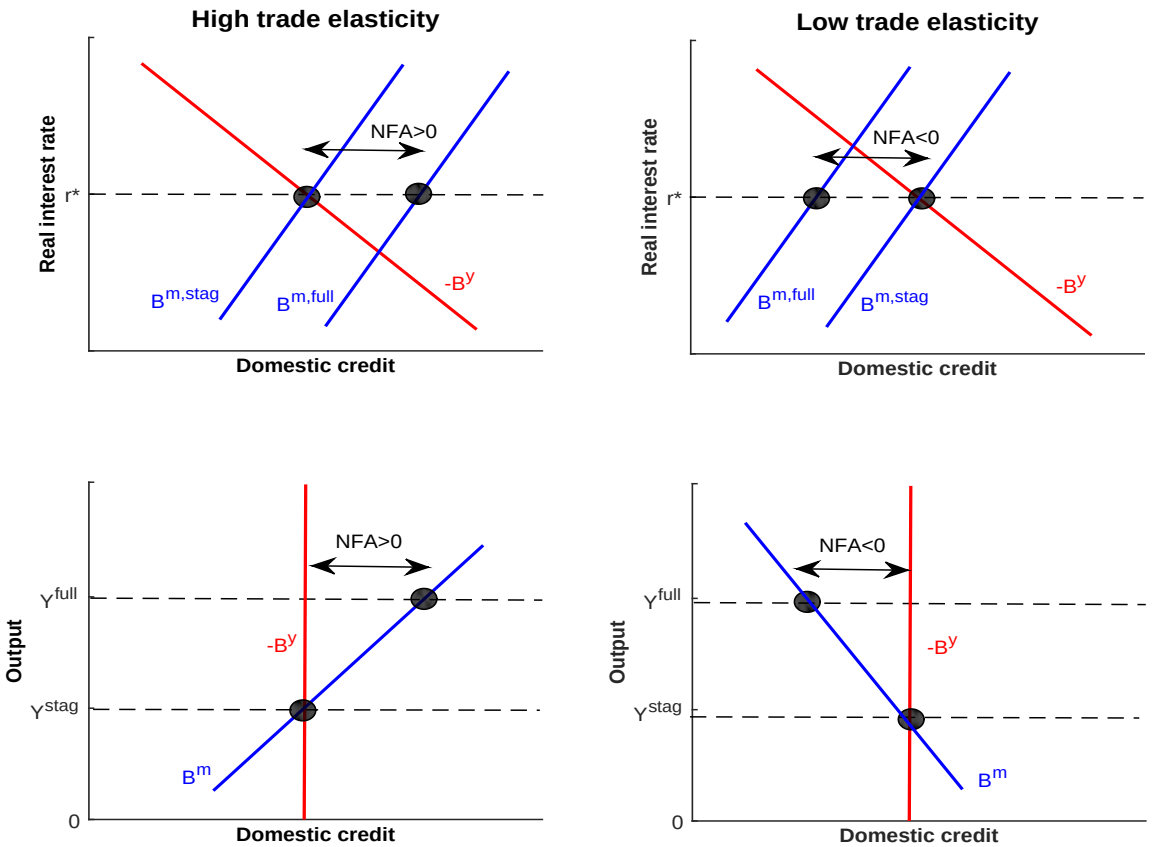
1. Real interest rate same as r^W by UIP and too high
2. $\Pi = \Pi^* < 1$
3. $i = 0$
4. $Y < Y^f$, same as abroad

Two Steady States: the SOE in full employment

Full employment

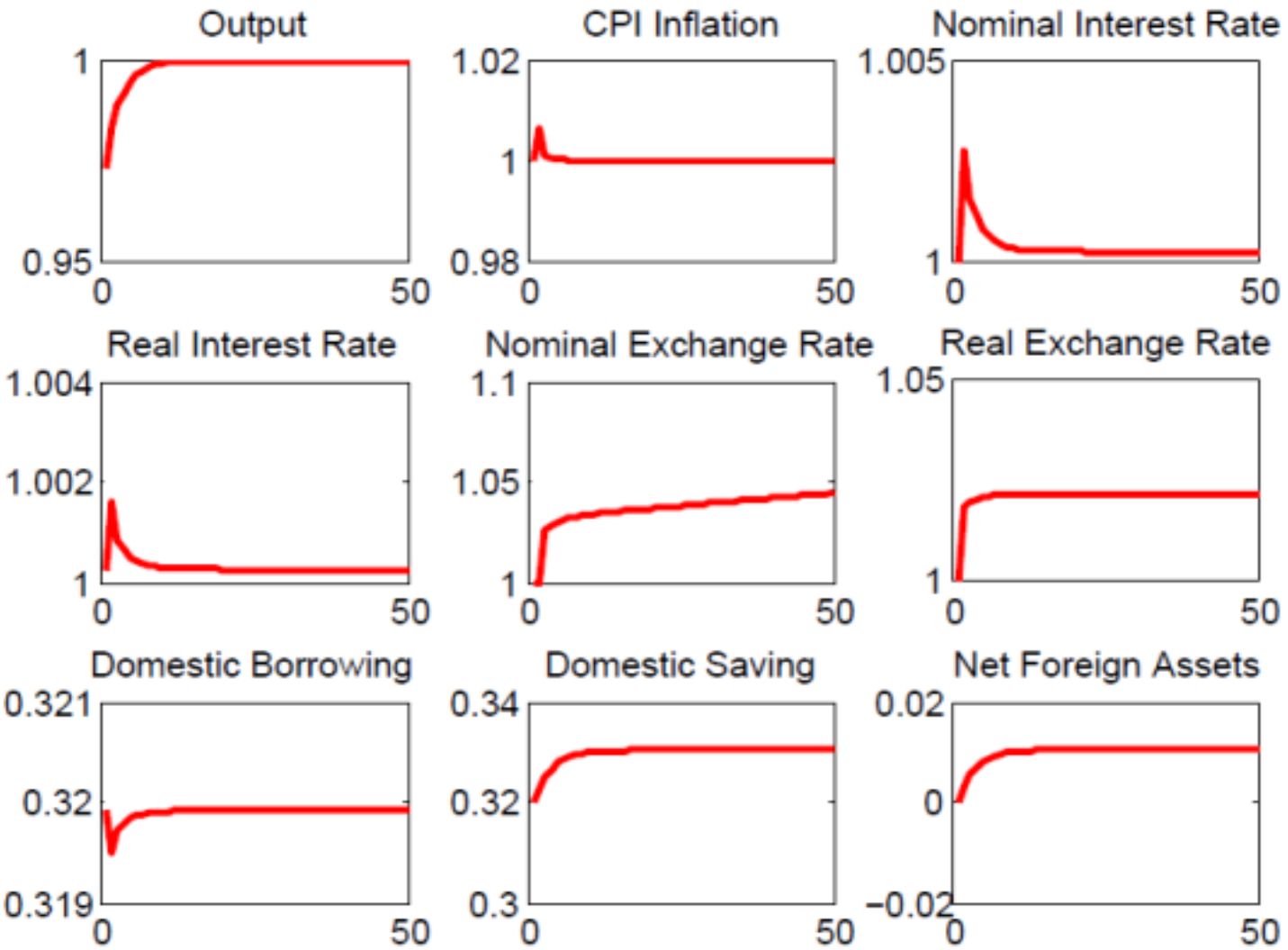
1. Real interest rate same as r^W by UIP and too high—remains true
2. but inflation at target, output at potential $Y = Y^f$
3. Nominal exchange rates constantly depreciates (by UIP), like in EMSS:
4. but also real depreciation to generate enough world demand $Q^f > Q^u$
   Here is a key implication
5. With trade elasticities sufficiently high, positive net foreign asset
   $NFA > 0$ and all generations gain
   Low elasticities: large adverse terms of trade movements lower income,
   $NFA < 0$ and consumption utility falls

High vs low elasticity

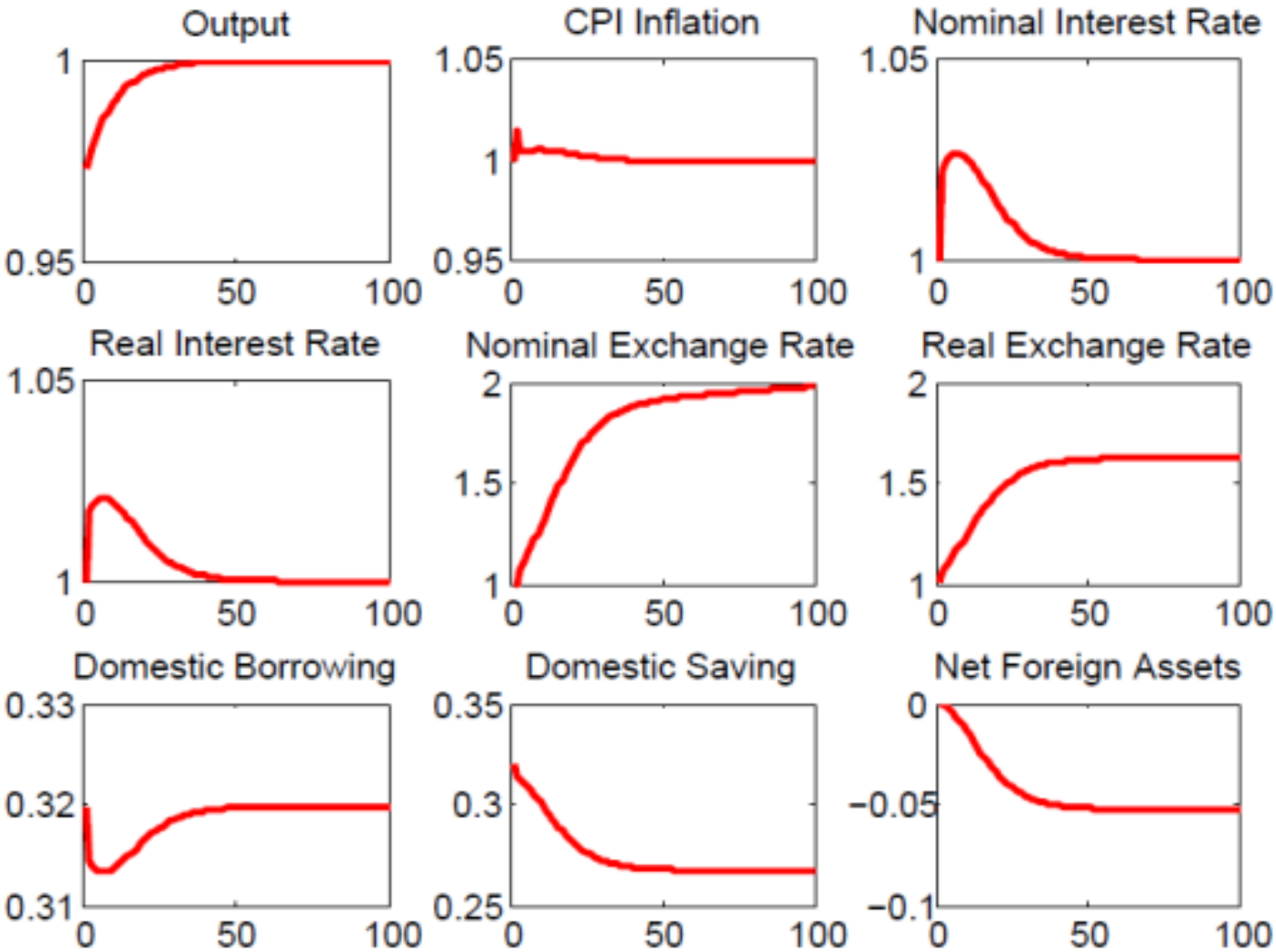


- **Monopoly power on the terms of trade: optimal tariff/immiserizing growth**

Transition to Full Employment: real depreciation boosts domestic output and life-time consumption



Low trade elasticity=high er volatility: "currency wars" can be beggar-thy-self



4. A new-Keynesian rejoinder

- Focus on AD:

$$\widehat{c} = -\left[(1+r_t)+(1+r_{t+1})+...(1+r_{t+T})...\right]+\lim_{T\to\infty}\widehat{c_T}$$

- Models of liquidity trap with unique steady state,
  last term is zero: raising demand requires lower real rates
- Models with long-run traps:
  switching across equilibria produces income effects that may raise demand even if real rates rise
- Open economy:
  international arbitrage constrains rates
  in the transition to full employment, output rises more than consumption, because of real depreciation

5. Policy

- In the EMSS (or the CMTW) model, one can show that incremental adjustment of the monetary policy framework are not necessarily helpful
  - In a stagnation ss, a lower ELB exacerbates deflation
  - Increasing inflation target does not prompt by itself a switch across equilibria
- Wanted: define policy problem upfront, specifying all the relevant constraints
  - The problem is there because of discretionary policymaking—should not give in the temptation of assuming commitment 'à la carte'
  - EMSS attempt to clarify the problem for fiscal policy
  - Much more difficult for monetary policy

To conclude

- Great reading
- look forward for more papers and different views on the subject (e.g. Caballero Fahri and Gourinchas stressing scarcity of safe asset)