Effectiveness of policies to mitigate the effects – demand versus supply-side?

The underwhelming global post-crisis growth performance – determinants, effects and policy implications

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What are the most interesting features of the current crisis?

1. Underutilized factors of production (labor underemployed – capital underemployed).
2. Nominal interest rate at zero
   – Central banks want to cut interest rate but can´t.
3. This has lasted for a very very long time

My view: We need a theory that accounts for all three things?

Why are we so confident interest rate will rise soon?

- Interest rates in the US during the Great Depression:
  - Started falling in 1929
  - Reached zero in 1933
  - Interest rates only started increasing in 1947
- Started dropping in Japan in 1994
  - Remains at zero today
- Why are we so confident interest rate are increasing in the next few years?
- Want to think about why we have had such a long-lasting slump and allow for the possibility it may last even longer.

One such theory

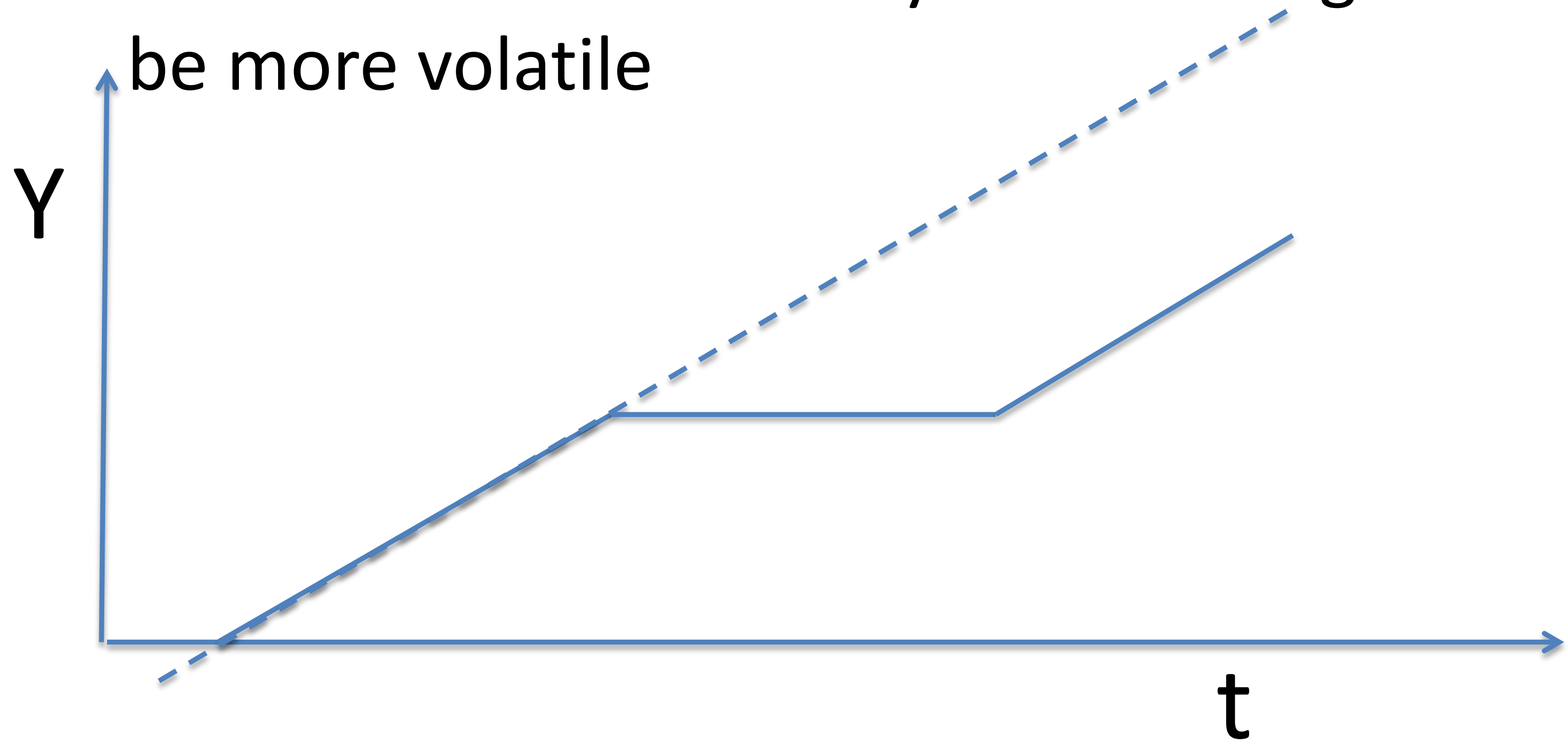
- Secular stagnation hypothesis (Hansen, Summers):
- Slow moving forces that make the natural rate of interest a very slow and persistent process.
- Can have ZLB binding for arbitrarily long period of time.
- Key aspect of theory: The natural rate of interest is negative for an arbitrarily long time

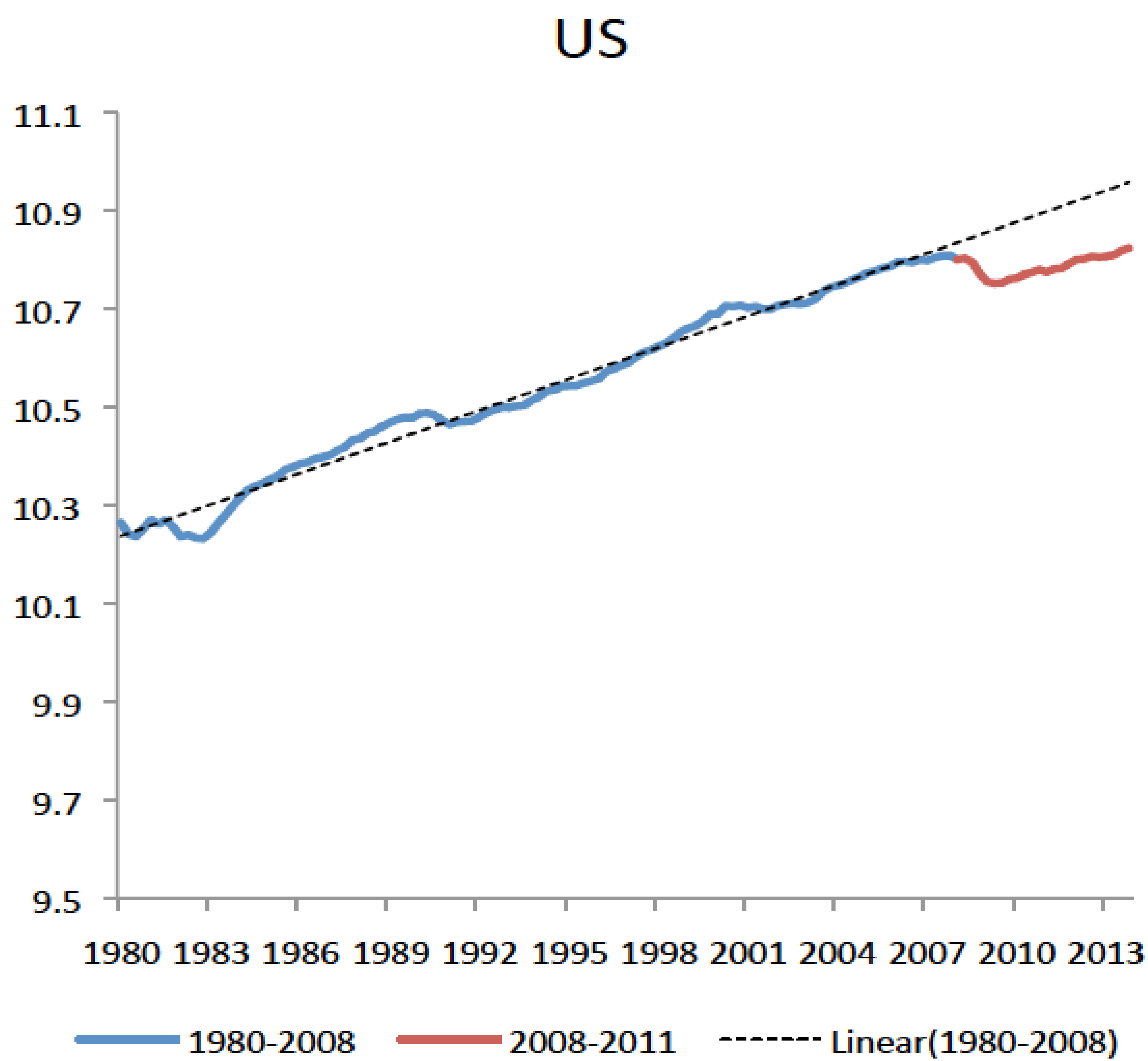
Elements of secular stagnation

- Eggertsson and Mehrotra 2015:
  - Move away from representative agent models
    - Aging population
    - Increase in income inequality
    - Fall in relative price of investment
    - Permanent deleveraging shock
  - Gives rise to permanently lower natural rate of interest
  - This is a problem for any model with nominal frictions
    - Can't accommodate this with negative nominal interest rates.
    - Need inflation or policies that raise the natural rate of interest.

What SS does it NOT imply

- Can still have growth at same ***rate***.
- Can still have business cycles: Will in general be more volatile




US
11.1
10.9
10.7
10.5
10.3
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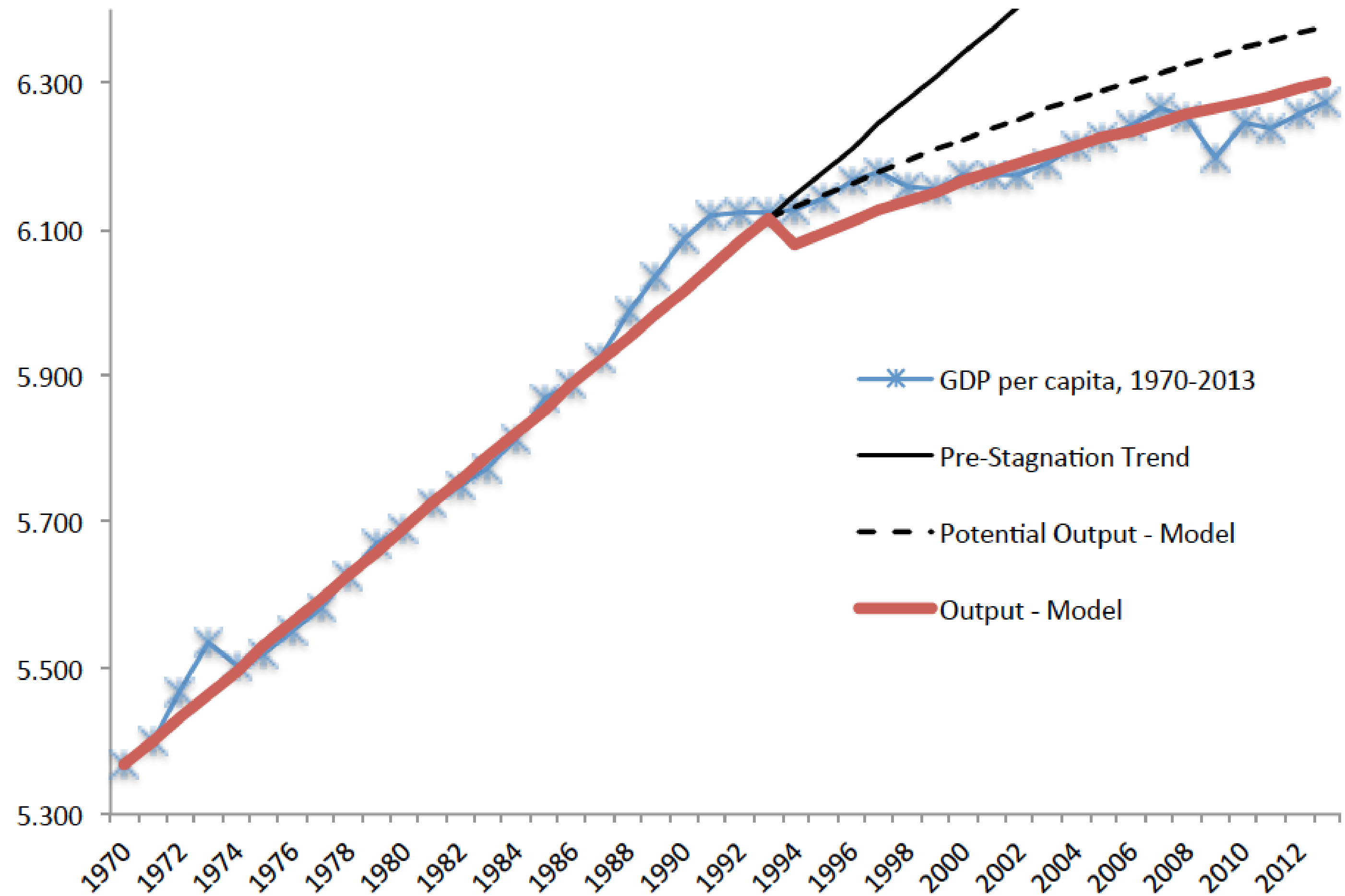
9.5
1980 1983 1986 1989 1992 1995 1998 2001 2004 2007 2010 2013
1980-2008
2008-2011
Linear(1980-2008)

Is it supply or demand?

- Here is an interesting questions:
- In a protracted slump: Does lack of demand starts destroying supply?
- Hysterisis effects.
- Is there evidence of scarring?
- Raises the stakes enormously.

Japan and hysterisis



What should be done?

- Key prediction of the model:
  - Focus in increasing DEMAND
- Increasing supply actually counterproductive
  - Paradox of toil
- What policies are effective
  - Things that ***reduce savings***

Examples

- Increasing retirement age
- Pay as you go social security
- Redistribute wealth from low MPC to high MPC
- Increasing government debt: You want to provide savings vehicle
  - Want to do so as long as you don't start increasing risk premia
- Increases in government spending that are not financed by those constrained
  - Reserve accumulations bad
  - Austerity bad
- Inflation (tax on savings)

Conclusion

- Low output now due to both demand and supply factors.
- But policy should aim at demand when interest rates low.
- Even if we see recovery, quite possible we are seeing a permanent reduction in the natural rate of interest
- If so: This episode may last a long time, or we may see another one coming up soon.