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Secular Stagnation, Low Interest Rates and Low Inflation: Causes and Implications for Policy

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Slow growth, low interest rates and low inflation have characterized the macroeconomic environment in the Euro Area and other advanced economies, since the global financial crisis of 2008-09. This economic landscape raises the fear that, absent policy intervention, advanced economies will face continued stagnation. Going forward, policymakers need to assess the underlying sources, and formulate macroeconomic policy appropriately. This special issue of the *Journal of Economic Dynamics & Control* consists of 8 papers that offer novel empirical and theoretical perspectives on slow growth and low interest rates and inflation rates, and on resulting challenges for macroeconomic policy. All papers were presented at an on-line conference organized by the *Journal of Economic Dynamics & Control*, the European Commission and the Centre for Economic Policy Research (CEPR) on 5-6 November 2020.

The first three papers analyze the role of low trend growth and low natural real interest rates for the monetary strategy of the European Central Bank (ECB), with special emphasis on the

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effects of the Zero Lower Bound (ZLB) constraint on the policy interest rate. Using an estimated New Keynesian dynamic stochastic general equilibrium (DSGE) model of the Euro Area, *Andrade, Galí, Le Bihan and Matheron* show that a fall in the steady state natural real interest rate raises the probability that the ECB policy interest rate hits the lower bound constraint. This calls for adjustments to the monetary policy strategy, namely an increase in the inflation target and/or the use of alternative monetary policy instruments or policy rules. *Erceg, Jakab and Lindé* analyse ECB monetary policy options using an estimated DSGE model in which agents have behavioral expectations (deviations from rational expectations). The authors find that, while a range of proposed adjustments to ECB strategy can provide efficient stabilization in a low rates environment, the rebound from a deep recession remains slow and painful, under behavioral expectations. Using the ECB's New Area-Wide DSGE Model, *Coenen, Montes-Galdon and Schmidt* show that the ZLB can cause substantial economic costs under standard inflation targeting; the authors find that price-level targeting and average-inflation targeting can, if well understood by the private sector, significantly reduce the costs induced by the effective lower bound of the policy interest rate.

The ZLB interest rate constraint is also at the heart of the next two papers. *Kumhof and Wang* focus on the implications of a ZLB constraint for *deposit* rates charged by banks. Using a New Keynesian DSGE model with financial intermediaries, the authors show that, when the ZLB constraint for deposit binds, an increase in the monetary policy interest rate can raise banks' net interest rate margins, and induce an *expansion* in credit and output; the authors argue that central bank rate setting should take credit conditions into account. *Kollmann* analyzes open economy implications of low interest rates. A two-country floating exchange-rate-model is developed; the ZLB constraint generates multiple equilibria: each country can experience recurrent liquidity traps induced by the self-fulfilling expectation that future inflation will be low. Liquidity traps can be synchronized or unsynchronized across countries.

The next two papers study fiscal policy in a low interest rates environment. *Pfeiffer, Roeger and Vogel* analyze optimal fiscal policy when the real interest rate is persistently below the growth rate. They find that the efficient policy response depends on the shock that causes the low real rate; in case of a shift in investor preferences in favor of government bonds, it is optimal to reduce fiscal distortions; a flight-to-quality shock makes it optimal to increase public capital as long as the shock persists. The global financial crisis and the Covid-19

epidemic have triggered a large rise in public debt, in the Euro Area, and globally; to shed light on the effects of that debt build-up, *Albonico, Ascari and Gobbi* develop the notion of a public debt multiplier that captures the output effect of *temporary* changes in government debt induced by the deferral of tax revenues. Using an OLG model, the authors show that the debt multiplier is small in normal times, but that it can be sizable in crisis times. The authors conclude that fiscal consolidation during a recession is inappropriate.

The final paper of the special issue is devoted to the role of demographic trends for the current low rates environment. *Papetti* shows that a large-scale overlapping generation model can explain the fall of the real interest rate in the EU as a consequence of demographic and technology trends; the model predicts a further real interest rate decline until 2030. Among the demographic factors, rising longevity dominates falling fertility. The paper also explores how a range of policy measures have affected the decline of the real interest rate.

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