Discussion of

"The Making of a Great Contraction with a Liquidity Trap and a Jobless Recovery"

By Stephanie Schmitt-Grohé and Martín Uribe

EABCN Conference: Inflation Developments after the Great Recession

Roberto M. Billi

Sveriges Riksbank

Eltville, December 6-7, 2013

To exit or not to exit

- The paper provides, prominently, a theoretical framework for thinking about monetary policy and **jobless recoveries**
- A warning about **unemployment traps**
- And a proposal to central banks for an **exit strategy**

To exit or not to exit

- The paper provides, prominently, a theoretical framework for thinking about monetary policy and **jobless recoveries**
- A warning about **unemployment traps**
- And a proposal to central banks for an **exit strategy**

To exit or not to exit

- The paper provides, prominently, a theoretical framework for thinking about monetary policy and **jobless recoveries**
- A warning about **unemployment traps**
- And a proposal to central banks for an **exit strategy**

The model features

- **Firms** never experience unfulfilled vacancies
- **Households/workers** suffer involuntary unemployment, because nominal wages are downward rigid
- **Fiscal authority** balances the budget each period with a lump-sum tax
- **Monetary authority** sets the nominal interest rate with a simple policy rule subject to the ZLB constraint

The model features

- **Firms** never experience unfulfilled vacancies
- **Households/workers** suffer involuntary unemployment, because nominal wages are downward rigid
- **Fiscal authority** balances the budget each period with a lump-sum tax
- **Monetary authority** sets the nominal interest rate with a simple policy rule subject to the ZLB constraint

The model features

- **Firms** never experience unfulfilled vacancies
- **Households/workers** suffer involuntary unemployment, because nominal wages are downward rigid
- **Fiscal authority** balances the budget each period with a lump-sum tax
- **Monetary authority** sets the nominal interest rate with a simple policy rule subject to the ZLB constraint

The model features

- **Firms** never experience unfulfilled vacancies
- **Households/workers** suffer involuntary unemployment, because nominal wages are downward rigid
- **Fiscal authority** balances the budget each period with a lump-sum tax
- **Monetary authority** sets the nominal interest rate with a simple policy rule subject to the ZLB constraint

Multiple equilibria

- Because of the ZLB constraint, the model has two distinct steady states:
  1. **Full employment** steady state, with inflation at target
  2. **Low employment** steady state, featuring deflation
- In the first steady state monetary policy ensures that economic resources are fully utilized, while in the second steady state the economy is stuck in a liquidity trap

Multiple equilibria

- Because of the ZLB constraint, the model has two distinct steady states:
  1. **Full employment** steady state, with inflation at target
  2. **Low employment** steady state, featuring deflation
- In the first steady state monetary policy ensures that economic resources are fully utilized, while in the second steady state the economy is stuck in a liquidity trap

Multiple equilibria

- Because of the ZLB constraint, the model has two distinct steady states:
  1. **Full employment** steady state, with inflation at target
  2. **Low employment** steady state, featuring deflation
- In the first steady state monetary policy ensures that economic resources are fully utilized, while in the second steady state the economy is stuck in a liquidity trap

Multiple equilibria

- Because of the ZLB constraint, the model has two distinct steady states:
  1. **Full employment** steady state, with inflation at target
  2. **Low employment** steady state, featuring deflation
- In the first steady state monetary policy ensures that economic resources are fully utilized, while in the second steady state the economy is stuck in a liquidity trap

Not all recessions are alike

- Depending on the cause of the recession, the model can explain two types of recovery:
  1. Adverse demand shock is followed by a **job creating recovery**
  2. Downward revision in expectations leads to a **jobless recovery**
- In the first scenario the public maintains confidence in the central bank, while in the second scenario confidence is basically lost

Not all recessions are alike

- Depending on the cause of the recession, the model can explain two types of recovery:
  1. Adverse demand shock is followed by a **job creating recovery**
  2. Downward revision in expectations leads to a **jobless recovery**
- In the first scenario the public maintains confidence in the central bank, while in the second scenario confidence is basically lost

Not all recessions are alike

- Depending on the cause of the recession, the model can explain two types of recovery:
  1. Adverse demand shock is followed by a **job creating recovery**
  2. Downward revision in expectations leads to a **jobless recovery**
- In the first scenario the public maintains confidence in the central bank, while in the second scenario confidence is basically lost

Not all recessions are alike

- Depending on the cause of the recession, the model can explain two types of recovery:
  1. Adverse demand shock is followed by a **job creating recovery**
  2. Downward revision in expectations leads to a **jobless recovery**
- In the first scenario the public maintains confidence in the central bank, while in the second scenario confidence is basically lost

Restoring confidence and exiting the liquidity trap

- Loss of confidence in the central bank seems to be the root cause of the liquidity trap
- To restore confidence, the central bank can just raise the nominal interest rate back to the intended target

Restoring confidence and exiting the liquidity trap

- Loss of confidence in the central bank seems to be the root cause of the liquidity trap
- To restore confidence, the central bank can just raise the nominal interest rate back to the intended target

Caveats about the exit strategy

- Even if expectations are fully rational, **confidence** in the central bank's ability to achieve its inflation target may be **easier to loose than to restore**
- **Overshooting** the nominal interest rate target, as part of the exit strategy, may speed up the recovery
- A further aspect of **forward policy guidance**

Caveats about the exit strategy

- Even if expectations are fully rational, **confidence** in the central bank's ability to achieve its inflation target may be **easier to loose than to restore**
- **Overshooting** the nominal interest rate target, as part of the exit strategy, may speed up the recovery
- A further aspect of **forward policy guidance**

Caveats about the exit strategy

- Even if expectations are fully rational, **confidence** in the central bank's ability to achieve its inflation target may be **easier to loose than to restore**
- **Overshooting** the nominal interest rate target, as part of the exit strategy, may speed up the recovery
- A further aspect of **forward policy guidance**