Discussion of "Debt, Deleveraging, and the Liquidity Trap"

by Gauti Eggertsson and Paul Krugman

Discussion by Bob Hall

Federal Reserve Bank of San Francisco
Annual Macro/Monetary Economics Conference
February 25, 2011

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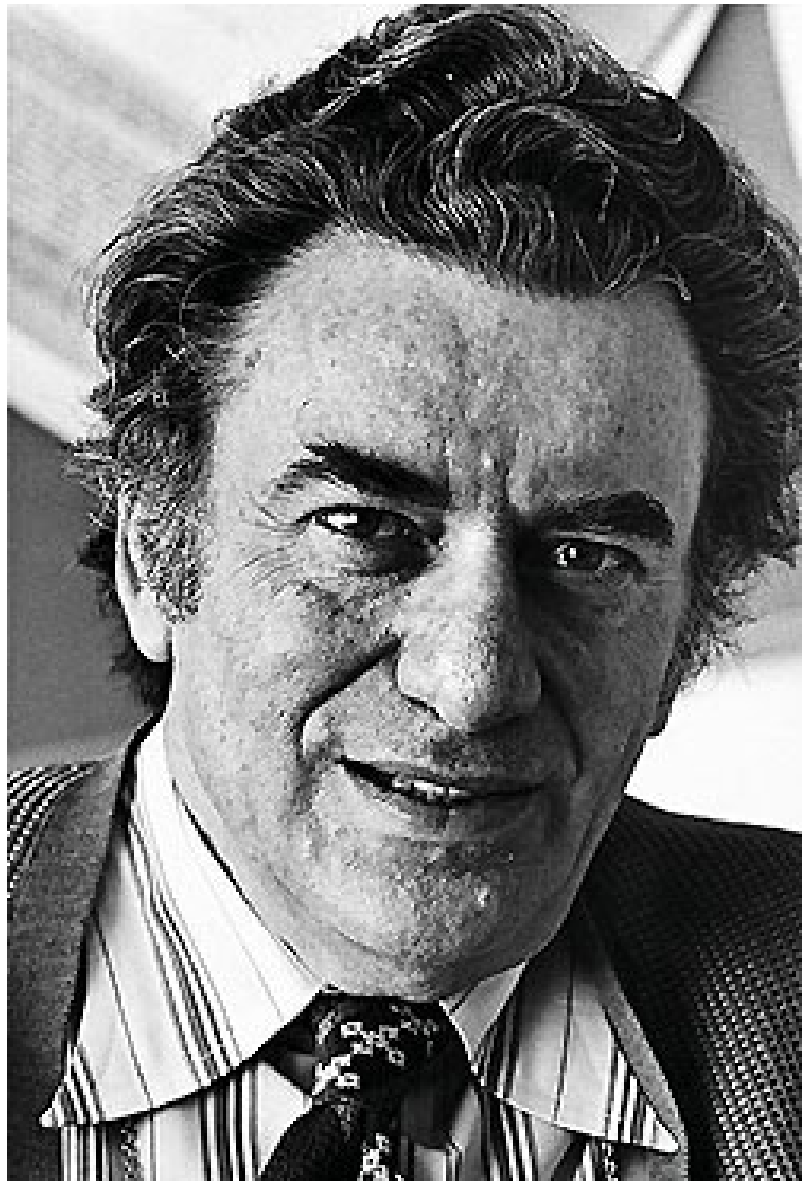
My adviser, Hyman Minsky



Krugman Effect

A force that results in an increase in the marginal rate of substutition must cause low real interest rates, possibly dangerously negative.

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This paper and Hall (*AER* 2011) rely on the more plausible Migraine Effect

Eggertsson Effect

$$r_n = r + \mathbb{E}\ \pi$$

and slackness causes a decline in $\mathbb{E}\ \pi$ and thus a greater danger of the calamity of $r_n = 0$.

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Fisher Effect

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The immediate effect of a decline in the price and wage level on household cash flow is only the increase in the current real obligation.

It would be erroneous to think that the household suffers a decline in current real income equal to the increase in the real amount of its debt.

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Migraine Effect

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The classical migraine headache hits during the period of relief after a stressful experience.

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My assessment

The Krugman Effect is part of bedrock macro and has to be right, but it is important, as this paper points out, that the MRS applies only to consumers who are not at the corner of the Bewley-Aiyagari intertemporal allocation problem.

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Fisher's debt deflation had essentially no role in the Great Slump.

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Eggertsson Effect

The effect arises from Calvo incapacity of immediate response by price setters. When output falls, they know they want to cut prices but they have to wait for Calvo to give the OK. The result is a decline in expected inflation.

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The paper refers to the *paradox of flexibility* but, with respect to the Eggertsson Effect, a better term would be the paradox of semi-flexibility—there's no problem from fully flexible prices and none from completely sticky prices, but a profound problem from the prices that come out of the standard Calvo model and parametrization.

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This paper does not include the Eggertsson effect in its model.

Stock-Watson Jackson Hole 2010

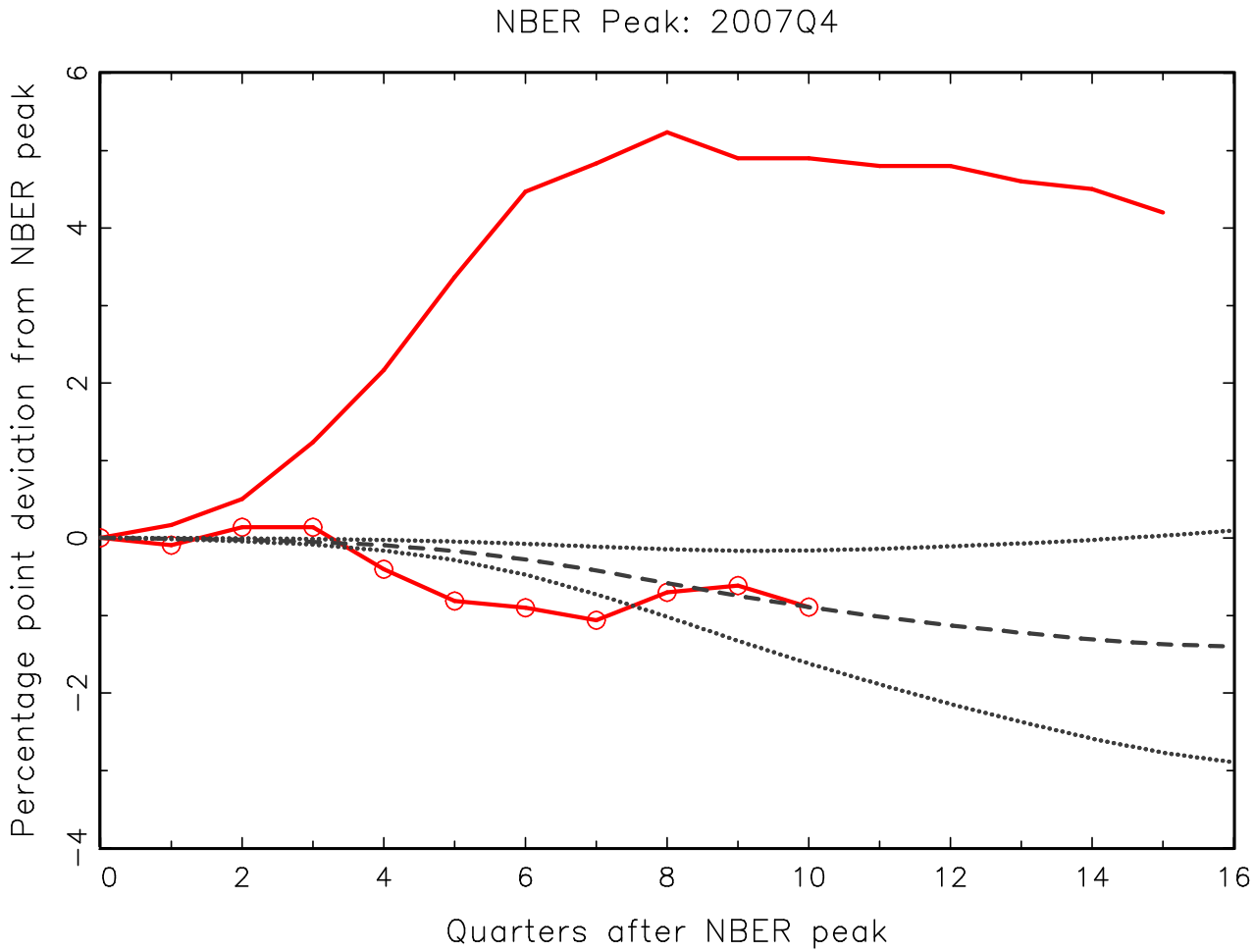
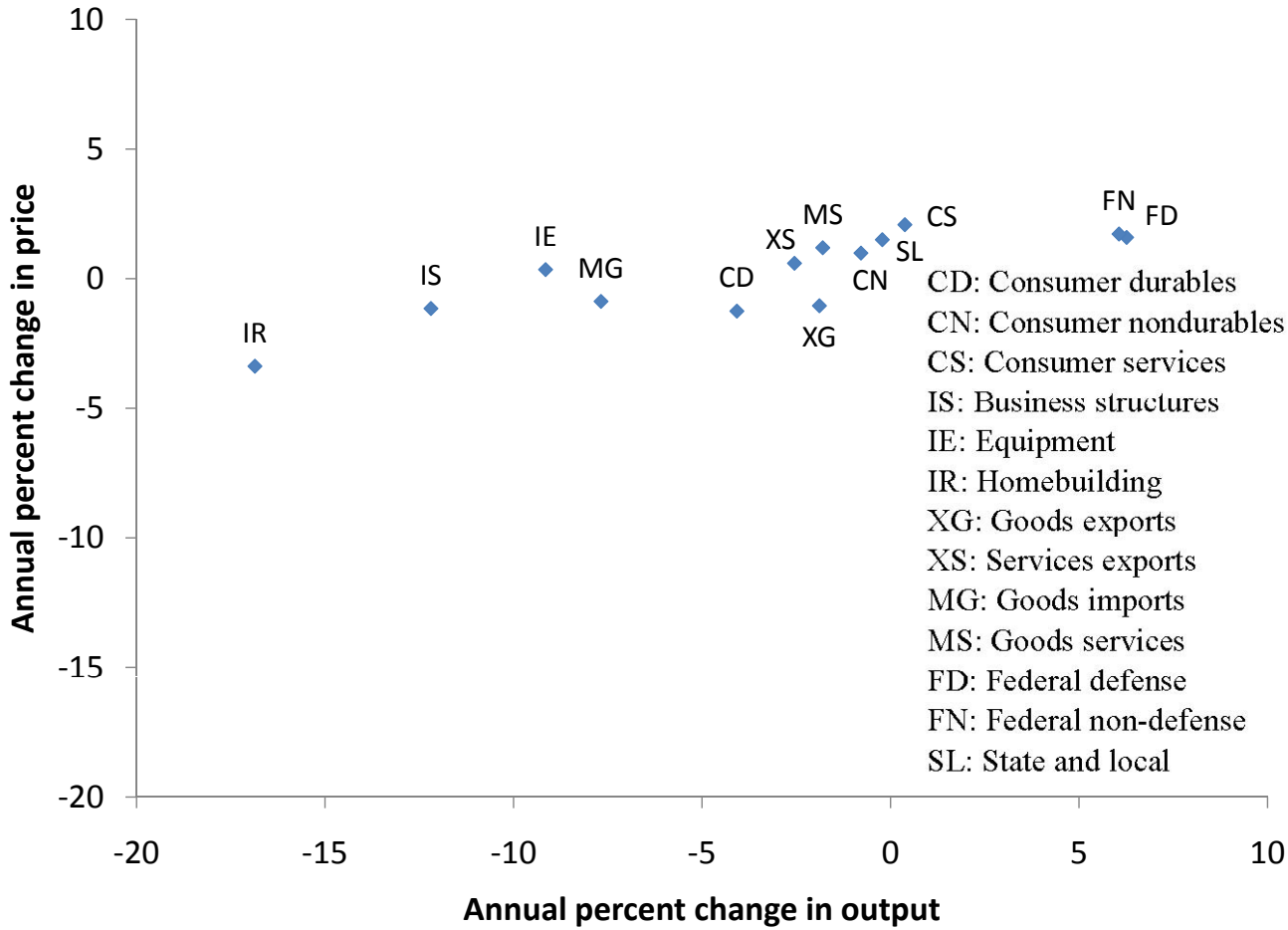


Figure 14. Dynamic simulation of 4-quarter core PCE inflation from 2007Q4 to 2011Q3 computed using the unemployment recession gap model. Unemployment values from 2010Q3 through 2011Q3 are SPF median forecasts. All series are plotted as percentage point deviations from their values at the NBER peak. Dashes are mean predicted values, dots are 90% confidence bands.

Annual Percent Changes in Output and Prices, 2007 Q4 to 2009 Q4



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The next 3 slides are from Hall (*AER*, 2011)

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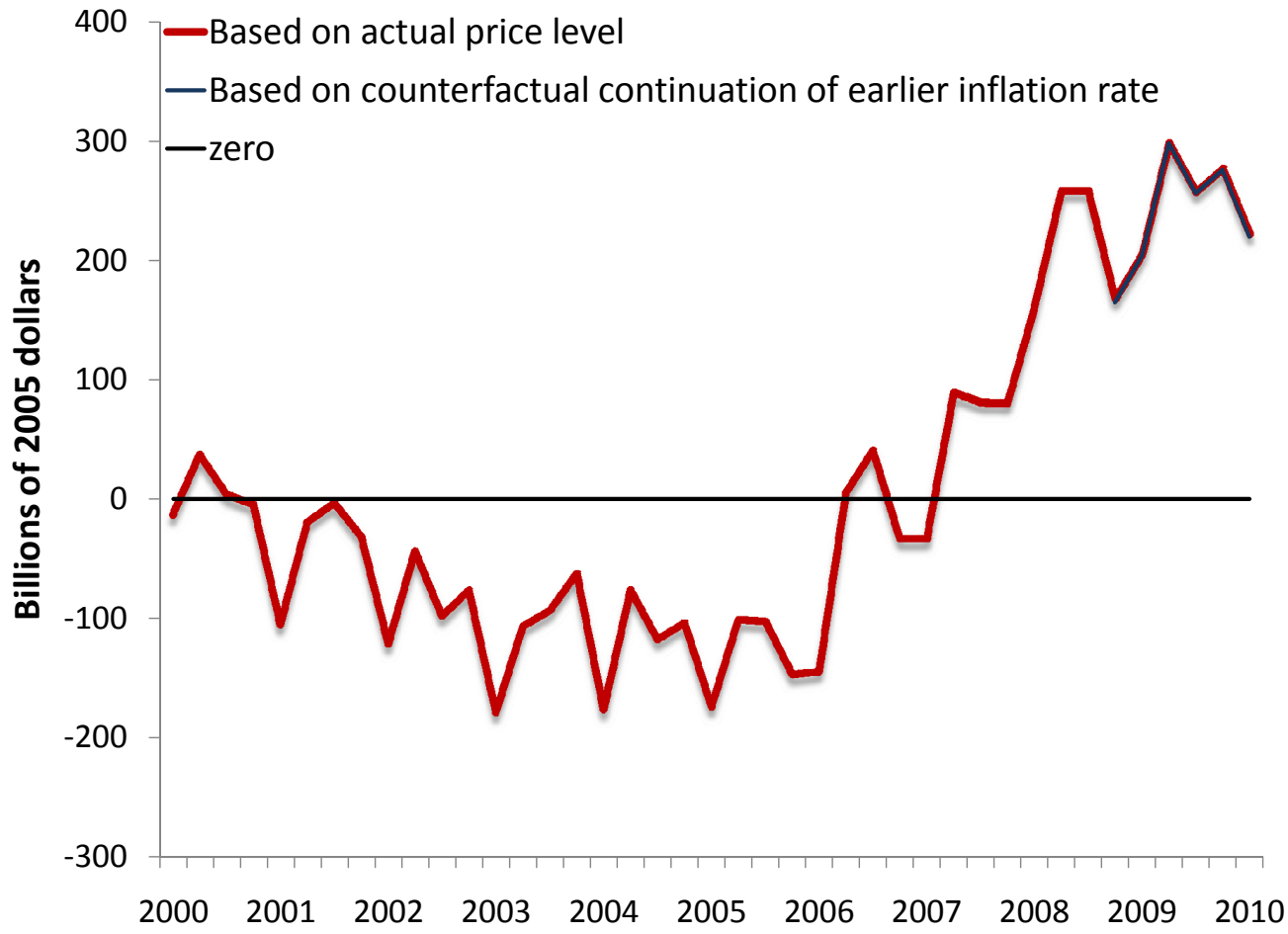
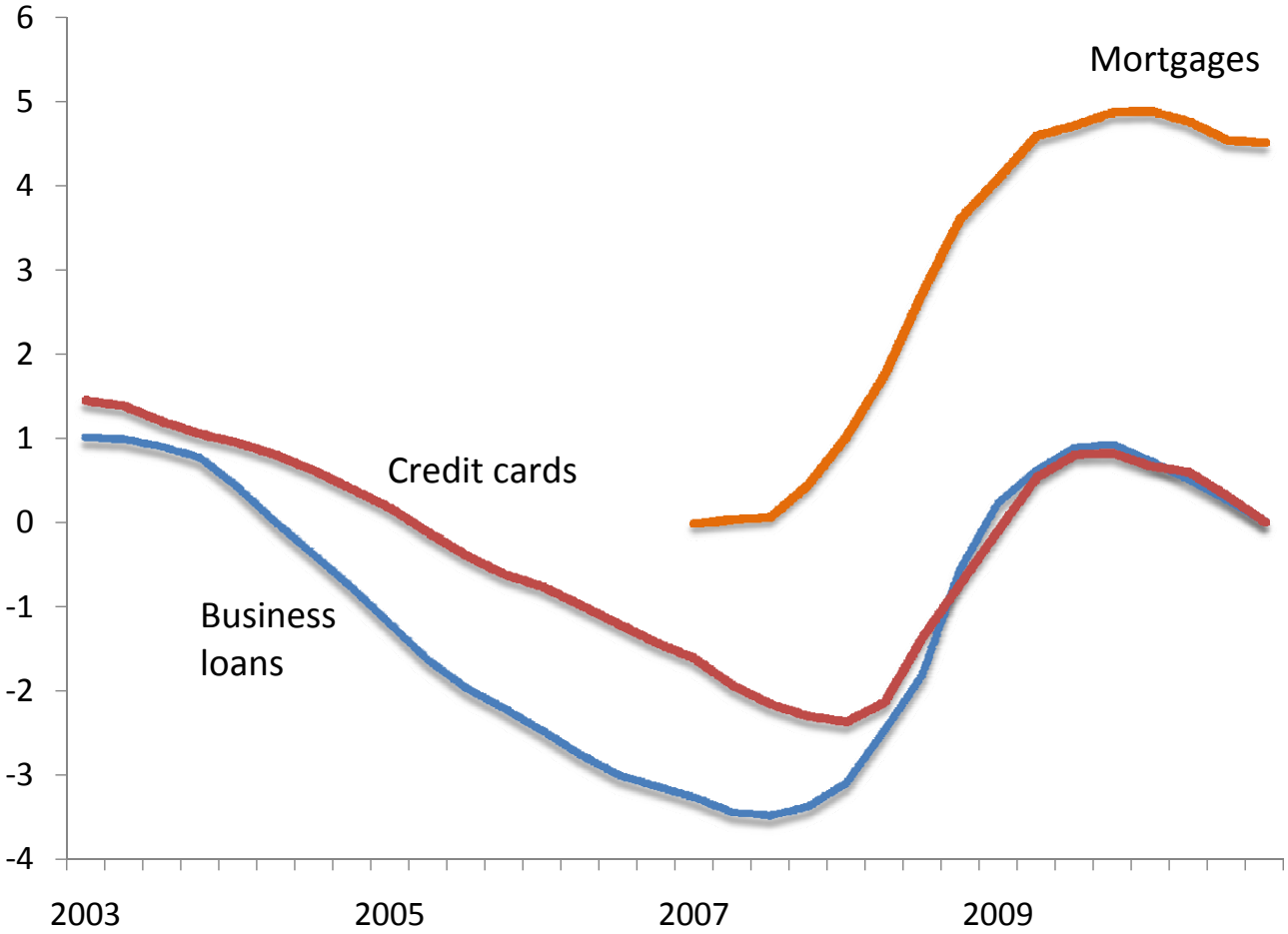
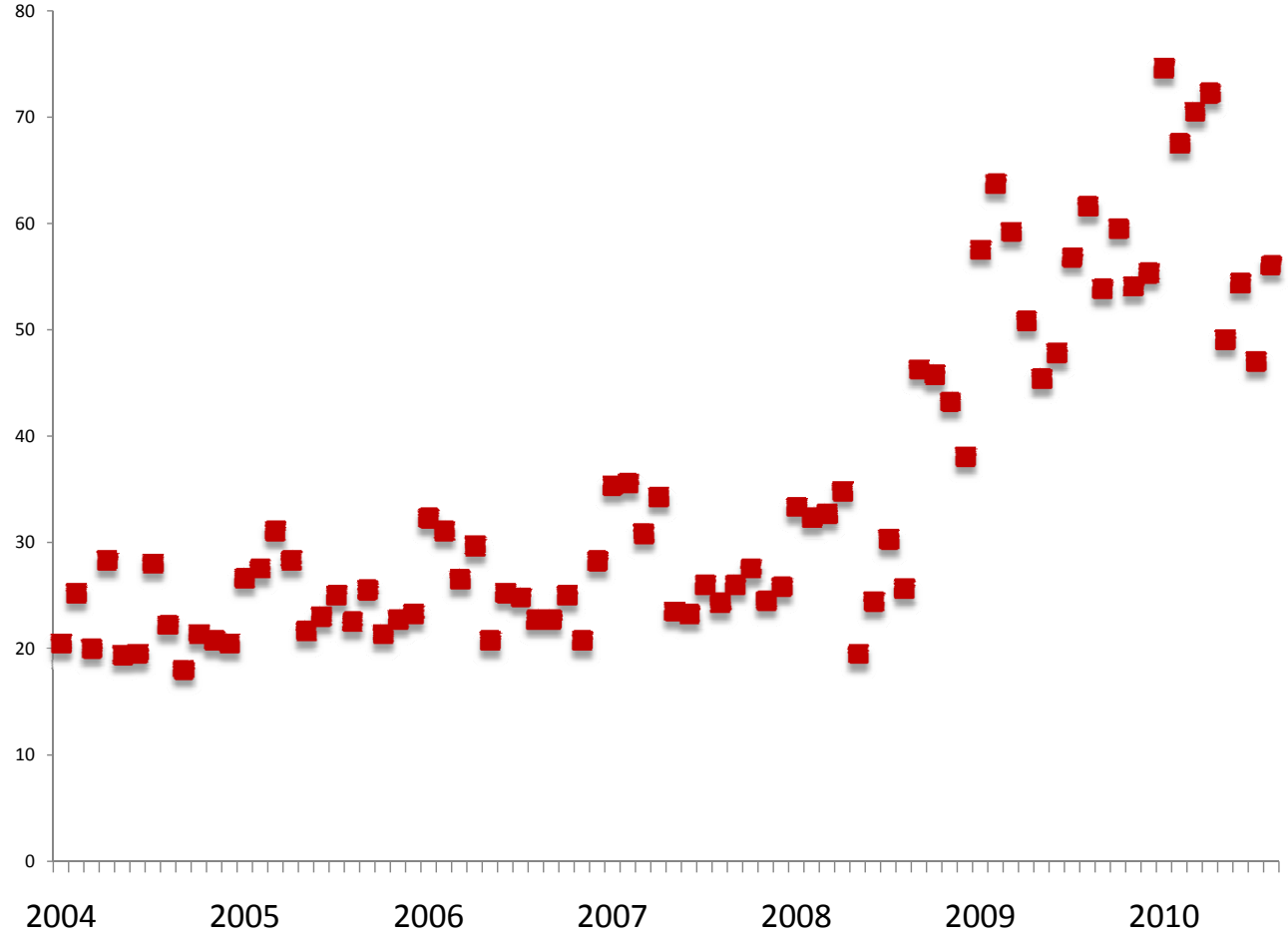
Real Burden of Debt Service



Indexes of Lending Standards Inferred from the FRB Senior Loan Officer Survey



Share of Google Search Queries for the Term "withdrawal penalty"



Modeling issue: The clash of unemployment theories

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But we also have the acclaimed DMP model of unemployment, which gives a different answer.

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