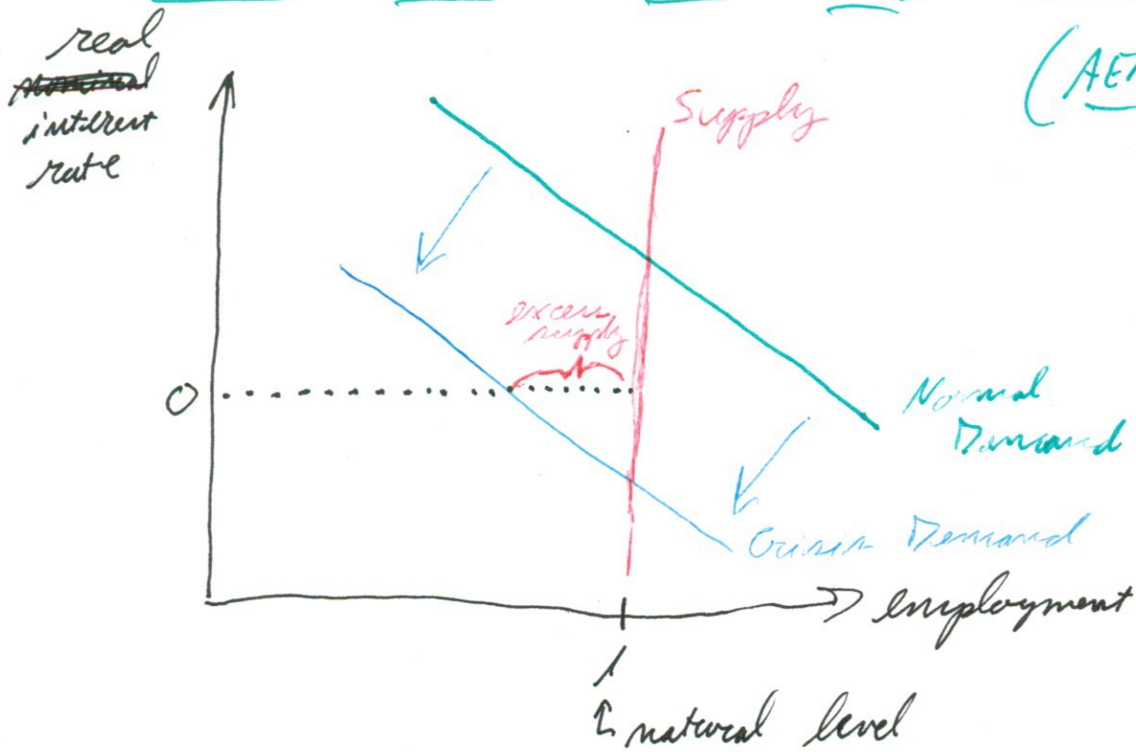
Robert Hall: The Long Slumps

(AER, April 2011)



$r = i - \pi^e$

in crisis $i = 0$, so need high positive expected inflation to reduce real interest rate to a negative value otherwise employment will remain below its natural level

→ agency frictions, default costs & credit rationing have kept real interest rate too high

→ financial frictions

- agency relationship between investors & financial intermediaries
- moral hazard: investors have already deposited funds with the intermediary
- intermediary can now:
  - lend out the funds
  - abscond with some fraction of its value
- intermediary charges a higher rate to borrower than it pays to investor
  - continuation value ≡ present value of difference between credit & amount paid to investors
- if continuation value is less than the value of absconding, the intermediary will abscond with funds
- so investors accept widening of spread
  - when assets held by intermediary lose value because:
  - smaller difference between credit & amount paid to investors

→ lenders also face a larger adverse selection problem during slump so they tighten ~~the~~ lending standards (because more borrowers are on margin of failure)

→ when borrowers default, lenders incur substantial costs to recover value through modification, foreclosure or bankruptcy

→ How pinned interest rate causes slump

- what happens during hyperinflation?
  - households rush to spend money as fast as they can to get most value for their ~~own~~ currency
- what happens during deflation?
  - households hang on to cash as long as possible because value of money will increase over time

→ Hall then ~~develops~~ sketches a formal model

- some households liquidity constrained (i.e. cannot borrow any more), some not
- only a fraction of capital is utilized
- once nominal interest rate no longer ~~[illegible]~~ pinned at zero (deflation has passed)
  - → quick drop in unemployment rate
  - → liquidity constrained households increase consumption
  - → household + business ~~[illegible]~~ investment increases
- BUT must pass through a period of <u>negative</u> <u>real</u> <u>interest</u> <u>rates</u>

→ How to do so?

- monetary policy has already brought nominal interest rate to zero
- fiscal policy is held hostage by the GOP

→ Hall proposes tax policies that emulate the effect of low real interest rates so that consumption now is cheaper than consumption in future

- phase in a VAT (or other sales tax)
- phase out income taxes

→ if adopted, such a policy would accelerate spending & bring economy out of slump

→ would also have efficiency benefits (i.e. taxation of consumption would increase the economy's saving rate)