RIETI BBL Seminar Handout

"Secular Stagnation: Is Asia also at risk?"

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https://www.rieti.go.jp/jp/index.html

Revisiting the Asian Macroeconomic Framework

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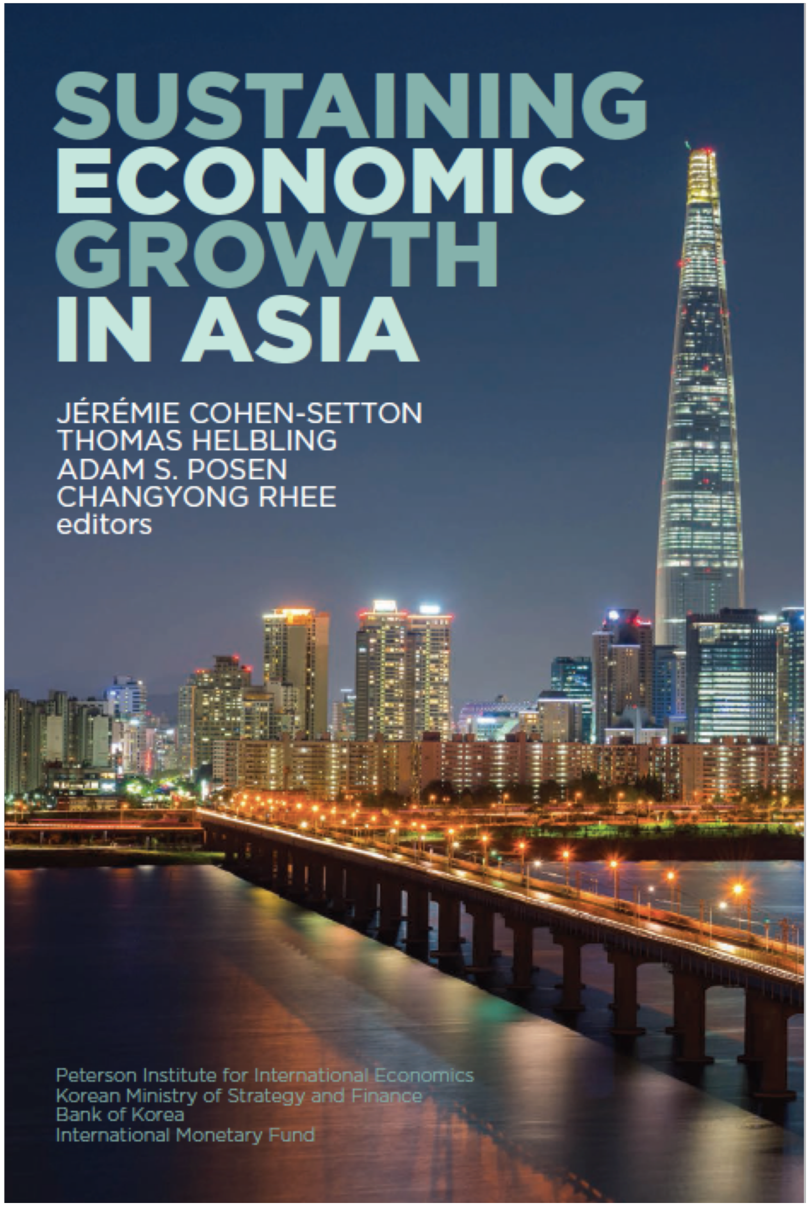
Overview

1. Adjusting to foreign secular stagnation requires rebalancing

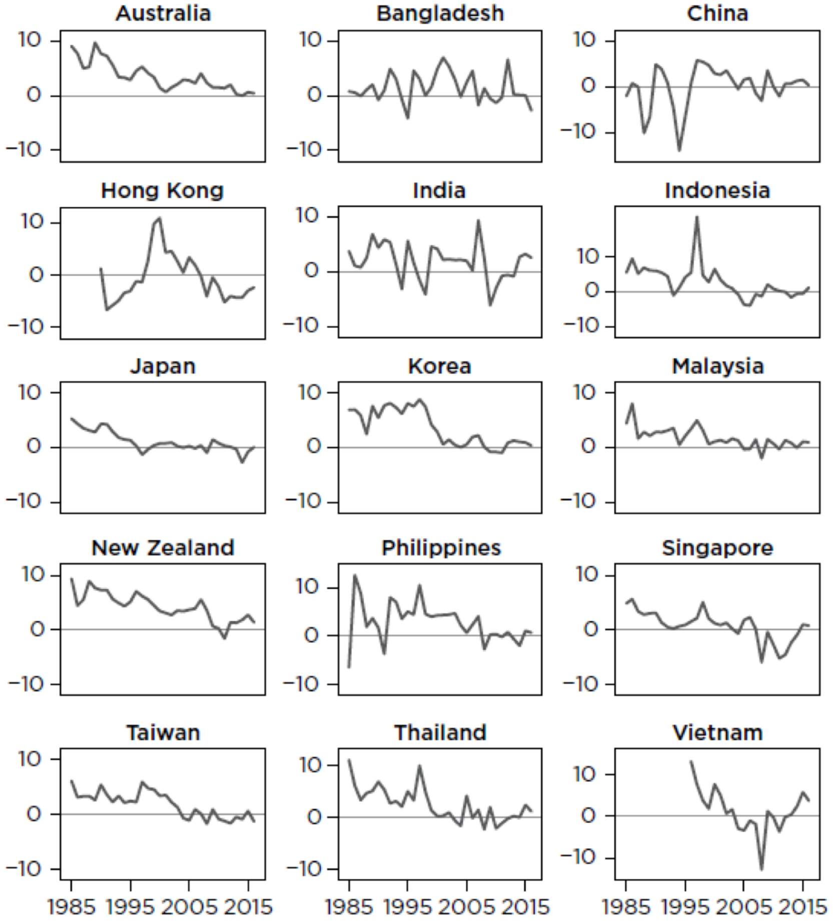
2. This can lead to boom-bust cycle and requires use of macroprudential tools

3. In an environment of lower growth and lower inflation, more aggressive fiscal and monetary policies are needed when there is a negative shock



The concomitance of interest rate declines suggests some form of international transmission

Figure 13.4 Real short-term interest rates in Asia, 1985–2016
(percent)



The transmission of foreign secular stagnation

<u>From the point of view of an Asian economy, foreign secular stagnation takes the form of:</u>

- a decrease in foreign demand for the country's exports and
- a decrease in the foreign real rate of interest

<u>To maintain full employment in the domestic Asian economy:</u>

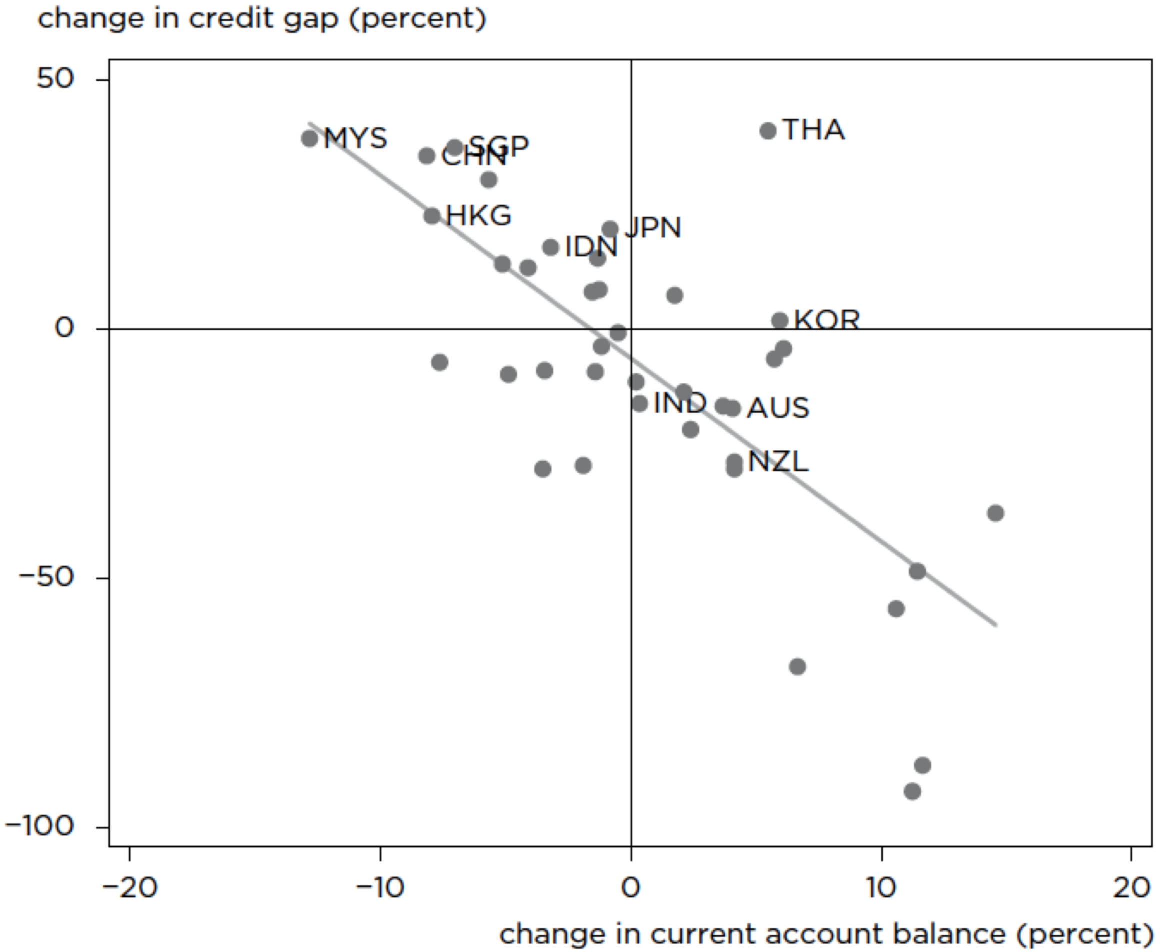
- The domestic policy interest rate needs to decline
- But by less than in the foreign economy that is the source of secular stagnation
- This interest rate differential generates net capital inflows

<u>Implications:</u>

- Rebalancing from foreign to domestic demand is a necessary adjustment to foreign secular stagnation
- Low interest rates and net capital inflows can, however, lead to boom-bust cycle

Changes in domestic demand have been strongly correlated with changes in domestic credit

Figure 5.5 Current account balance and credit gap, 2007–16

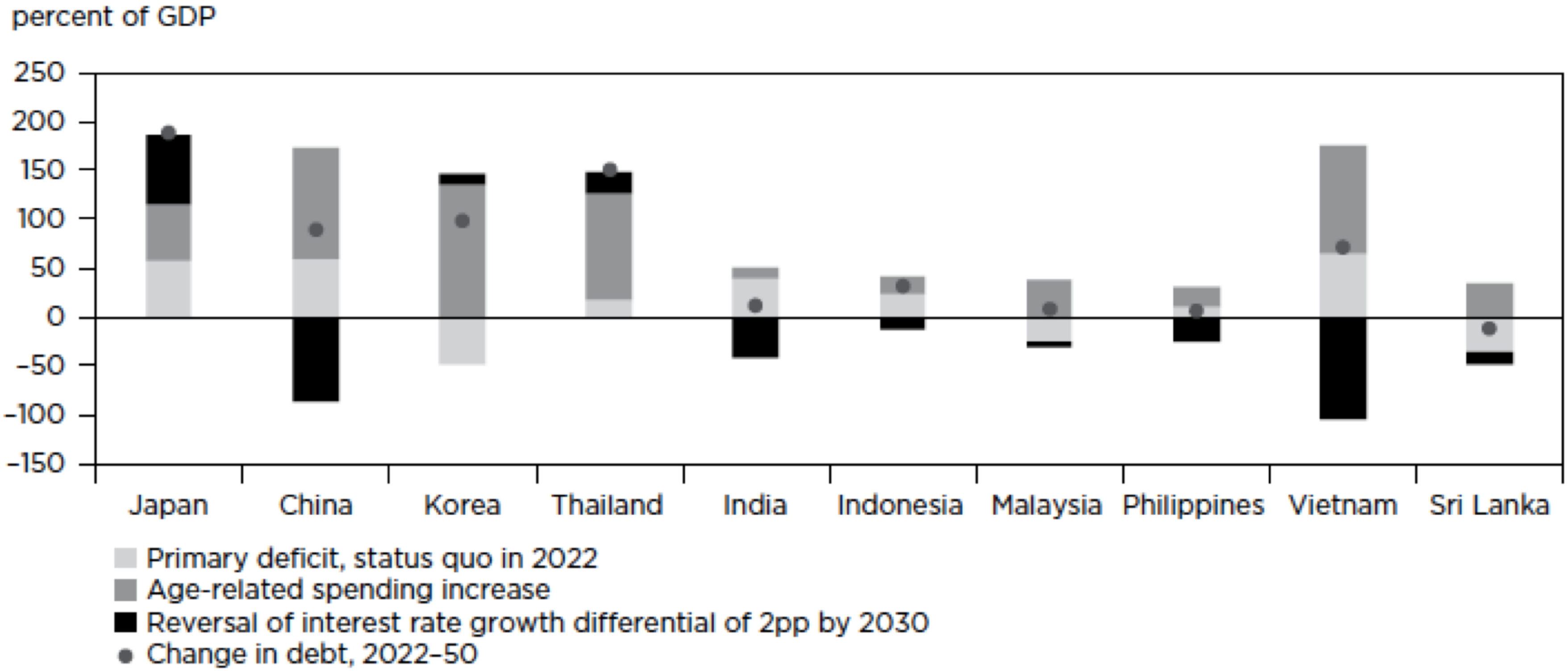


No easy answer to the tradeoff between demand stimulus and financial stability

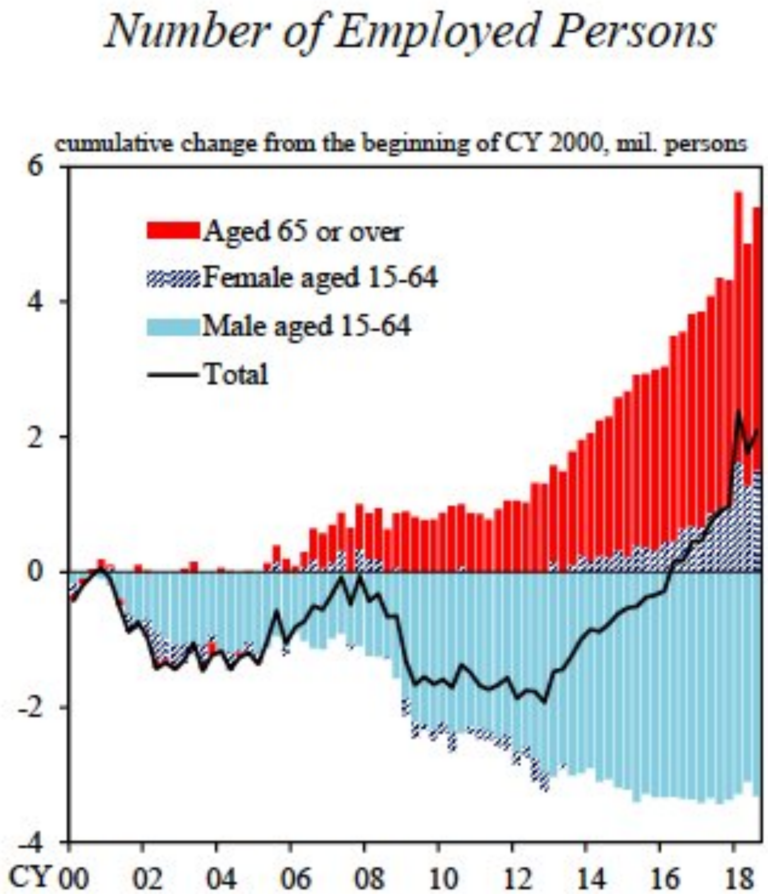
- Use of interest rates to lean against the wind is self-defeating
- Capital controls is not the right tool to insulate domestic interest rates against persistent pressure from secular stagnation
- Macroprudential tools should instead be used to address
    - Risks associated with larger maturity mismatch
    - Risks associated with high higher debt levels
    - Risks associated with FX mismatch
- Key is to make sure firms and households are able to withstand a possible future rise in interest rates.

Additional domestic headwinds to inflation and growth from future fiscal consolidation

Figure 15.5 Decomposition of change in debt ratio, 2000-2050



Additional domestic headwinds to inflation: positive supply shocks



Source: Wakatabe (2018)

Monetary Framework under Secular Stagnation needs to provide more stabilization

<u>The lower bound on policy rates is not a tail risk</u>

- With $\pi^*= 2\%$ and $r^*=1\%$, any recession that increases unemployment rate by more than 1.1 percentage point will make the ZLB bind

<u>Unconventional is a misnomer in a secular stagnation world</u>

- Unconventional tools needed
  - to decrease term and risk premiums
  - to counter sharp and unwarranted tightening of financial conditions associated with external developments
- These tools work best when they are not used for financial repression in normal times

<u>Being prudent does not mean being inactive</u>

- To avoid hitting ZLB, a prudent approach to a recessionary shock from a weak starting point is to take a more aggressive stance

Fiscal Framework under Secular Stagnation also needs to provide more stabilization

- Insufficient counter-cyclicality during down times is more prevalent in Asia than excessive spending or looseness in good times
- Better automatic stabilizers and more active discretionary fiscal policies are needed
  - Fiscal multipliers are high in bad times when monetary policy is constrained and there is slack
  - Stimulus is particularly effective when associated with a clear shock