The Making of a Great Contraction With a Liquidity Trap and a Jobless Recovery

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Discussion by Karel Mertens

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The Peril of Taylor Rules: Multiple equilibria

Benhabib, Schmitt-Grohé and Uribe 2001

\[ u'(C_t) = \beta R_tE_t \left[ u'(C_{t+1})/\pi_{t+1} \right] \]
\[ R_t = \max(f(\pi_t), 1), \quad \beta f'(\cdot) > 1 \]
\[ C_t = Y^n \]

Because of ZLB, infinitely many bounded deterministic solutions to

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Taylor principle does not hold globally.
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Taylor principle does not hold globally.
‘Confidence shocks’ can generate long ZLB episodes.

But how generate persistent below trend output/employment?

**Downward Nominal Wage Rigidities**

Authors posit a wage Phillips curve

\[
\frac{W_t}{W_{t-1}} \geq \gamma_0 \left( \frac{Y_t}{Y^n_t} \right)^{\gamma_1/\alpha}, \quad \gamma_0, \gamma_1 > 0
\]

\[
\frac{w_t}{w_{t-1}} \geq \gamma_0 \left( \frac{Y_t}{Y^n_t} \right)^{\gamma_1/\alpha} / \pi_t
\]

Rise in involuntary unemployment if

a. significant price deflation

b. limited wage deflation.
Significant Price Deflation?
Unanchored Inflation Expectations?

Ten-Year Expected Inflation and Real and Nominal Risk Premia

Limited Wage Deflation?

Yes

Daly, Hobijn and Lucking (DHL 2012):

Why Has Wage Growth Stayed Strong?

No

Elsby, Shin and Solon (ESS 2013):

Wage Adjustment During the Great Recession

Coibion, Gorodnichenko and Koustas (CGK 2013):

Amerisclerosis? The Puzzle of Rising U.S. Unemployment Persistence
DNWR in the Great Recession: Empirical Counterarguments

1. **Incidence of Zero Wage Growth in CPS**
   - CGK: Great Recession similar increase as 1982 recession.
   - ESS: Only moderately greater than before the Great Recession.

2. **Aggregate Wage Growth in the Great Recession**
   - CGK: Missing price deflation, but no missing wage deflation.
   - ESS: Real wages considerably procyclical (composition bias)
DNWR in the Great Recession: Empirical Counterarguments

3. **Measurement Problems in CPS**
   Small sample, self reported, rounding error
   ESS: Better data for the UK (New Earnings Survey, payroll based)

   ![Graphs for 2006 to 2011 showing wage distribution]

4. **Wage rigidities for new hires?**
   Not layoffs, but long unemployment duration.
Possible Extensions

1. Add nominal price rigidities to help explain missing deflation.
2. Stochastic equilibria
3. Combine confidence and fundamental shocks
   \[\rightarrow\text{self-fulfilling weak recoveries}\]
A Comment

Are jobless recoveries impossible with fundamental shocks (e.g. $\beta$-shocks)?

I think this difference has more to do with the shock persistence.

Fundamental shock is temporary. Confidence shock is permanent.
The Exit Strategy

Just raise $R_t$, and this will raise inflation expectations and employment. In the model, this is true for both types of shocks.

But:
Outcome depends on equilibrium selection and is not unique.
Hard to communicate.