

**Reply to the Referee Report on  
Secular Stagnation  
Ms 1309, submitted to Economics (e - journal)**

**Below is the Author's response to the comments by the Referee.**

***1. Although real capital and its market valuation provide a bridge to investment and aggregate demand in principle, this transmission channel does not play a significant role in the analysis. Thus, one is left to wonder whether the ineffectiveness of quantitative easing (QE) as a tool to lift the economy out of a secular stagnation trap still holds if the central bank extends the scope of its asset purchases not only to the long - term bond market, but also - even more unconventionally - to the stock market.***

The Referee is right drawing such a policy implication, and I allude precisely to this point on p.10 of the article when I refer to Nick Rowe's provocation. Indeed, what the central bank could do, at least in principle, is to purchase stock market shares directly, ultimately supplanting (or at least supplementing) the role of the private sector. Here, we would actually move farther away from central bank domain and well into the realm of fiscal policy. Of course, in extremely critical economic situations, consistently with the policy conclusions of my article, a sort of "helicopter money" (or, more precisely, a "overt monetary financing") operation could be envisaged whereby the government would determine the type of public spending program to be implemented (in principle, this could contemplate the purchase of stock market share, as the Referee suggests) and the central would finance the deficit by "printing" money.

***2. The ineffectiveness of QE is ascribed to "liquidity preference dominance". A somewhat more rigorous definition of this concept would be desirable. As stated, it appears as if it essentially amounted to a term for a shock to expectations, and hence spending, which is strong enough that no feasible amount of QE is large enough to kick - start the economy again. This is dangerously close to circular logic.***

The Referee is right, and I will reflect in the final version of the article a more rigorous definition of the concept of "liquidity dominance preference". In particular, I will be more explicit in stating that the theory of interest rate determination underlying my model is Keynes' Liquidity Preference Theory where, unlike classical or neoclassical theories (as well as their derivations, such as, for instance, the "loanable funds "theory), the determination of the rate of interest does not concern saving, but matters after the decision to save has been made. In other words, LPT is about deciding the degree of liquidity at which savings should be held, and it is a decision concerning the stock of savings – wealth – at any point in time, rather than any new flow of saving alone. The rate of interest is hence not determined by the supply of and demand for (flows of) saving, but by the supply of and demand for assets into which holdings of (stocks of) wealth can be placed. The critical implications that JMK drew from his theory – and which essentially underpin my model – are that:

- i. Not just the marginal efficiency of capital but also the expectations as to the future rate of interest is determined by mass psychology and by how this reflects on liquidity preference; and
- ii. The rate of interest is a conventional phenomenon: its value is governed by the prevailing view as to what its value is expected to be. Any level of interest that is accepted with

sufficient conviction as likely to be durable will be durable, unless expectations can be significantly altered by exogenous events, including policy interventions.

As regards my model, the theory implies that, to the extent that agent expectations remain strongly pessimistic and induce strong liquidity preference, no policy measures that can convincingly stimulate demand will be able to reverse moods and expectation. And if secular driven by pessimistic expectations determined a negative equilibrium interest rate, the rate will stay at that level until something will change those expectations. This conclusion should be seen in the context of my further illustration in the article as to why there are no sufficient transmission mechanisms between QE and aggregate demand, which can effectively alter agent expectations, and why only helicopter money can succeed in attaining this objective.

3. *The author begins his discussion of possible remedies for secular stagnation by considering a breach of the zero lower bound (ZLB) through negative interest rates. He dismisses the practical relevance of this escape route by pointing to the availability of alternative assets earning nonnegative returns, in particular foreign currency assets. This is the only instance in the paper of a reference to open - economy considerations. However, the author fails to point out that any substitution of foreign for domestic assets would invariably drive down the foreign exchange rate of the domestic currency and thereby activate a potentially powerful lever for boosting aggregate demand - as suggested many years ago by Lars Svensson (JEP, Fall 2003) in the context of Japan ' s deflation trap. More broadly, this raises the question of whether the implications of the “ liquidity preference dominance ” hypothesis would survive a generalization of the analysis to a small - open - economy framework.*

I agree with the Referee's comment that my article should look at the open-economy context. In this respect, while I share the argument on currency devaluation, I should also add a number of critical remarks to the use of negative interest rates (NIR) to stimulate demand through exchange rate depreciation. The first is that, unlike those cases where currency devaluation can be justifiably adopted to restore domestic competitive losses vis-à-vis foreign countries (as it rebalances a situation where the country has possibly over-spent to the benefit of others) inducing exchange rate depreciation to cure domestic economic failures that nothing have to do with external competitiveness amounts to shifting the solution of the problem abroad. This would be purely “beggar thy neighbor” policy, as it would divert demand from the rest of the world toward domestic markets. While this could be acceptable from very small open economies, whose diversion effect would be negligible internationally, it would be much less so from larger economies. In any case, in the policy ranking that my article tries to establish, a policy that works by “diverts” demand would be inferior to those that seek to create additional demand. Finally, while the referee considers only the trade channel, I wonder whether destabilizing capital account effects would not dominate in the event of a country adopting NIR.