This paper proposes a model of secular stagnation. Contrary to an earlier model by Eggertson/Mehrotra (EM) where a secular stagnation trap is caused by a demand shock and a subsequent chronic state of excess savings in the face of a binding zero lower bound, the mechanism here is an arbitrary upsurge of pessimistic self-fulfilling expectations which creates an excess demand for liquidity. Expectations are modelled as rational, but amended for a distortion in information processing which opens a door for emotions and animal spirits to affect agents’ perception of the future. The asset spectrum encompasses four assets: money, a short-term government bond, a long-term government bond, and real capital. The paper shares with EM the conclusion that fiscal policy offers a way out of secular stagnation - and particularly so if it is financed by the printing press (helicopter money).

The line of reasoning is fairly straightforward and the major conclusions of the paper appear to be robust. Nevertheless, a number of questions arise along the way which one would like to see explained more clearly and thoroughly:

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.

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.

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.
4. On page 11, the author states that, whereas QE is ineffective, expectations of a QE reversal ("tapering") might negatively affect $P^k$ - and hence presumably aggregate demand. This asymmetry requires some rationalization.

5. With respect to fiscal policy, the author states that “the fundamental factor characterizing fiscal policy is that the government can use only debt and taxation to finance its budget.” This definition allows him to construe a stark contrast to the case of “helicopter money” (HM) in that the effectiveness of fiscal policy may suffer from concerns about the government’s long-term solvency which do not arise in the case of HM. This contrast is not as stark in practice as it is painted here by the author. It is enough for fiscal policy to have the central bank as a backstop when it applies a stimulus to aggregate demand. If the backstop is credible, it can rule out a “bad” equilibrium (as shown De Grauwe 2011) and fiscal policy is as effective as HM without the central bank ever having actually to turn on the printing press.

6. Optimism and pessimism are reflected in subjectively expected income prospects, which are modelled around job values defined (in the appendix) in terms of the difference between productivity and worker’s pay. Job value is crucial for the hiring decisions of firms, but if agents are both workers and owners of the productive capital, why don’t they relate their income prospects to the expected future path of total national income?

Finally, a word on exposition: The paper consists of a main text, augmented by an appendix of about equal length. The main text, after introducing a terse version of the model, is mainly concerned with discussing policy alternatives in the face of liquidity preference dominance. The appendix gives a fuller account of the model, with both the main text and the appendix cross-referencing each other. This way of presenting the argument makes for a somewhat unwieldy and not particularly reader-friendly format. As it stands, the paper comes across more like two distinct short papers combined into one. A single paper which develops the model to the point necessary to derive the policy results of the main text would be preferable.

Some minor points to be straightened out in a revision:

p. 4  The author specifies a general utility function in consumption and current asset holdings $u(C,M,T,B,K)$ (unnumbered equation), but later goes on to specify the utility of individual assets $Q$ as $u(Q)$. Probably, the notation should distinguish between these two types of utility function. Also, it would be helpful to see how the general $u(C,M,T,B,K)$ function nests the partial asset utilities $u(Q)$.

p. 5:  2nd paragraph, second line: “shortest” instead of “shorter”

p. 6:  2nd paragraph below eq. (1b), sixth line: cancel (less)