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The Post-Crisis Slump

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The global financial crisis of 2007-09 triggered a sharp fall in output growth that was followed by a persistent slump in Europe and other advanced economies. Almost a decade after the outbreak of the global financial crisis, the recovery remains very weak in many major advanced economies. This special issue of the *European Economic Review* consists of eleven papers that offer novel empirical and theoretical perspectives on the persistent post-crisis slump and on resulting challenges for global monetary and fiscal policies. All papers were presented at a conference at the European Commission in Brussels on 1-2 October 2015, organized by the *European Economic Review*, the European Commission, CAEPR, Indiana University and ECARES.

The first two papers of the special issue provide original empirical evidence on the drivers of the post-crisis slump in the United States and the Euro Area (EA). ***Cette, Fernald and Mojon*** point out that total factor productivity (TFP) growth in the U.S. and the EA slowed down significantly *prior* to the global financial crisis; this suggests that forces other than the crisis itself contributed to the protracted post-crisis slump. The U.S. TFP growth slowdown followed a phase of rapid adoption of information technology (IT) between the mid-1990s and the early 2000s. In that period, the gap between US and EA TFP widened; the authors attribute this to rigidities in EA product and labor markets that hampered IT innovation, adoption and reallocation. In Southern Europe, the inflow of cheap credit after the launch of the Euro also

contributed to rising misallocation and low TFP growth. *Kollmann, Pataracchia, Raciborski, Ratto, Roeger and Vogel* use an estimated three-region—EA, U.S., and Rest of World—new Keynesian dynamic stochastic general equilibrium (DSGE) model to analyze why the post-crisis slump has been markedly more persistent in the EA than in the U.S. The authors find that the EA slump reflects a combination of adverse aggregate demand and supply shocks, and persistent adverse shocks to capital investment, linked to the continuing poor health of the EA financial system, in the aftermath of the 2010-11 sovereign debt crisis; adverse financial shocks were less persistent in the U.S.

The next three papers focus on the dynamics of inflation, and its interaction with real activity, after the global financial crisis. *Kuvshinov, Müller and Wolf* note that post-crisis inflation has been very low, both in EA core countries and in EA periphery countries whose output collapse was much deeper; this implies that intra-EA real exchange rates adjustments have been limited. The authors present a two-country DSGE model of a currency union that is consistent with these observations. The key mechanism is that a sharp credit contraction in one country generates union-wide deflationary pressure that cannot be offset by monetary policy when policy is constrained by the zero lower bound (ZLB). That bound on monetary policy dampens real exchange rate adjustments to exacerbate the output contraction. *De Michelis and Iacoviello* analyze recent attempts (since 2013) by the Bank of Japan (BOJ) to boost inflation and output, and to escape the ZLB, by permanently raising the BOJ's inflation target. DSGE model simulations presented by the authors suggest that, at the ZLB, increasing the inflation target can have powerful positive effects on inflation and real activity, provided that the private sector perceives policy to be credible. The policy is less effective if it is not fully credible; this might explain the limited success of the BOJ policy. *Arias, Erceg and Trabandt* also study the effects of persistently low inflation on real activity. Using DSGE model simulations, the authors

show that those effects depend crucially on the *source* of the low inflation. A persistent fall in inflation due to adverse nominal shocks—for example, a decline in long-run inflation expectations—can be sharply contractionary when the ZLB is binding. A fall in inflation driven by a persistent productivity increase, by contrast, is likely to raise output, even in the near term. Irrespective of its source, persistent low inflation makes the economy more vulnerable to unexpected adverse shocks.

The special issue also includes three papers that focus on fiscal policy issues. The financial crisis and the subsequent slump led to a sharp increase in public debt that threatens fiscal sustainability, in many countries. A key policy challenge over the coming years will be to reduce public debt, without harming real activity. **Lemoine and Lindé** show (using DSGE models) that the effectiveness of long-lasting expenditure-based consolidations hinges on the credibility of announced future spending cuts. Limited credibility raises the output costs of fiscal consolidations, especially in a currency union, and when the ZLB binds. Gradual consolidations may be more effective under limited credibility. **Bi, Shen and Yang** analyze whether public debt reduces the fiscal spending multiplier—the effect of changes in government purchases on output. Using a non-linear DSGE model, the authors show that there is no simple link between public debt and the size of the fiscal multiplier. The multiplier depends on a range of factor, including private agents’ preferences, the details of fiscal policy rules, and the economy’s physical capital stock. Using historical data for the U.S., Germany and Italy, **Kliem, Kriwoluzky and Sarferaz** show that the low-frequency interaction between inflation and the primary fiscal deficit is determined by the interaction between monetary and fiscal policy. The authors argue that this corroborates economic models in which fiscal policy is a key determinant of the price level, as in the fiscal theory of the price level.

The last three papers of the issue deal with financial and uncertainty shocks, demographic trends, and the political consequences of financial crises. The global financial crisis has stimulated much research on the macroeconomic effects of financial shocks and of uncertainty (volatility) shocks. *Caldara, Fuentes-Albero, Gilchrist and Zakrajšek* use structural vector autoregressions to disentangle these two types of shocks, in U.S. data. The authors find that both financial and uncertainty shocks are important sources of macroeconomic fluctuations. Uncertainty shocks have an especially strong negative macroeconomic impact when they induce a tightening of financial conditions. *Carvalho, Ferrero and Nechio* focus on the fact that real interest rates in advanced economies have been very low—even negative—since the crisis, an outcome often attributed to loose monetary policy. But real interest rates have been trending down for several decades, which suggests that other forces are at work. Using an overlapping generations model, the authors argue that demographic trends, such as rising life expectancy, contributed to the persistent fall in real rates, and may also be a driver of “secular stagnation.” *Funke, Schularick and Trebesch* study the political consequences of financial crises, using a novel comprehensive dataset on general election results and financial crises during the past 140 years, in 20 advanced economies. The authors document that financial crises trigger a sharp rise in political polarization and fractionalization and a strong increase in the vote share of far-right parties. The resulting political uncertainty may contribute to slow recoveries from financial crises. Financial crises are politically much more disruptive than recessions that are not accompanied by financial crises. The authors conclude that “preventing financial crises also means reducing the probability of a political disaster.”

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