INDEBTED DEMAND
AND IMPLICATIONS FOR MONETARY POLICY

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(based on work with Atif Mian and Amir Sufi)
Standard story goes from right plot to left: reduced interest rates increase debt levels.
TODAY: FROM HIGH DEBT LEVELS TO LOW INTEREST RATES

➤ Explore a complementary story, going the other way:
  ➤ high levels of debt …
  ➤ cause high debt service payments …
  ➤ reducing aggregate demand if MPC of borrower > MPC of saver …
  ➤ pushing down r* !

➤ In other words:
  ➤ When debt levels are high, monetary policy has a hard time normalizing rates!
DO SAVERS HAVE GREATER SAVING RATES?

➤ Identify savers as top 10% & foreigners, then compute their saving rates.

Mian Sufi Straub (2021): “Saving Glut of the Rich”
THE INDEBTED DEMAND FRAMEWORK

➤ Stylized model, matches the key features. Rich savers, poor borrowers.

➤ Main insight: Increased debt levels give rise to an increased resource flow from borrowers to savers, which reduces aggregate demand, and hence r*

➤ Implications for recent trends in inequality and financial deregulation, monetary policy, redistribution

➤ Next: explain framework & implications graphically
**THE INTEREST RATE - DEBT DIAGRAM**

**demand condition:**
captures demand for debt for any given $r$

**supply condition:**
greater debt levels imply greater redistribution from high to low MPC, hence lower $r^*$
**Demand Condition:** captures demand for debt for any given $r$.

**Supply Condition:**
- Greater debt levels imply greater redistribution from high to low MPC, hence lower $r^*$.  

**Supply Condition in Standard Model (without MPC difference):**
Rising inequality shifts resources from poor to rich

All else equal reduces r*, stimulates debt, which reduces r* even more, etc…

IMPLICATIONS FOR RISING INEQUALITY: FALLING R* AND RISING DEBT
CAN SEE DIRECT EVIDENCE OF THIS IN THE DATA

➤ Left: Over time, national level. Right: Across U.S. states

Mian Sufi Straub (2021): “Saving Glut of the Rich”
➤ Financial deregulation induces boom & bust episode
IMPLICATIONS FOR FINANCIAL DeregULATION: BOOM & BUST

➤ Financial deregulation induces boom & bust episode

➤ Boom phase: credit expands, demand increases, $r^*$ rises
  ➤ flows go from saver to borrower

➤ Bust phase: new credit stalls, debt service flows > new credit growth

new credit growth

Saver ➔ Borrower

new credit growth

Saver ➔ Borrower

debt service flow

debt service flow
Imagine a rate cut. Debt levels start rising, adding to demand.

However, once stimulus should be faded out, debt burden reduces demand, r* lower.

- Monetary policy affects r*, no “natural rate hypothesis”.

**MONETARY POLICY AFFECTS R**
ZLB AND DEBT TRAP

➤ Once debt is sufficiently high, \( r^* \) is so low that economy is at ZLB. “Debt trap”.

➤ Not so easy to resolve!
  ➤ e.g. macroprudential policies to reduce credit creation will reduce demand

➤ Better policies resolve imbalances between savers and borrowers, i.e. inequality
  ➤ many ways to do this, ranging from redistribution to progressive taxes

➤ In currency area context, saver & borrower could be different countries
  ➤ redistribution could take the form of payments from “North” to “South”
TAKEAWAYS

➤ Indebted demand = idea that demand falls when debt service flows are high.

➤ Implies that ...
  ➤ rising inequality causes low r* and high debt.
  ➤ financial deregulation causes boom-bust episodes.
  ➤ monetary policy has effects on r*, breaking natural rate hypothesis.