Step away from the zero lower bound: Small open economies in a world of secular stagnation

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We study how small open economies can escape from deflation and unemployment in a situation where the world economy is permanently depressed. Building on the framework of Eggertsson et al. (2016), we show that the transition to full employment and at-target inflation requires real and nominal depreciation of the exchange rate. However, because of adverse income and valuation effects from real depreciation, the escape can be *beggar thy self*, raising employment but actually lowering welfare. We show that as long as the economy remains financially open, domestic asset supply policies or reducing the effective lower bound on policy rates may be ineffective or even counterproductive. However, closing domestic capital markets does not necessarily enhance the monetary authorities' ability to rescue the economy from stagnation.