

EE432 Monetary Theory and Policy



Lecture 14 Modern monetary policy and the challenges

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Outline

- Deflation and the Effective Lower Interest-Rate Bound

Chapter 23

Modern Monetary Policy and the Challenges Facing Central Bankers

*Deflation and the Effective
Lower Interest-Rate Bound*

Deflation and the Effective Lower Interest-Rate Bound

- **Nominal interest rates can not be *deeply negative*.**
 - There is an ***effective lower bound (ELB)*** that is **below zero** due to transactions costs
 - Investors can ***always hold cash***, so ***bonds must have yields*** above the ELB to attract bondholders.
- Such risk which policymakers have ***no scope to lower rates further***, has concerned central banks since Japan's experience in the 1990s.

Deflation and the Effective Lower Interest-Rate Bound

- Think about the *consequences of a shock that depresses aggregate expenditure*.
 - The **dynamic aggregate demand curve** shifts to the *left*.
 - Real output *falls below* potential - a *recessionary output gap* putting ***downward pressure*** on inflation.
 - **Monetary policymakers** would normally react by *cutting interest rates*.
 - This would *increase spending*, ***raise*** real output, and ***eliminate*** the output gap.

Deflation and the Effective Lower Interest-Rate Bound

- What if, when the shock occurs, inflation is zero and the policy interest rate that central bankers control is **at the ELB**?
 - The **decline** in aggregate demand still *drives real output below potential output*.
 - There is *downward pressure on inflation*.
 - But when **inflation falls**, it drops below zero so that, on average, *prices are falling*.
- This result is **deflation**.

Deflation and the Effective Lower Interest-Rate Bound

- When there is a recessionary output gap, **current inflation** is *below expected inflation* and **expected inflation falls**, which drives deflation down even more.
- Because the **nominal interest rate** is at the ELB, policymakers cannot counter the *worsening deflation* by *lowering* it.

Deflation and the Effective Lower Interest-Rate Bound

- The interest rate stays near zero and could ***not be negative***.
- Inflation *keeps falling*, real interest rate *thus increases*
- The *effects of the shock* could be ***amplified through a deterioration in confidence and expectations of declining prices, exacerbating the initial deflationary impulse and recessionary output gap.***
- The result is ***deflationary spiral*** in which *deflation grows worse and worse.*

Deflation and the Effective Lower Interest-Rate Bound

- **Deflation** makes it *more difficult* for businesses to *obtain financing for new projects*.
 - Without investment there is *no growth*.
- **Deflation**, therefore, **increases** the *real value* of a firm's **liabilities** without *affecting the real value of its assets*.

Deflation and the Effective Lower Interest-Rate Bound

Policymakers can minimize the chances of this sort of catastrophe:

1. They can ***set*** their inflation objective with the ***perils of deflation in mind***
2. They can ***act boldly*** when there is ***even an indication of deflation***
3. They can ***utilize*** unconventional policy tools

Deflation and the Effective Lower Interest-Rate Bound

- ***Reducing*** the interest rate ***significantly*** and ***rapidly*** when faced with the ***possibility of hitting the ELB*** is “acting preemptively”
- Central bankers can use ***unconventional policy tools*** that *include*:
 - Forward guidance
 - Quantitative easing
 - Targeted asset purchases

Deflation and the Effective Lower Interest-Rate Bound

- Central bankers are *very reluctant to use unconventional policy tools*
 - Continued uncertainty about *how and why they work* and *how to apply them effectively*
 - *Policy exit* may be difficult

End of lecture