Credible Escape from a Liquidity Trap

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Abstract

Central banks commit to keep the nominal interest rate low for an extended period after the economy recovers from a deep recession. However, such a commitment may suffer from a time-consistency problem. That is, central banks are tempted to lift off from the zero lower bound earlier than they originally announced. Specifically we ask: to what degree are central banks can credibly commit to future policies when they are facing a liquidity trap? We analyze sustainable plans (Chari and Kehoe, 1990) for the optimal monetary policy with a zero lower bound on nominal interest rates. As our analysis is very relevant to actual policies conducted by central banks after the financial crisis, we believe it would give a new sight on the conduct of monetary policy.