Liquidity effects and international effects of the zero lower bound on nominal interest rates

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Abstract

The tightening effect of the zero lower bound on the nominal interest rate is a non-trivial topic in monetary policy: at the zero lower bound, responding to a rise in money growth by reducing the nominal interest rate—what is called the liquidity effect—is not possible because the nominal interest rate cannot be further decreased. However, the absence of the liquidity effect caused by the zero lower bound might amplify the tightening effect of the zero lower bound. I call this tightening effect of the zero lower bound through its liquidity effect on the economy the *rebound of liquidity effect*, and demonstrate it quantitatively with a simple two-country dynamic stochastic general equilibrium framework. This paper found that the zero lower bound mitigates the effect of the domestic quantitative easing shock to the domestic economy, and affects the dynamics of the foreign nominal interest rate after the period of the zero lower bound through the structure which generates the liquidity effect.

Keywords: liquidity effect, zero lower bound, monetary policy

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