Anchored expectations and liquidity traps

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Abstract

Liquidity traps remain a persistent policy risk rather than a relic of the past, particularly in developed economies with persistently low growth and inflation. This paper revisits a liquidity trap using a New Keynesian framework in which the natural rate of interest can be negative and agents' long-run expectations are anchored. We characterize, for both the standard and unintended steady states, their existence, determinacy, and stability under adaptive learning. The main result is stark: (1) if long-run expectations are well anchored, the global indeterminacy is eliminated; (2) in this situation, the standard steady state equilibrium is unique, determinate, and stable when the natural rate is high, so is the unintended one when the natural rate is low; (3) the latter one features an expected real interest rate above the natural rate and an upward bias and disagreement in long-run expectations. Raising the inflation target, even under the imperfect credibility observed in practice, can help resolve liquidity traps through a mechanism distinct from those emphasized in existing models.

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