

LIQUIDITY TRAPS: AN INTEREST-RATE-BASED EXIT STRATEGY*

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This paper proposes a strategy for escaping liquidity traps based on an augmented Taylor-type interest-rate feedback rule that differs from usual specifications in that when inflation falls below a threshold, the central bank temporarily deviates from the traditional Taylor rule by following a deterministic path for the nominal interest rate that reaches the intended target for this policy instrument in finite time. The proposed policy is designed to set a floor on inflationary expectations. Importantly, the effectiveness of the proposed exiting strategy does not rely on the existence of an accompanying fiscalist (or non-Ricardian) fiscal stance.

1 INTRODUCTION

The USA is in a liquidity trap. The short-term nominal interest rate has been virtually zero since December 2008 and the rate of inflation has been falling ever since. More importantly, expansionary monetary policy whether of the traditional type, limited by the zero bound on nominal rates, or of the non-traditional type, also known as quantitative easing, appears to have lost traction. A number of policymakers, academics and economic observers are increasingly concerned about the possibility that the US economy will become stuck in a deflationary equilibrium like the one observed in Japan over the past two decades.

The issue of whether deflation is harmful or beneficial to the economy is controversial. Some argue that deflation is desirable because it minimizes the opportunity cost of holding money. In turn, this argument goes, higher money holdings are welfare increasing because they ameliorate the frictions involved in the transaction of goods, services and financial assets. The strongest version of this argument is known as Friedman's rule, and calls for targeting a long-run level of deflation equal to the long-run level of the real interest rate. On the other hand, in a world in which downward nominal rigidities, particularly in wages, are pervasive, deflation has the potential of

* Manuscript received 3.4.14; final version received 15.4.14.

creating persistent disequilibrium in markets for goods and factors of production. As a result, deflation leads to high and persistent unemployment and under utilization of other factors of production. It is our view that the historical record suggests that the negative effects of deflation outweigh the positive ones. Therefore, throughout this paper we will take as given that the deflationary equilibrium is undesirable and that a benevolent central bank should aim at fighting deflationary pressures.

A counterintuitive aspect of liquidity traps is that many central economic relationships that both economists and the general public hold as timeless truth cease to be valid and might indeed reverse sign. One such reversal of sign concerns the relationship between tightening of interest rates and inflationary expectations in the short run. During normal times, i.e. when the economy is not in or heading toward a liquidity trap, it is reasonable to expect that, in the short run, the primary effect of an increase in nominal interest rates is a decline in inflationary expectations via a fall in aggregate demand. Similarly, under normal circumstances, a reduction of the nominal interest rate tends to boost short-run inflationary expectations through an elevated level of aggregate spending. In sharp contrast, in a liquidity trap, the sign is reversed. Low interest rates are not accompanied by high levels of inflation but rather by falling and even negative inflation. Moreover, because the economy is already inundated by liquidity, a fall in interest rates has no longer a stimulating effect on aggregate demand. This part of the reversal of signs is not too controversial. The experience of Japan in the past two decades as well as the recent economic performance of the USA and other developed countries seems to suggest that zero nominal interest rates are not doing much to push expected inflation or aggregate demand higher. The central premise of this paper is that the reversal of sign in the relationship between interest rates and expected inflation also operates in the upward direction. That is, that in a liquidity trap, an increase in nominal rates tends to raise inflationary expectations without further depressing aggregate spending. The reason why this premise may be difficult to digest is also empirical. Guided by the short-run relationship between nominal rates and inflationary expectations that prevails during normal times, no central bank dares to raise interest rates when the economy is in a liquidity trap out of fear of exacerbating the crisis. We believe, for example, that this factor explains in part why the Bank of Japan has not allowed its short-term nominal interest rate to rise above 50 basis points in the past 15 years.

In summary, the central premise of this paper is that while during normal times the short-run relationship between interest rates and expected inflation is dominated by the liquidity effect, during a liquidity trap this relationship is driven by the Fisher effect. Based on this premise, any policy that is to succeed in raising inflationary expectations must be associated with a credible increase in nominal rates. This argument is not independent of the assumed fiscal regime. We are implicitly assuming that the policy regime in place is Ricardian or non-fiscalist. For we believe that this is the case of

greatest empirical relevance around the developed world. Of course, if one is willing to drop the assumption of Ricardian fiscal policy, then there exist ways to lift the economy out of deflation that may not involve the raising of the nominal interest rate.

This paper proposes a strategy for escaping liquidity traps based on an augmented Taylor-type interest-rate feedback rule that differs from usual specifications in that when inflation falls below a threshold, the central bank temporarily deviates from the traditional Taylor rule by following a deterministic path for the nominal interest rate that reaches the intended target for this policy instrument in finite time. We embed this augmented interest-rate rule in a simple model in which the combination of a Taylor rule, the zero bound on nominal interest rates and Ricardian fiscal policy opens the door to self-fulfilling deflations ending in a liquidity trap. This analysis follows closely the work of Benhabib *et al.* (2001). The proposed interest-rate policy sets a floor on inflationary expectations while at the same time maintaining all of the desirable local properties of the Taylor principle in a neighborhood of the intended inflation target. Section 4 shows that the proposed modified Taylor rule succeeds in lifting inflationary expectations to the level consistent with the central bank's inflation target. Section 5 is central to our argument. For it puts our proposed interest-rate-based exit strategy into context by highlighting the policy goals that can and cannot be attained through its application and stressing the requirements to make it credible.

2 THE MODEL

For simplicity, we develop the central argument of this paper in the context of an endowment economy with flexible prices. This simplification allows us to focus sharply on the Fisher effect, which we believe is at the heart of the ongoing deflationary pressures in the US economy. A downside of the assumption of price flexibility is that it implies that deflations are costless, which, as argued in the introduction, appears to be highly counterfactual. We leave for future research the task of enriching the theoretical framework with downward nominal rigidities.

2.1 Households

Consider an economy populated by a large number of identical households with preferences described by the lifetime utility function

$$\sum_{t=0}^{\infty} \beta^t U(c_t) \quad (1)$$

where c_t denotes consumption of a single perishable good, and $\beta \in (0, 1)$ denotes the subjective discount factor. The function U is a period utility index

and is assumed to be strictly increasing and strictly concave. Each period, households receive a constant endowment of goods denoted y and pay lump-sum taxes in the amount τ_t measured in real terms. In addition, they have access to one-period nominal bonds that pay the gross rate of return R_t when held between periods t and $t + 1$. The household's sequential budget constraint is then given by

$$P_t c_t + B_t + P_t \tau_t = R_{t-1} B_{t-1} + P_t y \quad (2)$$

Household's borrowing is limited by the following no-Ponzi-game constraint:

$$\lim_{j \rightarrow \infty} \frac{B_{t+j}}{\prod_{k=0}^{j-1} R_{t+k}} \geq 0 \quad (3)$$

The household chooses paths $\{c_t, B_t\}_{t=0}^{\infty}$ for consumption and bond holdings to maximize (1) subject to (2) and (3). The associated first-order conditions are (2), (3) holding with equality, and

$$U'(c_t) = \beta \frac{R_t}{\pi_{t+1}} U'(c_{t+1}) \quad (4)$$

where $\pi_t \equiv P_t/P_{t-1}$ denotes the gross rate of inflation in period t .

2.2 The Government

The budget constraint of the government is given by

$$P_t \tau_t + B_t = R_{t-1} B_{t-1}$$

Fiscal policy is assumed to be passive (or Ricardian) in the sense that the government adjusts lump-sum taxes to ensure fiscal solvency regardless of the path of the price level. A simple example of such policy, which we adopt in this paper, is one in which τ_t is set so that $B_t = 0$ at all times. That is, $\tau_0 = R_{-1} B_{-1}/P_0$ and $\tau_t = 0$ for all $t > 0$, where B_{-1} and R_{-1} are exogenously given.

The paper has two novel elements. First, unlike most of the existing literature on avoiding liquidity traps, the class of fiscal policies we have specified cannot serve the purpose of avoiding liquidity traps by promising fiscal irresponsibility to the point of fiscal insolvency should the economy find itself trapped in a deflationary environment. Second, we assume that the central bank follows an interest-rate rule that sometimes feeds from current inflation and sometimes does not. Specifically, the interest-rate policy takes the form

$$R_t = \begin{cases} R^T(\pi_t) & \text{if } H_t < L_t \\ R^X(L_t) & \text{otherwise} \end{cases} \quad (5)$$

The function $R^T(\pi_t)$ represents the standard Taylor-type interest-rate feedback rule. Specifically, this function is assumed to be continuous, differentiable, non-decreasing, weakly convex and greater than or equal to unity. It satisfies the steady-state Fisher equation at the central bank's inflation target, which we denote by π^H . Formally, we have that

$$R^T(\pi^H) = \frac{\pi^H}{\beta}$$

In addition, we assume that it satisfies the Taylor criterion at the inflation target, i.e.

$$\frac{R^T'(\pi^H)}{R^T(\pi^H)} \pi^H > 1$$

We assume that there is an inflation threshold $\pi^L < \pi^H$ at which the central bank abandons the traditional Taylor rule in favor of a deterministic path of the interest rate. Under this exit strategy, the interest rate is governed by the non-decreasing function $R^X(k) > 1$, where k takes integer values between 0 and t^x . In turn, t^x is a constant denoting the number of periods in which the central bank wishes the interest rate to reach its intended target, which we denote by $R^H \equiv \pi^H/\beta$. The function $R^X(k)$ satisfies $R^X(t^x) = R^H$.

The variable H_t denotes the number of periods elapsed since the inflation rate was last observed to be greater than or equal to the inflation target π^H . This definition implies that $\pi_{t-H_t} \geq \pi^H$ and that $\pi_{t-k} < \pi^H$ for any $0 \leq k < H_t$. The law of motion of H_t is given by

$$H_t = \begin{cases} 0 & \text{if } \pi_t \geq \pi^H \\ H_{t-1} + 1 & \text{otherwise} \end{cases} \quad (6)$$

for $t \geq 0$, given $H_{-1} \geq 0$. The function L_t denotes the number of periods elapsed since the rate of inflation was last observed to fall from a value higher than π^L to a value lower than or equal to π^L . Thus, we have that $\pi_{t-L_t} \leq \pi^L < \pi_{t-L_t-1}$. The law of motion of L_t is given by

$$L_t = \begin{cases} 0 & \text{if } \pi_t \leq \pi^L < \pi_{t-1} \\ L_{t-1} + 1 & \text{otherwise} \end{cases} \quad (7)$$

for $t \geq 0$, given $L_{-1} \geq 0$ and π_{-1} .

2.3 Equilibrium

In equilibrium, the goods market clears

$$c_t = y$$

This means that consumption is constant over time. Combining this expression with the consumer's Euler equation (4), yields

$$\pi_{t+1} = \beta R_t \quad (8)$$

The market clearing condition and the fact that, by the assumed fiscal regime, $B_t = 0$ for all t imply that both the sequential budget constraint of the household and the no-Ponzi-game constraint hold with equality at all times.

A perfect-foresight equilibrium is a set of sequences $\{R_t, \pi_t, H_t, L_t\}_{t=0}^{\infty}$ satisfying (5)–(8), given initial conditions $L_{-1}, H_{-1} \geq 0$ and π_{-1} .

Before characterizing equilibrium dynamics under the proposed interest-rate-based exit strategy, we briefly review the inflation dynamics under a standard Taylor rule.

3 INFLATION DYNAMICS WITHOUT AN EXIT STRATEGY

A perfect foresight equilibrium under the standard Taylor rule is a pair of sequences $\{R_t, \pi_t\}$ satisfying (8) and the Taylor-type interest-rate feedback rule

$$R_t = R^T(\pi_t) \quad (9)$$

where the function $R^T(\pi_t)$ has the properties presented in the previous section.

Combining equilibrium conditions (8) and (9) yields the following first-order difference equation governing the equilibrium dynamics of inflation:

$$\pi_{t+1} = \beta R^T(\pi_t) \quad (10)$$

Figure 1 displays the graph of this dynamic equation. The assumed form of the function $R^T(\pi_t)$ guarantees that the intended inflation target π^H is a deterministic steady-state solution to equation (10). That is, $\pi_t = \pi^H$ satisfies equation (10). But, as shown in Benhabib *et al.* (2001), the existence of a lower bound on the nominal interest rate gives rise to a second, unintended, steady-state level of inflation, which we denote by π^{LL} .¹ That is, $\pi_t = \pi^{LL}$ for all t is also a solution to (10). The unintended steady-state π^{LL} is lower than its intended counterpart π^H and possibly less than unity, implying steady-state deflation.

In the vicinity of the intended steady-state π^H , the equilibrium dynamics of inflation are described by the linear difference equation

$$\hat{\pi}_{t+1} = \alpha^H \hat{\pi}_t \quad \alpha^H > 1$$

where $\hat{\pi}_t \equiv (\pi_t - \pi^H)/\pi^H$ denotes the proportional deviation of inflation from its intended target and $\alpha^H \equiv R^T(\pi^H)\pi^H/R^T(\pi^H)$. The fact that α^H is greater than

¹ This second steady state emerges not only in flexible-price, cashless, endowment economies like the one analyzed here, but also in sticky-price, monetary, production environments. See Benhabib *et al.* (2001) for details.

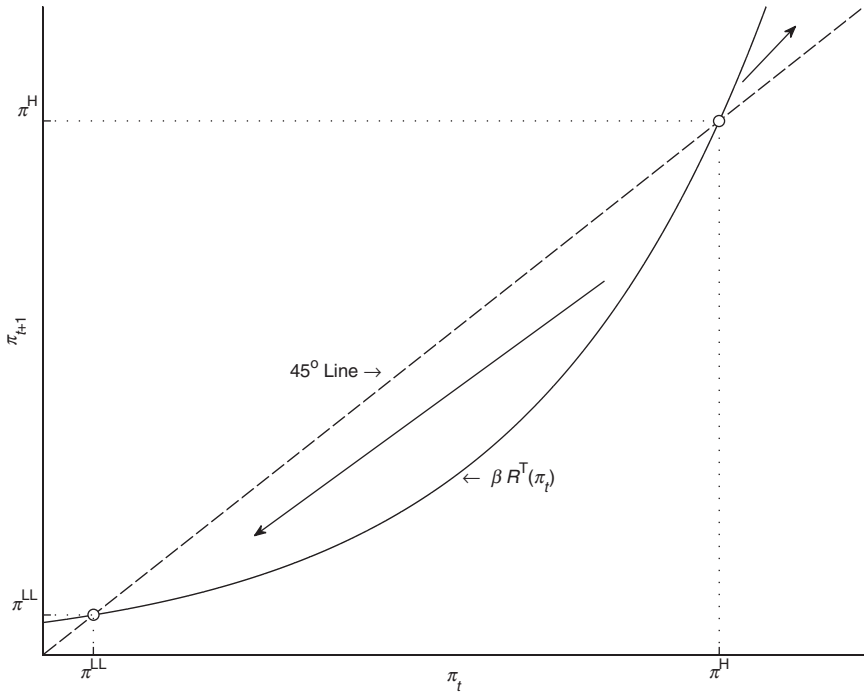


FIG. 1. Inflation Dynamics under a Taylor Rule

unity follows from our assumption that the function $R^T(\pi_t)$ satisfies the Taylor principle at $\pi_t = \pi^H$. Noting that π_t is a non-predetermined variable, this expression implies that $\pi_t = \pi^H$ is indeed the unique local equilibrium. For it is the only equilibrium path that remains forever bounded in a small neighborhood around π^H .

But there are many other, unintended, perfect-foresight equilibria. Of empirical relevance for understanding the current predicament of the US economy are inflation paths that originate close to but below the intended inflation target π^H . As can be seen from Fig. 1, these inflation paths are descending and converge to the unintended steady-state π^{LL} . The resulting dynamics contain all of the essential elements of a liquidity trap. For the central bank finds itself fighting deflation by lowering nominal rates only to fuel the ongoing deflationary process. The end point of these dynamics is the unintended low inflation rate π^{LL} . And because π^{LL} represents a steady state of this economy, the inflation rate can remain at this low unintended level forever.²

² In this model, there are other unintended equilibria in which the economy embarks in a self-fulfilling hyperinflation. See Loyo (1999) for a study of this case.

A central policy question is whether an economy whose central bank is committed to fighting deflation with low nominal interest rates, as is the case in our theoretical example, in which the monetary authority insists in adhering to a Taylor rule, can lift itself out of the liquidity trap. The answer is that a spontaneous recovery is highly unlikely in the context of our model. The reason is that the steady-state π^{LL} is dynamically stable. To see this, note from Fig. 1 that the graph of the difference equation (10) has a slope less than unity at π^{LL} . As a result, any inflation path originating above π^{LL} but below π^H will spiral down to π^{LL} .³

4 INFLATION DYNAMICS WITH THE EXIT STRATEGY

Under the interest-rate-based exit strategy given in equation (5), the monetary authority abandons the Taylor rule temporarily once the inflation rate falls below a threshold π^L . At this point it follows a deterministic path for the nominal interest rate for a finite and well defined period of time ending at the intended interest-rate level R^H . At this point, interest-rate policy switches back to the standard Taylor rule $R^T(\pi_t)$. Perfect-foresight dynamics are determined by equations (5) and (8).

We illustrate the dynamics of inflation invoked by the interest-rate-based exit strategy by means of a numerical example. We parameterize our simple model following Bullard (2010) who uses a Taylor rule of the form

$$R_t^a = A e^{B\pi_t^a} \quad A = 0.005015; B = 2.75$$

where π_t^a and R_t^a are the inflation rate and the nominal interest rate implied by the Taylor rule both expressed in percentage points at an annual rate. Noting that in our model both R_t and π_t are expressed in gross rates per quarter (so that, for example, an interest rate of 4 per cent per year and an inflation rate of 2 per cent per year correspond to $R_t = 1.0099$ and $\pi_t = 1.0050$), the Taylor rule used by Bullard corresponds to setting

$$R^T(\pi_t) = \left[1 + \frac{A}{100} e^{B(\pi_t^4 - 1)100} \right]^{1/4}$$

We set the parameter β equal to $0.995^{1/4}$, which corresponds to a subjective discount factor of half a percentage point per year, to match Bullard's calibration of a long-run real interest rate of 50 basis points. This parameterization implies an intended steady state in which the inflation rate, π^H , is 2.3 per cent per year and the nominal interest rate, R^H , is 2.8 per cent per year. In addition, the assumed parameter values and functional forms induce an unintended steady state characterized by an inflation rate, π^{LL} , slightly above

³ Of course, there is the possibility that the inflation rate jumps unexpectedly exactly to π^H .

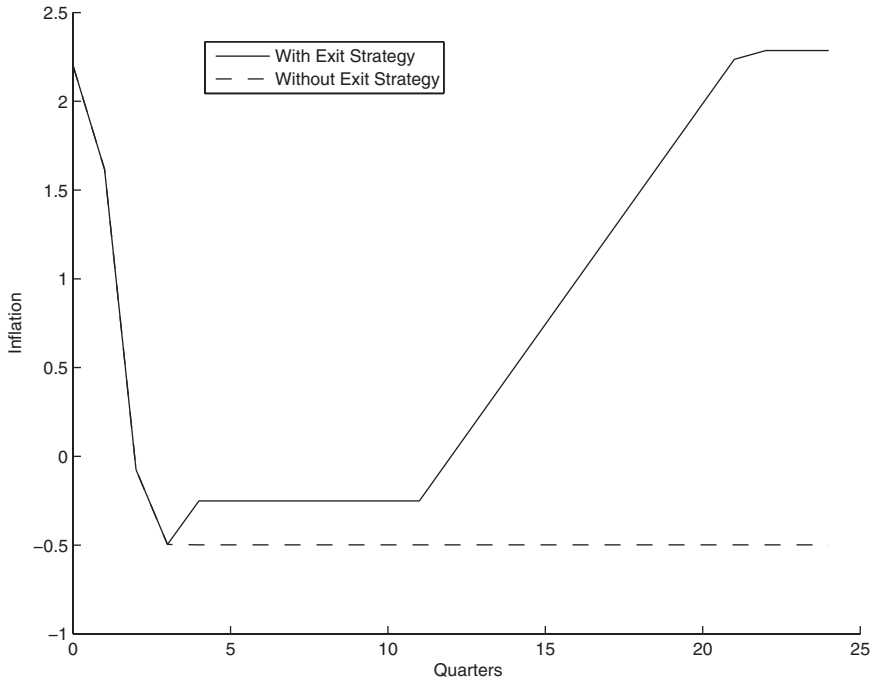


FIG. 2. Inflation Dynamics under the Interest-rate-based Exit Strategy

−0.5 per cent per year and a nominal interest rate slightly above zero. We assume that the inflation threshold at which the central bank switches to the exit strategy, π^L , is −0.25 per cent per year. In general, the determination of this threshold should be guided by two considerations. On the one hand, it should be low enough to allow the Taylor principle to be operative in a sufficiently large neighborhood around the intended steady-state π^H . On the other hand, the threshold should be high enough to avoid too high levels of deflation once the economy slips into a self-fulfilling liquidity trap. Finally, the deterministic interest-rate rule, $R^X(k)$, which the central bank applies during the exit transition sets the nominal interest rate at 25 basis points per year for eight quarters and then increases it by 25 basis points per year every quarter until reaching the intended interest-rate target of 2.8 per cent per year.

The inflation dynamics implied by our calibrated model are displayed in Fig. 2. In period 0, perhaps due to some unanticipated revision in expectations, the inflation rate falls to 2.2 per cent per year, a value slightly below the intended target of 2.3 per cent per year. In response to this decline in π , the central bank, following the Taylor rule, aggressively lowers the nominal interest rate, thereby validating people's expectations of lower future

inflation. In this way, a deflationary trajectory is set in motion. If the central bank insists in adhering to the Taylor principle, the economy falls into a liquidity trap with negative inflation and a nil nominal interest rate, as depicted by the broken line in Fig. 2. In the perfect foresight equilibrium, the economy remains in this deflationary situation as long as monetary policy continues to follow the Taylor rule. In contrast, under the exit strategy, shown with a solid line, once the rate of inflation falls below the threshold of -0.25 per cent, the central bank announces a monetary program whereby it keeps the interest rate at a low level of 0.25 per cent for two years and then begins to raise it slowly by 0.25 per cent each quarter until the intended level of 2.8 per cent is reached. By the Fisher effect, expected inflation mimics the path of the nominal interest rate. As a result, inflation stays low for two years and then starts climbing gradually until it reaches its intended target of 2.3 per cent after about five years.

The next section, which we regard as the one containing the main contribution of this paper, places the result obtained here in context.

5 DISCUSSION

The results derived thus far raise two fundamental questions: one is what monetary policy objectives can and cannot be achieved via the proposed interest-rate-based exit strategy. The second question has to do with the requirements for the proposed strategy to be credible. We tackle these issues in turn.

5.1 *Avoiding Self-fulfilling Deflations*

As argued by Benhabib *et al.* (2001), Taylor rules can give rise to expectations-driven dynamics in which inflation and nominal rates fall to undesirably low levels. As illustrated in Fig. 2, the exit strategy analyzed in this paper cannot protect the economy from such unintended dynamics. For instance, in the economy studied in this paper, nothing can prevent the inflation rate from falling from the intended steady-state π^H to the low level π^L . Put differently, the proposed exit strategy does not eliminate the inflation indeterminacy inherent in models with a Taylor rule, a zero bound on nominal rates and Ricardian fiscal policy. What the interest-rate rule developed in this paper does ensure, however, is a mechanism to generate a lower bound on inflation expectations, and, more importantly, to lift these expectations back up to a level consistent with the intended inflation target.

5.2 *Requirements on the Accompanying Fiscal Regime*

A significant departure of this paper from the existing literature on avoiding liquidity traps, notably Benhabib *et al.* (2002), is the assumed fiscal policy. In the related literature liquidity traps are ruled out by making them fiscally

unsustainable. In general, the mechanism invoked by the related literature works as follows: When the economy falls into a deflationary spiral, falling nominal prices lead to an increase in the real value of outstanding nominal government liabilities that is not met by an equivalent increase in government revenues, because the government is assumed to follow an active, or non-Ricardian fiscal stance. In contrast, in our formulation the fiscal authority ensures fiscal solvency at all times and independently of the path of nominal prices. Instead, the central bank avoids being caught for extended periods of time at the liquidity trap by acting directly on inflationary expectations via the full exploitation of the Fisher effect.

5.3 *Absence of Feedback during the Exit Transition*

Central to our proposed exit strategy is that the monetary authority breaks with the feedback of inflation to interest rates. For it is precisely this feedback that causes the economy to fall into a self-fulfilling deflation in response to an initial loss of confidence on the part of the private sector. By stubbornly pursuing a deterministic path for the nominal interest rate leading to the intended target R^H , the central bank acts as a coordinator of expectations away from the liquidity trap and toward the intended target. A further point that is deliberately made in Fig. 2 is that the exit strategy does not require an initial aggressive tightening for it to work. The central bank may choose to keep interest rates low for a protracted period of time and only then start raising them gradually toward the target level. Of course, the speed at which the economy gets out of the liquidity trap depends on the shape of the interest-rate path during the exit transition. For instance, in Fig. 2 the inflation rate remains low, indeed negative, during the first two years of the exit transition because the central bank's exit policy features low initial interest rates for the first two years.

5.4 *Is the Remedy Worse than the Infirmary?*

A natural objection to promising to raise rates in a situation in which the economy is in the midst of a crisis, possibly involving highly distressed levels of aggregate demand, is that doing so, even if successful on the inflation expectations front, may exacerbate the economic crisis. We believe that if the exit policy involves a sufficiently gradual convergence of interest rates to the intended target, the risk of exacerbation of the real contraction is negligible. The rationale for this conjecture lies in our belief that the current weakness in aggregate demand stems primarily from a lack of sufficient lending of financial institutions to households and firms, in spite of the fact that the financial sector is flooded with liquidity. The reason for the lack of lending, therefore, is not insufficient liquidity. Rather, it appears to be high levels of default risk. In the current situation, the typical borrower is more likely to be unemployed or under-employed, to have foreclosed on his mortgage, fallen behind in his

credit card service, or to own a mortgage that is under water. In this situation, the nominal interest rate, whether at zero or at 2.5 per cent is unlikely to be allocative. On the other hand, the economic cost of deflation can be large. A number of key nominal variables in modern economies display remarkable downward rigidity. This is the case particularly with nominal wages and mortgage payments of households that, because of their precarious financial situation, are not in a position to refinance. In the presence of these frictions macroeconomic adjustment to negative shocks involve higher and more persistent levels of unemployment and more distress in financial markets in the context of deflation than in an environment of mild inflation.

5.5 Credibility of the Exit Strategy

We identify three dimensions along which the credibility of the proposed exit strategy may be questioned. One dimension is the required commitment to raise nominal interest rates in the midst of an economic crisis. We believe that this is not the most problematic aspect of the proposed exit strategy. For the central bank can announce a sufficiently gradual and even delayed path for the nominal interest rate during the exit transition that could be interpreted by the public as a policy easing rather than a policy tightening. For example, in the policy experiment presented in Fig. 2, it is assumed that once the economy falls below the inflation threshold π^L , the central bank keeps the interest rate constant at 25 basis points for 8 quarters and then increases it by 25 basis points every quarter until it reaches the intended interest-rate target of 2.8 per cent, at which point it switches back to the standard Taylor rule. The announcement of such path for the nominal interest rate can hardly be interpreted as tightening from the point of view of the period in which it is put into effect.

Perhaps the most problematic aspect of the proposal in regard to credibility is the need to communicate to the public that the increase in nominal interest rates is intended to raise inflationary expectations. The reason why it might be difficult to convey this idea is that in an economy that has been operating for many decades in the vicinity of the intended steady state, as is arguable the case in the USA between the end of World War II and 2007, the monetary authority is likely to be viewed as following a policy whereby the key role of tightening is to keep short-run inflationary expectations from rising above some desired target. This logic does not apply in the neighborhood of the liquidity-trap equilibrium π^{LL} . Near the liquidity trap, zero nominal interest rates, far from producing high levels of inflation, generate low and possibly negative inflation over time. We believe that after observing falling inflation in combination with near-zero interest rates for a sufficiently large number of quarters the public will come to intuitively internalize the notion that the Fisher effect has become dominant and accept the monetary authority's argument of raising interest rates to fight deflationary pressures.

A third aspect of the exit proposal laid out in this paper that may affect its credibility is the required commitment on the part of the central bank to abstain from responding to incoming news about the state of the business cycle in setting interest rates during the exit transition, i.e. while $L_t < H_t$ and $R_t = R^X(L_t)$. We believe that in order to minimize the vulnerability of the proposed exit strategy in this regard, the central bank must communicate clearly the policy trade-off that is relevant during a liquidity trap. The benefit from engaging in an exit strategy like the one propose here is to escape a deflationary equilibrium, which, as the recent Japanese experience painfully documents, may last for over two decades. The cost is a temporary restriction in the Fed's ability to ease money-market conditions. It is not unreasonable to argue that this trade-off may be resolved in favor of escaping from the liquidity trap.

5.6 Money-based versus Interest-rate Exit Strategies

An alternative exit strategy often heard in policy and academic circles consists in switching to a positive money-growth-rate rule. The idea behind this policy alternative is that by promising to create money at a positive rate for a relatively long period of time, the Fed creates inflationary expectations. A potential advantage of this alternative is that it avoids the need on the part of the central bank to explicitly announce an increase in the nominal interest rate (even if, in order to work, the policy needs to generate higher rates). In our view this strategy suffers from an important weakness. Namely, such policy requires the announcement not only of a money growth rate, but also of the initial nominal money supply. This second requirement is in our view highly problematic. For once the expected rate of inflation rises, the public will engage in a portfolio switch away from the enormous quantity of money that it acquired during the time when its opportunity cost was zero, and toward interest bearing assets that the central bank purchased during this same period. To fix ideas, let 0 be the period in which the central bank announces the switch to a constant-money-growth-rate rule. Suppose that in period zero, the government does not engage in any money market operation, so that the nominal money supply in period zero, denoted M_0 , equals the money supply in period -1 , denoted M_{-1} . Suppose that the announcement of the new monetary regime increases inflationary expectations and that, as a result, the public chooses to reduce its demand for real balances by a sizable fraction, say 50 per cent. Such a number is not unreasonable in light of the fact that when the nominal rate was zero, the central bank had increased the money supply by at least a factor of 2.5. But if the nominal money supply is fixed at the pre-policy-switch level of M_{-1} , the only way the desired contraction in the money demand can be brought about is through a doubling of the price level. Thus, the central bank might be trading deflation for a once-and-for-all doubling of the price level. In order to avoid this undesirable

side-effect of a potentially large initial jump in the price level, the central bank must accompany the policy switch with an appropriate sale of interest-bearing assets in period zero. The difficulty is that it might be extremely hard for the government to predict the size of the portfolio switch that takes place in period zero. Put differently, it might be extremely difficult for the central bank to pick the level of M_0 so as to accommodate the decline in real balances through a decline in nominal balances and not via a jump in the price level. In contrast, an interest-rate-based exit strategy achieves this goal automatically. For when the central bank controls the nominal interest rate, it must stand ready to buy or sell any quantity of money as desired by the public. The advantage that an interest-rate-based exit strategy has over a money-based-exit strategy resembles, in reverse, the well-studied advantage that an exchange-rate-based inflation stabilization program has over a money-based stabilization program for stopping high inflation in developing countries (see Uribe, 1999). In these episodes, the problem of adopting a money-based strategy is to pick the initial amount of money to allow for reliquefaction without creating deflation.

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