Revisiting Monetary Policy in a Low Inflation and Low Utilization Environment

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FRB Boston Conference
October 16, 2010
Bagehot and recent history

• “Lend freely, at a penalty rate, against good collateral.”
  ↓
Most CBs did
  ↓
Well, not much.
  ↓
Well, it varied.

• For the ECB, Bagehot+ was just about enough (until Greece).
• But the Fed, BoE, and now BoJ felt compelled to do more.
• Why? In Fed’s case, the ZLB led to a perceived need for unconventional monetary policy.
  o ECB never hit the ZLB; neither did the BoE, but it came close.
Friedman and recent history

- “Don’t peg the nominal interest rate.”
- Why not? \( r = i - \pi \)
- Friedman was thinking mainly about upward instability when \( \pi \) is rising and \( r \) is falling.
- But the argument is symmetric: When \( i \) is stuck at zero, and \( \pi \) is falling, \( r \) is rising.
- The ZLB is what leads to unconventional monetary policy.
Four conclusions

1. (obvious) In an environment of low inflation, we need to worry much more about the ZLB.

2. (less obvious, but should be obvious) If that environment also has low utilization, we may need a large dose of expansionary monetary policy.
   - Especially if fiscal policy is paralyzed, e.g., by large budget deficits.

3. (deduction) Given our starting point, unconventional monetary policy will be more important than in the past.
   - So the recent episode may be less aberrant than it appears.

4. Maybe we should devise more safeguards against bumping up against the ZLB.
Types of unconventional monetary policy

- Commitment via words
- A higher $\pi^*$
- Lower the interest rate on reserves (no ZLB here)
- Quantitative easing
  - Treasuries (work on term premia)
  - Private-sector assets (work on risk premia)
- Supervisory forbearance (if CB is a supervisor)
Question for research/thinking

Which of these is best, under what circumstances?