Monetary Policy at the Zero Lower Bound and Beyond

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- *Keynes recognized that in deep downturns, monetary policy has relatively little effect*

- *We have been in deep downturn, and indeed there is evidence that it has had little effect*

Why?

Key questions

- Is there anything, beyond using the bully pulpit to get fiscal authorities to do their job, that monetary authorities can do?
- Is there anything that monetary authorities can do to mitigate unintended consequences of some new tools?

Key insights

- Not zero lower bound
  - Was perhaps relevant in Great Depression
  - Little evidence that lowering real interest rate a few percentage points would have made much difference
  - If small changes in intertemporal prices could have made a difference, they could have been accomplished through fiscal policy (sliding tax rates)

- Real issue is access to finance and terms of access
  - Strongly affected by bank regulation
  - Perhaps could have done more by linking bank recapitalization funds and access to Fed window to lending to SMEs

Key insights *cont.*

- Must first ask why the economy is so weak—and would it have been weak in 2007 were it not for the Fed created bubble(s)
  - Part of the answer is growing inequality
  - But Central Bank policies can exacerbate inequality
  - Lowering interest rates hurt low income retirees who had invested money in government bonds
  - One of main channels of QE was increase in asset prices—assets owned by the wealthy
  - Trickle down benefits limited

Could the Fed have done more to mitigate adverse effects ?

- Underlying problem: financial system clogged, resulting in limiting lending to SMEs
- Further, increasing concentration in financial system means lower interest rates were only partially passed on to homeowners

Could the Fed have done more to mitigate adverse effects ?

- Should have done more to unclog financial system, for example by recapitalizing smaller and regional banks
  - each of which was not systemically significant, yet their collective weaknesses contributed to weak economy
- Should have done more to promote competition in the financial system
  - Including competition in the payments mechanism
  - Hidden tax on all transactions, particularly hurting poor
  - Could have used regulations to better direct flow of credit
  - 2008 crisis illuminated serious discrepancies between private and social returns to investment

Fundamental problem: Basic DSGE models are flawed

- DSGE models providing poor guidance
  - to ordinary conduct of monetary policy
  - to crisis prevention
  - to crisis resolution
- Instead, propose alternative framework focusing on credit, recognizing
  - importance of institutions like banking
  - importance of asymmetries of information and other market imperfections
  - the poor fit of individuals' behavior to the standard model
  - importance of inequality
  - importance of macro-economic externalities
  - importance of credit interlinkages

Good news

- Basic ingredients of alternative models already available.