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Breaking Through the Zero Lower Bound

Abstract

Under current monetary systems, paper currency (and coins) guarantee a zero nominal rate of return, apart from storage costs, which are relatively small. It is then difficult for central banks to reduce their target interest rates below the rate of return on paper currency storage, which is not far below zero. This limitation on central bank target interest rates is called the "zero lower bound." Because the zero lower bound is a consequence of how monetary systems handle paper currency, it is possible to eliminate the zero lower bound by alternative paper currency policies. Though there are costs as well as benefits to any policy, there is nothing intrinsically difficult about paper currency policies that eliminate the zero lower bound. Eliminating the zero lower bound would give central banks a wider range of options for their target interest rates.

Because the zero lower bound is more likely to bind when the long-run inflation target is low, central banks have been concerned about setting the long-run inflation target too low. Indeed, some economists have advocated raising long-run inflation targets for this reason. (See for example Larry Ball, "The Case for Four Percent Inflation," Johns Hopkins University working paper.) Moreover, the Bank of Japan has raised its inflation target because of concerns about the zero lower bound. By eliminating one of the costs of low inflation, eliminating the zero lower bound is likely to reduce the optimal level of the long-run inflation target. For countries such as Japan that are trying to raise their inflation rate because of concerns about the zero lower bound, studying ways to eliminate the zero lower bound (and their costs and benefits) is especially urgent, since increases in inflation are not easy to reverse.

Moreover, to the extent that raising the rate of inflation is difficult when a central bank is already up against the zero lower bound, eliminating the zero lower bound may be the most practical way to gain more freedom for monetary policy to maneuver. Freedom for monetary policy to maneuver, however obtained, can relieve some of the burden on short-run fiscal policy for stabilizing the economy at the natural level of output. To the extent that fiscal stimulus generates other concerns, such as increasing national debt or increasing the needed long-run level of tax rates, a wider range of options for monetary policy can be especially valuable.