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Scarcity of Safe Assets, Inflation, and the Policy Trap*

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Abstract

A goal of this paper is to make sense of the seemingly puzzling behavior of interest rates and inflation - and the role of central banks in that behavior - during and after the Great Recession, particularly in the United States. To this end, we construct a model in which government debt plays a key role in exchange, and can bear a liquidity premium. If asset market constraints bind, then there need not be deflation under an indefinite zero interest rate policy (ZIRP). Further, ZIRP may not be optimal under these circumstances. A Taylor-rule central banker could be subject to a ZIRP trap and persistently undershoot target inflation. As well, a liquidity premium on government debt creates additional Taylor rule perils, because of a persistently low real interest rate. We make a case that this is the key policy predicament currently faced by many central banks in the world.

1 Introduction

In this paper, we start with a basic idea – that modeling the role of all government and central bank liabilities as liquidity can give us important insights into the behavior of inflation, interest rates, and the effects of monetary policy. We then show how this can matter for our understanding of the Great Recession and its aftermath, and for the performance of conventional monetary policy rules.

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