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Zero lower bound interest rate policy

Technical box extracted from:

Inflation Report no.3, August 2014 [1]

In recent years, some major advanced economies got locked into a liquidity trap, namely the inability to generate an economic recovery by cutting interest rates, as the relevant rates were already near zero. This is the case of Japan (since 90s) and the USA (since December 16, 2008).

The concept of "zero lower bound" implies that interest rates should not fall below zero. However, there have been episodes both historical and recent, in which some market interest rates became negative, and these episodes were quite isolated. Therefore, it is a theoretically possible fact, but rarely applied in practice. Financial markets are generally designed to operate under positive rates and might face significant deviation if the rates are negative. To avoid such disruptions, policymakers tend to keep short-term interest rates above zero (positive), even when trying to relax monetary policy in other dimensions. An example is the large purchase of assets to provide additional monetary stimulus used in recent years by the Federal Reserve System of the United States.

Thus, an appropriate decision of monetary policy authorities would be the use of a range of monetary policy instruments, namely the interest rates, with the primary aim of directing inflation. In turn, economic growth is also important for the proper functioning of the economy, but compared to inflation, economic growth can be also sustained by fiscal policies, for example, to reduce the unemployment rate. Stimulation of economic growth by reducing interest rates in the long run may lock the economy in a liquidity trap, recovery costs being significant.

Such a policy has been recently adopted by the European Central Bank (June 5, 2014). Thus, the interest rate on the main refinancing operations of the Eurosystem was reduced from 0.25 to 0.15 percent and the rate on the marginal lending facility was reduced to 0.4 percent. The interest rate on the deposit facility was reduced to minus 0.1 percent. Negative rates will be also applied to the average reserve holdings that exceed the required reserves and other deposits held with the Eurosystem.

Given the limited experience of markets to operate with interest rates at the zero lower bound, it is difficult to predict with certainty how the international markets will react in the long run to the European Central Bank policy. Although this decision is based on the low level of inflation and the ECB's tendency to maintain it in the corridor of 2.0 percent target level of inflation, this policy should accelerate the economic recovery of the euro area. At least a first reaction, namely that through the exchange rate channel, is already evident, the European single currency depreciated against other major international currencies, which favors exports of euro area countries. However, if tax stimulus will not be sufficient to improve the situation on the labor market in the euro area, in the long run, the euro area economy may be stuck in a liquidity trap, and once the interest rate instruments range is lost, the ECB's efforts to sustain economic growth in the long run could be extremely costly.

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