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Reputation and Liquidity Traps

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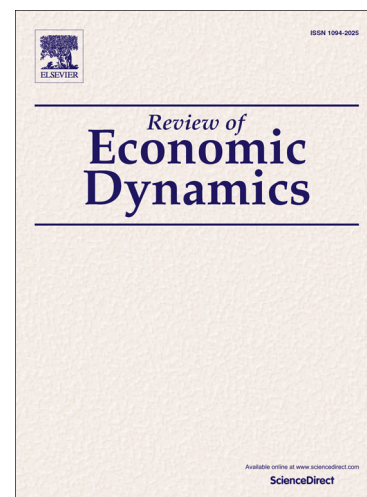
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Reputation and Liquidity Traps*

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Abstract

Can the central bank credibly commit to keeping the nominal interest rate low for an extended period of time in the aftermath of a deep recession? By analyzing credible plans in a sticky-price economy with occasionally binding zero lower bound constraints, I find that the answer is yes if contractionary shocks hit the economy with sufficient frequency. In the best credible plan, if the central bank reneges on the promise of low policy rates, it will lose *reputation* and the private sector will not believe such promises in future recessions. Even with a very small probability of future contractionary shocks, the incentive to maintain reputation outweighs the short-run incentive to close consumption and inflation gaps and keeps the central bank on the originally announced path of low nominal interest rates.

JEL: E32, E52, E61, E62, E63

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