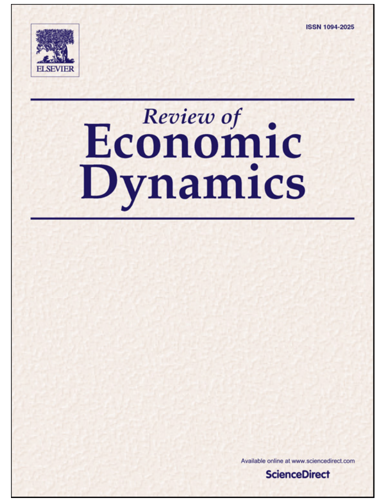
Accepted Manuscript



Reputation and Liquidity Traps

Taisuke Nakata

PII: S1094-2025(17)30072-8
DOI: http://dx.doi.org/10.1016/j.red.2017.09.001
Reference: YREDY 839

To appear in: *Review of Economic Dynamics*

Received date: 10 February 2015
Revised date: 5 September 2017

Reputation and Liquidity Traps*

Taisuke Nakata†
Federal Reserve Board

First Draft: March 2013
This Draft: September 2017

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

*I would like to thank the Editor, two anonymous referees, Klaus Adam, Roberto Chang, John Cochrane, Gauti Eggertsson, George Evans, Mark Gertler, Keiichiro Kobayashi, Takushi Kurozumi, Olivier Loisel, Nick Moschovakis, Toshihiko Mukoyama, Juan Pablo Nicolini, Georgio Primiceri, Sebastian Schmidt, Takeki Sunakawa, Pierre Yared, my colleagues at the Federal Reserve Board, and seminar participants at 16th Macro Conference at Keio University, 2014 Annual Meeting of Society for Economic Dynamics, 2015 European Economic Association Meeting, 2015 North American Winter Meetings of the Econometric Society, 2015 Spring Midwest Macro, 2015 World Congress, 9th Dynare Conference, 20th International Conference on Computing in Economics and Finance, Bank of Japan, Bank of England, European Central Bank, Federal Reserve Board of Governors, NYU Alumni Conference, Philadelphia Fed, Sargent Reading Group Alumni Conference, St. Louis Fed, and University of Tokyo for thoughtful comments and/or helpful discussions. Timothy Hills and Paul Yoo provided excellent research assistance. The views expressed in this paper, and all errors and omissions, should be regarded as those of the author, and are not necessarily those of the Federal Reserve Board of Governors or the Federal Reserve System.

†Division of Research and Statistics, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue N.W., Washington, D.C. 20551; Email: taisuke.nakata@frb.gov.