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The Deflationary Bias of the ZLB and the FED's Strategic Response

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Abstract: The paper shows, in a simple analytical framework, the existence of a deflationary bias in an economy with a low natural rate of interest, a Zero Lower Bound (ZLB) constraint on nominal interest rates and a discretionary Central Bank with an inflation mandate. The presence of the ZLB prevents the central bank from offsetting negative shocks to inflation whereas it can offset positive shocks. This asymmetry pushes average inflation below the target which in turn drags down inflation expectations and reinforces the likelihood of hitting the ZLB. We show that this deflationary bias is particularly relevant for a Central Bank with a symmetric dual mandate (i.e. minimizing deviations from inflation and employment), especially when facing demand shocks. But a strict inflation targeter cannot escape the sub-optimal deflationary equilibrium either. The deflationary bias can be mitigated by targeting “shortfalls” instead of “deviations” from maximum employment and/or using flexible average inflation targeting. However, changing monetary policy strategy risks inflation expectations becoming entrenched above the target if the natural interest rate increases.