Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events?

Hess Chung, Jean-Philippe Laforte, David Reifschneider, and John C. Williams

Monetary Policy at the Zero Lower Bound  
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The opinions expressed are those of the authors and do not necessarily reflect the views of the Board of Governors of the Federal Reserve System, the management of the Federal Reserve Bank of San Francisco, or anyone else in the Federal Reserve System.
Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events?

• Yes …
• … unless you think we were hit by a once-a-century event
Goal: Address Three Questions

1. How surprising have recent events been?

2. Has the estimated probability of hitting the ZLB changed over time?

3. How severely did the ZLB bind during the crisis?
   – What might unconstrained policy have done?
   – Did asset purchases significantly ease the constraint?
Past as Prologue: Estimated Incidence of the Zero Lower Bound: 2 Percent Inflation Target

<table>
<thead>
<tr>
<th></th>
<th>FRB/US</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Original Taylor Rule</td>
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<tr>
<td>Frequency of ZLB episodes</td>
<td>5</td>
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<tr>
<td>Mean duration of ZLB episodes</td>
<td>4</td>
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<tr>
<td>Frequency of deep recessions (output gap &lt; -6 percent)</td>
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Source: Reifschneider and Williams (2000)
How Surprising Have Recent Events Been?

• Others were even more sanguine:

In light of the finding that the Ramsey-optimal inflation rate is negative, it is puzzling that most inflation-targeting countries pursue positive inflation goals. We show that the zero bound on the nominal interest rate, which is often cited as a rationale for setting positive inflation targets, is of no quantitative relevance in the present model.

Schmitt-Grohe and Uribe (2007)
Methodology

• Re-examine the probability of hitting the ZLB and the duration of such episodes using a broad set of estimated structural macro models and atheoretical statistical models.

• Include models that allow for time-varying:
  – Parameters
  – Neutral real interest rate ($r^*$)
  – Variances

• Incorporate uncertainty about:
  – Shocks
  – Parameters
  – Latent variables (output gap, $r^*$)
How Surprising Have Recent Events Been?

## Model Summary

<table>
<thead>
<tr>
<th></th>
<th>EDO (DSGE)</th>
<th>Smets-Wouters (DSGE)</th>
<th>FRB/US</th>
<th>TVP-VAR</th>
<th>Laubach-Williams</th>
<th>GARCH</th>
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<td>Estimation method</td>
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</table>
How Surprising Have Recent Events Been?

Decline in Output, Rise in Unemployment, and Hitting the ZLB Were Huge Surprises to FRB/US
How Surprising Have Recent Events Been?

EDO Was Also Quite Surprised
How Surprising Have Recent Events Been?

Smets-Wouters, Too

![Graphs showing Federal Funds Rate, GDP Deflator Inflation (Q4), and Output Gap from 2000Q1 to 2010Q1.](image-url)
How Surprising Have Recent Events Been?

Most Statistical Models Were Also Surprised if We Ignore Uncertainty About Parameters and Latent Variables

LW

TVP-VAR

GARCH
How Surprising Have Recent Events Been?

Influence of the Shock Process Sample Period to Estimated Probabilities of a ZLB Event Occurring Within 20 Quarters After 2007Q4, Ignoring P/LV Uncertainty

<table>
<thead>
<tr>
<th></th>
<th>FRB/US</th>
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How Surprising Have Recent Events Been?

Influence of Uncertainty About Parameters and Latent Variables on Estimated Probabilities of a ZLB Event Occurring Within 20 Quarters After 2007Q4

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Has the Probability of Hitting the ZLB Changed Much Over Time?

Rolling Estimates of the Probability of a Future ZLB Event Within the Next 20 Quarters Vary Considerably Over Time
Has the Probability of Hitting the ZLB Changed Much Over Time?

But the Probability of a *Persistent* ZLB Event Varies Much Less
Summary of Part A

• Pre-crisis, structural models were fairly sanguine about macro risks
  – Saw almost no chance of a persistent ZLB event in the medium term
  – Saw little risk of unemployment rising above 7 percent

• During the crisis, the DSGE models remained optimistic
  – Anticipated quick rebound in real activity (low intrinsic persistence)
  – Thus saw no persistent ZLB problem

• Going forward, researchers assessing ZLB risks should ...
  – Use a broader range of models
  – Take account of P/LV uncertainty
  – Put less weight on short periods, such as the Great Moderation
  – Make greater allowance for tail risks & low-frequency dynamics
Gauging the Severity of the ZLB Constraint

• Run counterfactual simulations from 2009Q1 on using FRB/US & history/Blue Chip baseline (Oct ’10)
• Funds rate follows unconstrained prescriptions of:
  – Taylor (1993) rule
  – Taylor (1999) rule
  – Est. rule \( R_t = .82R_{t-1} + .18\left[ R^*_t + \pi_t + .65(\pi_t - \pi^*_t) + 1.04Y_t \right] \)
  – Optimal-control path

\[
L = E_t \sum_{j=0}^{m} .99^j \left[ \left( U_{t+j} - U^*_{t+j} \right)^2 + \left( \pi_{t+j} - 2 \right)^2 + \Delta R_{t+j}^2 \right]
\]
How Severely Did the ZLB Bind During the Crisis?

Counterfactual FRB/US Simulations of the Evolution of the Economy If Monetary Policy Had Not Been Constrained by the ZLB

- Federal Funds Rate
- Real GDP (Q4/Q4)
- Unemployment Rate
- Core PCE Inflation (Q4/Q4)
How Severely Did the ZLB Bind During the Crisis?

Counterfactual FRB/US Simulations: Caveats

• Results are model dependent
  – EDO & S&W suggest ZLB constraint was less binding
  – DSGE results hinge on large effects of anticipated policy shocks

• Results are sensitive to slack estimates
  – Simulations assume peak GDP gap = 8 percent
  – IMF/OECD estimates would imply less binding ZLB constraint

• Results understate the overall severity of the ZLB constraint because baseline incorporates actual and projected effects of large-scale asset purchases
How Severely Did the ZLB Bind During the Crisis?

Phases of the Expansion of Federal Reserve Holdings of Longer-Term Securities in the System Open Market Account

Illustrative Projected Paths for SOMA Holdings of Securities

Projected Excess SOMA Holdings of Longer-Term Assets

Projected Excess SOMA Holdings of Longer-Term Assets

ratio to GDP

Phase 1

Phase 2

Phase 3
Transmission Channels for Asset Purchases

• Asset purchases can reduce long-term interest rates ...
  – Through portfolio-balance, duration, and other effects that reduce term premiums
  – Through lower risk premiums (reduced adverse tail risks)
  – By improving market functioning
  – By altering expectations for future short-term interest rates

• As a result ...
  – Financial conditions improve
  – Real activity stimulated through lower cost of capital, increased wealth, and lower value of the dollar
  – Deflationary pressures checked
How Severely Did the ZLB Bind During the Crisis?

Calibrating Financial Effects of Asset Purchases

- Treasury bond term premium effects:
  \[ \theta_t = \lambda E_t \sum_{j=0}^{\infty} \beta^j \left[ \frac{A_{t+j}}{X_{t+j}} - \phi_{t+j} \right] \]

- Projecting \( \Theta_t \):
  - \( \Theta_0 = -50 \text{ b.p.} \) (Gagnon et al, 2010)
  - Generate \( \Theta_t \) based on path of \( A_{t+j} \)

- Simulating macro effects in FRB/US:
  - Shock T-bond premiums by \( \Theta_t \)
  - Shock mortgage rate spreads -50 b.p. in 2009 and early 2010
  - Assume endogenous spillovers to other asset prices, conditional on "neutral" response of conventional monetary policy

Effect of Large-Scale Asset Purchases on Treasury Term Premiums
How Severely Did the ZLB Bind During the Crisis?

Macroeconomic Effects of the Three Phases of the Asset-Purchase Program Under Basecase Assumptions

10-Year Treasury Yield

Real GDP

Unemployment Rate

Core PCE Inflation (4-qtr)
Estimated Effects of Asset Purchases: Caveats

- Considerable uncertainty about financial effects
  - Theory at preliminary stage
  - Empirical evidence limited
- FRB/US may overstate macro response to financial effects
  - Inflation may be more inertial
  - Real activity may be less responsive under current conditions
  - Agents may expect future trade-off in conventional monetary policy
- Other models could yield different effects
  - Research hindered by lack of channels in most DSGE models
  - Early work with Smets-Wouters and EDO suggests sizeable spending
effects
    - Baumeister and Benati (2010) also find significant effects
- More research needed on ...
  - Macro benefits of asset purchases
  - Costs and complications of use