

RESEARCH SUMMARY

Lessons for Monetary Policy When Interest Rates Are Near Zero

In the early 2000s, a small group of economists at Princeton University (including Paul Krugman and Ben Bernanke) provided insightful analysis for how to make monetary policy more effective when interest rates are near zero. In “The Princeton School and the Zero Lower Bound,” Scott Sumner shows how this school of thought began to influence Federal Reserve policy and how its key ideas relate to other recent policy models advocated by market monetarists and NeoFisherians.

THE PRINCETON SCHOOL AND LOW-INFLATION ENVIRONMENTS

The ideas of the Princeton School emerged in the late 1990s as economists were debating policy solutions to Japan’s long recession in the midst of a zero-interest-rate environment. While the traditional Keynesian view was that monetary policy is ineffective when interest rates are near zero and that fiscal stimulus is required, the Princeton economists argued that monetary policy might still be effective as long as a central bank credibly commits to raising the expected future rate of inflation. This might involve a shift from traditional inflation targeting to price-level or nominal GDP-level targeting.

Princeton School members made the case that monetary policy should be “history dependent”—meaning that current policy decisions should be based on previous paths of inflation and output in addition to current macroeconomic conditions. The Princeton School had an important influence over the Fed’s 2020 decision to implement “flexible average inflation targeting,” which means it would make up for previous misses of its inflation target.

THE PRINCETON SCHOOL AND MARKET MONETARISM

Since the Great Recession, market monetarism has emerged as a new school of thought in macroeconomics. Like the Princeton School economists, market monetarists agree that a central bank

- needs to commit to catch-up inflation or nominal GDP growth in order for policy to be stimulative when interest rates are close to zero, and
- should set policy based on the forecast value of policy variables, such as inflation and nominal GDP growth.

However, market monetarists disagree with Princeton School economists on the causes of recessions. While market monetarists believe recessions are primarily caused by bad central bank policy, the Princeton School sees a relatively greater role for instability in the market economy.

Market monetarists also believe central banks should rely on market signals in setting policy. For example, Sumner, specifically, recommends that central banks should target nominal gross domestic product and that it should achieve this goal by establishing an NGDP futures market where it would buy and sell contracts until the market

forecast of NGDP growth equals the policy target for NGDP growth. If this proposal is too radical, a central bank could target a weighted average of market and internal central bank forecasts. In recent years, central banks have moved toward just such a hybrid approach to forecast targeting.