Rate Expectations

By Kerry Pechter *Wed, Dec 5, 2012*

At a time when low interest rates are pinching off the annuity industry's oxygen supply—not to mention starving bond investors and crippling pensions—a Columbia University economist's rationale for raising rates might sound like salvation in certain quarters.

If Stephanie Schmitt-Grohé were in Federal Reserve chairman Ben Bernanke's polished, cap-toe oxford shoes, she would favor a monetary policy that raised nominal interest rates to four or five percent instead of keeping them suppressed at zero to 25 basis points.

In a new paper, Schmitt-Grohé (right) and fellow Columbia University economist Martin Uribé contend that the Fed's easy-money policy, rather than raising expectations of high inflation, is causing Americans to expect a Japan-like scenario of long-term low inflation.

Instead of helping jump-start the economy, they say, that low rate policy is keeping unemployment rates high by keeping real wages high. And if executives truly expected higher inflation, which would lower real wages and boost prices, they'd feel more confident about hiring.

Monetary policy, of course, is a murky science where the normal rules of cause and effect seem to vanish, where ordinary intuition and common sense get no purchase, and where one economist's holy grail is another's heresy, and vice-versa.

So it's difficult to evaluate new ideas. But, at a time when low interest rates are pinching off the annuity industry's oxygen supply—not to mention starving bond investors and crippling pensions—a rationale for raising rates might sound like salvation in certain quarters.

Different kinds of shocks

At the heart of the Columbia economists' argument is the difference between a "fundamental shock" to the economy (they give the example of a natural fall in interest rates) and a non-fundamental "lack-of-confidence shock," such as the public's reaction to central bank policy.

They think we've experienced the second kind. "If it's a *fundamental* shock, [the low-rate policy] should be stimulative to employment, but only if it's a given that the economy will return to normal inflation rates over the next five to 10 years," Schmitt-Grohé told RIJ.

"But if we've had a *confidence* shock, if every believes that we will become Japan, then the current policy of having a Fed funds rate of zero to 25 basis points isn't right." Japan's interest rates were reduced after a stock market crash in 1989, but inflation and rates have stayed near zero since then.

"In the paper, we entertain the idea that a zero policy makes people think that we'll never go back to two or three percent annual inflation, but instead move to a Japan-type scenario, where inflation will stay at a half-percent or a quarter percent indefinitely," she said.

"If the Fed's paradigm is that our change in expectations is temporary, then its current policy is right," she added. "But if our assumption is right, if the zero-rate policy is cementing the deflation prediction, then that goes against the policy of easing. It says that we should go back to the four to five percent Fed funds rate. That will kill the belief that we have indefinite deflation ahead. Then you will really change the expectations of inflation."

The unemployment problem

Schmitt-Grohé and Uribé went down this road in part because they wanted to figure out why lower interest rates have not stimulated the economy and led to higher lending and lower unemployment, as theory says they should.

The problem may be that the real cost of labor hasn't gone down, and companies, faced with weak demand and no expectation of rising prices, can't afford to hire at current wage rates. The Columbia economists believe that expectations of inflation would bring expectations of higher prices, lower real wages, and would therefore create the right conditions for more hiring and less unemployment.

"When there's high unemployment, you would have expected wages to give in. But there's been no decline in real wages," Schmitt-Grohé told RIJ. "It's very hard to cut the hourly wage. Employers would rather reduce employment costs by cutting the number of hours that people work. But if you can generate a little inflation, you lower the real wage rate, and you inspire employment."

She gives Bernanke high marks for preventing a deflation spiral and putting a floor under the value of stocks, mortgage-backed securities and housing, which were in freefall in 2008. But she sees lingering unemployment as a bigger problem than the prospect of a drop in asset prices.

Not everyone fully agrees with this interpretation. Workers might balk at the idea of absorbing the cost of recovery. As Guillermo Calvo of Columbia's School of International and Public Affairs and others assert in a new paper, "A spike of inflation during financial crisis may help to reduce jobless recoveries, but at the expense of sharply lower real wages."

Unemployment, they argue, has stayed high because, under current conditions, banks prefer to finance investment in physical capital rather than in labor-intensive projects. Where physical capital is involved, the collateral is easier to seize in the event of default. “Only relaxing credit constraint might help both unemployment and wages,” they write.