Monetary Policy and Interest Rates

An essential point to grasp about our approach to macroeconomics is that we don't think of interest rates the way most financial pundits and professional forecasters do. For us, interest rates are just another traded asset class, a set of markets that help us triangulate in on the overall picture that markets paint about the amount of money likely to be spent in the economy in the near future. As a result, we don't think a short term interest rate in a country says a whole lot about the stance of monetary policy. This is a big difference in our approach compared to others, and it's a good point to be aware of to make full sense of our analyses.

Other analysts might see a country has a 0% policy rate and think of that as an extreme measure by the central bank, a policy to be “normalized” as soon as possible. We would see a zero interest rate as merely one of many idiosyncrasies of a national economy, one of many facts that would help us form an opinion of what is going on in the country, which by itself tells us little.

What is monetary policy? We don't need to make it complicated, monetary policy is simply the act of managing the value of a particular currency in terms of what it will buy in local markets, or (as more commonly but less helpfully used) in terms of foreign currencies. Central banks do this by virtue of their monopoly on currency creation. Central banks usually have broad authority to regulate financial markets within their national jurisdiction, but ultimately they go about the act of managing the value of their currency through selling assets (to soak up currency) and boost the value of the currency, or by making more currency and using it to buy assets, thereby putting downward pressure on the currency. It turns out that changing the value of a given currency has profound effects on total spending in an economy.

In the old days, before communications were well-developed, monetary policy was a fairly mechanistic and delayed process, and governments likely didn’t even realize they were conducting monetary policy! A Roman emperor might order that a new batch of coins be issued, either from plundered precious metals, or from debased alloys. The new coins would slowly seep through the imperial economy, and the Roman *Denarius* would be worth less than it otherwise would be, and nominal GDP in the empire would be higher than it otherwise would be. Beginning with the invention of the telegraph and accelerating thence, the role of market expectations has become ever greater, and now a central bank not only has to take an action, it has to convince markets that it "means business"--it has to manage expectations.

The central bank could announce that it has doubled the money supply and then also announce that if inflation goes up at all, it will reign in that new money. Now if we went back to our simple model of the Roman economy, wherein no one really knew what was going on with coin production, outside of a few at the imperial mint, then a doubling of the money supply would surely lead to a doubling of prices when the money eventually spread through the economy. However, today, with modern financial markets, traders usually know what the central bank will do before the bank does, they get good at this because there's lots of money to be made in outguessing the Fed. As a result, central banks might make huge increases in the money supply and nothing much will happen, or if central banks make credible promises, markets might move before the bank has time to implement the actual mechanics of a new policy strategy.

Thus we get the famous case from the early 2000s where the Bank of Japan increased the monetary base (the basic measure of the money supply) a huge amount, but because traders guessed the bank would pull the money in if inflation increased at all, the Japanese Yen didn't move a whole lot.

Eventually, after further monetary base expansions, when inflation did move a bit higher, the BoJ promptly increased interest rates, proving traders more or less right as the higher rates implied the bank was unhappy by the increase in spending betokened by the higher inflation. The central bank is still all powerful in the monetary world, it just needs to ensure traders don't second guess it, thus with the so-called "Abenomics" policy of 2013, wherein the BoJ raised the Japanese inflation target, while also talking about how the bank wanted a cheaper Yen, led the private sector to do what the bank wanted (trade the yen cheaper, lift stocks, increase money velocity).

The key difference between the two Japanese episodes is that in the first, the central bank ostensibly made a monetary policy move (monetary base expansion) but largely canceled out its effects by telling the private sector that if inflation went up (an obvious consequence of greater spending in the economy) then the bank would unwind the stimulus. The BoJ sabotaged itself by mismanaging expectations. In the second case, the BoJ backed up its monetary base expansion with a coherent message for markets: that higher inflation was an intended consequence of their policy change. The result was a productive shift in Japanese monetary policy. It turns out that monetary policy is both about "doing things" like changing an interest rate target or expanding the monetary base, and "saying things" or managing market expectations through policy language.

So what's going on with interest rates? The previous examples of the Roman Empire and modern Japan layout how we see things: we're money focused, interest rates don't play a big role in our model. Central banks essentially use a short term interest rate target as a framework for getting more money into the market, and as a sort of signal of what they intend to do with the monetary base. They use an interest rate target because central bankers are *bankers*, they think in terms of interest rates, which is how banks make profits. The direct effects of interest rates, vis-a-vis their effect on bank lending, don't matter as much as central bankers might have you believe though. Indeed, as events of the last decade have shown, the interest rate targeting regime that most central banks used before the 2008 crisis, has proven wanting, as it didn't have an obvious path for banks to follow should rates fall to 0%.

In the years since the crisis, major central banks have come up with half measures to deal with the shortcomings of the interest rate policy framework, which at least prevented demand from falling dramatically, as it did between 2008 and 2009. These include large monetary base expansions (Quantitative Easing), rules about when the interest rate target would be raised (Evans Rule), currency ceilings and negative interest rate targets. These policies however failed to grasp the near irrelevance of interest rates vis-à-vis monetary policy, as they're all framed within the context of returning rates to a 'normal' range.

The simple truth is that interest rates are just another price—the price to borrow money. It's not much of an exaggeration to say that interest rates are no more important for understanding monetary policy than the price of apples, or houses or Microsoft stock shares. If money lending were outlawed, interest rates would cease to exist, and while such a policy would certainly constrain the possibilities for economic activity, we can still imagine that money would be spent and other markets would exist, and thus for a need to manage the value of money and by extension the total amount of money spent in the economy (nominal GDP), i.e. a need for monetary policy. Those to imagine that monetary policy is made

ineffective when rates hit the 0% threshold, would do well to ask themselves if it would be impossible to weaken a currency by increasing its quantity if credit markets didn't exist.

An illustrative anecdote to make the point is to consider what happened to longer term US interest rates in 2012. US 10-year treasury rates in this period ranged between all-time lows of about 1.4% to a high of about 2.4%. Oddly, in this period, the 10-year treasury yield stopped tracking changes in stock prices. More often than not, interest rates will go up when stock prices rise, and vice versa, however in 2012 they seemed to move independently on most trading days. Stocks trended straight up, while yields fell. It turns out that US yields fell when the spread between Spanish and German government bonds rose. Investors were moving out of Spanish paper and into the Treasury market. The moves were big enough to push yields lower. Nominal income growth in the US chugged along around 4% per year, the same as in 2011, 2013 and 2014. The lower interest rate didn't seem to do anything for the US economy, yet under the standard story told by other analysts, the lower rates should have spurred consumption and investment by making it cheaper to borrow.

Interest rates tell us nothing about the direction of inflation and nominal growth; nothing important about whether monetary policy is working to lift or lower the growth rate in either of these variables. Take for example 1979, when the Federal Funds rate was over 10% and yet inflation was galloping at about the highest rate in US history and wages were soaring. Rates were historically "high", yet clearly the economy was under too much monetary stimulus. Or the period of 1996-97, when the Fed's target rate was 5.5%, core inflation averaged 1.8% and real growth held around 4%. Under an interest rate view of monetary policy, this period must surely be more restrictive than the 2011-12 periods, when the target rate was 0%, inflation was around 1.7% and real growth around 2%.

The price to borrow or lend money is simply not that informative. Interest rates are determined by all sorts of factors: the prevailing inflation rate, a spike in demand for the debt due to a crisis in some other asset class, or changes in the desire to hold money by the population. These disparate factors make it hard to interpret interest rates, and make it necessary to instead look at full yield curves, prices in other markets, as well as measured economic data, to get a full sense of economic conditions.