

More on the Fed's Zero-Bound Problem

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The Fed is mulling over a new approach to its zero-bound problem. A *Wall Street Journal* story by Nick Timiraos (“Yield Caps on Table in Next Recession”, January 27, 2020) uses historical context to describe the policy tool under consideration: “From 1942 until 1951, the Fed capped yields on Treasury securities – first on short-term bills and later on longer-term bonds – to help finance war spending and the recovery.” The pros and cons of reviving what was then called “Operation Twist” involves analysis about which mainstream macro theory frequently misleads.

Zero-Bound Problem

Again from Timiraos: “At issue is how the central bank should manage a faltering economy when short-term interest rates are already low.” The Fed’s specific anti-recession objective here is to “drive down longer-term interest rates to encourage new investment by households and businesses.” In a more technical matter, some officials also believe a revival of Operation Twist would produce the same amount of stimulus, while requiring the Fed to acquire fewer securities, as did the Quantitative Easing (QE) used in 2012 through 2014. During that period, the Fed added \$1.6 trillion in Treasury and mortgage securities to its portfolio.

Readers of the GEM Blog are familiar with the conundrum implicit in the Fed’s obsession with the zero-bound problem. Interest rates in recessions, especially those that are especially severe, are not particularly significant in the effective management of downturns. Their presumed criticality is largely an artifact of the often misleading market-centric general-equilibrium theory, which is the mainstream New Keynesian (NK) model preferred by the Fed staff and economist members of the Board. (Their devotion to the capacity of general market equilibrium to explain the massive, persisting market *disequilibrium* that exemplifies recessions is an embarrassment that the GEM Project seeks to clarify.)

Stimulating Aggregate Demand

That collapsing investment spending is a principal driver of recessions is not in dispute. Instead, the modern problem here is that mainstream macroeconomics badly describes the determinants of outlays on equipment, structures, and software.

Illustrative is the famous small-scale NK model, widely used in classrooms and for policy advice. In all of its many variants, the model identifies interest rates as the primary, usually the only, determinant of investment spending. The ease with which that assumption is accepted has always puzzled me. Practitioners, who actually make business investment decisions, are not reluctant to tell anyone who asks that their decisions here are almost wholly driven by the expectation of pure profit. (Impending and actual recessions unsurprisingly cause such expectations to weaken.) From two decades on the board of directors of a large multi-line financial-services company, I can attest that interest rates were never more than a minor consideration in investment decisions.

The key to understanding that conundrum is to understand the policy-relevance of market-centric general-equilibrium theory. In particular, that ubiquitous model class features continuous equilibrium that eliminates pure profit. (For elaboration, see the GEM post of June 29th, 2015, available on the website.) By default, investment spending is driven by interest rates. GEM theory, by contrast, is governed by continuous general decision-rule equilibrium that accommodates both cyclical and trend market disequilibrium, with rational investment spending driven by both expected profit and interest rates. The first exerts a strong influence, while the second is quite weak. Indeed, when market interest rates are near zero in recession, their influence on total spending is insignificant; and effective stabilization policy must look elsewhere. That is what Bernanke and company did in 2008-09, implementing policies that directly impacted total spending and altered investor/lender expectations of future profits.

Moreover, as described in another early post, Barro and Grossman’s *FWGE* modeling many years ago demonstrated that nominal wage rigidity introduces income and wealth into rational consumption decision-making. B&G also demonstrated that, in mainstream market-centric, general-equilibrium equilibrium modeling which precludes meaningful wage rigidity, consumption is primarily influenced by interest rates, an outcome that again badly misleads policymakers.

Putting the pieces together, generalized-exchange macroeconomics indicates that a Fed policy of capping Treasury yields would be ineffective in stimulating investment (and consumption) spending in recession – a conclusion that is especially strong in downturns that feature nonstationary contractions in total demand. Capping would still be effective in reducing national-debt servicing costs, at least as long as the dollar's reserve-currency status remains undamaged. Lowering such costs was the primary objective of Operation Twist after the war.

Final Word

The fundamental message here is a continuation of last week's post. The absence of rational-behavior, evidence-consistent labor pricing in modern NK macro theory has deprived analysts of crucial guidance in their attempts to usefully model cyclical aggregate behavior. Adequate macro analysis became more complex after the advent of large bureaucratic firms in the Second Industrial Revolution. The new corporate forms enabled a jump in labor specialization and productivity that has never been effectively incorporated into general-market-equilibrium analysis. Inadequate market-centric roadmaps, especially with respect to optimizing exchange occurring inside large-scale establishments, made macro theorists vulnerable to debilitating model-building wrong turns. In a now-familiar example, microfounded MWR would have steered macroeconomists clear of the very costly wrong turn that resulted in the widespread, futile use of labor search/match theory to explain the existence of forced layoffs in the aftermath of adverse demand disturbances.

More relevant to this post, another important example of inadequate guidance from mainstream market-centric general-equilibrium theory is the New Keynesian preoccupation with the zero-bound problem. Evidence-inconsistent guidance here is rooted in NK theory's convenient use interest rates to drive almost all investment spending.

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