



Policy Note

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WHY RAISING RATES MAY SPEED THE RECOVERY

JAN KREGEL

Criticisms of the Federal Reserve's "unconventional" monetary policy response to the Great Recession have been of two types. On the one hand, the tripling in the size of the Fed's balance sheet has led to forecasts of rampant inflation in the belief that the massive increase in excess reserves might be spent on goods and services. And even worse, this would represent an attempt by government to inflate away its high levels of debt created to support the solvency of financial institutions after the September 2008 collapse of asset prices.

On the other hand, it is argued that the near-zero short-term interest rate policy (ZIRP) and measures to flatten the yield curve (QE plus "Operation Twist") distort the allocation and pricing in the credit and capital markets and will underwrite another asset price bubble, even as deflation prevails in product markets.

Both lines of criticism have led to calls for a return to a more conventional policy stance, and yet there is widespread agreement that this will have a negative impact on the economy, at least in the short term. However, since the analyses lying behind both lines of criticism are mistaken, it is probable that the analyses of the negative impact of the risks of return to more normal policies are also in error.

Senior Scholar JAN KREGEL is director of the Levy Institute's Monetary Policy and Financial Structure program. He is a professor at Tallinn University of Technology and holds the title of Distinguished Research Professor at the University of Missouri-Kansas City.

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Fear of Inflation

The “fear of inflation” view is bolstered by the declaration of the former chairman of the Federal Reserve Board of Governors that since there is no limit to the Fed’s ability to increase the money supply by a few keystrokes on its computer, it is always possible to create demand that would outstrip the capacity of the economy to produce real goods and services, leading to rising prices.¹ Indeed, inflation is the avowed aim of Fed and European Central Bank (ECB) policy.

But, despite the fat finger of the Fed on its computer, the money supply has not increased, and the money multiplier has become moribund. Just as in the response to the Great Depression, the Fed has found that it is impossible to increase the money supply by means of providing central bank reserve deposits in exchange for existing bank assets. Bank deposit liabilities that form the money supply and provide the purchasing power of the private sector can only be created if the private sector is willing to issue liabilities to fund new productive investment or the acquisition of existing assets. And this can only occur if banks are willing to acquire these liabilities in exchange for deposit liabilities. It is the private sector that controls the transformation of the reserve base into money financing.

This was clearly understood in the 1930s: “Central bank credit is not in the hands of the community to be spent for commodities so that the first necessity is to show the effects of central bank policy on the volume of member bank credit” (Dunkman 1933, 166). Further, “in order to get the bank credit into the hands of the public, someone must borrow from the banks, since no technique has been devised for placing bank credit directly at the disposal of the community without a reciprocal claim being established” (206).

In the Depression, the absence of commercial paper due to the unwillingness of business to borrow to undertake expenditure was thought to be the problem that stymied the Fed’s ability to expand the money supply. But it is just as likely that it was unwillingness on the part of the banks to accept paper that they believed to be of dubious value, instead preferring less-risky government paper.

Today, the need to delever balance sheets means the private sector is destroying credit by paying off loans rather than seeking to fund new commitments. And this action leads to reductions, rather than expansions in the money supply.

The simple point is that the growth of the central bank’s balance sheet is the result of swaps of assets held on bank bal-

ance sheets for central bank reserves held on the Fed’s balance sheet. Unless the Fed is purchasing newly created assets from the bank, this operation can have no impact on the relation between the demand for and supply of goods. There can be no inflation until the private sector starts issuing liabilities that will provide the assets the banks hold on their balance sheets as the counterpart of the expansion of deposits that create money growth.² The size of the Fed balance sheet thus has no direct impact on the money supply or on spending, since the Fed is powerless to directly affect the decisions of the banks to finance increasing expenditures in the private sector, or the private sector’s decisions to borrow to make these expenditures.

Inflating Away the Debt

But, even if the size of the Fed balance sheet has no impact on inflation, it is believed that the absolute size of the government debt will have a negative impact on capital markets and interest rates, even though there is no credible evidence to support this belief—Japan’s decade-long experience of rising debt and near-zero interest rates being the classic example. Nonetheless, it is argued that it is the government rather than the central bank that will seek to reduce the debt by generating inflation. In the absence of any plausible threat of inflation—indeed, the present concern is the possibility of deflation, which increases the real value of the debt to creditors—this argument has taken a different tack. Based on the belief that the Fed will soon return to more conventional policies and thus return policy interest rates to more normal levels, holders of debt, whether the Fed or the public, may experience capital losses (or reduced capital gains) on existing holdings of fixed-interest securities, depending on acquisition price.

But this tack fails to take into account the impact of a rise in interest rates on the yield to maturity of fixed-interest securities. While it is true that a rise in interest rates causes a fall in the current price of bonds, it does not change the fact that face value is always paid at maturity, which reverses any capital loss during the holding period. And further, a rise in interest rates produces for the holder a higher flow of interest income on the reinvestment of the bond’s periodic coupons, which means that the holding-period yield on bonds will be higher than the coupon yield in a rising-rate environment. As Paul Samuelson (1945) pointed out in his analysis of the rise in interest rates from the low levels imposed by the Fed to help finance the

Second World War, higher rates are not necessarily negative for bondholders or the level of overall demand. Indeed, in the absence of any evidence of wage or price pressures, higher rates will increase incomes and improve pension funding schemes, and thus may be positive for aggregate demand.

Fear of Bubbles

For those who have no fear of inflation or higher interest rates, there is the fear that unconventional policies have laid the foundation for another asset price bubble. But this is precisely what the unconventional monetary policy is meant to do. As lower rates drive the search for higher yields, the Fed is trying to drive investors away from riskless Treasury securities into higher-yielding, but higher-risk, assets that are more likely to fund expanding production and investment. The problem is that in the presence of the need to delever balance sheets, as noted above, the private sector, and households in particular, are hesitant to incur new liabilities; rather, outstanding liabilities are being destroyed, so that any increase in risk appetite on the part of investors will encounter a declining supply of assets, driving up their prices. Thus, the primary impact of unconventional monetary policy has been a sustained rise in equity prices, intensified by the sharply increased rate of corporate buybacks, indicating the failure to discover profitable new investment opportunities.

Indeed, the rise in equity prices was predictable and intended to drive investors into riskier assets in order to generate a divergence between the price of acquiring income-earning assets by a stock purchase and borrowing to invest in new productive capacity.³ In John Maynard Keynes's terms, the policy seeks to establish a condition of backwardation in which it is perceived to be more profitable to build new productive capacity to service future demand than to buy up existing capacity by acquiring company stock or via merger.⁴

But corporate deleveraging and rising profits on overseas production have made corporations cash-rich, with no desire or need to finance new productive capacity, which explains part of the failure of bank lending and the money supply to increase. As long as corporations see no need to expand capacity, it remains rational for them to continue to buy back shares and for investors to continue to buy equity.

While there is a real risk that a return to more normal interest rate policy would bring about a downward adjustment

in equity prices, in calculating the value of uncertain future earnings (as Keynes pointed out long ago), it is the expectation of rising earnings from higher expected sales and profits raising the marginal efficiency of capital (MEC) that is much more important than the impact of a low interest rate in discounting future earnings. The current level of equity prices is thus only a bubble if there is no recovery in expected future demand.⁵ Finally, there has never been conclusive evidence that lower interest rates lead to higher investment. Indeed, the easiest way to increase investment is by an expansion in household incomes to boost consumption expenditures, which account for well over 60 percent of national income. But the household sector is dealing with excess leverage that can only be resolved via increased saving, which means that they cannot be the source of the required increase in the MEC.

This makes it clear that current policy, with its emphasis on stabilizing asset prices and financial institutions, is only part of the recipe for recovery, and cannot be successful in the absence of policy to support expectations of increasing sales and employment. Again, the easiest way to generate expectations of higher future earnings that would induce an expansion in the money supply would be household debt reductions or direct expenditure by government.⁶

It's Only Over When It's Over

Much of the fear surrounding the potentially negative impact of the reduction in the Fed's balance sheet and the move away from ZIRP on the incipient recovery stems from the market reaction to the indication in May that the Fed might move to "taper" its purchases under QE. The purchases have now come to an end, without any similar market reaction, so attention has been focused on the impact of possible action to reduce the size of the Fed's balance sheet. But there is no particular need to deal with the size of the balance sheet, for, as Ben Bernanke (2003) has noted, "one could make an economic case that the balance sheet of the central bank should be of marginal relevance at best to the determination of monetary policy." With QE purchases at an end, the size of the balance sheet will be driven by the private sector's expectations of recovery. As pointed out, higher rates may be a positive element in supporting recovery, and the return to normal policy should provide a strong signal to improve investor sentiment. The Fed's balance sheet can only decline when the private business and financial sector increases

its demand for the assets that the Fed currently holds, and this can only occur when rates return to what is considered a more permanent level (see Kregel 2014), leading to private sector expectations of improving conditions, which will increase the creation of private liabilities that the banks agree to hold by creating deposits—which in turn will reduce the amount of excess reserves and the size of the Fed’s balance sheet.

Notes

1. “The monetary authorities can issue as much money as they like. Hence, if the price level were truly independent of money issuance, then the monetary authorities could use the money they create to acquire indefinite quantities of goods and assets. This is manifestly impossible in equilibrium. Therefore money issuance must ultimately raise the price level, even if nominal interest rates are bounded at zero. This is an elementary argument, but, as we will see, it is quite corrosive of claims of monetary impotence” (Bernanke 2000, 158).
2. Again, a point well understood in the 1930s crisis: “The bank does not create credit but creates a liability against itself, which circulates due to the fact that the bank has credit. Where, then, does the credit of society arise? It arises from the future surplus earnings of business firms and individuals. The credit of banks is a reflection of the credit of those to whom they have extended purchasing power” (Whitney 1934, 20–21).
3. Indeed, Keynes predicted this in his own proposals for ZIRP and QE in the 1930s. See Kregel (2011).
4. As noted, the Fed has little direct control over private sector decisions. In the low-interest-rate environment of the late 1920s, it circulated guidance to banks to restrict call market and equity lending, with no impact on the expansion in financing of stock speculation. There is thus no guarantee that the increase in the money supply and inflation will produce the expected increase in productive expenditure.
5. One could say that the market is counting on a “recovery put” rather than the “Greenspan-Bernanke-Yellen put” to support equity prices.
6. The case of the ECB is slightly different, where policies have led to bank borrowing from the ECB to finance the acquisition of impaired sovereign debt, reducing spreads of some highly indebted southern periphery countries’ bonds

relative to German benchmark bonds. This is interference with market assessments of risk, but it was intended, and has been one of the most successful policies of the ECB in terms of reducing the rollover rates for highly indebted sovereigns and thus easing default risk.

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