

Comments on “Conducting Monetary Policy at Very Low Short-Term Interest Rates” by
Ben S. Bernanke and Vincent R. Reinhart
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Ben and Vince’s paper is part of the large literature on the monetary transmission mechanism. During the 1960s and 1970s, one of the major topics of debate in macroeconomics dealt with the nature of this transmission mechanism. As attention shifted towards the role of expectations and inflation, research on the transmission mechanism slipped from its prominent position. Instead, monetary models of the 1980s often simply assumed the inflation rate was under the direct control of the central bank, while models since the mid-1990s have often treated the output gap as if it were directly controlled. The linkages from the central bank’s actual instruments, such as the level of reserves, and macro variables such as output were ignored. That is, the transmission mechanism was treated as an uninteresting issue, or perhaps as one that was sufficiently well understood that it no longer attracted the attention of most researchers.

With nominal interest rates at or near zero, however, the need to better understand those channels of the monetary transmission process that continue to operate when the central bank can no longer reduce short-term interest rates has become an important priority.

Ben and Vince discuss three aspects of the transmission mechanism that continue to operate even when short-term rates have fallen to zero. These are 1) announcements of future policies, 2) alterations in relative asset supplies, and 3) adoption of “quantitative easing.”

As befits the role of a discussant, I will adopt a somewhat skeptical view of these particular channels. This is not to argue that such channels do not exist, just that they may be weak foundations on which to rest the conduct of monetary policy. But, if the economy is caught in a deflationary recession, the exact details of any of these channels may be of minor importance; the central bank should actively pursue any and all tools available to it.

Since I am not Lars Svensson, I will follow the authors and focus on the case of a closed economy, ignoring the exchange rate channels that operate in open economies and that have provided the focus for several proposals for dealing with the situation faced in Japan.

Asset substitutability and wealth effects

Let me first discuss the role of asset supplies and “quantitative easing,” then I will turn to future policies. The possibility that altering the relative supply of short-term and long-term securities will have real effects is based on the idea that different assets are imperfect substitutes. Altering their relative supplies via open market operations can thus

force adjustments in their relative prices.¹ In standard models, the almost universal assumption is that non-monetary financial assets are perfect substitutes. Thus, while altering the relative supplies of money and non-monetary assets does lead to interest rate effects, altering the relative supplies of non-monetary financial assets does not.

The absence of these effects in most models reflects two judgments. First, there is an empirical judgment. As Ben and Vince note, the empirical evidence for imperfect asset substitutability is limited. What evidence does exist suggests a relatively high degree of substitutability. Second, we do not have a generally agreed theory to account for imperfect substitution. Recent attempts to model such effects (e.g., Andres, Lopez-Salido, and Nelson 2003) rely on various asset market restrictions that, while perhaps plausible, must still be viewed as ad hoc. One would like to have a better understanding of why long-term securities and short-term securities are imperfect substitutes if altering their relative supplies is to play an important role in policy design.

On the empirical side, there has been some recent work that integrates finance models of the term structure of interest rates with the type of small scale model often used for policy analysis. For example, Glenn Rudebusch and Tao Wu (2003) find, consistent with the finance literature, that a two-factor model accounts quite well for the behavior of the term structure. They also find that these two factors appear to correspond to the Fed's implicit inflation target and the short-term movements of the funds rate associated with a Taylor rule. This may suggest that little is left over to be explained by other factors, such as relative asset supplies.

The second policy channel, quantitative easing, involves an expansion in the central bank's balance sheet rather than simply a shift in its composition. At the zero bound, this channel corresponds to the traditional real balance effect and to a fiscal wealth effect. The real balance effect is a standard channel of transmission, but it is also one normally viewed as quantitatively unimportant, and recent empirical work finds little evidence in support of direct real balance effects.

However, Ben and Vince also note that replacing interest-bearing with non-interest-bearing debt implies a reduction in the present discounted value of future taxes. Thus, such a policy implies a form of fiscal expansion. As they also note however, this channel will operate only if the public believes the shift from interest-bearing to non-interest-bearing debt is relatively permanent. This illustrates that some monetary policy actions may have effects primarily because they have fiscal implications.

Ben and Vince mention the Fed's experience with quantitative policies during the Volker period. The Volker era may not provide a clean example of a quantitative policy. To a large degree, the Fed still formulated policy in terms of a target level for interest rates. The Fed then used an estimate of reserve demand to back out the level of reserve supply needed to achieve the target interest rate level.

¹ For one attempt to model the connection between asset substitutability and relative price movements, see Walsh (1982).

Perhaps a better example would be the Fed's policies during the 1930s. Gordon Sellon (2003) has argued that the Fed seemed little concerned with the fact that nominal rates were at zero in the early 1930s precisely because the Fed was focusing on quantitative measures. As is well known, the expansion of reserves in the 1930s was absorbed in excess reserves by the banking system and did not translate into increased lending. Of course the Fed compounded its policy errors of the 1930s by raising reserve requirements in 1936 in an attempt to reduce excess reserves.

Communicating future policies

Now let me return to the issue of commitments to future actions. Ben and Vince state that when the nominal rate is at zero, "a central bank can impart additional stimulus by offering some form of commitment to the public to keep the short rate low for longer than previously expected." Ben and Vince seem to have in mind the situation of a central bank that has encountered the zero bound and must now alter the public's expectations about future policy – that is, it must surprise the public by committing to lower interest rates for longer than had previously been expected. Doing so may be difficult – altering the public's perception of how policy will be conducted once one is in an historically new policy environment is likely to be particularly difficult.

Suppose we turn back the clock to 1978 for a moment. At that time, many prominent economists argued that all central banks had to do to lower inflation costlessly was to promise (i.e., commit to) a future policy of low inflation. As we all know now, the disinflations of the 1980s were costly in terms of lost output and high unemployment. What is open to debate is the degree to which these costs arose from a lack of credibility on the part of central banks or from the presence of inherent, backward-looking aspects to the inflation process itself.

Fortunately, central banks such as the Federal Reserve have gained a great deal of credibility over the past 20 years, and this should give them greater flexibility in affecting the public's expectations. But this credibility may be one-sided – major central banks have gained credibility in keeping inflation low. Whether this translates into the ability to credibly promise higher future inflation is uncertain. As the authors note, central banks have attempted to improve the clarity with which they communicate with the public, and, to quote the authors, "a major benefit of such efforts should be a greater ability to align market expectations of policy with the policymaking committee's own intentions." The extent to which *should* translates into *can* is still an open issue. Recent experience with the Fed's attempt to signal future policy via the "considerable period" language in the FOMC's press releases suggests the difficulty in "fine-tuning" expectations.

In any case, Ben and Vince are correct in emphasizing the distinction between an unconditional and a conditional promise to maintain interest rates at low levels. If the central bank communicates its short-term policy actions in terms of its overall policy strategy and its longer-term goals, then statements about the future path of interest rates are inherently conditional in nature. This point seems to provide a further argument for adopting a more formal inflation targeting framework within which to conduct this communications exercise.

Conclusions

Real GDP growth during the third quarter of 2003 recorded its fastest pace since 1984, suggesting that, just as the ends of long expansions are usually signaled by conferences on whether the business cycle is dead, perhaps sessions on monetary policy near a zero interest rate are a leading indicator that the problem is likely to quickly recede as an issue of concern. However, the research on the transmission channels of monetary policy that has been generated by the concern with the zero bound is likely ultimately to improve our understanding of monetary policy, even at more normal levels of nominal interest rates, and Ben and Vince have provided a very careful and informed discussion of these channels.

References

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