The Limits of Monetary Policy: Why Interest Rates Don’t Matter

In my last essay, It’s Time to Change the Monetary Policy Debate, I argued that attention should not be focused on whether policy would be better if policymakers used a specific policy rule. In Fixing a Bad System, I argue that monetary policy should be conducted within the bounds set by economic reality—what monetary policy can and cannot do. Policymakers should not attempt to do things or achieve objectives that are beyond the limits set by economic realities. This is the first of four essays that will discuss the limits of monetary policy. Since the Federal Open Market Committee (FOMC) has been implementing monetary policy by changing its target for the overnight federal funds rate for nearly 30 years, my first essay discusses the most basic reason why the FOMC’s interest rate policy is not having a large effect on output. Specifically, it is a well-known and well-established fact that interest rates are not very important for investment, or for spending decisions generally.

I will begin by quoting from a very famous paper by Ben Bernanke and Mark Gertler, Inside the Black Box, (the paper has been cited 4,572 times).

Most economists would agree that, at least in the short run, monetary policy can significantly influence the course of the real economy. Indeed, a spate of recent research has confirmed the early findings of Friedman and Schwartz (1963) that monetary policy actions are followed by movements in real output that may last for two years or more (Romer and Romer, 1989; Bernanke and Blinder, 1992; Christiano, Eichenbaum, and Evans, 1994a,b). There is far less agreement, however, about exactly how monetary policy exerts its influence: The same research that has established that changes in monetary policy are eventually followed by changes in output is largely silent about what happens in the interim. To a great extent, empirical analysis of the effects of monetary policy has treated the monetary transmission mechanism itself as a “black box.”

I’ll paraphrase: Economists have found that output changes, at least for a little while, after various types of policy actions, but they don’t understand how these monetary policy actions are transmitted to the real economy. Economists don’t know what’s inside the black box.

Bernanke and Gertler go on and mention one thing that the evidence suggests is not in the black box.

One problem is that, in general, empirical studies of supposedly “interest-sensitive” components of aggregate spending [fixed investment, housing, inventories, and consumer durables] have in fact had great difficulty in identifying a quantitatively important effect of the neoclassical cost-of-capital variable [interest rates].

The conclusion from empirical studies was supported by surveys of firms that showed interest rates were relatively unimportant for firms’ investment decisions. Monetary policy doesn’t work through the interest rate channel—interest rates don’t matter.

Bernanke and Gertler failed to mention that the papers they cited as evidence that monetary policy actions affect output use very different measures of “monetary policy actions.” Friedman and Schwartz and Romer and Romer
used the “narrative approach” to determine policy actions, but use different sets of monetary policy actions. Bernanke and Blinder find that monetary policy works through the bank credit channel of monetary policy—not through interest rates. However, as I noted in The Credit View, because banks have financed most of their lending by borrowing funds from the public since the mid-1960s, it is unlikely that the bank credit channel is important. I also present evidence that the effect through this channel “is quite small.” I concluded that “it is ironic interest in the bank credit channel of monetary policy has been rejuvenated at a time when justification for it has eroded.” It is now well-recognized that the bank credit channel of monetary policy is very weak.

Christiano, Eichenbaum, and Evans research also provides no evidence that monetary policy actions affect output. The reason is their measure of monetary policy actions, changes in nonborrowed reserves—total reserves minus banks’ borrowing from the Fed, is not due to monetary policy actions. I showed borrowed reserves and nonborrowed reserves, that their finding is due to the fact that the Fed offsets the effect of bank borrowing on total reserves. Consequently, the effect they found vanished in the early 1980s when banks stopped borrowing from the Fed.

The fact that output changes for a while following different measures of monetary policy actions is hardly compelling evidence for the efficacy of monetary policy. “So why do policymakers believe that monetary policy works through the interest rate channel and that monetary policy is powerful?” Well, there was one important event that brought economists and policymakers to this conclusion. Specifically, the Fed under Chairman Paul Volcker brought an end to the Great Inflation of the 1970s and early 1980s.

Prior to this event, Keynesian economists (most economists were Keynesians and most still are) believed that monetary policy was totally ineffective. “Why?” Keynesians believed that the only thing monetary policy could affect was interest rates. Since interest rates were not important for spending, the effect of monetary policy actions on interest would have essentially no effect on spending and, consequently, no important effect on output. Keynesians believed that monetary policy was essentially useless.

There was a smaller group of economists called monetarists who believed that monetary policy could have a large effect on output. But they believed this effect was due to the effect of monetary actions on the supply of money, not interest rates. Both Keynesians and monetarists believed that the effect through the interest rate channel would be tiny.

When he became chairman of the Fed, Paul Volcker made ending inflation the goal of policy. The day before the October 6, 1979, FOMC meeting, Volcker outlined a new method for conducting monetary policy during a conference call with FOMC participants. He announced that he wanted to pursue a new approach to implementing monetary policy that “involves leaning more heavily on the [monetary] aggregates in the period immediately ahead.” Much has been written about Volcker’s policy. But the bottom line is that it seems to have worked. Inflation declined from its April 1980 peak of 14.5% to about 2.4% in July 1983. Inflation subsequently rose again to a high of 6.4% in October 1990, but never returned to double-digit rates. The policy change was also followed by back-to-back recessions. Some economists believe that these two recessions (that were only a year a part) should be characterized as one very long and very severe recession. In any event, the fact that the change in policy was followed by a marked reduction in both inflation and output led economists and policymakers to dramatically change their view about the power of monetary policy to effect output and inflation.

Reminiscent of the “black box” problem, economists debated whether the success of the Volcker’s monetary policy was due to a marked reduction in the supply of money or to higher interest rates. But the growth rate of M1 monetary aggregate changed little over the period. Moreover, the growth rate of M2 actually increased. In contrast, the federal funds rate, which was 11.6% the day the FOMC changed policy, increased to a peak of 17.6% on
October 22, 1979. The funds rate then cycled, hitting cyclical peaks above 20% in late 1980 and mid-1981. Given the behavior of the M1 and M2 monetary aggregates and the behavior of the federal funds rate during the period, a consensus formed around the idea that the success of Volcker’s policy was attributable to high interest rates not to slow money growth. Like the Phoenix, the idea that monetary policy worked through the interest rate channel rose from the ashes. Indeed, after a failed attempt to characterize monetary policy in terms of some monetary or reserve aggregate under Alan Greenspan, the FOMC adopted the federal funds rate as its policy instrument in the late 1980s, circa 1988. (I document this change in Greenspan’s Cunundrum. Also, see Greenspan’s characterization of the FOMC’s evolution to federal funds rate targeting at the bottom of this essay). Since then, monetary policy has been characterized by changes in the FOMC’s target for the federal funds rate. Policymakers pay essentially no attention to monetary aggregates as I have documented here and in several other essays.

The problem is that nothing else changed. There have been no new studies showing that spending is much more sensitive to changes in interest rates than previously thought. Moreover, the survey evidence, that helped convince Keynesians to conclude that the interest rate channel was so weak as to be useless, has been confirmed recently by Sharpe & Suarez 2014. Consequently, Bernanke and Gertler’s statement that monetary policy does not work through the interest channel is as true today as it was 20 year ago. What has changed is economists’ belief that monetary policy works through the interest rate channel. What’s wrong, of course, is there is no evidence that spending is strongly related to changes in interest rates. Hence, economists’ and policymakers’ belief that monetary policy has strong effects on output through the interest rate channel is more akin to religion than to science. It is built on a belief that it seems to have worked once. This belief is reinforced by fact that few economists believe that policy could work through any of the other possible channels of policy: the exchange rate channel, the wealth effect channel, the money supply channel, or the credit channel. Monetary policy seems to work, but it cannot work through any of these other channels. Conclusion: it must work through the interest rate channel.

The total commitment to the interest rate channel explains why the FOMC engaged in quantitative easing (QE), forward guidance, and its so-called maturity extension program, in what is increasingly seen as a failed attempt to reduce long-term interest rates when the federal funds rate hit zero.

Policymakers need to undertake a realistic appraisal of the extent to which changes in interest rates affect spending. Moreover, they should evaluate under what circumstances changes in interest rates are most likely to be effective. For example, the last recession was characterized by an excess supply of real capital, in the form of residential and, to a lesser extent, commercial real estate. In such circumstances, it is reasonable to assume that it would take a much larger reduction in interest rates to have much, if any, effect on spending. Such discussions would produce better monetary policy because the FOMC’s policy actions would be constrained by economic realities.

**Greenspan’s description of the evolution to interest rate target**

As you may recall, we fought off that apparently inevitable day as long as we could. We ran into the situation, as you may remember, when the money supply, nonborrowed reserves, and various other non-interest-rate measures on which the Committee had focused had in turn fallen by the wayside. We were left with interest rates because we had no alternative. I think it is still in a sense our official policy that if we can find a way back to where we are able to target the money supply or net borrowed reserves or some other non-interest measure instead of the federal funds rate, we would like to do that. I am not sure we will be able to return to such a regime...but the reason is not that we enthusiastically embrace targeting the federal funds rate. We did it as an unfortunate fallback when we had no other options. – Alan Greenspan, FOMC Transcript, July 1-2, 1997, pp. 80-81.