The trouble with interest rates

By J. Bradford DeLong
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Of all the strange and novel economic doctrines propounded since the beginning of the global financial crisis, the one put forward by John Taylor, an economist at Stanford, has a good claim to being the oddest. In his view, the post-crisis economic policies being carried out in the United States, Europe, and Japan are putting a ceiling on long-term interest rates that is "much like the effect of a price ceiling in a rental market where landlords reduce the supply of rental housing." The result of low interest rates, quantitative easing, and forward guidance, Taylor argues, is a "decline in credit availability [that] reduces aggregate demand, which tends to increase unemployment, a classic unintended consequence."

Taylor's analogy fails to make sense at the most fundamental level. The reason that rent control is disliked is that it forbids transactions that would benefit both the renter and the landlord. When a government agency imposes a rent ceiling, it prohibits landlords from charging more than a set amount. This distorts the market, leaving empty apartments that landlords would be willing to rent at higher prices and preventing renters from offering what they are truly willing to pay.

With the economic policies Taylor criticizes, this mechanism simply does not exist. When a central bank reduces long-term interest rates via current and expected future open-market operations, it does not prevent potential lenders from offering to lend at higher interest rates; nor does it stop borrowers from taking up such an offer. These transactions don't take place for a simple reason: borrowers choose freely not to enter into them.

So how does Taylor arrive at his analogy? My intuition is that his reasoning has become entangled with his beliefs about the free market. Taylor and others who share his view probably begin with a sense that current interest rates are too low. Given their belief that the free market cannot fail (it can only be failed), they naturally assume that some government action must be behind the unnaturally low rates. The goal then becomes to figure out what the government has done to make interest rates so wrong. And, because any argument that treats government action as appropriate can only be a red herring, the analogy to rent control emerges as one of the possible solutions.

If my intuition is correct, Taylor and his fellow travelers will never be convinced that they are wrong. Accepting the idea that central bankers may be doing the best they can in a difficult situation would require entertaining the possibility that markets are imperfect and fallible. And that is one thing they will never do.

We have seen this play out before. Five years ago, Taylor and his intellectual allies wrote an "Open Letter to Ben Bernanke," warning that the quantitative easing planned by the Federal Reserve's then-chairman risked "currency debasement and inflation." But, although their prediction turned out to be spectacularly wrong, that has not led Taylor or any of the other signatories to rethink their theories or to consider that perhaps Bernanke knows something about monetary economics. Instead, Taylor seems to have settled on another theory – his rent-control analogy – for why the government is doing everything wrong.

The only possible response is to point to logic and evidence. Given real economic conditions, European and American monetary policy is not too loose; if anything, it is too restrictive. The "natural" interest – what would be ground out by the Walrasian system of general equilibrium equations – is actually lower than what current monetary policy is producing. Yes, the inertial expectations of the economy have combined with monetary policy to distort interest and inflation rates, but not in the direction that Taylor is proposing. On the contrary, compared to what is needed (given the current state of the economy) or to what a free-market, flexible-price economy in proper equilibrium would deliver, interest rates are too high and inflation is too low.

There is indeed something wrong with today's interest rates. Why such low rates are appropriate for the economy and for how long they will continue to be appropriate are deep and unsettled questions; they call attention to what MIT's Olivier Blanchard calls the "dark corners" of economics, where research has so far shed too little light. What Taylor and his ilk fail to understand is that the reason interest rates are wrong has little to do with the policies put in place by central bankers and everything to do with the situation that policymakers confront.

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