**Paul Krugman - New York Times Blog**

**June 10, 2013, 9:05 am**

## Abenomics and Interest Rates: A Finger Exercise (Wonkish)

Japan has announced a long-term turn to easier money and a higher inflation target. Stocks are up (if bouncing around a lot), the yen is down, but long-term interest rates are somewhat higher (although still very low). Is this a puzzle or a problem?

Richard Koo, Nick Rowe, and Noah Smith have all weighed in. So I guess I should put in my bit. Basically, I think Rowe is mostly right; Koo isn't making sense; and Smith is worried for no good reason.

Let me start, as I often do, with my original 1998 itsy-bitsy liquidity trap model. This was an infinite-horizon model, but one in which all the action took place in either the first or the second period, since it was assumed that nothing would change after period 2. I imagined a situation in which a temporary negative shock to demand pushed the economy in period 1 up against the zero lower bound, and showed that in that case increasing the monetary base in period 1 had no effect. To get traction, the central bank would have to convince the public that it would increase the base in period 2 — e.g., that it would not withdraw any quantitative easing it was doing now — so as to generate expected inflation.

In that model, I only talked about the one-period-ahead interest rate. But we certainly could imagine two-period, three-period etc. bonds. How would an Abenomics-style monetary policy affect these longer-term rates?

Well, the answer would depend on what monetary policy is expected to do after period 2. If we're looking at a one-time step up in the monetary base, which was my thought experiment in 1998, the short-term rate would remain at zero, and future interest rates would also remain unchanged, so no effect. But it's easy to imagine that the change in monetary policy involves not just a one-time jump in the monetary base but faster growth forever after, or at least for a long time. In that case, future short-term rates will be higher in nominal (though not real) terms, and so long-term rates will rise even in period 1. The long rate will, however, rise by less than expected inflation, because the one-period-ahead nominal rate will stay at zero, so even as nominal rates rise, real rates will fall.

I think this is pretty much where Rowe is. Smith, however, loses the thread a bit, if I'm reading him correctly; he worries that the rising rates will cause a problem because of Japan's huge public debt. But remember, while nominal rates may be going up, real rates are going down; so Japan's debt becomes more, not less, sustainable. Also, bear in mind that there's a lot of preexisting long-term nominal debt, whose real value will be eroded by inflation. So Abenomics is all good from a fiscal point of view, even if it makes headline interest payments rise.

Finally, Koo seems to regard higher inflation expectations as a disaster, when in reality they are the whole point of the exercise. What?

I guess I've always found Koo fairly incomprehensible on monetary policy. He emphasizes the importance of balance-sheet constraints, and deserves a lot of credit for being ahead of the pack here. He's also right in emphasizing the useful role budget deficits can play in a balance-sheet recession. However, he has this violent opposition to monetary expansion that, as far as I can tell, isn't actually justified — actually, isn't at all justified — by his underlying analysis. On the contrary, when some of us (pdf) try to model Koo-type problems, we find that monetary policy that raises expected inflation could be quite helpful.

Maybe part of the problem is that Koo envisages an economy in which everyone is balance-sheet constrained, as opposed to one in which lots of people are balance-sheet constrained. I'd say that his vision makes no sense: where there are debtors, there must also be creditors, so there have to be at least some people who can respond to lower real interest rates even in a balance-sheet recession.

Also, if the problem is a debt overhang, isn't debt-eroding inflation a good thing?

As I said, I just don't understand Koo's position here. If he wants to argue that monetary policy is unlikely to be effective, fine; but he wants to claim that it's positively harmful, and I just don't get the logic.

Anyway, back to Japanese interest rates: they really don't pose a puzzle, nor, at least so far, do they pose a threat.