LONG-TERM RATES | Future credibility at risk

FED’S CURRENT STANCE IS TRAGICALLY WRONG

A deeply troubling concept in economic theory, “time inconsistency” of policy, has become highly relevant to recent Federal Reserve policy. It’s not being disclosed, and the public has a right to know.

Before the current recession, the traditional approach to monetary policy operated through purchase and sale of Treasury bills to influence short-term interest rates and the money supply.

The Fed avoided intervening in the market for long-term bonds. Long-term interest rates were freely determined in bond markets, except during a brief period of experimentation with “twisting” the intertemporal distribution of interest rates (the “yield curve”) in 1961. Bond markets set long-term interest rates to provide adequate compensation for expected changes in future short-term interest rates. Fed intervention in long-term bond markets seeks to undermine the market’s determination of that compensation. “Operation Twist,” named after the famous Chubby Checker song, was widely viewed in 1961 as inappropriate and a failure.

Fed policy in the recent crisis has diverged dramatically from its past conventions in two respects. First, the Fed has intervened aggressively into the market for long-term Treasury bonds and long-term mortgages, buying more than one-quarter of outstanding Treasury debt and almost all newly issued mortgage bonds backed by conventional fixed-rate mortgages.

Second, and more importantly, the Fed has sought to amplify the effects of its actions by intervening in the formation of public expectations about future interest rates through statements providing “forward guidance,” intended to “manage expectations.” The combined policies of suppressing long-term interest rates while lowering expectations about future interest rates produce a dangerous game between the Federal Reserve and the public. When the unemployment rate declines to normal levels, the Fed will increase short-term interest rates to meet its target of price stability. Long-term bond prices will unexpectedly drop dramatically. The potential adverse consequences of the Fed’s gamble need to be understood by the public, which is an unwitting player in the complicated game.

Private ownership economies operate at their best in “reputational equilibrium,” under which the public dependably believes the government is telling the truth. Large or frequent changes in policy do not produce suspicions among the public about the motives for previous governmental statements or actions. Policy changes are viewed as resolving honest mistakes or responding to differing conditions, rather than reflection of prior misleading policy.

In contrast, if governmental policy is shortsighted and “time inconsistent,” private sector confidence in the credibility of governmental statements and motives is lost, and private sector behavior becomes defensive. The economy sinks into a stagnation trap, causing long-term economic damage. The world’s weakest economies are often caught in the resulting trap, which is the cause of those economies’ stagnation.

The complicated phenomenon of time inconsistency in central banking is defined and well known in macroeconomic game theory and occurs if the central bank appears to have an incentive to mislead the public about its intentions, under the belief that it is in the best interests of the public to be misled. A government which behaves in that manner has been called a “benevolent disseminating government” by Stanley Fischer, governor of the Bank of Israel.

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require the central bank actually to misrepresent its intentions, but an incentive to mislead must be evident. With the currently high ratio of national debt to national income, there is the appearance of a Fed incentive to bias downward expectations about future interest rates as a means of helping the Treasury with its debt service. When the economy recovers and interest rates rise, bond prices will drop and bondholders will be likely to wonder whether they were intentionally misled to keep down long-term debt service costs to the Treasury. Historically, losses of central bank reputation through time-inconsistent policy have been very difficult to reverse and have characterized troubled economies throughout the world and throughout history.

Regardless of whether Fed policies are currently influenced by Treasury debt service, the appearance of such a potential linkage cannot be denied. It should be emphasized that the problem is not the combination of Operation Twist with forward guidance. The problem is adoption of those policies at a time of high national debt. The need to finance high national debt produces the conditions for time inconsistency of a policy designed to suppress long-term interest rates and future interest rate expectations. The time inconsistency of current policies might be a contributing cause of the economy’s slow, weak recovery. But far more ominously, the Fed risks serious future reputation loss and consequent major economic damage when long-term rates increase and U.S. Treasury bondholders, both domestic and foreign, take unexpected large capital losses. The Fed’s well-intentioned policy game is not likely to end well.

William A. Barnett is the Oswald distinguished professor of macroeconomics at the University of Kansas, director of the Center for Financial Stability in New York and editor of the Cambridge University Press journal Macroeconomic Dynamics.

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