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Higher Rates Would Boost Growth, Paper Argues

By Michael S. Derby

The Federal Reserve believes aggressively easy monetary policy is the key to lowering unemployment. A new paper argues increasing rates may be the only thing that can get the economy moving again.

The research, written by **Columbia University**'s **Stephanie Schmitt-Grohe** and **Martin Uribe** and released by the National Bureau for Economic Research, is an attempt to take stock of why the Fed's super easy policy of recent years has at best delivered modest growth. Despite historic Fed action, unemployment, while off its peak, remains very high.

Central bankers have long argued that as moribund as the current environment may be, a less easy path would have almost certainly resulted in even greater woe. They believe higher rates would depress whatever growth the economy managed to generate. That would leave a significant amount of slack in the economy, in turn generating inflationary pressures well under the 2% price rise level officials want to see.

The Columbia academics said it may be the Fed has misdiagnosed the true problem at the heart of the economy. At the heart of the issue is the management of inflation expectations and confidence in the wake of a significant shock.

The paper's authors argue jobless recoveries of the current variety are frequently tied to a lack of confidence somewhat divorced from the economy's fundamentals. When a central bank, such as the Fed, cuts interest rates massively and pledges to keep them near zero percent for a long time to come, instead of inspiring confidence, the opposite may happen. With very easy policy, "the central bank validates expectations of future deflation," the paper said.

So the prescription for policymakers is to reverse course: Raise rates to get things moving again, the paper says.

"In a liquidity trap caused by a confidence shock, an increase in nominal rates tends to raise inflationary expectations without further depressing aggregate spending," the researchers said. "Any policy that is to succeed in raising inflationary expectations during an expectations-driven liquidity trap must be associated with an increase in nominal rates."

When a central bank is trying to counter the liquidity shock and blow to confidence, it should move its target rate to something in line with its inflation goal.

“Raising the nominal interest rate to its intended target for an extended period of time, rather than exacerbating the recession as conventional wisdom would have it, can boost inflationary expectations and thereby foster employment,” Schmitt-Grohe and Uribe write.

“Our emphasis on the role of a confidence shock to explain the great contraction appears to be supported by the data,” the economists wrote. They added, “the experience of Japan in the past two decades as well as the recent economic performance of the United States and other developed countries seems to suggest that zero nominal interest rates are not doing much to push expected inflation higher.”

The paper’s findings are controversial within the economics community. By its actions, a strong majority of Fed officials don’t appear to agree higher rates will help the economy.

Meanwhile, an influential paper presented at the Fed’s annual Jackson Hole conference at the end of the summer by their **Columbia Colleague, Michael Woodford**, chastised the central bank for not making a firmer commitment to keeping rates low well into the future. He believes such a policy can inspire confidence in the future and drive up activity levels.