Central Banks Need to Get Real (Not Nominal)

By Antonio Fatas , INSEAD Professor of Economics

To benefit the economy in the long–term, central banks need to reassess their attitude to short-term nominal interest rates.

While the European Central Bank (ECB) and Bank of Japan (BOJ) are exploring negative interest rates, the U.S. Federal Reserve is preparing us for a slow and cautious increase in short-term interest rates. Long-term rates remain at very low levels, inflation expectations have come under pressure and remain below what they were a few months or years ago. As this is going on, markets are trying to figure out if they like low or high interest rates. And even if they decide that they like low rates, are negative rates too low?

In all these debates there seems to be an unusual amount of what economists call “money illusion” or lack of understanding of the difference between nominal (the interest rate before inflation is taken into account) and real interest rates. This confusion, in my view, is partly motivated by the communication strategy of central banks that seem to obsess with the asymmetric nature of their inflation targets (for both the ECB and US Fed, inflation targets are defined as close but below 2 percent) and they are not

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clear enough on their final goal and its timing.

How do we want interest rates to react to aggressive monetary policy? The common answer is that we want interest rates to go down. This is correct if we think in real terms: given inflation expectations (or actual inflation), we want interest rates to move down relative to those inflation levels. But in some cases, in particular when inflation expectations are lower than what central banks would like them to be, the central bank by being aggressive is targeting higher inflation expectations, and this can possibly lead to higher nominal (long-term) interest rates.

This is what happened in the three rounds of quantitative easing by the U.S. Federal Reserve. Ten-year interest rates went up which was a signal of increasing inflation expectations (and even higher expectations of future real interest rates). This was seen as a success.

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But the behaviour of long-term interest rates or inflation expectations in response to recent communications by central banks has gone in the opposite direction. Long-term rates have come down (in particular in the Euro area). But don't we want lower interest rates? Isn't this the objective of massive purchases of long-term assets by central banks? Yes if we talk about real interest rates but not obvious if we talk about nominal ones. What we really want is inflation expectations (and inflation) to increase and this is likely to keep long-term interest rates from falling so much.

And here is where I feel the central banks are not helping themselves. They are making two mistakes with what they are doing: in their messages about interest rates they do not distinguish clearly between nominal and real interest rates. What I want to do is to send a message that real interest rates will remain low for an extended period of time to ensure higher inflation ahead and to ensure that nominal interest rates increase in the future so that we can escape the zero lower bound. By talking only about nominal interest rates central banks are sending a signal that we will be stuck at the zero lower bound for a long time, a message that seems to be an admission of defeat. They cannot get out of this trap.

And this leads me to the second mistake of central banks: their asymmetric view of their inflation target. In the U.S., inflation and core inflation is slowly moving towards the 2 percent target. This is seen by some as proof that the zero lower bound or the deflation trap has been defeated. But this is the wrong reading. The fact that the federal funds rate remains so close to 0 percent means that we are still at the zero lower bound or close enough to it and we should not be complacent with what has been achieved. The US Federal Reserve should only call it a success when the federal funds rate is back to 3 percent or higher, safely away from 0 precent. But to get there we need to shoot for higher inflation, at least temporarily. The same message or even stronger applies to the ECB.

In summary, success in escaping the zero lower bound should be judged by how central bank interest rates manage to move away from 0 percent not by how long they stay at 0 percent. Central banks are not communicating this

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clearly because of the fear that this would be interpreted as a message of future tightening of monetary policy. But by doing so they are hurting their ability to escape the deflation/lowflation trap.

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