The Wall Street Journal August 19, 1994

What the Fed Can't Do

by Robert J. Barro

Recent debates between Congress and the Federal Reserve have an Alice-in-Wonderland flavor. Sen. Paul Sarbanes (D., Md.), among others, has criticized Fed Chairman Alan Greenspan for the recent increases in interest rates. The belief here is, first, that the Federal Reserve controls these rates, and second, that the Fed has chosen capriciously to raise them in order to choke off the economic recovery.

Mr. Greenspan's response seems to be to acknowledge that the Federal Reserve controls interest rates, but to argue that the increases in rates have been necessary to maintain low inflationary expectations. In this view, further increases in interest rates will be needed if the economy's growth becomes too rapid to be consistent with low inflation. (Unexplained here, or in most textbooks on macroeconomics, is why an expanded quantity of goods and services is supposed to raise the price level.)

Both views are mistaken about the nature of the recent increases in interest rates. The recent rise in real rates is a symptom of an improving economic situation and has nothing to do with Fed policy. Basically, real rates are high when growth prospects are good and investment demand is correspondingly strong.

In 1992 and 1993 real interest rates had been stuck around zero because of a weak world economy. Rates have since increased with global economic prospects, but the recent level of real rates, 1.9% to 2%, is not high by historical standards; it is just about the average since 1961. Real rates remain well below the average of 3% that prevailed during the period of high growth and robust investment from 1984 to 1989.

Mr. Greenspan could have told senators that the Federal Reserve lacks any strong or sure influence over expected real interest rates, even in the short run. These rates are determined by the interplay between the supply and demand of credit, determined by the willingness of people all over the world to save and their desire to invest.

Mr. Greenspan might also have argued that the Fed ought not to try to counteract fluctuations in real interest rates. Rather, the Fed 's mission is to ensure that these fluctuations occur against a background of low and stable inflation, the variable that it does control. In this respect, the Fed has been highly successful in recent years.

I guess the reason that Mr. Greenspan does not make these kinds of arguments (aside from the unlikely chance that he disagrees with my economic analysis) is that he would have to confess to possessing much less power than is generally assumed. He would have to acknowledge that the Fed is mainly a passive observer with respect to movements in real interest rates. In particular, given that the Fed managed in recent months to maintain low and stable inflation, he would have to say that the rises in short-term nominal rates were not separate policy decisions, but were rather constraints imposed by the world's financial markets. (Probably some senators would react to this confession by saying that if the current chairman lacks the power to control real interest rates -- in particular, to lower them -- then someone with more skill ought to be appointed to the job.)

Most economists think that investment responds more to long-term real interest rates than to short-term rates. But these long-term real rates are even less responsive than short-term rates to monetary policy. Even long-term nominal rates are difficult to control because they depend on long-term inflationary expectations. The Fed has a lot of influence over inflation and, hence over short-term inflationary expectations. But it has little power to affect beliefs about the distant future, that is, about the behavior of future Federal Reserve Boards and chairmen.

It is also hard to know how to divide observed long-term nominal rates – such as the 30-year government bond yield shown in the chart – into real rates and expected inflation. The problem is that reliable direct estimates of long-term inflationary expectations do not exist for the U.S. One imperfect method is to use the figures on long-term real interest rates for the United Kingdom. These data are available because the U.K. government issues indexed bonds (on which the payouts adjust automatically for changes in a retail price index), and the prices of these bonds provide direct information about real interest rates. (Perhaps the U.S. government will one day also issue indexed bonds.)

The chart shows the behavior of these long-term real rates since 1984. If the long-term real rate in the U.S. is similar to that in the U.K., then the difference between the 30-year U.S. government bond yield and the U.K. real rate provides a rough estimate of long-term expected inflation in the U.S.

Because the fluctuations in long-term expected inflation are usually much greater than those in real rates, the changes in the nominal yield are usually a good guide to the movements in long-run inflationary expectations. For example, the decrease in the 30-year bond yield from 13.4% in mid-1984 to 7.3% in mid-1986 corresponds to a fall in expected inflation from 10% to 3.9%. This period was crucial in the restoration of long-run credibility for low inflation.

In recent years, shifts in long-term real rates and in long-run expected inflation have contributed roughly equally to the fluctuations in the 30-year bond yield. From November 1992 to October 1993, the yield fell from 7.6% to 5.9%, while the real rate declined from 3.9% to 3.2% and expected inflation fell from 3.7% to 2.7%. Then, from October 1993 to today, the yield rose back to 7.6%, while the real rate returned to 3.9% and expected inflation advanced back to 3.7%.

The recent rise in long-term real rates is a good sign about the world economy. It suggests that long-run prospects for growth and investment are improved relative to those that prevailed last fall.

The news from higher long-term nominal rates is, however, not at all good. It also means that long-term expected inflation has risen by a full percentage point since last fall. This weakening of long-run credibility is disturbing, but it is unclear whether the Fed and its current chairman can counteract it.

The president and Congress have a little more long-term influence through their control over legislation and appointments. Apparently, the financial markets have examined this record and have decided to add another percentage point to the forecast of long-run inflation. I have no reason to quarrel with this prediction.

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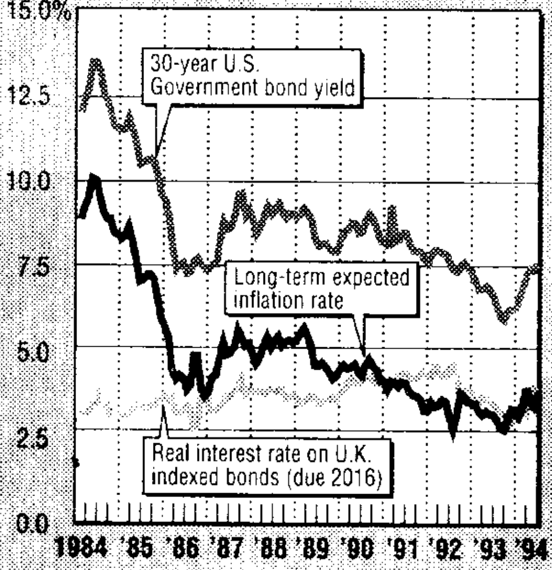
U.K. Bonds Yield a Clue

Long-term interest rates, annually



Source: Bank of England, Federal Reserve