Transcript of IMF podcast:

Ruchir Agarwal and Miles Kimball on Negative Interest Rates and Inflation

Bruce Edwards:

So what are negative interest rates?

Miles Kimball:

It's actually very simple. So we are used to the borrower, paying the lender for the use of money. Negative interest rates are simply when the lender is paying the borrower to take care of money. And believe it or not, this already happens. So a negative interest rate is not at all an impossibility, it just switches who pays whom.

Ruchir Agarwal:

So what we have been advocating in our research is to free up interest rates to be cut deeper into negative territory when needed. Now, part of the reason why central banks around the world have been slow in raising rates is because when they were hit by the pandemic shock, instead of cutting rates deeper into negative territory, they committed to keeping rates low. So once the inflation started rising quickly in an unexpected way, central banks had tied their hands up and so they ended up being behind the curve.

Bruce Edwards:

Welcome to this IMF Podcast. In this episode, why you can't talk about inflation without talking about interest rates... Above or below zero.

Miles Kimball:

One of the big advantages of negative interest rate policy is that it allows you to bring down inflation safely.

Ruchir Agarwal:

Hi, I'm Ruchir Agarwal. I'm an economist at the IMF.

Bruce Edwards:

Well, I asked him for a short introduction and that's what he gave me, but Ruchir's work delves into several aspects of our economic lives including our relationship with nature, and he also heads the IMF Global Health and Pandemic Response Taskforce.

Miles Kimball:

I'm Miles Kimball, I'm a professor of economics at the University of Colorado Boulder. And in addition to thinking about monetary policy, I work on cognitive economics which is a branch of behavioral economics on the border between psychology and economics.

Bruce Edwards:

That sounds like a whole other podcast (laughter).

Bruce Edwards:

We're talking about inflation today so let's just jump into this. So a lot of very influential economists warned of the risk of high inflation... And so here it is. Is it real, or is it a bit of a self-fulfilling prophecy, do you think?

Ruchir Agarwal:

Yeah. So Bruce, thanks for having us. We are currently seeing very high rates of inflation across most parts of the world today, and these high levels of inflation at least in advanced economies have not been experienced for several decades. So it is a painful reminder that inflation is indeed costly and it is very much real.

Bruce Edwards:

And so what's driving it, Miles?

Miles Kimball:

Well, a lot of things are driving it. But I think fundamentally, not just the fed, but other central banks were facing a shock they hadn't had a lot of experience with, with the pandemic. And so they were quite worried about having a repeat of the great recession. I mean, it wouldn't be exactly alike, but they were worried about having a lot of unemployment and so they leaned hard on the side of monetary stimulus. And so all of that, actually, I don't think Ruchir and I are critical of what the central banks have done in the past. Where we're very critical is their plans for the future, they ought to be raising their rates very fast right now.

Bruce Edwards:

Ruchir, would you agree with that?

Ruchir Agarwal:

Yeah. So let's break it down a little bit into what are the drivers, and then go back to, as Miles has talked about, what central banks should do. On the question of what's driving high inflation, I would say it depends on where you are in the world. But broadly, because of the disruptions caused by the pandemic, there has been large impact across global supply chains which has led into supply chain bottlenecks leading to sharp increase in prices. And a big impact of the pandemic was how we live and how we spend. A lot of us have been working from home, there's been a big shift of demand for goods away from services. And that combined with the supply chain bottlenecks basically led to a rapid rise in particular goods prices.

Ruchir Agarwal:

But now in the second phase of the pandemic, I would say, more recently, you start seeing the knock on effect on prices. So wages have started to go up now, and with the Ukraine war, what's happened is the food and energy prices have gone up substantially in large parts of the world. So when you take all these four or five effects together, you have a recipe for very high inflation that we've not experienced for a long time.

Bruce Edwards:

Yeah. And so Miles, I mean, you mentioned the action or inaction on the part of central banks. I mean, what could they have done to mitigate or prevent inflation getting to the level that it is today?

Miles Kimball:

Well, as I said, I think they mainly did the right thing in the past. In a situation where it's unprecedented and where you don't know what's going to happen and with inflation so low to begin with, you really want to avoid a big recession and that's your first order of business. But I think their plans for the next year or two are really way too stimulative, they should be planning to raise rates very fast.

Miles Kimball:

Now I'm very heartened that at a minimum that Jerome Powell said explicitly, "Look, we don't have a speed limit of a quarter of a percent rise in the interest rate, each meeting. But even at a half percent per meeting, I think it's behind the curve, and their plans are less than a half a percent per meeting over the next two years, and they ought to be going more than a half a percent per meeting up over the next two years. So they're planning to be much, much too stimulative and not reign things in quickly enough.

Bruce Edwards:

And so Ruchir, do you think that we'll still be talking about inflation at this time next year?

Ruchir Agarwal:

I think the chances are good that we are not going to go back to the low inflation of 2% that we were seeing before the pandemic, but a lot of the shocks will start to unfold as well. So broadly, the way we write about it in this inflation trilogy is the precise answer to that depends on both the nature of the shocks going forward, and exactly as miles has laid out, is how the central banks will respond to those shocks. Part of the additional uncertainty now is the very large increase in food and energy prices. So let me give you one interesting statistic.

Ruchir Agarwal:

If you look at much of the African continent and in other low income countries, food and energy makes up about 50% of the consumption basket in these countries. So the impact of the recent increase in food and energy prices because of the war is going to be quite sizable and may take a while to unpack.

Miles Kimball:

I think I'd say more strongly, absolutely, we will be talking about inflation 12 months from now. I mean, there's a fair bit of inflation momentum out there. Where Ruchir and I are more optimistic is that we still believe that the major central banks are determined to ultimately get back to their 2% inflation targets. They're behind the curve in their plans for the future, they're not planning to raise rates as fast as they should, but maybe 18 months from now, they'll really get serious and raise the rates enough to do the job.

Bruce Edwards:

Okay. So you mentioned the 2% inflation target that they've been looking at for quite some time now. Why should we be setting a target at 2% for inflation? I mean, why is that a good thing when most people think that higher prices are a bad thing? Why shouldn't we just be aiming for zero inflation?

Miles Kimball:

Well, we think you should, but to make zero inflation safe in terms of being able to deal with recessions, you have to have a genuine willingness to use robust negative interest rate policy, which, of course, Ruchir and I have been strong advocates for. And so one of the big advantages of negative interest rate policy is that it allows you to bring down inflation safely. So basically, if you have a deep recession, you need to be able to have interest rates quite a bit below inflation in order to get the economy back humming again.

Miles Kimball:

And so even if inflation is 2%, it's a problem if you're not willing to take interest rates below zero because you often need to be more like briefly, for even 6% below inflation in order to get the kind of stimulus you need, or sometimes even more depending on how bad the shocks are. And so the lower inflation is, the lower you need to be willing to go with interest rates. And there's nothing wrong at all with going to low interest rates, but it's not something that central banks have been used to.

Miles Kimball:

It was quite big news when some central banks were willing to go to minus three quarters of a percent on their interest rates, and that is an advance in policy, but you could have zero inflation and be fine if you were willing to go to substantially lower interest rates than that.

Ruchir Agarwal:

Perhaps I can give a bit of a background to Miles's answer as well. So Bruce, you asked why have central banks settled on a 2% inflation target in many advanced countries despite the public often thinking about inflation being costly? It is indeed very much the case that when you ask the general public about the costs of inflation, they report very high costs, even for moderate inflation like 2%.

Ruchir Agarwal:

So our part two of the trilogy is exactly about this issue is how costly is inflation? And we say that inflation actually is much more costly than typical economic models suggest. That raises the question which is exactly what you asked us, Bruce, why do central banks choose the 2% inflation target and not a 0% target or lower, right?

Bruce Edwards:

Yeah. The way that Miles is explaining it, it sounds like the 2% isn't enough to help central banks pull back from recessions anyway.

Miles Kimball:

Unless they're willing to use the robust negative interest rate policy, and so...

Bruce Edwards:

Which we haven't seen much of.

Miles Kimball:

Yeah. And a lot of it has to do with a myth that you can't do deep negative rates, and that's simply not true. I mean, there are quite reasonable modifications of paper currency policy that take care of the

paper currency problem. Ruchir and I and our other work on negative interest rate says there are kind of three problems. One is the paper currency problem, one which is readily solvable. Another is the bank profits problem which central banks already solved. It's really straightforward to attend to the financial health of banks.

Miles Kimball:

And then there's a political problem that people don't understand negative interest rates, and they're scared of them and that's where we're trying to be helpful. We think that the more we can talk about negative interest rate policy, the less of the irrational fears about it, there'll be

Bruce Edwards:

Sorry, Ruchir, I jumped in on you and you were about to answer the question why central banks have chosen 2% as a target.

Ruchir Agarwal:

Yeah. I guess one very simple thing that may not be always obvious to folks who are not macro economists is the concept of the real interest rate. The real interest rate is nominal interest rate less inflation. So it is the inflation adjusted interest rate. The issue is that the real interest rate has fallen over the last several decades. So whatever your nominal interest rate will be has to come down in line with the real interest rate.

Ruchir Agarwal:

And so when a central bank chooses a 2% inflation target, that means basically that allows the nominal interest rates to be higher than they will be otherwise. If on the other hand central banks choose a inflation target of 0%, then basically the nominal interest rates will be lower by on average two percentage points. And so then as Miles has laid out, what ends up happening is the chance of hitting what's called the zero lower bound which is the central bank's unwillingness to cut rates below 0% increases substantially. So to avoid that risk of hitting the zero lower bound, central banks have settled back early in the '90s on a number like 2%. That's why the 2% number came about.

Miles Kimball:

Yeah. Actually, I want to say something in relation to this real interest rate that's important. So first of all, number one, you need to be able to move interest rates a lot to stabilize the economy and being willing to go to deep negative rates is part of that, but also as Ruchir and I said in one of our pieces, we think now central banks should very quickly move to 7% or more in order to restrain inflation. So you need large interest rates in both directions, so that's the first point.

Miles Kimball:

But the second point is in this context of being willing to move interest rates a lot to stabilize the economy so you don't get either inflation or a recession, in terms of the average values, if the central banks end up trying to set an interest rate that's below the long run equilibrium real rate, then you'll wind up with hyperinflation ultimately. If you keep going for 10, 15 years, you'll definitely get to hyperinflation if you try to set the interest rate too low for too long.

Miles Kimball:

And if you set the interest rate too high for long, you're going to get another great recession, so it matters. What the central banks do has to be in line with the real interest rate that is beyond their control. The central banks can't control the long run real interest rate, they have to just deal with that and they have be able to move interest rates quite a bit above and below that to stabilize the economy.

Miles Kimball:

So with the long run real interest rate coming down, we desperately need to be able to do both negative interest rate policy and you need to be willing to raise rates quite a bit quite fast when you're in a situation as inflation areas we're in now.

Bruce Edwards:

So what do we do? I mean are there alternative approaches to this 2% inflation targeting practice that would leave both central bankers and people, consumers happier?

Ruchir Agarwal:

So if you look at the last 15 years of central banking, so this is since the great recession since 2007, 2008, if you compare what the central bank set interest rates were, right, so the Fed funds rate in the US, for example, compare that to what a Taylor rule type approach would suggest. So that's a rule which says what central bank should do. For much of these 15 years, rates have been either too high, so that's right after the great recession, or too low which is currently the case.

Ruchir Agarwal:

So if you go to the Atlanta Fed's website and look up their Taylor rule facility, the rule will suggest that interest rates should be above 7%. And there are various ways to estimate this, but many of these estimates will give you close to a number like 7%. So what Miles is saying is if you were to follow a rule-based approach, you would have cut rates deeper into negative territory right after the great recession and raise rates much faster now.

Ruchir Agarwal:

Now, why are we stuck in the current predicament and what can be done about it? That's your question, Bruce, right? What we have been advocating in our research is to free up interest rates to be cut deeper into negative territory when needed. Now, part of the reason why central banks around the world have been slow in raising rates is because when they were hit by the pandemic shock, instead of cutting rates deeper in the negative territory, they committed to keeping rates low for a long time until the economy is back to its full potential. So once the inflation started rising quickly in an unexpected way, central banks had tied their hands up and so they ended up being behind the curve.

Miles Kimball:

Yeah. I want to add something to what Ruchir had about the Taylor rule. So the Taylor rule actually isn't optimal monetary policy. What it is though, is something very interesting. The Taylor rule is a description of what the Fed reserve did, and there are similar descriptions for other countries, that the Taylor rule is a description of what the Fed did during several decades that what's called the great moderation, when it looked like we had the dream of relatively good aggregate demand management without a lot of inflation, without bad recessions. There'd be recessions, but they would be pretty mild.

Miles Kimball:

And so if you do the Taylor rule, even when the Taylor rule says negative rates, and even when it says to go up quite quickly to rates like 7% or 8% now, if you follow the Taylor rule, you can hope to get back to the great moderation. If you don't follow the Taylor rule, you probably won't get back to the great moderation and we're going to have bad results.

Miles Kimball:

Now that doesn't mean the Taylor rule is the very best thing. In fact, we think it might be good to raise rates even quicker and lower rates, even more than the Taylor rule says, but you want to do at least as much as the Taylor rule and we're not.

Ruchir Agarwal:

So what we are proposing is a robust negative interest rate policy by moving to an electronic money standard will allow central banks to move rates quickly in both directions down and up such that they don't end up being caught behind the curve in the future.

Bruce Edwards:

Miles Kimball and Ruchir Agarwal, it's always a pleasure. Thanks for this enlightening conversation about inflation, and I look forward to the next one.

Miles Kimball:

Thank you very much.

Ruchir Agarwal:

Thank you very much. Thank you, Bruce.

Bruce Edwards:

And stay tuned for part two of this series on inflation where we'll look at what an electronic money standard really means and how it would help central banks implement some of those things we discussed in today's episode.

Miles Kimball:

We probably already, in some sense, have an electronic money standard. If you're willing to go a little further and admit that paper currency is becoming secondary, and nudge things in that direction, then your paper currency problem goes away and you can do deep negative rates.

Bruce Edwards:

That's next time on IMF Podcasts. I'm Bruce Edwards, thanks for listening.