WEP Warwick Evans Publishing

Transactions on Economics, Business and Management Research
ISSN: 2960-1789, eISSN: 2960-2254 | Volume 13
BMMFT 2024

In The Face of Disinflation, Policymakers Are Hesitant to Reduce Interest Rates: is This in Line With Economic Theory?

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Abstract. This paper approaches the issue by first considering whether such reluctance to lower interest rates even in the face of disinflation is supported by standard economic theory. Expanding through Neo-Fisherianism and reflective equilibrium, this paper examines how counterproductive effects further interest rate cuts could be and whether scope exists for conventional monetary policies. Practical limitations are in line with Keynesian economics prescription on lower interest rates to boost demand. The zero lower bound and liquidity traps render such measures, while not limited to, an inadequate remedy for the ailment as revealed by the not-so-distant experiences during the 2008 credit crunch and current COVID-19 outbreak. The debate also embraces other influences from the globe concerning economics and politics, like exchange rate volatility and public faith in the role of central banks. Since further rate cuts magnify the risks and reduce potential returns, a more appropriate strategy would therefore be a mixed policy approach—to alternative instruments—entailing fiscal stimulus plus quantitative easing in view of disinflation. The paper concludes, therefore, that the cautious approach by policymakers is based on theory as well as on evidence; this therefore underlines the call that responses in policy need to be nuanced and specific to the context.

Keywords: Disinflation interest rates; Neo-Fisherian proposition; Zero lower bound (ZLB); Monetary policy.

1. Introduction

Disinflation has become a common phenomenon in those economies which have been affected by the 2008 financial crisis and later by the COVID-19 pandemic whereby, most of them have recorded disinflation despite having interest rates that are historically low. Using the Neo Fisherian proposition and the concept of reflective equilibrium, there are different possibilities of limitations and counterintuitive consequences of reducing interest rates. Moreover, operational factors such as lower bound of zero interest rate, fear of a financial crisis, and anchoring of long-term inflation rates are very relevant. In addition, global economic effects, opinion of the public, and political influences make the issues more complicating in terms of policy. Therefore, there is merit in not wanting to cut interest rates during disinflation as any perceived gains come with great risk and that is consistent with theory and empirics [1-3].

2. Economic Theory and Practical Considerations

2.1. Neo-Fisherian Proposition and Reflective Equilibrium

The Neo-Fisherian proposition gives incongruent rationale that lower nominal interest rates can result in lower inflation rates. This opinion is completely opposite to the Keynesian economics that called for formation of lower interest rates to induce inflation. García-Schmidt and Woodford emphasize that one may get a misleading result by using PFE models since they may support the Neo-Fisherian view [1]. In their stead, they introduce what is known as the notion of the reflective equilibrium through which agents build their expectations in a reflective manner and not through a process of foresightedness. This approach simply points out that though inflation and output should increase

with low interest rates, with other things constant, this impact might not be very large as PFE analyses argue [1].

A pertinent example of this theoretical nuance can be observed in Japan's economic experience since the 1990s. The Bank of Japan's persistent efforts to stimulate the economy through aggressive monetary easing have not yielded the anticipated inflationary pressures. This empirical evidence underscores the argument that the mechanisms underlying the Neo-Fisherian proposition and reflective equilibrium are more intricate than traditional models predict [4]. In the same way, disinflation became a common theme during and after the COVID-19 crisis and the 2008 financial crisis, even when interest rates were slashing and all sorts of rates were being fiddled with, thus debunking this common rule that lower rates cause higher inflation [2].

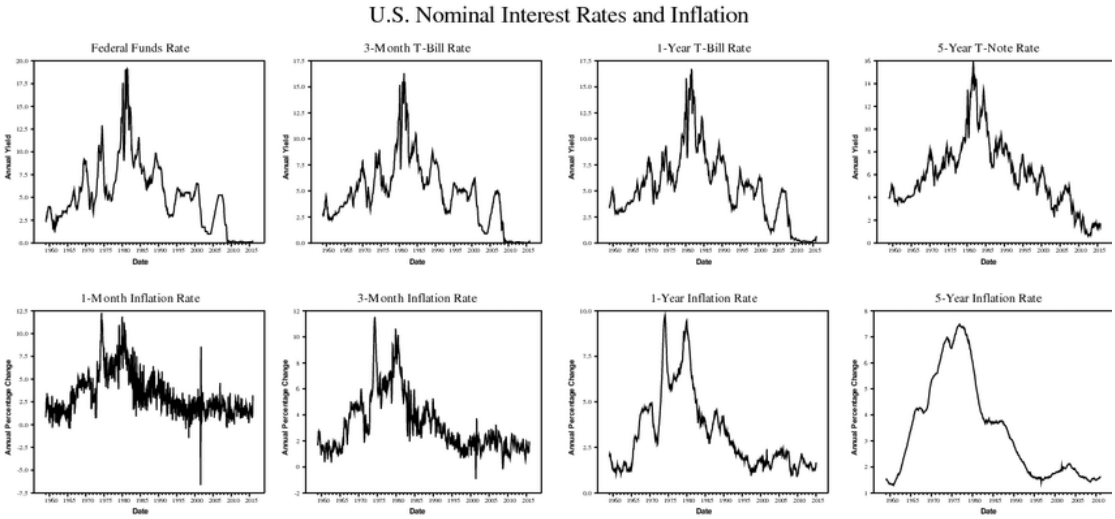

Figure 1. US Nominal Interest Rates and Inflation [5].

2.2. Traditional Keynesian Economics

According to the Keynesian economics, lowering interest rates should in turn increase the aggregate demand since the cost of borrowing is brought down hence increasing the consumption and investment to offset disinflation. However, in real life, Keynesian theory mostly supports rate cuts, but these practicalities like the zero lower bound and liquidity traps can hinder them [6]. If the interest rates are already low, then any reduction in the rates may not bring much result hence policy actions exhibiting diminishing returns. This scenario was seen during the 2008 financial crisis and the subsequent years when the Federal Reserve and the European Central Bank among others cut their rates to near zero. Figure 1 illustrates this by showing the relationship between US nominal interest rates and inflation during this period. Despite the drastic rate cuts, inflation remained subdued, demonstrating the limitations of traditional monetary policy in such contexts. However, many economies remained with low inflation and slow growth, which revealed that monetary policy alone was insufficient to solve the problem of disinflation [7].

3. Practical Constraints and Risks

The problem of the zero lower bound (ZLB) and liquidity traps presents major challenges that limit the effectiveness of further cuts in interest rates. When rates are close to zero, additional cuts may not lead to the desired increase in borrowing and spending. This problem was most apparent in the 2008 financial crisis and the COVID-19 pandemic periods. Even though central banks have cut rates to near zero, economic policy remained too weak [8]. These periods exemplify the problems of conventional monetary policy when facing the ZLB. Major central banks such as the Federal Reserve and the European Central Bank led in the use of deep interest rate cuts. However, these measures did not bring the expected economic recovery mainly because the rates were cut to such low levels that cutting them further did not have much effect on borrowing costs and, therefore, the economy [9].

However, where interest rates are close to zero, such as in a liquidity trap where people keep cash instead of spending or investing, these restraints arising from the ZLB are made worse. This is because in a liquidity trap even when interest rates are low, people will not borrow and spend more because of negative expectations about the economy or high levels of uncertainty. This was seen during the COVID-19 outbreak where due to fear and uncertainty of the virus, people increased their savings rates and decreased their consumption rates though the interest rates were relatively low [10]. Thus, the expected impact of low rates on the economy was considerably reduced.

4. Global Economic and Political Considerations

When interest rates are lowered, effects are felt on exchange rates and this causes competitive devaluations and shifts in trade balances. The Figure 2 shows how interest rate policies like that of ECB have affected the exchange rates of the different currencies. The negative interest rate policy of the ECB led to depreciation of the Euro and thus altering the trade relations by making exports from Eurozone cheaper and imports dearer [11].

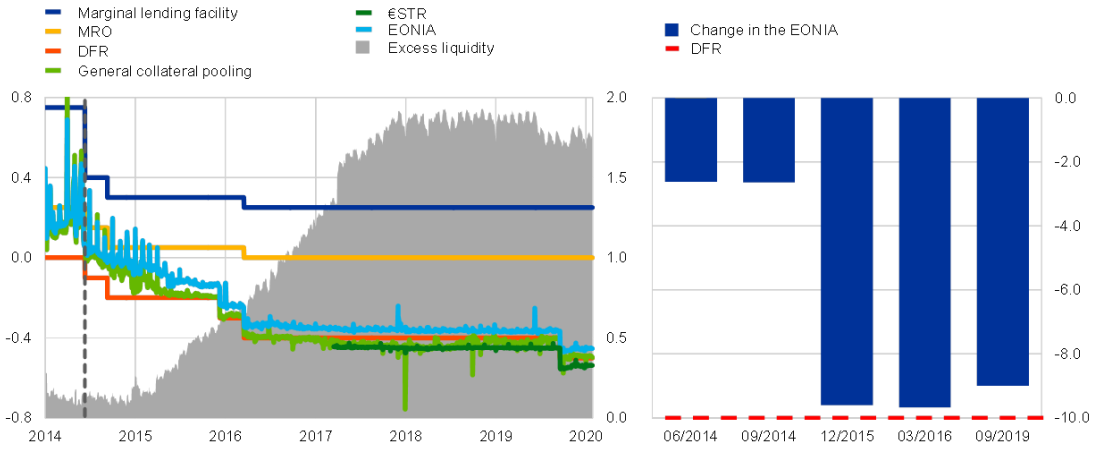

Figure 2. Short-term money market rates and excess liquidity [12].

Maintaining the public's confidence in the management of the economy is important. Deep interest rate cuts can be viewed as signs of panic, which in turn, can negatively affect economic expectations and limit people's trust to the central bank. Also, there are political factors because savers and borrowers have opposing interests when it comes to interest rate fluctuations. Savers may be against the rate cuts because savings yields are reduced while borrowers may be for rate cuts because borrowing costs are reduced. Blinder has pointed out that these complexities are the realities of policymaking that need to be managed to attain balanced and efficient economic management [13].

5. Alternative Policy Tools

Because of these and other drawbacks and potential dangers accompanying the further rate cut, the policymakers turn to other options. The fiscal policy which entails spending and taxing can directly reactivate the demand and support the monetary policy. For instance, the government's fiscal stimulus during the COVID-19 pandemic led to the U. S. economy's support, along with low interest rates. Another tool is quantitative easing in which the central banks buy financial assets to boost the monetary base and thereby reduce long-term interest rates. This approach was adopted by the Federal Reserve Bank and the European Central Bank after the 2008 financial crisis to restore sanity in the financial markets and spur the economy.

6. Conclusion

It will be seen that economists' caution against further cuts in interest rates in the light of disinflation is underlined by both theory and real-world factors. The theoretical literature, especially García-Schmidt and Woodford offers both, argumentation for and against cutting interest rates, however,

realities of the economic and financial world including the ZLB, financial stability, and global effects call for prudence. Hence, although it is possible to disinflation by reducing rates as shown above, it is equally important to have a policy mix that matches the situation and is not a one size fits all approach.

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