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Discussion

Comment on: "Using a long-term interest rate as the monetary policy instrument"☆

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Abstract

The use of a long-term interest rate as the instrument of monetary policy would not have the advantage, sometimes claimed for it, of relaxing the constraint on what can be achieved by monetary policy when the zero lower bound on short-term interest rates is reached. The proposal would also seem an impractical one to implement.

McGough et al. (2005) entertain the proposal that the Fed might use a long-term bond rate as the instrument of monetary policy, rather than the federal funds rate as at present. It is not entirely clear what such a proposal would imply in practice; but at the very least, it would mean that the Fed would have a view at each point of time regarding the appropriate level of bond prices (given other economic conditions at the time), and would use the means at its disposal to seek to bring bond prices in line with this view. Most of the paper is concerned more specifically with an analysis of the properties of Taylor-type rules for monetary policy, in which an operating target for a longer-term interest rate (rather than a very short rate, as in Taylor's original formulation) is a linear function of current inflation.

The idea that the Fed might wish to target a long bond yield, and perhaps even directly intervene in the market for Treasuries to achieve such a target, was discussed a great deal in early 2003, as the federal funds rate fell to a historically low level.[1] It was proposed that

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[1] Bernanke (2002) was one of the first to raise this possibility.

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intervention to lower long rates could provide a possible source of additional monetary stimulus that would not require further reductions in the current level of overnight interest rates. Similar proposals have often been urged upon the Bank of Japan in recent years, where deflation continues despite an overnight rate that has essentially been equal to zero for several years. It is therefore of particular interest to ask whether a policy that targets a long bond yield would lead to improved outcomes in the case of an economy where the zero lower bound on interest rates becomes a binding constraint on what can be done with a short-term policy instrument such as the federal funds rate.

1. Would a long-rate instrument increase the set of possible equilibrium outcomes?

The idea that use of a long rate as the instrument of policy would allow greater scope for effective monetary policy under at least certain circumstances, when the room for further stimulus using an overnight-rate instrument is constrained, seems to presume that there is a set of outcomes that would *not* be attainable using the overnight-rate instrument, because they would require the overnight rate to be negative, but that would nonetheless be attainable using a long-rate instrument. The argument usually given is that long rates are observed still to be positive even when (as in Japan in recent years) overnight rates have already hit the zero bound; under such circumstances, it is argued, there is no further possibility of stimulus using the overnight-rate instrument, while it would evidently still be possible to stimulate the economy by lowering long rates.

But the constraint on the possible equilibrium paths of inflation and output owing to the existence of a zero lower bound on nominal interest rates, derived in papers such as Eggertsson and Woodford (2003), has nothing to do with the assumed use of a short-term interest rate as the instrument of policy. A given state-contingent evolution of the economy implies a particular path for the short-term nominal interest rate; and this must be non-negative at all times. A well-defined, and non-negative, equilibrium short-term interest rate must exist even when a long rate is used as the policy instrument, and the constraint on the set of possible equilibria remains the same.

Moreover, the zero lower bound for short rates implies a lower bound for long rates as well, given expectations about the future conduct of policy. And when it is expected that policy will be conducted in the future in a way that implies that short rates will not be zero in all states of the world, the implied lower bound on long rates can be higher than zero, as illustrated by Eq. (2.9). Thus, the mere existence of a positive long rate need not imply the possibility of further stimulus through open market operations, including open-market purchases of long-maturity bonds. Once short rates have fallen to zero, Eggertsson and Woodford (2003) show that open-market operations have no effect on long *or* short rates (or on inflation or real activity, either), if the open-market operations do not imply any change in the rule according to which policy is expected to be conducted in the future. Committing to an alternative future approach to monetary policy *can* stimulate the economy, even when short-term interest rates are zero; but that is possible even in the case that the instrument of policy is an overnight rate.

2. Is a long-rate instrument a substitute for history-dependent short-rate policy?

The authors' discussion states clearly that they do not assume that adjustment of a long-rate instrument can accomplish anything that could not also be accomplished through a