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Macro Roundup Article

Headline: Expectations and the Neutrality of Interest Rates, Final Version

Article Link: https://www.grumpy-economist.com/p/expectations-and-the-neutrality-of-9e7

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Tweet: .@JohnHCochrane argues that recent events support the fiscal theory, which implies that high interest rates ultimately raise, not lower, inflation.

Summary: The zero bound, QE, and the post-covid inflation amount to dramatic experiments, about as clean as you can ask for in economics, to distinguish our main theories of inflation. With the new-Keynesian + FTPL view, inflation is stable, determinate, and long-run neutral under an interest rate target. It works much like a money growth target: inflation eventually settles down to the nominal rate plus real rate, as it settles down to money growth. That prediction seems natural, but has a very uncomfortable implication that I have been wrestling with for years. If at zero rates inflation just bats around zero +/- a small real rate, then inescapably if the central bank raises the peg to 2% interest rate, inflation would eventually rise by two percentage points. It might go the other way in the short run, and the short run might last a long time, but the proposition that a perpetually higher rate means perpetually higher inflation, eventually, just flows from stability and (even approximate) neutrality.

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Primary Topic: Financial Markets

Topics: Financial Markets, GDP, Monetary Policy, Op-Ed/Blog Post

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