The Daily Dish

About Those Long and Variable Lags

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This may be the high-water mark of general interest in the making of monetary policy. A 40-year high in inflation, a record pace of interest-rate hikes by the Federal Reserve, and a few bank failures tend to focus the mind. And the key questions are always the same: How much impact have the Fed hikes had on inflation and growth? How much additional impact will occur even if the Fed stops raising rates? How fast will inflation return to the 2 percent target?

The answer usually invokes Milton Friedman's dictum that monetary policy works with a long and variable lag. A recent research paper from the San Francisco Federal Reserve Bank puts some empirical meat on the bones of that argument. Specifically, the authors find that interest-rate increases have effects lasting over a decade: "We find that these long-run effects develop primarily through investment decisions that ultimately result in lower productivity and lower capital stock than would be available without policy intervention…These productivity effects persist for at least 12 years following a period of monetary policy tightening." For example, in response to a 1 percent interest-rate increase, real gross domestic product would be about 5 percent lower after 12 years.

This is interesting for three reasons. First, it suggests that past tightening will continue to have effects going forward and that the key impact is on business investments, as opposed to residential mortgages, car loans, or other interest-sensitive household purchases. And recall that a business investment slump is the early indicator of recession in the postwar United States.

Second, nobody expects it to take 12 years to get back to the 2 percent target. This means that long after policy has returned to neutral, the impact of restrictive monetary policy will still be felt. In contrast, most analysts assume that monetary policy stops influencing the path of the economy once it is back to neutral.

Third, the impact is not symmetric. One might think that the Fed could cut rates, boost investment, and undo the negative impacts. The paper finds "a central bank might not be able to undo the long-run effects on the economy's potential by running the economy hot." As usual, there is no free lunch. If you want to get rid of inflation, you have to pay a price.

Most observers expect the Fed to be on hold at its September meeting. But this research and a hot inflation report could make the November meeting very interesting.