The Seoul Economic Daily Special Feature
Interview with Paul Sheard, Research Fellow, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School
Interviewer: YoungPill Kim, New York Correspondent
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1. Rate Hikes

At the FOMC meeting in June, the Fed predicted that this year's PCE would rise 3.4% year-over-year. Chairman Jerome Powell said "Inflation has increased notably in recent months. And bottleneck effects have been larger than anticipated".

Given the inflation figures and Chairman Powell's remarks, when do you think the Fed will raise rates? The dot-plot shows two hikes in 2023. But St. Louis Federal Reserve President James Bullard said he expects rate hikes in late 2022.

The Fed is unlikely to start raising its target range for the federal funds rate (currently zero to a quarter of a percent) any time soon and probably not until 2023, assuming there are no negative economic shocks in the interim. The Fed has announced that two conditions will need to be satisfied before it will consider hiking rates: labor market conditions will need to have reached a level consistent with its assessment of full employment and its target PCE (personal consumption expenditures) inflation will have reached 2% and be expected to be moderately above 2% for some time, to make up for past inflation shortfalls. The unemployment rate in June was 5.9% and the Fed's current (FOMC median) estimate of the unemployment rate consistent with full employment in the long-run is 4.0%, and it expects the unemployment rate to go considerably lower than that in the medium term. Other measures suggest even more spare labor resources, notwithstanding record job offers: a closely watched measure of un-/under-employment, at 9.8%, is still three percentage points above its pre-Covid low.

As for inflation, the Fed regards the current jump in consumer price inflation to be transitory and to be due to a combination of unfavorable base effects (inflation was pushed down last year by the Covid-19 shock) and temporary supply bottlenecks and labor market glitches as the economy fully opens up and the return of strong demand outstrips supply in some areas.

As these factors are eased and reverse in coming months and into next year, the Fed expects inflation to fall back and to run at a rate which falls short of the condition it has set to begin hiking rates.

Before starting to hike rates, the Fed will first start to taper its monthly purchases of Treasury securities and agency MBS (mortgage-backed securities), currently $80 billion and $40 billion, respectively. For this to happen, the Fed has said that it needs to see "further substantial progress" towards its full employment and price stability goals. The Fed is likely to follow the playbook it developed to unwind its earlier rounds of QE: first, give the markets a heads-up that it is close to deciding to begin tapering its asset purchases and then start to reduce the amounts over several meetings; then it will keep its balance sheet roughly constant in size until it starts to raise rates, and start to shrink its balance sheet gradually after that process is well underway.

In terms of trying to divine the future policy moves of the Fed, the statements of the Chair, in particular, but also the Vice Chair and other members of the Board of Governors, should be accorded more weight than those of other Federal Reserve Bank presidents, except for those of the President of the New York Fed

2. Taper Tantrum

The US economic rebound and inflation are driving interest rate hikes around the world. Notably, the Fed has started discussing tapering. Can we avoid the taper tantrum of 2013? Will there be a crisis in emerging markets?

The so-called "taper tantrum" was an overblown story. It refers to the fact that 10-year treasury yields rose about 90 basis points in three months or about 120bp in six months in 2013 after then Fed Chairman Ben Bernanke started to send signals that the Fed was starting to think about reducing the size of its monthly purchases of Treasury securities and agency MBS (then $45 billion and $40 billion, respectively), which it started to do in December of that year. Looking at a long-term chart of 10-year treasury yields today the "taper tantrum" is hardly noticeable among the normal volatility of yields over time. What surprised the Fed and many observers at the time was that just the hint of a change in policy in the future was enough to cause yields to shoot higher. The conundrum for monetary policy is that the yield curve has to serve double duty: both transmitting monetary easing and reflecting its success.

Those two forces push in oppositive directions, which can lead to volatility from time to time when something tips the balance, in the taper tantrum's case that being the all-powerful Fed chairman delivering a new key message.

Given how low yields currently are it would not be a surprise for them to start to move higher, perhaps sharply so, when the Fed signals that it is gearing up to taper and then completely stop its Treasury security and agency MBS purchases. Such a move should be seen as a natural adjustment as a key plank of treasury market buying support is removed and the bond market starts to factor in further removal of extraordinary monetary policy support for the economy in the future.

Treasury yields moving higher can impact global financial markets including particularly emerging markets, but there is no reason to expect a change in Fed policy to trigger a crisis in emerging markets, certainly not a widespread one. If and when the Fed is able to start to normalize its stretched unconventional monetary policy settings, it will be because the US economy has recovered and is growing strongly, which would be good news for emerging markets too.

3. Treasury Yields

Although the Fed is becoming more hawkish and inflation concerns have grown, the yield on 10-year Treasuries are low. It is still below 1.5%. What's going on in the Treasury market?

The low treasury bond yields reflect the very accommodative monetary policy settings of the Fed and the assessment of bond market participants that monetary policy is set to remain highly accommodative for a good while, despite the recent, almost certainly temporary, jump in inflation.

In theory, the 10-year treasury yield should reflect the market's expectation of the future path of short-term interest rates together with a term premium (for treasuries any risk and liquidity premiums can be expected to be negligible). The lower the federal funds rate and the longer it is expected to remain low, other things equal, the lower the 10-year treasury yield. The federal funds rate has averaged just 0.63% in the past ten years and the Fed now sees the neutral rate for the federal funds rate – the rate expected to prevail when the economy is at full employment and monetary policy has been fully normalized – to be about 2.5% (150-

200 basis points lower than it estimated a decade or so ago). The Fed is signaling that it plans to keep the federal funds rate close to zero at least until 2023 and the Fed's large-scale purchases of treasury securities are intended to put downward pressure on the term premium. From both angles, it not too surprising that treasury yields are so low.

4. Debt Ratio

The federal government's debt-to-GDP ratio has exceeded 100% of GDP. After 30 years, it is expected to exceed 200%. Is this a sustainable? Is there an appropriate level of the debt-to-GDP ratio in your opinion?

Economists, policymakers and the public need to change the way they think and talk about government debt and fiscal sustainability. A debt-to-GDP ratio of 100% sounds worrisome but what it means is that the stock of government debt is equivalent to one year of that country's GDP. This is an apples (stock) and oranges (flow) comparison and is almost meaningless. It means that, were the government to have to pay off all of its debt at once, it would have to requisition one year's worth of GDP; for a government with an indefinite life span, spanning generations, one year is not much. But the government is not like a household and never actually has to repay its debt in the sense that a private sector borrower has to, any more than the US government has to repay a twenty-dollar bill.

The stock of government debt equals cumulative prior government deficits and represents one source of the purchasing power (money) that the economy needs in order to function. Government debt allows its holders to accumulate purchasing power and transfer it into the future. The policy issue, when debt levels are high, is whether at some point in the future too much purchasing power will be unleashed into the economy at once, causing inflation. That would be the cue for monetary and fiscal policy to be tightened,. The government might have to raise taxes, not to raise the revenue to pay down its debt, but to rein in demand in an overheating economy.

For the US and other major economies, government budget deficits and debt levels should not be policy targets but rather should be viewed as policy instruments, the aim of which is to help keep the economy at full employment with price stability.

4a. Fiscal policy in the early stages of COVID-19 helped a lot in overcoming the crisis. But countries that are not reserve currencies, including South Korea, should pay more attention to debt management. What do you think?

South Korea should not put the (fiscal) cart before the (growth) horse. It should see fiscal policy as a means to an end, not as an end it itself.

South Korea is now one of the leading economies in the world. It is the tenth largest economy in nominal terms and number 14 in terms of purchasing power parity (PPP). Per capita GDP is 51% of the US level (81% of Japan's) or 69% in PPP terms (5% above Japan's). South Korea's real GDP in the pre-Covid decade averaged 3.3% per annum, compared to 2.3% for the US and 1.2% for Japan. South Korea's current account surplus in the past ten years has averaged 4.9% of GDP, helping to make South Korea a significant net creditor to the rest of the world.

South Korea's monetary and fiscal policies should aim to deliver macroeconomic stability and provide a favorable backdrop for growth-enhancing structural reforms and other government policies. When it come to debt management, unlike the 1997 Asian financial crisis, South Korea does not have to be at the mercy of international financial markets. South Korea is no longer an "emerging market." It should focus on bolstering its monetary sovereignty and on increasing its attractiveness to international investors, joining the ranks of the likes of Japan, Australia, Canada and New Zealand as countries boasting mini-reserve currencies.

5. Economic Inequality

Income and wealth inequality has increased during the COVID-19 pandemic. In particular, house prices are rising rapidly. In my view, an accommodative monetary policy tends to widen economic inequality. How do we solve income and wealth inequality after COVID-19?

Monetary policy works by influencing financial conditions, easing them to try to stimulate economic activity or tightening them to try to rein it in. Monetary policy easing, particularly QE, can widen income and wealth inequality: for instance, in the US the unemployment rate, at 5.9%, is still 2.4 percentage points above its pre-Covid trough and the labor force participation rate is 1.7pp lower, meaning hardship for many lower income people, while the S&P500 is 28% above its pre-Covid peak, meaning good times for wealthy investors.

But two wrongs don't make a right: the fact that monetary easing exacerbates inequality, while helping to dig everyone out of an economic hole, doesn't mean it should not be used. Rather it is an argument for revisiting the division of labor and "balance of power" between monetary and fiscal policy and for better coordinating their separate and joint mobilization. Appropriately designed fiscal policy can complement monetary policy easing and offset some of its inequality-exacerbating aspects.

House prices rising during and in the wake of the biggest negative hit to economic activity in modern times has been one of the big surprises in the Covid-impacted economy. Easy monetary policy has likely played some part, although more in terms of offsetting the downward pressure on house prices stemming from a deep recession and suppressed economic activity. The rise in house prices would seem to reflect mainly demand and supply changes driven by Covid, as lockdowns and telework have increased the demand for residential space, including second or third houses for the more affluent, while constricting new supply at the same time. Again, to the extent that rising housing prices present public policy challenges, such as stymieing the ownership aspirations of first-time home buyers, or raising financial stability risks, these are better addressed by fiscal policy and macroprudential policy, respectively.

6. Productivity

COVID-19 has had a large impact on the labor market. Although the number of jobs in the US has continued to increase recently, the structural problems of the labor market have not changed. Also, zero interest rates allow zombie companies to survive. What can be done to increase productivity after COVID-19?

Productivity is important because it drives rising living standards over time. Labor productivity usually falls in a recession, because of "labor hoarding" (output falls faster than companies cut their workforces), and rises in a recovery. Once the economy is at full employment, productivity is driven by technological innovation, by using more capital and capital that embodies better technology, and by the competitive market mechanism whereby resources tend to move from less to more efficient uses.

The experience of Covid-19 is likely to lead to permanent structural changes both on the demand and supply sides of the economy, as Covid leaves its mark on consumer behavior, work and travel patterns, and on the digital and virtual economy. Macroeconomic policies that help economies get back to full employment as quickly as possible and structural policies that promote innovation and flexible and efficient allocation of labor and capital resources are needed. Targeted policies to help students and workers make up for lost education and training opportunities and equip them for a more digital world may pay off over the longer term.

I have never been convinced by the “zombie company” argument that easy monetary policy keeps too many weak companies on life support and impedes productivity growth. There may be an element of this, but it is not a first-order economic factor. There has been too much reliance on monetary policy and too little on fiscal policy in recent recessions: once monetary policy gets close to or hits the zero interest rate bound it is time for fiscal policy, supported by monetary policy, to take up the reins of stimulating demand. A different mix and better coordination of monetary and fiscal policy would get economies back to full employment faster. The main side effect of over-reliance on monetary policy is that economic activity remains too weak for too long, leading to higher economic costs losses being incurred than necessary and impeding longer term potential growth via weaker investment and the atrophying of worker skills. While there are some subtle inter-linkages, the job of monetary and fiscal policy is to boost demand in the short- and medium-term and that of supply-side policies to improve productivity performance over the longer term. The two – demand management and supply-side policies – are complementary, not at odds with one another.