

Nominal rates matter

François Geerolf, OFCE-Sciences Po and UCLA¹

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Abstract

It is widely believed that only real interest rates matter for economic decisions. This belief shapes both macroeconomic models and policymaking. For example, “neutral” interest rates which guide many central banks decisions are real interest rates, and monetary policy is considered to be more accommodative when real interest rates are lower. This paper argues that nominal interest rates also matter, independently of real interest rates. First, nominal interest rates have strong effects on the housing market both with adjustable-rate (through disposable income) and fixed rate mortgages (through borrowing limits). Second, nominal interest rates can also play an important role on corporate investment that relies on bank funding. Third, interest rates also matter in the Eurozone because of fiscal rules which take into account interest payments as a percentage of GDP and not inflation. These three effects shed new light on some historical episodes such as the 2007 financial crisis, the 2010-13 Eurozone crisis, and shows that monetary policy is more restrictive in the current inflationary environment than is commonly believed.

Keywords: Monetary policy, housing, fiscal rules

JEL codes:

Introduction

What is the current stance of monetary policy?

Macroeconomic models have many problems but most of these problems revolve around the issue of magnitudes. This problem is different: . This makes it much more problematic because central bankers mostly rely on heuristics when setting monetary policy. Macroeconomic models are so complex

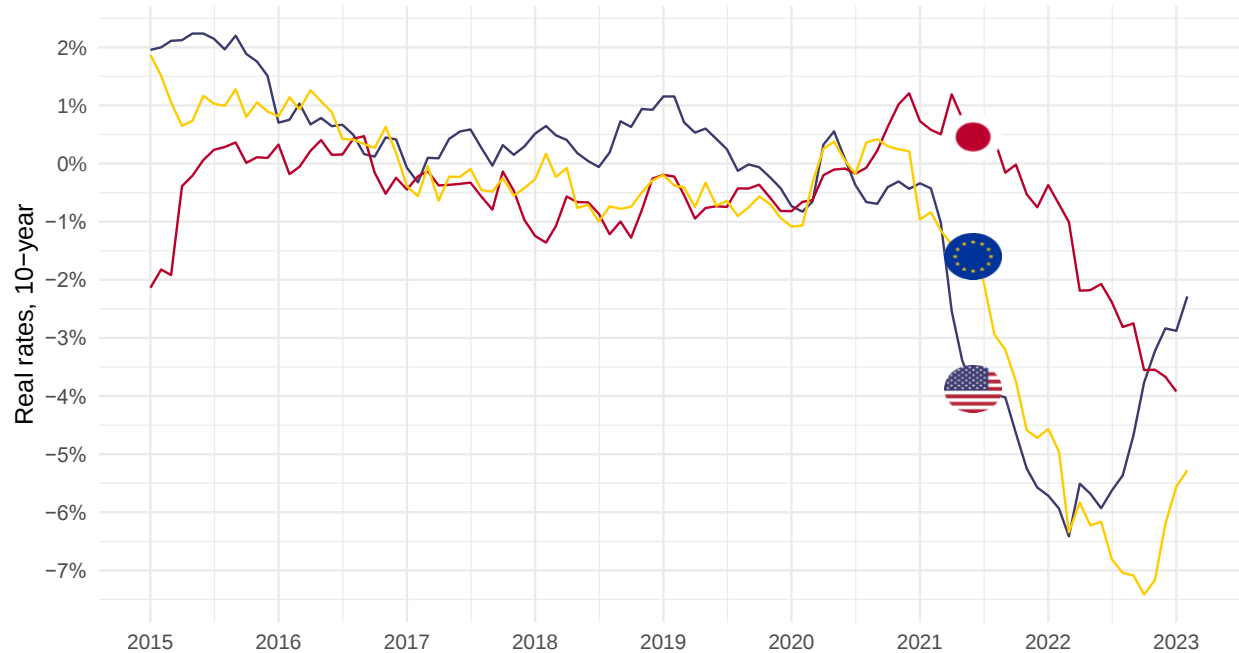
This article discusses the approach in Bachmann et al. (2022) and Baqaee et al. (2022). It argues that these papers are very problematic from a methodological point of view and strongly biased towards finding small effects of a natural gas embargo. Overall, this article argues that Olaf Scholz was correct in saying that the mathematical models which were used “don’t really work” here and do not permit such categorical statements. Section 1 discusses the simplest “production function approach”. This is a natural starting point, since this approach is used in the Bachmann et al. (2022) paper to compute worst-case scenarios, and the concept of an elasticity of substitution is central to the whole discussion. Section **Error! Reference source not found.** then discusses the more sophisticated “Baqaee-Farhi approach” that arrives at the figure of 0.2-0.3% of GDP, the main bottom line of their follow-up paper. Section **Error! Reference source not found.** discusses the “sufficient statistics approach”, and finally section **Error! Reference source not found.** provides more general remarks prompted by this study and concludes.

1 The macroeconomic production function approach

1.1 Computing the % change in GDP

¹ This is

Figure 1: Data on real 10-year Government Benchmark bond yield as published by the ECB



1.2 Examples with Jean-Claude Trichet

Historical precedents: Trichet's increase in interest rate in 2011. Both a misconception in diagnosis: no, monetary policy was not particularly accommodative in 2011 before Jean-Claude Trichet decided to hike interest rates. And moreover, most of the effect of monetary policy fed through

Another question revolves around

Bibliography