Junayed, Sadaquat; Khan, Hashmat

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Inventory Investment and the Real Interest Rate

Sadaquat Junayed and Hashmat Khan
Carleton University

Abstract
The relationship between inventory investment and the real interest rate has been difficult to assess empirically. Recent work has proposed a linear-quadratic inventory model with time-varying discount factor to identify the effects of real interest rate on inventory investment. The authors show that this framework does not separately identify the effects of real interest rate on inventory investment from variables that determine the expected marginal cost of production. Consequently, understanding the relationship between inventory investment and the real interest rate continues to be a challenge for macroeconomists.

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Correspondence
Hashmat Khan, Department of Economics, Carleton University, D891 Loeb, 1125 Colonel By Drive, Ottawa, K1S 5B6, E-mail: Hashmat_Khan@carleton.ca.
1. Introduction

Business reports and financial media often link higher interest rates to lower inventory investment by firms. In contrast, the academic literature has found little influence, if any, of a relationship between real interest rates and inventories. This discrepancy led Blinder and Maccini (1991) to note that

It is not clear whether the trouble is with the theory or with the empirical tests...Whatever the reason, the question of why inventory investment seems insensitive to changes in real interest rates remains open, important, and troublesome.

One channel by which the real interest rate may influence inventory investment is via the discount factor. But in the linear-quadratic framework with Euler equation estimation, authors have typically assumed a constant discount factor to facilitate estimation of structural parameters associated with other important issues. See, for example, West (1986), Eichenbaum (1989), Ramey (1991), and Ramey and West (1999). In the production function literature, authors have allowed for a variation in the real discount factor but have either found no evidence or some evidence of a relationship between the real interest rate and inventories. See, for example, Miron and Zeldes (1988), Ramey (1989), Kahn (1992), and Bils and Kahn (2000).

In a recent paper, Maccini et al. (2004) propose a modified linear-quadratic inventory model with time-varying real discount factor. They show that in the linearized Euler
equation of this model the real interest rate enters with its own coefficient, which is then parametrically estimated. A key motivation behind this approach is that one could potentially estimate the structural parameters determining the real interest rate-inventory relationship, thereby overcoming the criticisms of the earlier reduced-form literature (see, for example, Akhtar (1983)).

We show that in the linear-quadratic model of inventories with time-varying real discount factor, the real interest rate does not enter the Euler equation with its own coefficient under the model’s restriction. This restriction implies that the coefficient on the real interest rate in the model depends on structural parameters. When this restriction is explicitly taken into account, the coefficient on the real interest rate cannot be parametrically estimated. As it turns out, in the linear-quadratic framework with time-varying discount factor, the effects of expected real interest rate movements on inventories cannot be separately identified from the variables determining expected marginal cost. We provide the intuition for this result. The implication is that for understanding the relationship between inventory investment and the real interest rate (in either short- or long-run), the linear-quadratic framework with time-varying discount factor does not offer any particular advantage relative to the earlier reduced-form literature.

2. The model

To illustrate our main point, we consider the linear-quadratic inventory model with time varying real discount factor proposed by Maccini et al. (2004). A representative firm
minimizes the present value of its expected per-period real costs, \( \{C_0, C_1, \ldots, C_t, \ldots\} \) at time \( t = 0 \). In any given period, \( t \), these costs are assumed to be quadratic and given as

\[
C_t = \xi W_t Y_t + \frac{\theta}{2} Y_t^2 + \frac{\gamma}{2} (\Delta Y_t)^2 + \frac{\delta}{2} (N_{t-1} - \alpha X_t)^2
\]

(1)

The first and the second terms in (1) represent production costs, the third term represents adjustment costs associated with changing output levels (e.g., hiring and firing costs), and the last term represents the conventional accelerator term reflecting a balancing of inventory holding and stockout costs. Real costs depend on two endogenous variables, namely, real output \( Y_t \), and beginning-of-period \( t \) real finished goods inventories, \( N_{t-1} \). They also depend on two exogenous variables, namely, \( W_t \), a real observable cost shock due to variations in input prices, and \( X_t \), real sales. There are five structural parameters denoted as \( \theta, \gamma, \delta, \xi, \) and \( \alpha \) which are all positive. \( \Delta \) is the first-difference operator.

From (1), the marginal cost is given as

\[
MC_t = \theta Y_t + \xi W_t
\]

(2)

For a given period, the change in inventory, or the inventory accumulation constraint, is simply the difference between production and sales. The real discount factor, \( \beta_t \) is time-varying and defined as \( \beta_t = 1/(1 + r_t) \), where \( r_t \) is the real interest rate. Formally, the firm’s optimization problem is to choose \( N_t \) by minimizing the present discounted value of real expected costs

\[
\min E_0 \sum_{t=0}^{\infty} \prod_{j=0}^{t-1} \beta_j C_t \quad \text{subject to} \quad \Delta N_t = Y_t - X_t
\]

(3)
The first order condition of (3) gives the inventory Euler equation

\[ E_t \{ \theta (Y_t - \beta_{t+1} Y_{t+1}) + \gamma (\Delta Y_t - 2\beta_{t+1} \Delta Y_{t+1} + \beta_{t+1} \beta_{t+2} \Delta Y_{t+2}) + \xi (W_t - \beta_{t+1} W_{t+1}) + \delta \beta_{t+1} (N_t - \alpha X_{t+1}) \} = 0 \] (4)

Linearizing (4) around the steady state values \( \{ \overline{\beta} = \frac{1}{1+r}, \overline{Y}, \overline{W}, \} \) we get

\[ E_t \{ \theta (Y_t - \overline{\beta} Y_{t+1}) + \gamma (\Delta Y_t - 2\overline{\beta} \Delta Y_{t+1} + \overline{\beta}^2 \Delta Y_{t+2}) + \xi (W_t - \overline{\beta} W_{t+1}) + \delta \overline{\beta} (N_t - \alpha X_{t+1}) + \eta r_{t+1} + c \} = 0 \] (5)

where \( \eta = \overline{\beta} (\theta \overline{Y} + \xi \overline{W}) > 0, \) \( c = -\overline{r} \overline{\beta} (\theta \overline{Y} + \xi \overline{W}) < 0. \) The Euler equation (5) forms the basis of Maccini et al. (2004)’s short- and long-run empirical analysis.

3. Effect of interest rate

Imposing the model’s implied restriction \( \eta = \overline{\beta} (\theta \overline{Y} + \xi \overline{W}) \) in (5) gives the linearized Euler equation under time-varying discount factor as

\[ E_t \{ \theta (Y_t - \overline{\beta} Y_{t+1} + \overline{\beta} \overline{Y} r_{t+1}) + \gamma (\Delta Y_t - 2\overline{\beta} \Delta Y_{t+1} + \overline{\beta}^2 \Delta Y_{t+2}) + \xi (W_t - \overline{\beta} W_{t+1} + \overline{W} r_{t+1}) + \delta \overline{\beta} (N_t - \alpha X_{t+1}) + c \} = 0 \] (6)

From (6), it is evident that the real interest rate does not have a separate coefficient in the Euler equation when the discount factor is allowed to vary over time. The influence of expected real interest rate on inventories is captured by the two structural cost parameters \( \theta \) and \( \xi \) which determine the slope and the level of marginal cost, respectively. The intuition behind this is that the real interest rate acts as a shock to future marginal

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costs of the firm. To see this, we can isolate the terms involving future output, cost
shock, and the real interest rate in (6), and denoting the effective expected marginal
cost as $\tilde{MC}_{t+1}$, write

$$
\tilde{MC}_{t+1} \equiv \theta \beta (Y_{t+1} - Y_{t+1}^r) + \xi \beta (W_{t+1} - W_{t+1}^r)
$$

using (2) (one period ahead) where $MC \equiv (\theta Y + \xi W)$. A higher expected real interest
rate, for example, lowers the effective expected marginal cost. This makes producing an
additional unit of output less costly tomorrow. As a result, firms choose to lower their
current buffer stock and hence decrease inventory accumulation. This implies a lower
level of inventory, $N_t$, at the beginning of period $t+1$. The extent to which the real
interest shock matters to the firm’s optimal inventory decision (or, the strength of the
intertemporal substitution mechanism) is captured by the marginal cost parameters $\theta$
and $\xi$. Note that the costs of adjusting output levels captured by $\gamma$ do not interact with
the real interest rate.

In the empirical implementation, variation in the real interest rate influences esti-
mation of the structural parameters $\theta$ and $\xi$. It is, however, not possible to estimate a
separate structural effect of the real interest rate on inventories as shown in (6). In this
context, the linear-quadratic framework with time-varying discount rate shares the same
weakness as the earlier literature which examined only the reduced-form effects (see, for

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example, Akhtar (1983)). Put differently, the linear-quadratic model with time-varying
discount factor does not help to parameterically estimate the effect of real interest rate
on inventories.

4. Conclusion

We show that in time-varying discount factor models of inventory investment, the real
interest rate does not have a separate coefficient in the Euler equation under the restric-
tion implied by the model. One cannot, therefore, separately identify the effects of the
real interest rate from other variables determining the marginal cost. Therefore, from
a structural estimation perspective, understanding the relationship between inventory
investment and the real interest rate in the short- and long-run remains a challenge for
macroeconomists.
Please note:

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