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The Idolatry of Interest Rates
Part I: Chasing Will-o'-the-Wisp

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It seems one can hardly open a financial newspaper or read a blog these days without tripping over some academic-*cum*-central banker talking about the once arcane notion of the equilibrium real interest rate. Bernanke chose exactly that subject to inaugurate his blog.[1] According to Gavyn Davies,[2] Yellen used the term "equilibrium real interest rate" no less than 25 times in a recent speech. (I have to be honest, life is simply too short to make me want to check that count.) The word cloud drawn from the text of Yellen's speech below does certainly suggest that number is about right. The president of the Cleveland Fed went so far as to say that the equilibrium real interest rate was **the** issue for policymakers today.

Exhibit 1:

A Word Cloud from Yellen's March 27, 2015 Speech

Source: GMO

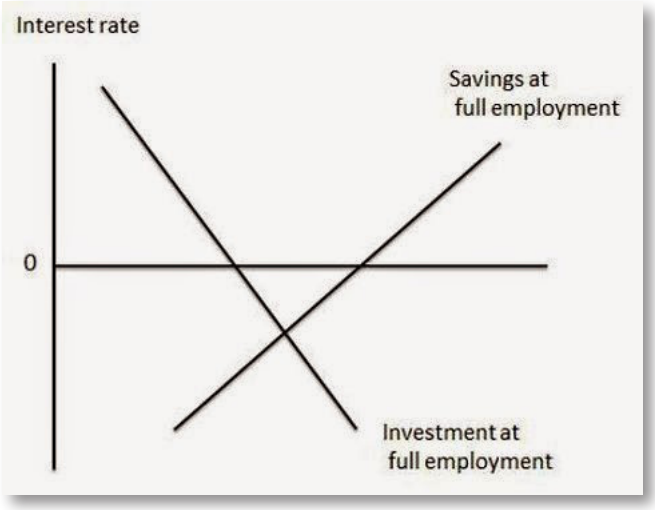
[1] http://www.brookings.edu/blogs/ben-bernanke

[2] http://blogs.ft.com/gavyndavies

Summers and Krugman are also devotees of the concept of an equilibrium (aka natural or neutral) rate of interest. For Summers, "…the essence of secular stagnation is a chronic excess of saving over investment." Krugman uses diagrams such as the one in Exhibit 2 to illustrate the case. In order for the "market of savings and loans" to clear, the real rate of interest must be negative,[3] or so the argument goes.

Exhibit 2:

Krugman's Loanable Funds Viewpoint



Source: Krugman

As Bernanke explains, "…the concept of the equilibrium real interest rate (sometimes called the Wicksellian interest rate, after the late nineteenth- and early twentieth-century Swedish economist Knut Wicksell). The equilibrium interest rate is the real interest rate consistent with full employment of labor and capital resources, perhaps after some period of adjustment. Many factors affect the equilibrium rate, which can and does change over time. In a rapidly growing, dynamic economy, we would expect the equilibrium interest rate to be high, all else equal, reflecting the high prospective return on capital investments. In a slowly growing or recessionary economy, the equilibrium real rate is likely to be low, since investment opportunities are limited and relatively unprofitable."

This is, of course, more evidence of the wisdom of Keynes' insight that "Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back."

[3] Indeed, the entire Bernanke vs. Summers discussion could be framed around the Krugman diagram. Bernanke is arguing that it is the savings curve that has shifted to the right, and hence has induced a negative natural real interest rate. Whilst Summers is arguing that it is the investment curve that has shifted to the left, and has induced exactly the same thing. Sadly, this is like debating the number of angels that can dance on the head of a pin.

Wisdom of crowds or groupthink extraordinaire?

One could take the view that so many bright individuals all coalescing around a single framework was evidence of the wisdom of crowds. However, rather than representing the power of consensus, it appears to me to be evidence of extreme groupthink – it is very telling that not one of the aforementioned luminaries has questioned the framework itself.

One of the preconditions for the wisdom of crowds to hold is that people must be independent. This clearly isn't the case with the above coterie[4] of economists, many of whom trained at the same university under the same teacher. As Steve Keen[5] pointed out, "If I were describing a group of thoroughbred horses, alarm bells would already be ringing about a dangerous level of in-breeding."

The term "groupthink" was coined by Irving Janis in 1972. In his original work, Janis cited the Vietnam War and the Bay of Pigs invasion as prime examples of the groupthink mentality. However, modern examples are all too prevalent.

Groupthink is often characterised by:

- A tendency to examine too few alternatives;
- A lack of critical assessment of each other's ideas;
- A high degree of selectivity in information gathering;
- A lack of contingency plans;
- Poor decisions are often rationalised;
- The group has an illusion of invulnerability and shared morality;
- True feelings and beliefs are suppressed;
- An illusion of unanimity is maintained;
- Mind guards (essentially information sentinels) may be appointed to protect the group from negative information.

Perhaps it is just me, but these traits seem to pretty much capture the nature of mainstream economics these days.

Hunting of the Snark or chasing Will-o'-the-Wisp[6]

I have written before on issues surrounding the invalidity of the concept of a natural real interest rate.[7] In essence, my view is the same as Karl Marx who, in Das Kapital, Vol. III opined, "There is no such thing as a natural rate of interest."

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[4] I've often pondered on the proper collective noun for economists…my personal favourites are either a consensus of economists, or an indecision of economists.

[5] http://www.forbes.com/sites/stevekeen/2015/04/04/the-inbred-bernanke-summers-debate-on-secular-stagnation

[6] Both Lewis Carroll's "Hunting of the Snark" and the English folklore of a flickering light seen by travelers receding if approached and luring them from a safe path (Will-o'-the-Wisp) are, of course, about looking for things that aren't real.

[7] See GMO 2Q 2013 Quarterly Letter, "The Purgatory of Low Returns." Available with registration at www.gmo.com.

According to the Wicksellian perspective so beloved by Bernanke et al., the natural rate of interest is simply assumed to exist. This has disturbing parallels with perhaps the oldest joke concerning economists that I know. When I first studied the subject nigh on 30 years ago, one of my teachers told us the old hackneyed tale of the shipwrecked academics: An engineer, a chemist, and an economist were all stranded on a desert island with no implements and a can of food. The engineer rigs up a Heath Robinson-like contraption with stick levers and vine pulleys. The chemist suggests using salt water to erode the can and then heating it once it is weakened. They then turn to the economist who merely says, "Let's assume we have a can opener!"

Wicksell himself defined the natural rate of interest as "obtained by thinking of it as the rate which would be determined by supply and demand if real capital were lent without the intervention of money." By real capital, Wicksell is referring to machines, tools, etc. There are numerous (wonkish) reasons for thinking that this is a very suspect concept that I won't go into now (but, as mentioned above, I have explored previously and the interested reader is referred to that essay).

I'll content myself here by highlighting perhaps the most damning argument against the Wicksellian perspective: that it simply doesn't fit the way the world actually works. At this point, economists often reach for the Friedmanite position – that a model shouldn't be judged by the realism of its assumptions, but by its predictions. I've always found this to be a very weak defence. Yes, of course, all models are abstractions; as Joan Robinson pointed out long ago, a map on a scale of 1:1 is of no use to anyone. However, how on Earth can you rely upon any conclusion from a model that fails to capture the basic structure of the world as we know it, and furthermore abstracts away from the very issues under consideration?

The reality is that there is no market for "real" capital, and there never has been such a market.[8] A cursory glance at the real world reveals that banks make loans (denominated in money, not real capital) based on the expected profitability and creditworthiness of the borrowers. They then seek to ensure they have sufficient reserves in order to achieve their reserve requirement. As Kalecki noted, "An important consequence of [this] is that the rate of interest cannot be determined by the demand for and supply of new capital because investment 'finances itself.'"

Under such a system, the central bank sets the interest rate (and can do so without any reference to a natural rate of interest). As Keynes noted, "The monetary authorities can have any interest rate they like… They can make both the short and long-term [rate] whatever they like, or rather whatever they feel to be right… Historically the authorities have always determined the rate at their own sweet will." He also wrote "It cannot be maintained that there is a unique policy which, in the long run, the monetary authority is bound to pursue" – echoing Marx's skepticism on the concept of a natural rate of interest.

Take a look at Exhibit 3. It plots the real Fed funds rate over time. You can see I have drawn levels around which the real rates appear to have fluctuated. N.B. the plural – levels, not level.[9] Does it seem more likely to you that some mythical market for real capital has shifted its market-clearing equilibrium periodically, or that the central bank has simply set an interest rate at differing levels to

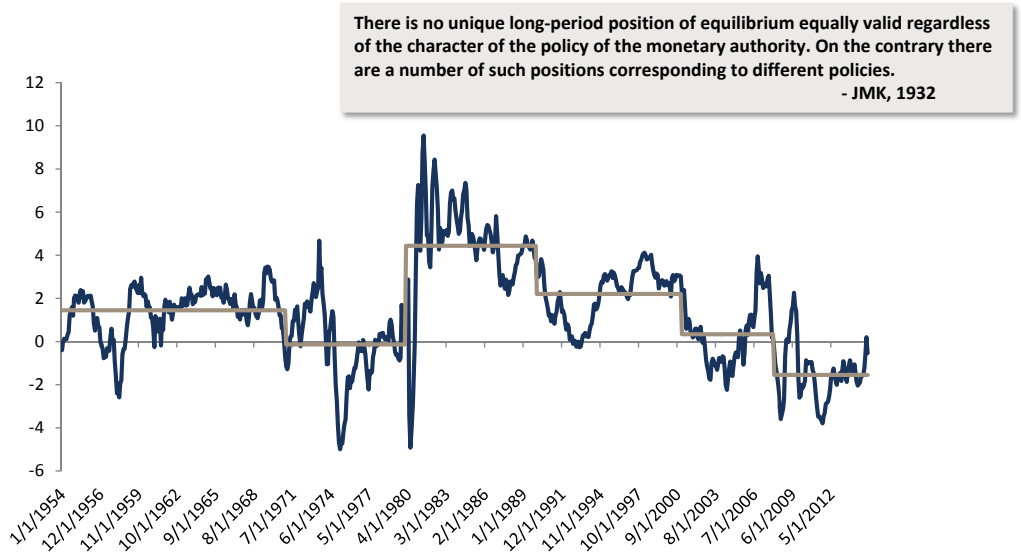
[8] See David Graeber's entertaining "Debt: The First 5000 Years," Chapter 2, The Myth of Barter (2011).

[9] These are not just arbitrarily drawn, but are actually the outcome of a statistical test that searches for structural breaks.

achieve varying policy goals? Were real rates high during Volcker's tenure because there was a scarcity of real capital, or because Volcker wanted to engineer a recession to break inflation?

Exhibit 3:

Central Banks Set the Short Rate Real Fed Funds Rate (%)



Source: U.S. Federal Reserve, GMO

To me, the latter response to both questions seems eminently more plausible. Indeed, the entire pattern of interest rates in the post Volcker era looks like it follows the pattern that Kalecki warned about in 1943: "The rate of interest or income tax [might be] reduced in a slump but not increased in the subsequent boom. In this case the boom will last longer, but it must end in a new slump: one reduction in the rate of interest or income tax does not, of course, eliminate the forces which cause cyclical fluctuations in a capitalist economy. In the new slump it will be necessary to reduce the rate of interest or income tax again and so on. Thus in the not too remote future, the rate of interest would have to be negative and income tax would have to be replaced by an income subsidy. The same would arise if it were attempted to maintain full employment by stimulating private investment: the rate of interest and income tax would have to be reduced continuously."

As the prior quotation from Bernanke illustrates, the New Keynesians accept that the natural rate moves over time, and they assume (there is that most dangerous of words once again) that it moves with the growth rate of consumption. Higher growth rates imply higher real rates and, conversely, lower growth rates should imply lower real rates.

However, as a very recent paper by some highly respected econometricians, inter alia,[10] concludes, "We found little support in these data for two of the popular conceptions many people have about real interest rates. First, although it is often assumed in theoretical models that there is some long-run constant value toward which the real interest rate eventually returns, our long-run data lead us

[10] See Hamilton, Harris, Hatzius, and West, "The Equilibrium Real Funds Rate: Past, Present and Future" (2015).

to reject that hypothesis, consistent with other studies... We also found little support for the popular assumption that the long-run economic growth rate is the primary factor driving changes in the equilibrium real interest rate over time."

The theory underlying the concept of the equilibrium real rate seems, to me at least, to be dubious in the extreme. It has many theoretically suspect features, it doesn't match the way the world works, and it is at odds with the empirical evidence. It really doesn't seem to have a lot going for it at all.

Even Wicksell himself noted, "This does not mean that the banks ought actually to ascertain the natural rate before fixing their own rates of interest. That would, of course, be impracticable." Never ones to be deterred by dubious theory, bound by reality, or flinch in the face of impracticality, many economists have engaged in an exercise of estimating a number that might not even exist. The range of estimates that have been generated should alone give pause for reflection (see Exhibit 4).

Exhibit 4:

Estimates of Something that Doesn't Exist: Economists Guess at the Equilibrium Real Interest Rate

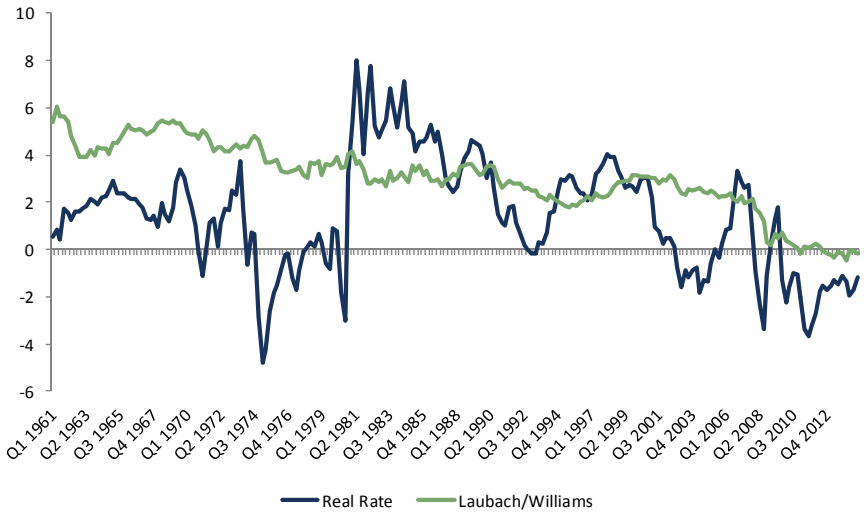
	Method	Period	Range of NRI
Bomfim	TIPS	1998-2001	3% to 4%
Brzoza-Brzezina	SVAR	1960-2002	-5% to 8%
Brzoza-Brzezina	Laubach/Williams	1980-2002	-5% to 8%
Laubach/Williams	Kalman Filter SMM	1960-2002	2% to 5%
Clark/Kozicki	IS/CBO	1960-2004	-3% to 7%
Manrique/Marques	Laubach/Williams	1965-2001	1.5% to 5%
Amato	Latent Variable	1965-2001	2.5% to 4%
Orphanides/Williams	Kalman Filter SMM	1965-2002	-3% to 6%
Andres et al.	Structural Model	1981-2003	-5% to 12%
Amato/Laubach	Structural Model	1981-2003	0% to 10%
Barsky et al.	Structural Model	1990-2013	-1.5% to 3%

Source: GMO

One of the most frequently cited examples of snark hunting is the Laubach and Williams model (created by members of what was then Yellen's staff at the San Francisco Fed, where Williams is now the president). That estimate for the natural rate of interest is plotted along the actual real Fed funds rate in Exhibit 5.

Exhibit 5:

The Most "Popular" Estimate of the Equilibrium Real Rate vs. the Real Fed Funds Rate



Source: San Francisco Federal Reserve, GMO

As Williams himself noted in a recent speech,[11] in this model "The natural rate of interest is assumed to change over time due to various unobservable influences. In principle, one would like to use data on the factors that influence the natural rate in order to quantify the effects. In practice, these are difficult to measure using available data and methods."

So they fall back on the same approach that Wicksell himself outlined. "The procedure should rather be simply as follows: So long as prices remain unaltered the banks' rate of interest is to remain unaltered. If prices rise, the rate of interest is to be raised; and if prices fall, the rate of interest is to be lowered; and the rate of interest is henceforth to be maintained at its new level until a further movement of prices calls for a further change in one direction or the other."

This highlights another of the significant problems with these kinds of approaches: They inherently assume that all inflation is demand-led (that is, caused by output being above potential). Hence they find that the "natural rate of interest" should have been considerably higher in the 1960s and 1970s because growth must have been above trend because we witnessed inflation.

This strikes me as a strange thing to assume. This paper is long enough without me adding an extended diatribe on inflation (I'll save that for another rant), but suffice it to say that monotheistic explanations of inflation seem to be particularly myopic. Inflation is almost certainly not always (or even often) demand-led. It is often cost-push as Robinson observed: "The general level of prices in an industrial economy is determined by the general level of costs." To my mind, the Vietnam War and the oil price shocks followed by a wage-price spiral seem very plausible candidates for the cause of inflation during the 1960s and 1970s.

[11] See Williams, "The Decline in the Natural Rate of Interest" (2015); http://www.frbsf.org/economic-research/economists/jwilliams/Williams_NABE_2015_natural_rate_FRBSF.pdf

Getting back on track, how much can you or should you trust a model that essentially uses the trend rate of growth (an empirically invalid input as per Hamilton et al.) plus a bunch of completely "unobservable influences" to guide your decision making? I'd suggest that skepticism is warranted.

It would seem that central bankers who rely on the concept of an equilibrium, natural, or neutral rate of interest are engaged in a prolonged hunt for a snark, or are chasing Will-o'-the-Wisp. This, of course, raises the question as to why there is an obsession with this approach.

I think this telling passage below from Simon Wren-Lewis (a professor at Oxford, and another member of the dominant approach) is instructive.

"What is a NK model?[12] It is a RBC[13] model plus a microfounded model of price setting, and a nominal interest rate set by the central bank. Every NK model has its inner RBC model. You could reasonably say that these NK models were designed to help tell the central bank what interest rate to set. In the simplest case, this involves setting a nominal rate that achieves, or moves towards, the level of real interest rates that is assumed to occur in the inner RBC model: the natural real rate. These models do not tell us how and why the central bank can set the nominal short rate, and those are interesting questions which occasionally might be important… NK models tell us very little about money. Most of the time, however, I think interest rate setters can get by without worrying about these how and why questions."

The same basic idea can be found in Yellen's recent speech in which she set out an example Taylor rule as follows: "The Taylor rule is $R_t = RR^* + \pi_t + 0.5(\pi t - 2) + 0.5Y_t$, where R denotes the federal funds rate, RR^* is the estimated value of the equilibrium real rate, π is the current inflation rate (usually measured using a core consumer price index), and Y is the output gap. The latter can be approximated using Okun's law, $Y_t = -2\ (U_t - U^*)$, where U is the unemployment rate and U^* is the natural rate of unemployment."

Ultimately, the popularity of the equilibrium real interest rate amongst central bankers may simply be a case of "never ask a barber if you need a haircut," and their resistance to the ideas outlined here is a function of Upton Sinclair's view that "It is difficult to get a man to understand something when his salary depends on his not understanding it."

As someone insightful (if only I could recall who!) said: It is scary to realise you don't know what is going on. It is even more terrifying to realise those in authority think they do.

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12 NK means New Keynesian – think Yellen, Summers, Bernanke, Krugman, et al. This school arose in the 1980s. Adherents generally use rational expectations and assume that the cause of involuntary unemployment is sticky prices and wages (something Keynes was at pains to point out was not the case). They hold that in the long run, with perfectly flexible markets, everything will be fine. They represent one half of today's mainstream approach to economics. The other half are New Classicals, who can't deal with the idea of involuntary unemployment at all.

13 RBC stands for Real Business Cycle – a particularly odd version of economics, which (as Wikipedia puts it) assumes that "Business cycle fluctuations are an efficient response to exogenous changes." That is to say, the Great Depression was really the Great Vacation as a lot of people suddenly opted for more leisure time in an efficient fashion! No wonder economics has such a poor reputation.

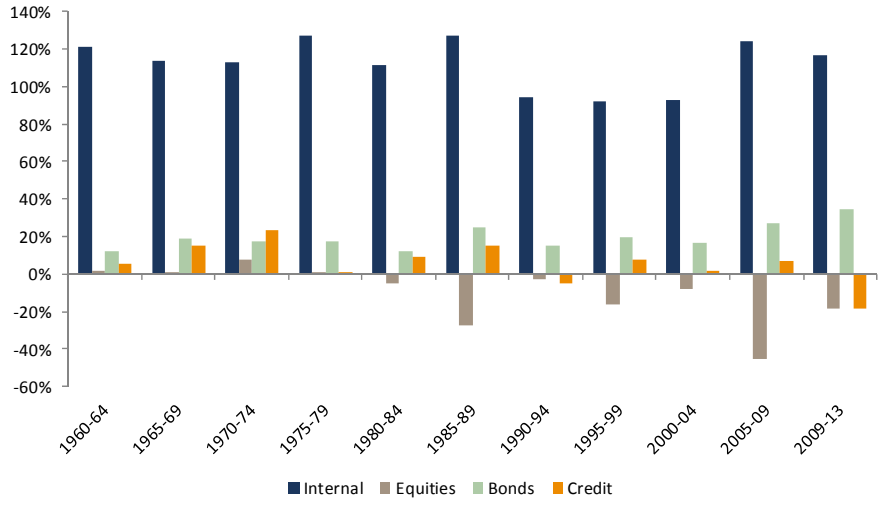
A wider idolatry: the greatest con ever perpetuated

Lest you think I am being unduly harsh on the world's poor central bankers, let me turn to the wider idolatry of interest rates that seems to characterise the world in which we live. There seems to be a perception that central bankers are gods (or at the very least minor deities in some twisted economic pantheon). Coupled with this deification of central bankers is a faith that interest rates are a panacea. Whatever the problem, interest rates can solve it. Inflation too high, simply raise interest rates. Economy too weak, then lower interest rates. A bubble bursts, then slash interest rates, etc., etc. John Kenneth Galbraith poetically described this belief as "…our most prestigious form of fraud, our most elegant escape from reality… The difficulty is that this highly plausible, wholly agreeable process exists only in well-established economic belief and not in real life."

This obsession with interest rates as a cure-all rests on some dubious views about the way the world works. First, is an interest rate cut expansionary or contractionary with respect to spending? Those who believe interest rates are an effective tool clearly believe a rate cut is expansionary because it reduces the cost of financing and then stimulates demand (via investment, consumption, and/or net exports). This emphasises the obvious but oft unspoken truth that monetary policy works via the debt channel (or reducing savings, which is the same thing as increasing leverage).

The idea that rates matter for investment is suspect. As I have shown before, firms generally rely on internal financing to fund investment, rather than borrowing – witness Exhibit 6. Over 100% of gross investment is financed by internal funds.

Exhibit 6:
The Financing of Gross Investment: The U.S. Non-financial Corporate Sector

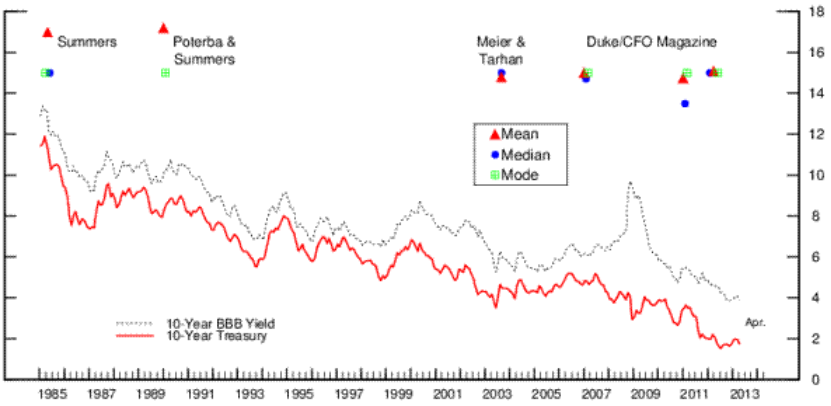


Source: U.S. Flow of Funds

Additionally, firms don't seem to reduce their internal hurdle rates for investment in line with interest rates as the survey data in Exhibit 7 shows. Despite long rates declining from 12% to sub 2%, the hurdle rate for investment essentially remained constant at around 15%.

Exhibit 7:

Hurdle Rates from Surveys Compared with Bond Yields



Note: BBB yield estimated from curve fit to Merrill Lynch bond yields. Treasury yields from smoothed yield curve estimated from off-the-run securities.
Source: Duke CFO Magazine Global Business Outlook; Meier and Tarhan (2007), "Corporate Investment Decisions, Practices and Hurdle Rate Premium Puzzle;" Poterba and Summers (1995), "A CEO Survey of U.S. Companies' Time Horizons and Hurdle Rates;" Summers (1987), "Investment Incentives and the Discounting of Depreciation Allowances."

Indeed, the latest CFO survey from Duke University asked CFOs how interest rates had impacted capital spending plans for the next 12 months. A whopping 81% said there was no change! Investment is much more a function of expected profitability than it is a function of interest rates.

A simple cross-plot of investment to GDP against interest rates reveals no evidence of a relationship at all. Yet despite this, the Fed's own model of the U.S. economy assumes a very large impact (nearly twice that seen for consumption) of interest rates upon inflation.[14]

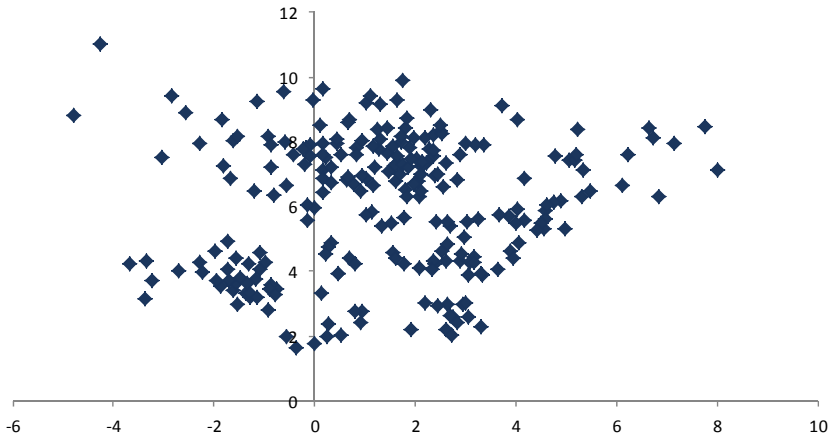
The consumption channel is no more convincing than the investment channel. It brings distributional issues into play. Monetary policy alters the distribution of net worth amongst individuals, but it does not alter the level of net worth they possess. Creditors and those on fixed incomes lose out when there is an interest rate cut, whilst the debtors benefit. Thus, for monetary policy to be effective via consumption, it must be true that debtors have a higher marginal propensity to consume than creditors. In reality, many consumers are both debtors and creditors, making it unclear as to the impact of interest rate changes on their behaviour. These consumers live in the same world as the firms above, and thus the impact of interest rates may well be overwhelmed by employment and wage income effects if the central bank is lowering rates in a recession.

A very simple plot of household savings against the real interest rate reveals that there simply isn't a relationship between the two variables (see Exhibit 8). It is essentially a random plot. So whilst it may seem compelling that lower rates cause households to save less, there just isn't any evidence of it actually occurring!

[14] According to Angeloni et al. (2002) every 1% increase in interest rates is assumed to generate over a 1% decline in investment expenditure over three years.

Exhibit 8:

Real Interest Rates vs. Household Savings in the U.S. (1954-2014)



Source: U.S. Flow of Funds, U.S. Federal Reserve, GMO

The other channel that monetary policy might use to influence consumption is via wealth effects. If low rates were to lead to higher prices for financial assets, then perhaps this might stimulate consumption. However, the evidence is that the stock market wealth effect is very low (probably because ownership is concentrated in the hands of the already wealthy, who generally have a low marginal propensity to consume). The housing market wealth effect is greater according to most evidence, but there isn't a strong relationship between house prices and interest rates, which limits the importance of this channel of influence for monetary policy.

This leaves the net export channel. This would seem an unlikely source of major impact for large, relatively closed economies like the U.S. (and obviously can't be true for the world as a whole). We would require exchange rates to be extraordinarily sensitive to interest rates (akin to perfect capital mobility), and then we would require exports to be exceptionally sensitive to changes in the exchange rate. Neither of these conditions seems like a good description of reality.

Thus, it would appear that monetary policy isn't the most effective tool for managing the economy. I am well aware that almost everyone reading this is likely to disagree: That is the nature of the greatest con ever perpetuated. However, the evidence seems to me to be clear that monetary policy is massively overrated.

Just in case you were wondering about the much-lauded ability of the central bank to create inflation via helicopter drops of cash (or its modern-day equivalent), this is actually a form of fiscal policy, not monetary policy. As I noted above, monetary policy alters the distribution of net worth while fiscal policy alters the levels of net worth. Because helicopter drops effectively give everyone a boost of cash, this is clearly a change in net worth and thus is likely to be helpful in stimulating demand.

As you may have gathered from the preceding paragraph, the good news is that there is an alternative to monetary policy, and that is fiscal policy. These days fiscal policy is deeply out of vogue amongst policymakers and politicians. However, it has a much more direct link to growth than any of the

channels suggested for monetary policy – it is part of the construction of GDP, and has a clear impact upon incomes.

This raises the question as to why fiscal policy is so neglected by economists and policymakers. As Mishkin[15] notes, "Fiscal policy has lost its luster as a tool to stabilize the aggregate economy because of doubts about the ability to time fiscal policy actions to obtain desirable outcomes as well as concerns about budget deficits." As if we could ever truly "fine tune" an economy.

The neglect stems at least from a theoretical point of view that the New Keynesian models are really Real Business Cycle models in drag: They tend to embody a belief in so-called Ricardian equivalence (at least in the long run). This doctrine (which can be traced to Barro) holds that agents in an economy are fully forward-looking, and thus a tax cut financed by increased borrowing is seen as implying a tax increase in the future. This is often coupled with a "crowding out" argument, which argues that fiscal deficits increase interest rates, and thus choke off private sector demand.

Both of these arguments are misguided. The Ricardian equivalence viewpoint is tied up with the austerity-defending "sound finance" school of rhetoric seemingly beloved by politicians of pretty much every hue these days. You may recognise it expressed in sound bites such as "A government should imitate a household, and it cannot spend beyond its means indefinitely." This is nonsense, at least for governments that issue their own currency. For such nations, the appropriate constraint isn't a financing one (i.e., government spending must be financed by either taxes or by issuing currency), but a real resource constraint (i.e., is government spending pushing the economy into demand-pull inflation?).[16]

On the idea of "crowding out," just take a look at Japan. Large deficits and a significant debt to GDP ratio have been a defining characteristic of Japan over the last two and half decades, but so too have some of the lowest interest rates in the world. In a world where the central bank can (and does) set interest rates, will someone please explain to me how we can see crowding out? Both of these arguments against fiscal policy are fallacious.[17]

Ultimately, the neglect of fiscal policy stems from political rather than economic foundations. Perhaps the most insightful analysis of the "political problems" with fiscal policy as a policy tool can be found in Kalecki's excellent analysis from 1943, "Political Aspects of Full Employment." In this short paper, Kalecki lays out three reasons why "business" doesn't like the idea of fiscal policy.

"The reasons for the opposition of the 'industrial leaders' to full employment achieved by government spending may be subdivided into three categories: (i) dislike of government interference in the problem of employment as such; (ii) dislike of the direction of government spending (public investment and subsidizing consumption); (iii) dislike of the social and political changes resulting from the maintenance of full employment."

With regard to the "dislike of government interference," "Every widening of state activity is looked upon by business with suspicion," and this is especially true with respect to the creation of employment by government expenditure. Kalecki notes that in a system without significant active fiscal policy, business is in the driver's seat, and their animal spirits may determine the state of the economy. "This

15 Mishkin, "The Channels of Monetary Transmission: Lessons for Monetary Policy" (1996).

16 Interestingly, Michael Woodford, the leading New Keynesian guru of central bankers, has written extensively and sensibly on this topic. See "Fiscal Requirements for Price Stability," www.columbia.edu/%7Emw2330/jmcb.pdf

17 I may well return to the topic of fiscal policy and the way in which it is treated in a future note.

gives the capitalists a powerful indirect control over government policy," he writes. Effectively, anything they don't like will be said to dampen their confidence and thus endanger growth and employment. Because active fiscal policy should reveal that the state can create employment, it must be undermined from the business perspective.

On the "dislike of the direction of government spending," Kalecki notes that industrial leaders hold a "moral principle of the highest importance" to be at stake. "The fundamentals of capitalist ethics require that 'you shall earn your bread in sweat' – unless you happen to have private means."

Finally, businesses may not like the long-term consequences of the maintenance of full employment. "Under a regime of permanent full employment, the 'sack' would cease to play its role as a 'disciplinary' measure… 'discipline in the factories' and 'political stability' are more appreciated than profits[18] by business leaders. Their class instinct tells them that lasting full employment is unsound…and that unemployment is an integral part of the 'normal' capitalist system."

As to when fiscal policy may come back onto the potential policy agenda is certainly beyond my ken. But until it does, our situation may be likened to fighting with one arm tied behind our back, with a badly functioning prosthetic being forced to do all of the work.

Conclusions

This paper has sought to tackle two forms of idolatry surrounding interest rates. First is the idolatry of the "equilibrium/natural/neutral" rate of interest displayed by central bankers around the world. This is a make-believe concept with no foundation in the way our financial world really works. It is scary to think that this is the topic that central bankers are debating. Talk about a massive exercise in navel gazing!

The second idolatry I've sought to tackle is the modern-day belief in the world's greatest con: that monetary policy matters. There is precious little evidence that monetary policy matters for the major components of demand (investment and consumption look pretty immune to the shifts in interest rates over time). Perhaps it is time to recall that we have another tool in our economic kit: fiscal policy. This is a political pariah of a policy, but offers a potential way out of the low growth we find ourselves facing.

In Part II of this series, I'm going to explore the idolatry of interest rates in finance.

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[18] Under full employment, everyone would be working and thus spending, which, as per the Kalecki profits equation, would be good for corporate profits.

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