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Louis-Philippe Rochon

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In pursuit of the holy grail: monetary policy, the natural rate of interest, and quantitative easing

Louis-Philippe Rochon
Department of Economics, Laurentian University, Sudbury, Ontario, Canada

ABSTRACT
This article argues that mainstream economics’ approach to monetary policy and theory is based on two erroneous arguments: the existence of a natural rate of interest, and a predictable causality between monetary policy and inflation. The article then discusses an alternative post-Keynesian approach to monetary policy that rests on the presence of a strong fiscal policy.

KEYWORDS
Endogenous money; income distribution; interest rates; natural rate of interest; quantitative easing

Introduction
While there has been some evolution in mainstream monetary policy (for instance, the recognition of central banks’ ability to set the rate of interest rather than the money supply), conventional monetary theory nevertheless remains rather stagnant. At the heart of mainstream thinking are two fundamental notions that have evolved very little despite the crisis, and that differentiate mainstream from heterodox economics: the assumed existence of a natural rate of interest, and a crucial and predictable relationship between monetary policy and inflation. It is assumed the causation runs from changes in monetary policy (whether through changes of the money supply or rates of interest) to inflation.

While the 2008–2009 global crisis shook confidence in some areas of mainstream thinking, mainstream thinking has not weakened its devotion to these two fundamental principles. This essay argues that the continued acceptance of these neoclassical ideas explains some of the more unconventional policies implemented since the crisis, and also explains their limited effectiveness.

Throughout his long career, Marc Lavoie has been a persistent critic of mainstream or orthodox economic thinking, especially with respect to central bank policy, but also its analysis of banks, credit, and money. His latest book, Post-Keynesian Economics: New Foundations, deconstructs mainstream thought and reveals its inconsistencies, both internal and external, and sheds new light on heterodox approaches to money’s endogeneity. As summarized in his keynote lecture included in this forum, Lavoie offers a genuinely positive contribution to economic analysis, proving that there are rigorous and feasible alternatives to the failed orthodox model.
Consistent with Lavoie’s description of the internal fallacies of orthodox monetary policy, I argue (from a heterodox or post-Keynesian perspective) that the mainstream’s continued reliance on the assumed existence of a natural rate of interest has fundamentally shaped the so-called unconventional policies implemented since 2008—2009. Because these policies (such as quantitative easing) ultimately reflect a warped understanding of the way the banking system operates, they will be less effective than what monetary policymakers expect.

In contrast, post-Keynesian economics can make a significant contribution in understanding the crisis and developing more effective policy responses to it. Although some heterodox ideas are slowly being recognized by the mainstream, so far they remain embedded in an otherwise mainstream framework that diminishes their more radical implications.

The natural rate of interest and monetary policy

The existence of a natural rate of interest remains a core element of the neoclassical approach to monetary theory and policy. According to Wicksell, “There is a certain rate of interest on loans which is neutral in respect to commodity prices, and tends neither to raise nor to lower them.” This rate is determined by real forces—that is, by the forces of productivity and thrift. In this sense, the natural rate can be defined as the real rate of interest (for instance, paid on federal reserve funds), where real GDP is equal to potential GDP, absent any transitory shocks to demand. Graphically, it is represented by the intersection of the standard IS and LM curves, at potential GDP. Underpinning Wicksell’s claim, of course, is a neoclassical general equilibrium framework in which profit is portrayed as a real return to the productivity of invested capital, rather than as a surplus, in heterodox traditions.

Today, most central banks accept the existence of this long-run, equilibrium rate, although it remains nonmeasurable, and, therefore, must be estimated or, rather, assumed. Moreover, any deviations of the benchmark rate from this (assumed or imagined) natural rate will either depress (interest rate above the natural rate) or stimulate (interest rate below the natural rate) the overall economy, resulting in a widening or narrowing of the output gap (that is, the difference between actual and potential GDP). In this sense, central banks aim to make the benchmark rate equal to this natural rate, presumably resulting in “full employment,” at least according to the neoclassical definition of that concept. Alternatively, it can be argued that the natural rate is the interest rate at which central banks can hit their inflation target.

The problem that emerged following the crisis is that the natural rate needed to close the output gap and bring the economy back to, and consistent with, full employment was thought to be negative. This explains the historically-low rates implemented in many countries; central banks continued lowering rates as growth remained elusive. Yet monetary policy then confronts the problem of the zero lower bound because, in essence, central banks cannot lower the short-term nominal interest rate below zero. This situation results in a benchmark rate that is persistently above the natural rate, thereby depressing the economy as long as the natural rate remains negative. Of course, with inflation, the real rate could become negative, but not sufficiently negative.
This argument is at the heart of the mainstream explanation of secular stagnation. According to Summers:

Imagine a situation where natural and equilibrium interest rates have fallen significantly below zero. Then conventional macroeconomic thinking leaves us in a very serious problem because we all seem to agree that whereas you can keep the federal funds rate at a low level forever, it’s much harder to do extraordinary measures beyond that forever; but the underlying problem may be there forever. It’s much more difficult to say, well, we only needed deficits during the short interval of the crisis if equilibrium interest rates cannot be achieved given the prevailing rate of inflation.  

In fact, Summers and, since then, Krugman—economists that Lavoie would label as “mainstream dissenters”—have argued that the natural rate has probably been negative for several years, if not decades, even as far back as the 1980s, and that only economic and financial “bubbles” were able to move the economy closer to full employment during that period. But in the absence of such bubbles, the economy remained woefully depressed, and, in this sense, they reject the argument that monetary policy has been too accommodating. As proof, they point to the absence of inflation.

In this context, the zero lower bound implies that there is a long-lasting discrepancy between the central bank rate and the natural rate. The former is higher than what is required for the economy to move to full employment, so monetary policy is unable to contribute in any substantive way to restoring economic growth. Interestingly enough, this is not unlike the Keynesian (textbook) theory of the liquidity trap. As any economics student is taught, when rates become too low, monetary policy becomes ineffective.

Yet the difference between the Keynesian liquidity trap literature of yesteryear and today’s views on the zero lower bound is the role played by fiscal policy. In Keynesian liquidity trap literature, fiscal policy was wholly encouraged to fill in the policy gap—in the absence of monetary policy, fiscal policy needed to expand, thereby shifting the IS curve sufficiently to the Right to contribute to a return to full employment.

Today, however, it seems that fiscal policy is to be avoided at all costs. For instance, in many of the New Consensus or New Macroeconomic models, fiscal policy is either absent or plays a very limited, and minor, role. A rejection of a countercyclical role for fiscal policy is one of the key conclusions of these models. In this sense, policymakers are unable to rely on the traditional expansionary role of fiscal policy.

The years after the crisis, following a brief initial period of fiscal expansion, have been dominated by fiscal restraint (austerity) combined with low interest rates, with monetary policy confronted by the zero lower bound. In this sense, both fiscal and monetary policies became ineffective.

**Quantitative easing**

The zero lower bound coupled with the absence of fiscal policy has created a significant policy problem. The challenge for central banks today, therefore, resides in showing how monetary policy can still be effective and relevant, even at low or zero rates of interest, especially in the absence of fiscal policy.

As such, central banks’ response to the lower bound issue can be found in the introduction of so-called unconventional policies, in particular quantitative easing.
This way, despite near zero rates, central banks appear to still play a role by injecting liquidity directly into the banking system, which, in turn, should stimulate the economy through increased lending. In this sense, quantitative easing can be interpreted as the theoretical and policy solution to the problem posed by the liquidity trap: despite the lower bound, central banks still have an important role to play. Lavoie reached a similar conclusion, and argues that ‘quantitative easing appears as a desperate attempt by monetary authorities and some economists still adhering to monetarism to demonstrate that monetary policy is always effective.’

The strategy of quantitative easing is to flood banks with deposits so they can then increase bank lending. This is done when the central bank purchases government securities or other securities from the market (nonbank firms or households), who then deposit the proceeds into their accounts at the banks. As the argument goes, once deposits increase, banks now have more funds from which to lend. Hence, central bank policy, despite zero or low rates, can still have an impact on economic activity.

The above scenario, however, is nothing more than the traditional money multiplier model, as Lavoie points out correctly. The view is that economies are depressed because of banks’ inability to lend. Yet from a post-Keynesian perspective, quantitative easing poses a number of problems, and this analysis helps to explain why it failed to stimulate bank loans—it is based on an erroneous understanding of the role and mechanics of bank lending.

As post-Keynesians have long argued, the endogeneity of money implies that banks are never constrained by reserves or prior deposits; banks can always lend as long as there are willing borrowers who meet the banks’ creditworthiness criteria. Banks refused to lend during the crisis because of a lack of borrowers whom they deemed creditworthy, as well as a decline in the demand for new loans, not because of a shortage of reserves or deposits.

In accordance with this view of endogenous money, loans create deposits, which then create reserves in the process. Reserves do not ‘cause’ loans or deposits. Hence, even if central banks increase bank deposits, this situation does not increase lending, so would not have contributed to increased economic activity.

As I argue elsewhere, banks may choose not to lend by tightening their credit standards during recession and loosening them during an expansion; this is partly what happened during the crisis. Banks became more pessimistic and increased their creditworthiness requirements, thereby making it more difficult to borrow. In other words, there was an important decrease in the number of borrowers deemed creditworthy.

Yet mainstream theorists have been unable to explain the failure or lack of success of quantitative easing. In the end, it succeeded in raising the price of long-term assets, thereby acting as an income-policy for rentiers.

**Post-Keynesian economics, monetary, and fiscal policy**

From a post-Keynesian perspective, mainstream approaches to both monetary theory and policy are inconsistent on many levels that have been brought to the fore during and since the crisis.
First, Post-Keynesians (and all heterodox schools) reject the existence—and indeed the assumption—of a natural rate of interest, arguing that it does not exist, so any monetary policy based on its assumption is erroneous. In this sense, to assume that the problem of weak economic growth today is due to the existence of a negative natural rate of interest must be rejected; monetary policy does not suffer from a problem of a zero lower bound.

This does not mean that post-Keynesians do not welcome the recent period of low interest rates. Quite the contrary, we do, but for very different reasons. For example, Lavoie has argued that, rather than seeing the rate of interest as an influential variable in determining borrowing, rates of interest are administered and, instead, should be seen more as an income distributive variable. This argument was also made forcefully by Smithin in his aptly-titled book, The Revenge of the Rentier.

If correct, this view raises important questions regarding the transmission mechanism of monetary policy, but also regarding the aim and purpose of monetary policy. In mainstream theory, interest rates are used to fine-tune the economy, with the specific aim of achieving an inflation target. This is the core argument in the New Consensus models: changes in the rate of interest are made to impact aggregate demand (the IS curve), and eventually to attain an inflation target through a predictable relationship between inflation and output (the Phillips curve). In this sense, changes in interest rates are thought to have a predictable effect on output, hence the refusal to consider fiscal policy.

From a post-Keynesian perspective, there are a number of problems with the above description of the transmission mechanism. First, it contributed to what Rochon and Setterfield have called 'monetary policy dominance,' that is, an over-reliance on monetary policy to the detriment of fiscal policy.

Post-Keynesians question both theoretical links described above: the link between changes in the rate of interest and aggregate demand, on the one hand, and the link between aggregate demand and inflation, on the other. The idea that changes in the rate of interest should be used to hit some inflation target is rejected. To begin, post-Keynesians do not see a necessary or predictable link between interest rates and investment, arguing that this relationship is more complex than what mainstream thought assumes. Second, inflation is not seen as the result of excess demand, but rather as the result of a struggle over fair income distribution; Lavoie has made both of these arguments. If these critiques are correct, then the whole of mainstream thinking collapses. What, then, would be a post-Keynesian approach to monetary policy?

The transmission mechanism of monetary policy runs from changes in the rate of interest to income distribution over time, which, in turn, will have an effect on aggregate demand. In this sense, the purpose of monetary policy is not to set interest rates to hit an inflation target, but rather to set a rate of interest in order to achieve a desired income distribution. This does not mean that interest rates cannot have an impact on output, for indeed they can. Interest rates, if raised sufficiently high, will eventually have an impact on investment and some components of consumption, which will depress the economy. This is akin to the analogy of using a sledgehammer to kill a fly, and hence illustrates the danger of the overdominance of monetary policy—the fly might not survive, but neither will the table upon which the fly
was resting. More often than not, the use of monetary policy will contribute to overall weakness in the economy.

Because lower interest rates affect income distribution, they are recommended by post-Keynesians, who favour rates not unlike those that have prevailed since 2009—2010. Post-Keynesians also advocate avoiding interest rate fine-tuning. In a series of articles, Mark Setterfield and I argue that countercyclical monetary policy should be avoided. As such, we identify three different interest rate rules that we labelled the Smithin Rule, the Kansas City Rule, and the Pasinetti Rule. The Smithin Rule advocates a real rate low or near zero, while the Kansas City Rule advocates a nominal rate equal to zero. As for the Pasinetti Rule, advocated by Lavoie, and Lavoie and Seccareccia, the real rate of interest should be set equal to the growth rate of labour productivity.

While these rules have some differences in terms of the specific distribution of income they would generate respectively, they also have some commonalities—in particular, the notion that the use of monetary policy can be problematic, and that it is best to set the rate and to rely more on fiscal policy to fine-tune the economy. On this score, all post-Keynesians agree that active fiscal policy needs to play a much larger role in countercyclical policy.

**Conclusion**

This essay has two goals. First, it illustrates the limitations of mainstream thinking with respect to monetary policy. This approach, in turn, is shown to rest on two core assumptions: the existence of the natural rate of interest, and the notion that changes in monetary policy have a predictable and reliable effect on inflation.

Secondly, I argue that quantitative easing was born out of the necessity to justify the usefulness of monetary policy, despite the existence of a zero lower bound—in light of an assumed negative natural rate of interest. Quantitative easing failed as a policy because it rested on an erroneous understanding of basic banking principles.

I conclude with this final thought: it is no longer sufficient to argue that the distinguishing difference between post-Keynesians and mainstream theorists is the recognition of endogenous money. Indeed, some mainstream models (such as Wicksellian models or New Consensus Models) seem to recognize the endogenous nature of money—or at least some form of it. As Smithin (1994), Lavoie (2014) and Rogers (1989) have argued, post-Keynesians further need to reject the existence of a natural rate of interest. Yet, I would argue that even this is not sufficient. Post-Keynesians also need to reject the inflation story embedded in mainstream thought—namely, the idea that changes in monetary policy bring about predictable changes in the rate of inflation. In this sense, it is irrelevant whether mainstream theory advocates control over the money supply or the rate of interest; these advocates will not alter their fervent belief in the natural rate of interest, nor their belief in the role of central banks in controlling inflation. Either way, to paraphrase Friedman, for them inflation remains always and everywhere a monetary policy phenomenon, and in this sense mainstream monetary theory has remained fully loyal to its orthodox neoclassical roots.
Notes

3. See, for instance, Krugman, “Secular Stagnation.”
5. See Rochon, “Quantitative Easing.”
12. Smithin, *Controversies in Monetary Economic*.
13. Rochon, *Credit, Money and Production*.
15. Lavoie, *Post-Keynesian Economics*.
16. As we argue, some post-Keynesians, whom we label activists, still advocate the use of interest rates to fine-tune, and to achieve either an output target, an employment target, or a growth target. See, for instance, Fontana and Palacio-Vera, “Is There an Active Role”; Palley, “A Post-Keynesian Framework”; or even Moore, *Horizontalists and Verticalists*.

Disclosure statement

The author reports no conflicts of interest. The author alone is responsible for the content and writing of this article.

Notes on contributor

Louis-Philippe Rochon teaches in the Department of Economics at Laurentian University in Sudbury, Ontario, Canada.

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