Artificial interest rate adjustments do not make sense.

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Abstract.

There is a glaring flaw in using artificial interest rate adjustments to regulate demand: the GDP maximising rate of interest is presumably the free market rate, thus in order to maximise GDP, artificial interference with interest rates should be minimised. That in turn means demand is best regulated by fiscal means.

As to “fiscal” in the sense “government borrows money and spends it”, that is defective because the fact of borrowing has a deflationary effect: the opposite of the intended stimulatory effect. Thus the best form of stimulus is one of the forms suggested by Keynes in the early 1930s, namely to have the state print money and spend it, and/or cut taxes.

Under the latter system, treasuries or politicians could be given access to the printing press, i.e. be given control of how large a dose of stimulus the economy gets each year. Alternatively it is not difficult to delegate that “amount of stimulus” decision to a committee of economists, while politicians retain the right to take strictly political decisions, like what proportion of GDP is allocated to public spending.

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There is a glaring flaw in using artificial interest rate adjustments to regulate demand. The flaw stems from a principle widely accepted in economics, namely that GDP is maximised where prices are determined by market forces, unless there is an obvious reason for thinking otherwise, i.e. unless "market failure" can be demonstrated, to use the jargon. So on the basis of the latter principle, interest rates ought to be left to find their own level.

It might seem that it can argued that the mere fact of a recession persisting is evidence that interest rates have not fallen far or fast enough and hence that artificial interest rate cuts are justified. However that idea is only valid if it can be shown that there is some sort of obstruction in the way of interest rate reductions, i.e. market failure. And it is far from clear what that obstruction might be. That is, the market for loans and savings would seem on the face of it to be very much of a free market: savers shop around for the best deal as do borrowers.

Artificial interest rate adjustments might be justified if they work much more quickly and/or predictably that fiscal stimulus. But there is not much evidence of that: see for example Dyson (2010) p.10.

Of course it might seem that fiscal adjustments work slowly because of the behaviour of Congress in the US where politicians sometimes spend months haggling over changes to tax or public spending. On the other hand in the UK tax adjustments are sometimes announced by the UK finance minister on budget day and come into effect the very next day. Certainly there is no reason in principle why, given a need for stimulus, a finance minister cannot have some freedom to make instant adjustments to tax or public spending, while politicians retain the right to change those adjustments at their leisure, if they so wish.

Also in the US, many arguments in Congress about changes to tax and public spending are at root arguments about whether to adjust the deficit and hence the national debt. As is shown below, it is perfectly feasible to have a system where deficit decisions are taken by technocrats, while strictly political decisions remain with politicians. So if the latter idea was implemented, much of the argument that clogs up Congress at the moment would vanish.

Abolishing interest rate adjustments was advocated by Friedman (1948): at least he advocated an end to public borrowing which effectively means an end to interest rate adjustments. That idea was also advocated by Mosler (2011). Or to be more accurate, under Mosler's "item 3" he advocates a permanent zero interest rate (i.e. government pays no interest on its liabilities). That, to repeat, means an end to interest rate adjustments. See also Mosler (2004) which also advocates a permanent zero rate.

The Pigou effect.

In contrast to interest rates and the above point that there are no obvious obstructions to market forces adjusting interest rates, there is another free market cure for recessions which is quite clearly obstructed. That's the so called "Pigou effect": that's the fact that in a perfectly functioning or almost perfectly functioning free market and given a recession, prices and wages would fall (in terms of dollars, Euros, etc). That in turn would increase the real value of money (base money to be exact), which in turn would encourage spending.

In addition, the real value of government debt would rise, which would also increase the real value of the private sector's paper wealth, all else equal. However, as explained for example by Wolf (2014, para starting "The purchases of equities…") government debt and base money are virtually the same thing. So to summarise, in a perfect market and given a recession, the real value of the private sector's stock of money and near money rises.

Note incidentally that base money is a net asset as far as the private sector is concerned, whereas commercial bank issued money is not: reason is that for every dollar of money created by commercial banks, there is a dollar of debt owed by a private sector entity. Hence the emphasis on base money above.

However, there is an obvious obstruction to the Pigou effect in the real world, namely Keynes's "wages are sticky downwards" phenomenon. That is, any attempt to cut money wages in the real world is opposed both trade unions and non–unionised workers. However that obstruction should not be a big problem since it is easy to increase the private sector's stock of base money by having the state (i.e. government and central bank) create new money and spend it and/ or cut taxes. (The word "state" is used here to refer to government and central bank considered as one unit).

Indeed Keynes (1933, 5th para) suggested doing just that. Incidentally, note that the fact of the state printing new money and spending it and/or cutting taxes has a fiscal as well as monetary effect. The fiscal effect arises partly from the fact of the number of public sector employees being increased more or less immediately when extra teachers etc are employed (assuming some of the new money funds extra pubic spending). As to the monetary effect: the latter "print and spend" exercise increases the private sector's stock of base money which, as noted above, tends to encourage spending. And there is also public spending in the form of direct transfers of money to households (unemployment benefit, state pensions, etc). Incidentally, the above idea of Keynes's, namely having the state print money and spend it and/or cut taxes amounts to the same as what is often called "QE for the people" nowadays.

It could be argued that an accurate imitation of the Pigou effect would consist of simple cash transfers to households: a helicopter drop. However, a significant proportion of public spending is "helicopter drop" in nature anyway: unemployment benefits, state pensions etc. Plus a cut in taxation amounts to a helicopter drop. Thus it is debatable as to whether setting up an entirely new system, i.e. a helicopter drop in the traditional sense, complete with thousands of bureaucrats is needed.

Keynes.

Returning to Keynes, in the passage mentioned just above, as well as suggesting that the state print and spend money, he also suggested having the state borrow and spend, which raises the question as to which of those two is better.

Well certainly "borrow and spend" is defective in that the object of the exercise is stimulus, but the effect of borrowing is the opposite: that is the effect is deflationary. Indeed, in the real world, central banks have to artificially counter that defective aspect of borrow and spend: that is, the effect of borrow and spend is probably to raise interest rates, thus central banks normally print money and buy back enough government debt to ensure that interest rates do not rise. And normally, given a recession, they go even further and do enough "print and buy back" to bring about a fall in interest rates.

In short, borrow and spend is defective. About the only excuse for it is that it might seem to be easier to reverse than print and spend: that is, so the argument goes, if the central bank has a stock of government debt, it can always impose a deflationary effect by selling that debt at below the going rate, which in turn withdraws base money from the private sector.

However, in an economy where there is no government debt, there would be nothing to stop a central bank wading into the market and offering to borrow at above the going rate. That ploy might not be allowed in various countries at the moment, but there is no good reason for it not to be allowed, where a quick "reversal" was needed.

Another relevant point here is that reversal in the form of raising taxes or cutting public spending is not always needed in order to effect reversal: reason is that inflation constantly eats away at the real value of the stock of base money and government debt, which amounts to reversal of a sort.

What constitutes no government interference with interest rates?

The claim that government should not interfere with interest rates raises a difficult question, as follows. Given that governments are extremely large borrowers they clearly have a significant effect on interest rates. That raises the question as to what amount of government borrowing constitutes "non-interference" – or put another way, it raises the question as to what the optimum amount of public borrowing is.

A popular answer to that question is the so called "Golden rule", i.e. that government borrowing should be limited to funding infrastructure investment and similar. But there is a glaring flaw in that idea, namely that education is a huge investment. But no one ever suggests the entire country's education budget should be funded via borrowing. Thus the "investment justifies borrowing" argument looks questionable.

Indeed, while numerous economists and politicians fall for the "Golden rule / investment justifies borrowing" argument, most small businesses and households do not. For example if a taxi driver wants a new taxi and happens to have more than enough cash available to buy it, the taxi driver is unlikely to borrow money and pay interest to a bank so as to fund the purchase of the new taxi given that there is no need for the taxi driver to pay interest to anyone.

In short, what justifies borrowing is shortage of cash, not the fact of making an investment. But the state is never short of cash in the sense that it can grab any amount of cash off taxpayers, plus it can print money, though clearly inflation places a limit to the amount of printing it can do.

Indeed, much if not most of the debt incurred via credit cards is for current consumption rather than the purchase of capital investment items. Whether it's really in anyone's interest to incur that sort of debt is of course debatable, but there is much to be said for a system where each consumer decides what is in their own interest, and clearly many consumers think the latter "current consumption debt" is in their interests.

Thus the conclusion would seem to be that there should be no government borrowing at all. Indeed, that is exactly the conclusion reached by Friedman (1948) – see second paragraph under the heading "Operation of the proposal". Mosler (2011) argued likewise, though Friedman did argue that government borrowing would be justified in emergencies, like war time. And that's very much in line with the conclusion reached a few paragraphs above, that is, that basically the state should borrow nothing, though if a particularly quick bit of reversal is needed, there is a case for the central bank wading into the market and borrowing at above the going rate.

Should politicians have access to the printing press?

To summarise so far, we have reached the conclusion that stimulus is best implemented by having the state print and spend more money and/or cut taxes rather than by interest rate adjustments. But the people who decide matters fiscal are normally politicians and treasuries. And that raises a problem namely that many of us have reservations about giving politicians access to the printing press.

The solution to that problem is not difficult, at least in principle, and is as follows.

The decision as to how much stimulus to impart, i.e. how large the deficit should be, can perfectly well be given to technocrats, i.e. a committee of economists (which could be based at the central bank, or not: it really doesn’t matter). At the same time, strictly political decisions, like what proportion of GDP is allocated to public spending, and how much of that goes to education, defence and so on, can easily be left with politicians. That split of responsibilities as between central banks and politicians is obviously different to the present split, but there is nothing difficult in principle about that new split.

The way the new system would work would be approximately as follows. The committee of economists would tell politicians what the deficit for the next year or so ought to be. Politicians would then decide what combination of tax and public spending put that deficit into effect. For example if the committee said that the deficit should be 5% of GDP over the next year, politicians could meet that objective by having tax equal to 20% of GDP and public spending equal to 25%. Or they could go for 30% and 35%.

Indeed Bernanke (2016) said such a system would be workable. His exact words were as follows.

"A possible arrangement, set up in advance, might work as follows: Ask Congress to create, by statute, a special Treasury account at the Fed, and to give the Fed . . . the sole authority to "fill" the account, perhaps up to some pre-specified limit. At almost all times, the account would be empty; the Fed would use its authority to add funds to the account only when the [Fed] assessed that a [helicopter drop] of specified size was needed to achieve the Fed's employment and inflation goals.

Should the Fed act, under this proposal, the next step would be for the Congress and the Administration—through the usual, but possibly expedited, legislative process—to determine how to spend the funds (for example, on a tax rebate or on public works)."

That sort of system was also advocated by Dyson (2010) p.10-12. Note that Dyson and co-authors devoted much of their work to advocating full reserve banking. That's not actually relevant for the purposes of the present discussion in that full reserve is perfectly compatible with the new split of responsibilities advocated here, as is the existing bank system.

Disposing of government debt is easy in principle.

Having advocated a "zero government debt" regime above, some readers may claim that is not too realistic and on the grounds that disposing of government debt is difficult. Certainly there are plenty of self-styled “economics professors” out there who have no idea as to how to drastically reduce the debt. Actually it is very easily done, at least in principle. That is there are no strictly economic or technical difficulties here, though possibly there are political difficulties.

The debt can be made to vanish in a very short space of time by simply printing money and buying it back (i.e. continuing with QE). As to any inflationary effect of that, that is easily dealt with by raising taxes and “unprinting” the money collected. Job done.

The only real difficulty is political: the population clearly objects to raised taxes. Though note that that rise in taxation would have no effect at all on living standards. That is, the sole purpose of the tax is to prevent excess demand, so there is no reason for real wages to fall.

Print money and buy non government debt assets?

One way of imparting stimulus which could be argued to be an imitation of the Pigou effect is to have the central bank print money and buy assets other than government debt (i.e. private sector assets like corporate bonds): a ploy favoured by Scott Sumner.

The policy advocated in this article, namely printing money and boosting public spending plus cutting taxes is actually nearer to the Pigou effect. Printing money and buying up private sector assets will boost the market price of those assets relative to the price of consumer goods, whereas the policy advocated in this article simply leaves the choice between buying private sector assets versus buying consumer goods to households, employers and government spending departments. Thus the latter policy is presumably the better of the two.

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