



Policy Note

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IN DEFENSE OF LOW INTEREST RATES

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Many years ago, as a very young economist on the staff of the House Banking Committee, I would from time to time receive a hand-typed letter, on thin paper, from an “Independent Consultant” in Santa Barbara, California. His name was Herbert Bab. The letters were addressed at first to my boss, Chairman Henry Reuss (D-WI), but, as I replied, they later came directly to me. The message was always the same: if John Maynard Keynes were still alive, he would favor a low rate of interest. My replies, invariably, expressed my agreement, that of Mr. Reuss, and our pleasure at having the good word from Keynes, via Bab.

To understand why Keynes held this view, one must fix in mind the two key features of the revolutionary theory of interest that he had advanced in his 1936 *General Theory of Employment, Interest and Money*. To do that, one must first review the doctrines that he sought to overturn.

Before Keynes—and in “mainstream” circles to this day—the theory of interest posited the existence of a “market for capital,” which balanced the desires of business (and other borrowers) for funds with the desire of households (and other lenders) to save. “The” interest rate—after adjusting for “risk” there was only one—was the hypothetical price bringing these two desires into alignment, and so ensuring the equality of investment and savings.

In this market, if banks figured at all, it was merely as intermediaries, effectively as brokers or auctioneers, who helped to determine the price of loans. Otherwise they played no independent role and could be ignored. This theory was known as the theory of “loanable funds,” and it continues to animate economics textbooks. It underpins the notion of a “natural rate” of interest,

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associated variously with an equilibrium rate of profit and an equilibrium rate of economic growth. And these were thought to be governed, in the final analysis, by factors outside economics: the rates of technological progress and population growth.

The concept of a natural rate of interest raises the question of what it might be. To answer this question, statisticians reach back into the history of the short-term, risk-free interest rate, adjusted for inflation, on the implicit notion that there might exist some historical norm that can serve as a guide. Note that this is wholly circular; it *assumes* the existence of a natural rate *and* of market forces that cause actual rates to fluctuate around it. Moreover, there is a question of what historical period to use. Roughly from the early 1970s through the late 1990s, there was a period of high interest rates on short-term assets, even after inflation faded away in the 1980s. Inclusion of that period gives a high “natural” rate. Taking only the most recent several decades would give a very different, much lower number. If one looks back far enough, to the 1950s and 1960s, the interest rate on federal funds was again very low.

The natural rate was (and is) a metaphysical apparatus. Keynes overthrew it by observing that, in the real world, banks set a range of interest rates according not only to risk, but also to the term of the deposit or loan. It takes a higher return to persuade an entity with financial wealth to forego access to that wealth for a longer period of time. Long-term interest rates are thus a reward for “not-hoarding,” and they offset a phenomenon Keynes called “liquidity preference.” The arena in which all this happens is a money market, not a “capital market” or a market for loanable funds. The difference between the interest rate on risk-free, short-term assets (such as Treasury bills) and longer-term secure assets of different maturities is the “yield curve.” It is typically upward-sloping for the reasons given.

What then determines the interest rate on the short-term, risk-free asset? As a speculator and former officer of HM Treasury, Keynes knew that, in a modern economy with a managed credit system—that is, with a central bank—this is a policy rate. It is set by the managing agency. It can be set, as we learned well in the 1970s, anywhere the central bank chooses. There is nothing natural about it. Thus, having blown up the previous notions of an equilibrium balancing of desires to save with demands for funds to invest, Keynes had destroyed the phantom notion of an underlying natural rate of interest, to which the central bank might, in its discretion, gravitate or aspire. Though the idea lives on in many imaginations, there is simply

no such thing. The closest Keynes would come is to hypothesize a “neutral” rate of interest, consistent with the level of investment required to sustain full employment. At that level, in the *General Theory*, income would rise to generate savings precisely matching the demand for funds.

In Keynes’s world and that of the *General Theory*, the main function of the banking system was to finance business investments. Businesses calculated their demand for funds by comparing the expected profitability of a project (“marginal efficiency of capital,” in Keynes’s phrase) to the cost of capital, which would be the rate of interest corresponding to the duration of the project. Interest was the return to the provider of funds, typically the idle *rentier*. Thus a low rate of interest and a high rate of investment would yield, in the long term, a “euthanasia of the *rentier*”—leaving capitalist society in the hands of its active elements, namely businesses, their workers, consumers, and the government—perhaps requiring a “socialization of investment.” As for speculation with cheap money—a phenomenon of which he was definitely aware—Keynes argued that it was harmless so long as it was merely a few “bubbles on a steady stream of enterprise” (Keynes 1936, Chapter 12). The task of keeping it that way was for the conservative instincts of bankers and, if that failed, for strict regulation by public authority.

From this it follows that the short-term, risk-free interest rate should be low—as low as possible—so long as business investment is below the level required to promote and sustain full employment. Only at very high rates of investment, employment, growth, and wage gains—wage gains pushing up prices and not lagging behind them—would any other policy be justified.

After the war, and with Keynes’s death in 1946, reaction set in. The old ideas—self-regulating markets and unregulated bankers—began to reassert themselves. In 1951, the Federal Reserve extracted from the US Treasury the right to adjust interest rates, once again, for monetary or macroeconomic reasons. Monetarists, led by Milton Friedman, began to harp on an alleged connection between price inflation and money growth—thus resurrecting the “Quantity Theory of Money” prevalent in the 19th century and before. And after a “Keynesian” interlude of demand-driven growth policy in the 1960s, the Federal Reserve seized control of macroeconomic policy, hiking interest rates to provoke recessions in 1970, 1974, and 1979–81—the latter being the main moment of our letters from Mr. Bab.

In 1979, Federal Reserve Chairman Paul A. Volcker announced a shift in the operating strategy of the Federal Reserve. Instead of setting a target for short-term interest—the federal funds rate—and attempting to hit that rate through open market operations, the central bank would now set a target for the growth of the money supply, and attempt to hit *that* target with open market operations. How this would work posed a host of questions: Which precise definition of the money supply? Over what time horizon? On the basis of what available data? That Volcker’s staff ever seriously resolved these questions is doubtful; congressional efforts to specify the meaning of the monetary targets soon revealed that they were mostly symbolic. But Volcker’s embrace of Milton Friedman’s doctrine was a radical ideological statement, covering a massive run-up in short-term interest rates, and leading to several vicious recessions, in 1980 and again in 1981–82.

The year 1982 marked the high tide of monetarism. From August 1982, facing a congressional rebellion and the threat of a Mexican default, the Federal Reserve relaxed policy. In the aftermath of sustained 20 percent interest rates, a rise of unemployment to 10 percent in October 1982, and a global debt crisis, the relation between money and prices collapsed. Inflation continued to decline, while the “demand for money” grew, since—without price increases to erode the value of money—the holding of idle cash balances for speculative or other reasons was now far less costly. Consequently, the close correlations between money growth and price changes that had driven the monetarist formulas broke down, and at least some of the monetarists abandoned the creed.

For the United States this period had deep and dark implications. It launched the deindustrialization that accelerated the rise of Asian competitors (Japan, Korea, and most notably, China) and the domestic politics that resulted ultimately in the election of Donald Trump. But it also marked the onset of a new era in monetary policy, as the US Treasury bond became the uncontested leading world reserve asset, permitting the US to assume the role of consumer-of-first-resort, and for the American public to enjoy the fruits of the world’s labor. This happened even though practically all new US employment was in service sectors paying mediocre and stagnant wages, while financial wealth accrued, almost exclusively, to a techno-financial elite.

Then, with the decline and fall of the Soviet empire, commodity prices fell—though to some degree the causation also

ran the other way, from the decline of commodity prices in the mid-1980s to the collapse of the USSR in 1992. With the rise of China, the price of imported manufactures became low and stable. Combined with the destruction of the power of organized labor, these forces yielded forty years without significant inflation in the United States. For this, central bankers were pleased to claim credit, even though after 1982 their contribution consisted, precisely, in doing nothing at all.

The new, largely post-industrial, structural configuration of the US economy reduced and even eliminated the inventory investment cycles that had previously driven macroeconomic volatility. The new phenomenon eventually became known as the “Great Moderation”—and, again, central bankers took credit for it. The self-congratulation was, as always, unwarranted. The law of large numbers guarantees that an economy dominated by decentralized service shops selling to households on a day-to-day basis will have less volatility than one driven by the (often coordinated) investment decisions of large industrial firms. It will also lack the resilience and self-sufficiency of a balanced industrial economy. It will lose the political and social force imparted to it by a technically trained, mechanically competent, and union-organized industrial middle class. It will instead become a population of atomized service workers dominated by the joint power of finance, a small technology sector, and the media—as America has become.

In this new situation the historic role of low interest rates—Keynes’s case, Bab’s, and mine—which was to create incentives and conditions for strong business (industrial) investment, could no longer apply. Business investment shrank as a share of total output, and much of what remained was oriented toward the acquisition of imported electronic equipment. The effect of offsetting a dollar of additional business spending on equipment with an additional dollar of imports is to further reduce the volatility of aggregate output, while (at the same time) the benefits of technical improvement accrue to the overseas producer.

Low interest rates therefore took on a new primary role: to support homebuilding, land purchases, and purchases of other assets, including corporate stocks and buybacks thereof by the issuing companies. In this new configuration, growth was led not by the purchasing power of workers in the machine-making sectors, but by spin-offs from capital asset appreciation: large houses, luxury goods, and ever more, ever-fancier service establishments and employees. All of this was built on a pyramid of private debt, making the structure quite fragile. Should the

Federal Reserve attempt to interrupt the flow of credit—as it did beginning in 1987 and periodically thereafter—asset markets were prone to sudden collapse. This would endanger the lending institutions and force both bailouts (as necessary) and a quick return to low interest rates. This pattern repeated with the busts of 1990, 2000, and 2007–9. As it did, long-term interest rates settled to very low levels, reflecting the experience of low short-term rates, repeated year after year and cycle after cycle.

As for inflation, since the early 2000s, the Federal Reserve has held itself responsible for maintaining a 2 percent target rate of change in the Personal Consumption Expenditure price index—an arbitrary choice, unsupported by any statute, but supposedly rooted in some general notion of price stability. The time frame over which the target is to be achieved remains unspecified. For reasons given above, there was no inflation until 2021, and the central bankers (again) celebrated their illusory success.

Unfortunately for the central bank, threats to or disruptions of the target are not matters within central bank control, as the quasi-inflation of 2021–22 demonstrated. They arise, instead, on the supply side. If not repeated, they pass through the economy quite quickly—usually within months—because nothing sustains them. But if they are sustained, or repeated, some other policy would be necessary to deal with it. Such policies might include action to reduce resource costs, to improve productivity, to reallocate resources from private to shared (public) uses, to make peace (in time of war)—or to control prices directly. Raising interest rates is not part of the menu in either case. All of this had been perfectly well understood in World War II, when prices in the United States were strictly controlled and the interest rate on long-term US government bonds was fixed at 2 percent.

The problem therefore lies in assigning the responsibility for controlling inflation to the central bank, and the use of the short-term interest rate to implement that responsibility. Long-term interest rates adjust only very slowly. Any effort to raise short-term rates necessarily implies pushing them above the very stable and strongly inertial long rates, thus inverting the yield curve. The inevitable consequence is a rush into short-term, liquid assets, and a collapse in whatever sectors had led the previous run-up in capital asset prices: real estate, technology, fraudulent mortgage-backed securities, and (most recently) even long-term government bonds. There would follow a crisis in whatever part of the financial sector was most

deeply implicated in the previous expansion. Thus the policy of a sustained increase in short-term interest rates was—and is—inherently a vector of financial crisis.

The 2022–23 episode of rising interest rates illustrates each of these facts and each fallacious argument. The preliminary price increases were mainly a combination of supply-side shocks and speculative asset price increases, which bleed over into price indices even though they are not, in any proper sense of the word, “inflation.” Despite repeated protestations about “demand” and “persistence,” neither was at play, and, as time passed, the price increases subsided. But the Federal Reserve, reacting to the initial impetus, to political pressure, and in pursuit of the “natural” will-o’-the-wisp, raised rates anyway and continued to do so for over a year. The yield curve duly inverted more seriously than in any episode since the early 1980s. Several banks failed and emergency measures had to be taken to prop up many others.

The analysis above leaves an open question. Apart from the illogical and the illusory, are there solid—if not necessarily defensible—reasons why the Federal Reserve would raise interest rates?

Two possibilities come to mind. The first is venal. The Federal Reserve works, in the main, for the largest banks, and since 2008 it pays interest directly on their reserves. Thanks to “quantitative easing,” the policy of buying at-risk assets such as mortgage-backed securities from the private sector and warehousing them in special purpose vehicles, the big banks are flush with reserves. Paying interest gives them income; paying more interest gives them more income. In return for this, nothing is demanded. As smaller banks with unstable deposit bases are hit by runs, the biggest banks can (and do) ride to the rescue, consolidating their hold on the banking system as a whole. All of this must be very well appreciated by the big bankers.

The other possible reason is global and strategic. Although legal responsibility for the dollar rests with the Treasury, not the Federal Reserve, power over the dollar exchange rate rests largely with the central bank, its interest rate, and their effect on capital flows. Although the topic rarely surfaces in public, there is little doubt that preserving the centrality of the dollar as the global reserve asset is a paramount US policy goal. So it was when Paul Volcker assumed office in 1979, flying back from an IMF meeting in Belgrade to announce the first “Volcker shock,” and so it remains today.

The difference between 1979 and 2023 lies in the industrial consequences of that earlier move to a strong dollar, over the five intervening decades: these are the deindustrialization of America and the rise, most notably, of China. In 1979 the main rivals were Germany and Japan; in 2023 the principal rival has four times the US population and a far greater industrial output. The position of the dollar, for these reasons alone, is all the more precarious. It is far from certain that a mere increase in interest rates can protect it. It is entirely certain that pursuing such a policy for a long time will shatter the illusion, such as it is, of present American prosperity.

In sum, there is no alternative, consistent with minimum economic functionality, to a policy of low interest rates. Keynes was right. Bab was right. But such a policy cannot be effective, in fact no policy can be effective, without a radical restructuring of the US economy as a whole. For this, definancialization, effective control of the speculative/predatory elements in the financial classes, and acceptance of—what is inevitable—a multipolar financial world are the key first steps. There is little doubt, at this stage, that the adjustment will be quite harsh at first. Adjustments typically are. But after forty years in the pursuit of a failed strategy, an easy path forward is not realistic.

As for Herbert Bab and our correspondence: the last I heard from him was in 1981, not long after I had moved over to become Executive Director of the Joint Economic Committee. His note, in a fat manila envelope, said simply, “I think you are the best person to have these.” Inside were about eight original letters, some quite lengthy, dated 1937 to 1944, typed and on stationery marked “Tilton,” “Bloomsbury,” and “Kings College, Cambridge.” They were addressed to Herbert Bab, and signed, “JM Keynes.”

I kept them for perhaps a decade, and eventually donated them to the Keynes Archive at the University of Cambridge, which is where they belonged.

References

Keynes, J. M. 1936. *The General Theory of Employment, Interest and Money*. London: Macmillan.

Notes

1. For the record, I helped author congressional staff efforts to specify and monitor money growth targets in the late 1970s—my motivation was accountability, though I was allied with several staff monetarists in this project. The 1982 rebellion took the form of amendments to the Budget Resolution ordering the Fed to change policy. The House and Senate had differing versions; I drafted both of them. I also organized unemployment hearings in early October 1982.