

Price stability versus financial stability and the real rate of interest – a reaction to Claudio Borio (2018)

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Ever since the global financial crisis (GFC), price stability and financial stability have been uneasy bedfellows. The single-minded pursuit of price stability did not prevent the greatest episode of financial instability since the Great Depression. Inevitably, minds were then concentrated on financial instability, and the idea of macro-prudential regulation was devised. Central banks could use quantitative measures to directly address potential sources of financial instability; the Bank of England has various capital ‘buffers’ to regulate consumer borrowing, for example. Correspondingly, significant resources have been devoted to monitoring private debt, with both the Bank for International Settlements (BIS) and IMF developing large-scale and valuable data resources.

With ‘macropru’ in place, the usual mechanisms (i.e. Bank rate) have still been aimed at inflation. But the overlap between the two processes has been blurred, and policy coordination has thus far been more of an art than a science.

Plainly, the traditional policy to restrain inflation – putting up Bank rate – might threaten financial stability. This is of course the world we are in now; and this is how the OECD (2018) handled these dilemmas in their November *Economic Outlook*:

"Rising market interest rates and declining asset prices are normal adjustment processes during monetary policy tightening. However, the associated increases in volatility could pose risks to financial stability, as asset price corrections could be amplified and spread across different asset classes and countries, exposing vulnerabilities. *Such risks are currently high.*" (p. 29, *my emphasis*)

In their November *Financial Stability Report*, the Bank of England (2018) judged that “risks from global debt vulnerabilities remain material” (p. 34). In a speech given around the same time, Claudio Borio (2018)¹ looked a little closer at this overlap. He too finds conflict in the good times that led to the bad:

“On the other hand, *the establishment of successful monetary policy frameworks focused on near-term inflation control* has meant that there was little reason to raise interest rates – the second anchor – since financial booms took hold as long as inflation remained subdued. And in the background, with the globalisation of the real side of the economy putting persistent downward pressure on inflation while at the same time raising growth expectations, there *was fertile ground for financial imbalances to take root in.*” (p. 14, *my emphasis*)

This would seem a damning indictment of contemporary policy. He ends his remarks on a downbeat note: “Paraphrasing Churchill’s famous line about democracy, ‘the current monetary system is the worst, except for all those that have been tried from time to time’” (p. 16). Perhaps to illustrate the scale of the challenge, in a footnote to the conclusion, Borio cites John Hicks writing fifty years earlier (1967): “To find a framework which can be relied on to give support when it is needed, and to impose restraint just when it is needed, is very difficult.

¹ Head of the Monetary and Economic Department at the Bank for International Settlements (BIS)

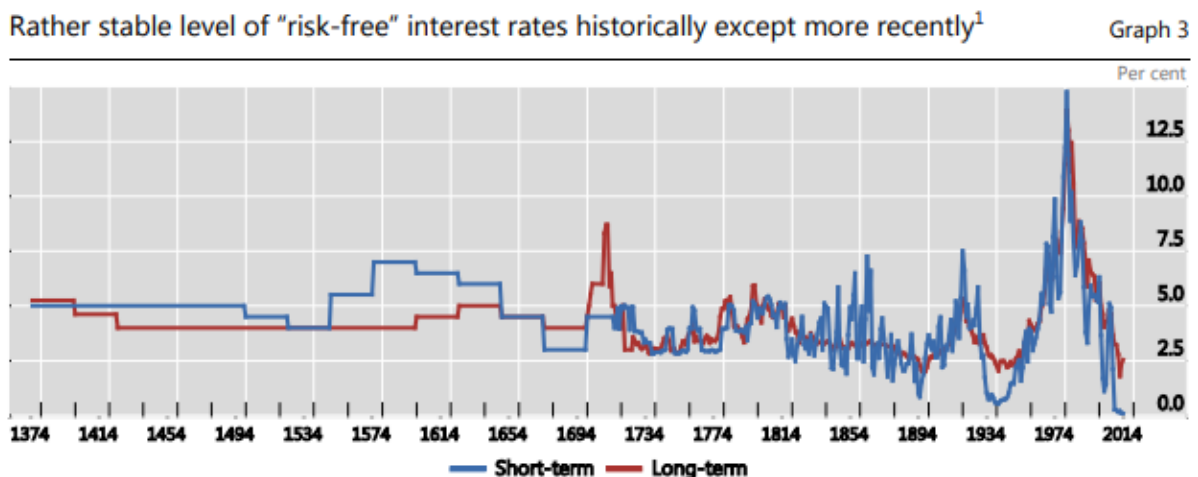
I do not think it has ever been perfectly solved. Even in this day we do not really know the answer” (*ibid.*). Moreover, echoing the OECD, he warns “sooner or later” a financial crisis “will erupt” (p. 15).

Fortunately the discussion also points to a more substantial alternative approach when he considers the determination of interest rates:

“...recent research going back to the 1870s has found a pretty *robust link between monetary regimes and the real interest rate* over long horizons. By contrast, the “usual suspects” seen as driving saving and investment – all real variables – do not appear to have played any consistent role.” (p. 14, *my emphasis*)

Reproducing a (very long-run) chart of interest rates from Andy Haldane at the Bank of England (below), he observes:

“As one might infer from the long-run stability of the short-term nominal interest, *convention* may well have played a bigger role than typically thought (Graph 3). Data limitations aside, this issue deserves further study.” (p. 7, *my emphasis*)



¹ The series is constructed by choosing the lowest interest rates available for each historical phase from various sources. See the original article for details

Source: Haldane (2015).

The remark resonates exactly with Keynes’s (1936) key conclusion on interest rates:

“It might be more accurate, perhaps, to say that the rate of interest is a highly conventional, rather than a highly psychological, phenomenon. For its actual value is largely governed by the prevailing view as to what its value is expected to be. Any level of interest which is accepted with sufficient conviction as likely to be durable will be

durable; subject, of course, in a changing society to fluctuations for all kinds of reasons round the expected normal.” (p. 203, *my emphasis*)²

Borio justly lambasts contemporary monetary thinking in academia, but he does not recognise how monetary thinking through history has also been diminished. The cited contributions from many monetarist economists were in part at least a reaction to the worthlessness of ‘Keynesian economics’, especially from a monetary point of view. Allan Meltzer, of the same persuasion but not cited, rightly looked back to Keynes and saw something more:

“He [Keynes] favoured policies to reduce interest rates to the level at which investment would absorb saving at full employment. That rate, he believed, would bring interest rates to zero in a generation. This is the correct interpretation, I believe, of Keynes’s statements favouring lower interest rates.” (Meltzer, 1988, p. 280)

Borio recognises post-Keynesians have long had something to say about these monetary matters and specifically the endogeneity of money:

“This point is one Post-Keynesians have long stressed, although arguably without paying sufficient attention to the factors that constrain the supply of credit noted above; see e.g. Moore (1988).” (p. 12, n. 36)

In fact, other post-Keynesians have taken the required, more sophisticated approach to money. But there is still in this school an excessive pre-occupation with a big state and some avoidance (or even denial?) of Keynes’s conclusions around the rate of interest. In doing so, the great substance of Keynes’s theory is still lost.

The *General Theory* leads to the conclusion that it is *necessary* for the authorities to intervene and set a low rate of interest, a.k.a. cheap money. Meltzer’s observation is helpful but only partial, for the same conclusion was no less important from the perspective of financial stability.

In the present context of price *versus* financial stability, Keynes’s conclusions are in two ways reversed relative to Borio’s thinking. First, the rate of interest is aimed at financial stability, and quantitative measures at inflation. Then, on financial stability specifically: for Keynes, financial instability was the result of dear money. The intuition is simple. Dear money is not always a deterrent to borrowing (or lending), but reduces the chance of repayment. So private debt inflation (on the balance sheet) is a consequence of dear money.³

Haldane’s nominal figures are less helpful for identifying ‘monetary regimes and the real interest rate’. Shifting to real corporate interest rates (below), the dear money of the 1920s and of 1980 onwards (following financial liberalisation) are the causes of the private debt inflations preceding the Great Depression and Great Recession, respectively. Conversely,

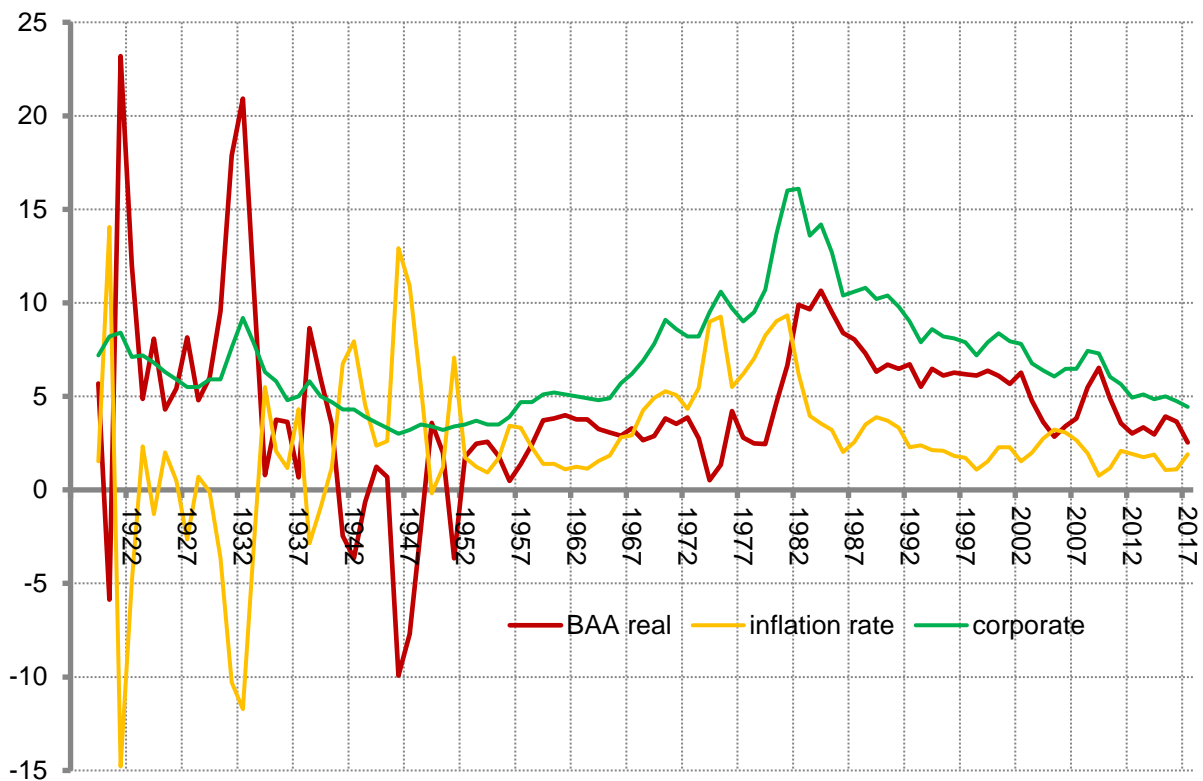
² See also my (2012) discussion on ‘Keynes’s monetary theory of interest’, presented at the BIS in December 2011.

³ In the *General Theory* the process is described as an interaction between the rate of interest and marginal efficiency of capital; Keynes did not explore the balance sheet outcomes but these follow straightforwardly from the same processes – see Tily (2010), Chapter 8.

cheap money permitted the great gains of the golden age without inflation of indebtedness. As Keynes (1936) had predicted:

“[T]he remedy for the boom is not a higher rate of interest but a lower rate of interest! For that may enable the so-called boom to last. The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom.” (p. 322)

The real corporate long-term rate of interest in the US



Source: Bureau of Economic Analysis and Federal Reserve

It has been common to associate cheap money with the global financial crisis - but the decisive and sustained reduction in corporate interest rates came only after the GFC, though the beginnings came in the aftermath of the dotcom bubble. This reduction was consequence not cause of crisis, in part as a result of emergency (quantitative) expansion of central bank balance sheets which was (is) regarded as temporary, rather than part of a wider regime change including (direct) action on interest rates (as from the 1930s).

Regulation of price inflation was a matter for fiscal policy and quantitative monetary control. On the former, Keynes famously remarked “the boom, not the slump, is the right time for austerity at the Treasury” (Keynes, 1937, p. 390). The quantitative measures were not (have never been?) formally elaborated, but the proof of the pudding is in practical measures that were implemented, especially during the Second World War. Above all, ‘Treasury deposit receipts’ obliged banks to lend to government, but banks were not able to use them to underpin

extra private credit creation (as they could with Treasury bills). A 'capital issues committee' also regulated the issue of financial instruments for purposes of capital investment. Conversely, of course, a critical precursor to the inflation of the 1970s in the UK was the removal of quantitative controls under the 1971-73 competition and credit control regime.

Ultimately the 'monetary regimes' that Borio mentions correspond to different *global* monetary regimes. On a Keynes view, the golden age – not the present regime – was the 'least bad'. The Bretton Woods regime may have permitted cheap money to prevail, but it was still a deeply flawed compromise. The best regime may yet prove to be Keynes's Clearing Union. Again resonating with the BIS and wider calls for a multipolar regime, his ideal global monetary architecture was underpinned by a world money of account and world central bank.

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