The long-term rate of interest as Keynes's "villain of the piece"

Review essay of "Long-term interest rates: a survey", The Council of Economic Advisers (2015)

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> "Personally I have come to believe that interest – or, rather, too high a rate of interest – is the 'villain of the piece' in a more far-reaching sense than appears from the above. But to justify this belief would lead me into a longer story than would be appropriate in this place." Keynes, "Saving and Usury", *Economic Journal*, March 1932, *CW* XXIX, 16 [2]

The US Council of Economic Advisers (CEA) has issued an account of the dynamics of the long-term rate of interest that typifies conventional wisdom, finding only a "decline in interest rates over the last three decades". An alternative interpretation of these dynamics is set out in two parts, the first empirical and the second from the perspective of theory and policy.

In section 1 the empirical techniques used by the CEA are contested as partial and inadequate, and an alternative presentation of these dynamics is offered that leads to very different conclusions. The long-term rate of interest has not declined in the manner suggested; instead, the dominant feature has been a severe rise in interest rates since financial liberalisation, with any subsequent decline, coinciding with the end of the bull-run at the turn of the millennium, relatively modest (and now potentially reversing).[3]

In section 2 an alternative account of and explanation for these movements is set out, deriving from Keynes's *General Theory* and specifically his liquidity preference theory of interest. Inherent to this interpretation is a wider argument about the scale of the distortion of Keynes's theory and policy goals, which is not fully appreciated even by the most prominent and/or sophisticated of his modern-day interpreters and followers. In the 1930s, under the impetus of his analysis, dear money came widely to be understood as the cause of the great depression. This understanding was suppressed by the post-war economics profession, even while policy operated broadly to avoid dear money. But at the start of the 1980s, dear money was again allowed to prevail, and has done so ever since – regardless of the trajectory of the rate of interest on US Treasuries (and other governments' debt). Whether wrong-footed by their predecessors or continuing in the same tradition, today economists can't even discern these movements in the underlying state of interest. Any understanding of interest is rooted in

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[1] Writing in a personal capacity.

[2] References to Keynes's work include a title (where relevant), date and the *Collected Writings* volume and page number.

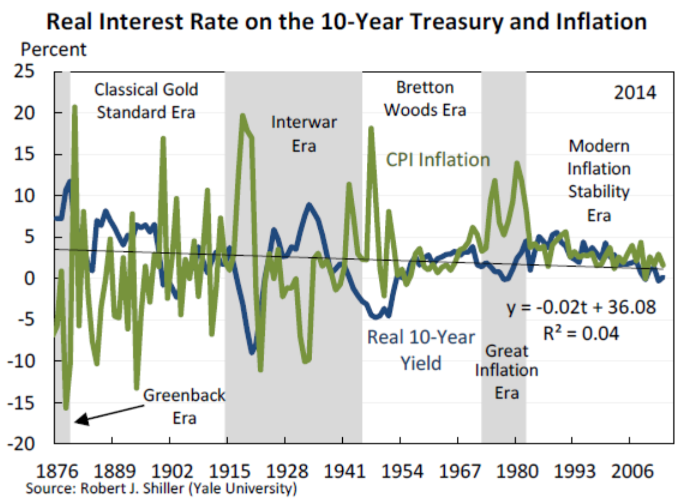
[3] The charts were constructed when provisional versions of this work were published at the start of September in two parts, on the websites of Prime Economics (http://www.primeeconomics.org/) and the World Economic Forum (http://www.weforum.org/). Since then the trends observed have intensified significantly, not least with the sharp rise in interest rates on US corporate debt: the Federal Reserve website shows rates on BAA corporate debt rising from 4.5 per cent over the first four months of the year to 5.5 per cent in November 2015.

'loanable funds', which underpins macro-prudential regulatory initiatives. In the meantime Keynes's very different interpretation of the cause of the economic depression and his (profoundly optimistic and vindicated) means to its resolution remains lost to society, when it so badly needs to be found.

1. Empirics

As is common in mainstream literature, the CEA emphasis is on US *government* rates. Under normal conditions government rates underpin and hence proxy wider rates in the economy, but it can be easily established that conditions have not been "normal" for much of the period in question. The particular problem with US government rates is that US government bonds are regarded by global investors as a safe asset. (Wider claims in the paper that the US analysis generalises to the rest of the world are not well founded, drawn on the basis of a handful of advanced economies.) Second, there is undue emphasis on nominal rather than real rates, even if the authors concede that real rates are most important for economic outcomes: "The real interest rate is the rate that influences economic activity—ultimately, market participants care about the returns to their saving and investment decisions net of inflation" (p. 3). This is all the more surprising given the normal emphasis in economics on the private sector and real quantities. The critical analysis here is poorly presented, with the important features not easy to discern (shown below).

Figure 2



Charts A and B offer an alternative perspective on nominal and real rates on US government and corporate borrowing background on methodology is in endnote.[4]

[4] Interest rate data are not readily available for most countries, the US is the exception, with long-run figures available from the Federal Reserve website, supplemented with Sidney Homer's *A History of Interest Rates*. Government figures are based on Treasury 10 -year bonds, corporate on BAA corporate bonds; both are adjusted with the GDP deflator, with BEA figures supplemented with historical information from Friedman's monetary history. CEA real-terms figures are based on the CPI, which seems too narrow a measure given the concern with activity across the economy as a whole. But the choice of index does not change any of the results (see e.g. n. vi). More generally, while plainly a special case, it is likely that rates on US corporate borrowing underpin rates on borrowing and therefore serve as a proxy for rates across the globe. Though "risk" premia in developing countries in particular

Chart A: US nominal interest rates, 1923-2015

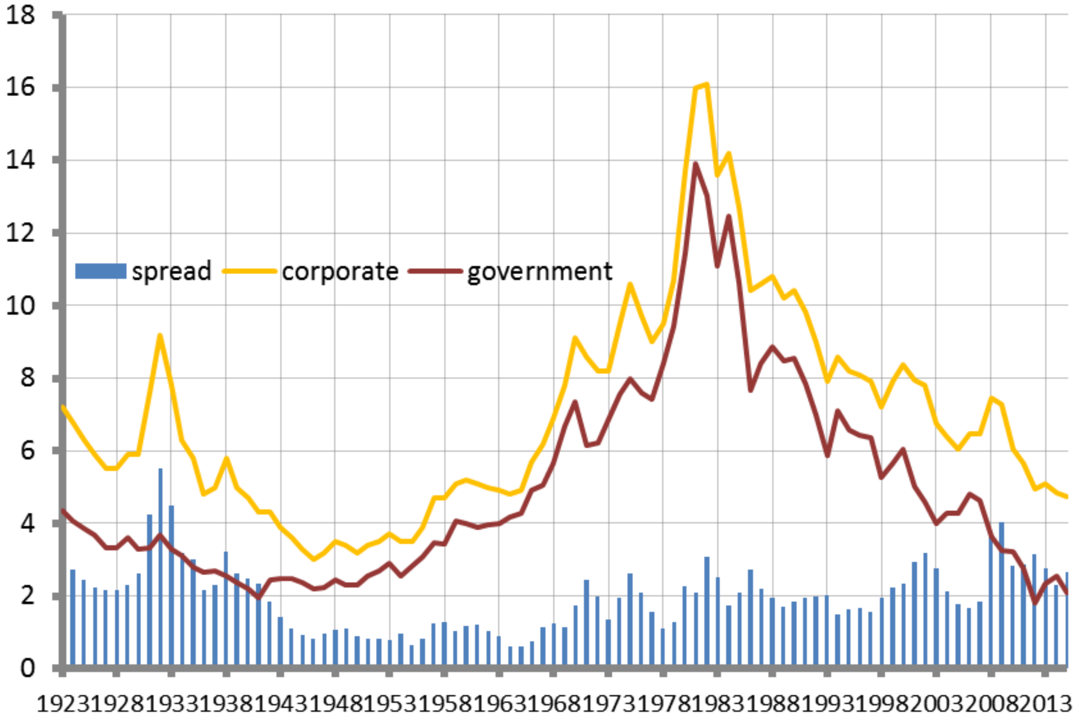
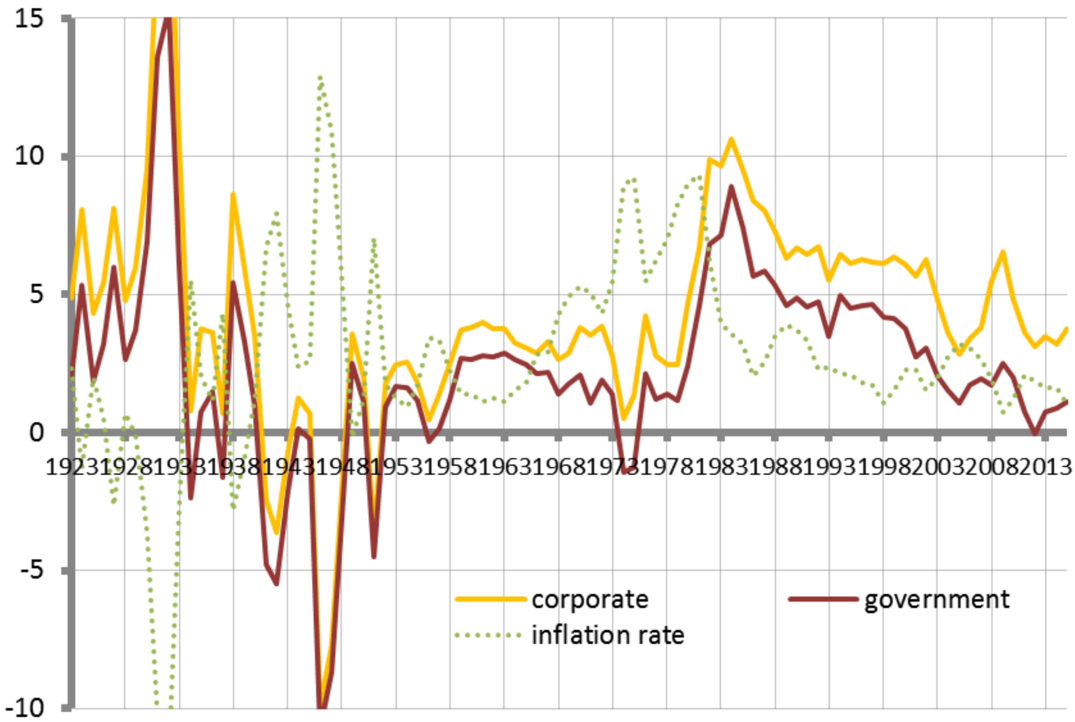


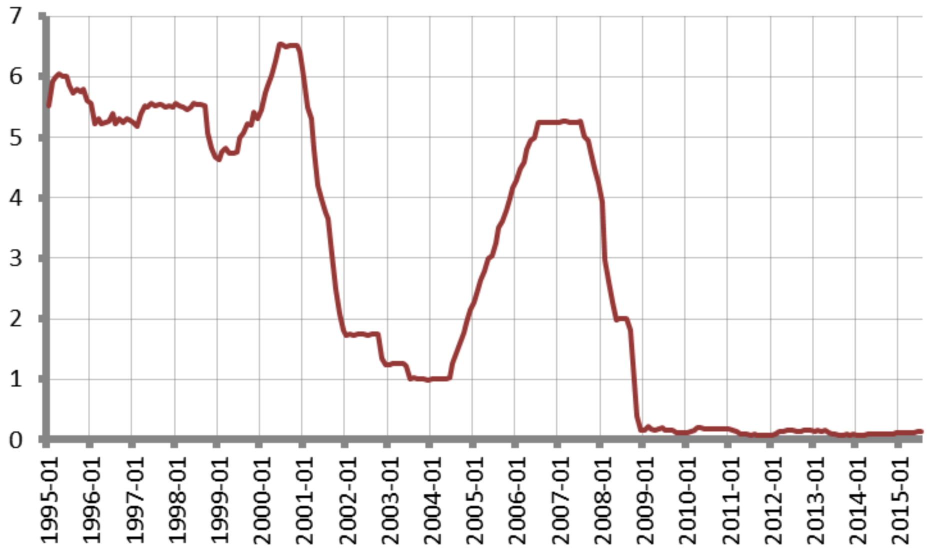
Chart B: US real interest rates, 1923-2015



may mean rates departing very significantly from the US benchmark. The 2015 figures on both charts are mid-year, given availability of GDP deflators at the time of writing.

On this basis the claimed 30-year decline is a feature only of nominal rates: real government rates have been falling for 17 years and real corporate rates for 15, though for the latter no continuous decline is evident. The relation with major economic crises should be obvious. The government rate began its material decline from 1998, in the wake of the South-East Asian crisis, Russian debt default and collapse of the hedge fund, long-term capital management. From that point on, US government bonds were a safe haven. The material decline in the corporate rate came at the end of the corporate (dot.com / new-economy) expansion of the 1990s which coincided with the turn of the millennium and the end of the long bull-run on equity markets; the rate fell to 5 per cent in 2001 from 6 per cent in 2000. From that point on, the major shifts in direction have followed policy on the federal funds rate and associated financial interventions, through with a widening spread.

Chart C: Federal funds rate



The most important feature of the dynamics of the long rate of interest is not the recent reduction, *but the long-standing and severe elevation of rates prior to that reduction*. Even now corporate rates have declined only to a level that was the upper end of the norm for the 30 years after the war. The increase in rates came at the start of the 1980s, in the wake of the Volker shock to monetary policy and full capital liberalisation. The latter a disastrously failed action, given it was ostensibly aimed at the reduction of rates. Apparently mystifying but at least recognised by policymakers at the time,[5] high real rates were the norm until the end of the millennium and equally recognised as such.[6] These rates were:

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[5] From the 1985 IMF *World Economic Outlook*:

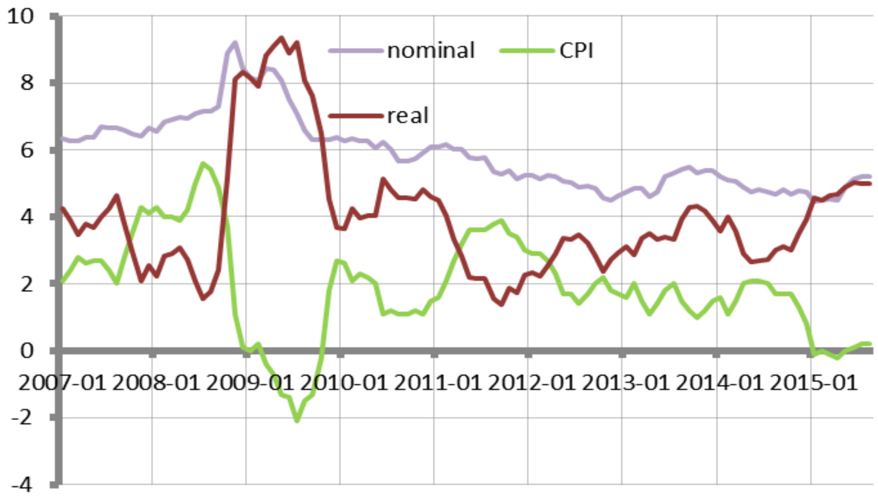
> "Perhaps the most striking and puzzling feature of monetary conditions in the major industrial countries over the past several years has been the persistence of high real interest rates, on both short-term and long-term financial instruments. These high real rates, which have no historical precedent outside periods of price decline during depressions, have persisted, despite lower inflation and the continued existence of a significant margin of economic slack. The phenomenon is quite widespread. Although real interest rates have differed across the major industrial countries, on the whole there has been less divergence of these rates, especially during 1982–84, than in previous periods… These measures imply that real interest rates in the major industrial countries during the 1980s have been significantly higher than those that prevailed in the 1950s and early 1960s and even further above those of the 1970s. Real interest rates increased sharply during the period from 1980 to 1982 and then remained at

- basically double the rates of the golden age; and
- broadly equivalent to the rates in the 1920s that preceded the great depression; the average rate over 1923-29 was 5.9 per cent and over 1980-2000 was 7.2 per cent[7].

With the real rate regarded by the CEA as "influenc[ing] economic activity", at face value it is hardly surprising that since 1980 the performance of the global economy has in general terms fallen well short relative to the post-World War Two period, and in terms of stability is not unlike the disastrous years of the inter-war period.

One final remark on current rates: in spite of the intensive focus on the extent of reductions in certain rates of interest, it is notable that these have not proceeded as far as they did in the aftermath of the great depression. After only four years in office, Roosevelt had reduced the nominal corporate borrowing rate by around half (chart A). In the meantime he had reflated the economy, so the average real rate over 1934 to 1937 was *2.2 per cent*. (Then followed the imposition of a deflationary policy leading to the recession of 1938, but these actions were quickly and decisively reversed.) Over the comparable four-year period today (starting two years after the peak nominal rate of 7.4 per cent in 2008), real rates over 2010-2013 were *3.7 per cent*. While nominal corporate rates match that achieved by 1936, the deflationary (or rather at present disinflationary) tendency has not been arrested. The CEA publish their analysis at a time when real rates have risen quite abruptly, and are at virtually a five-year high (a point normally ignored in the deflation debate).[8]

Chart D: Real corporate rate of interest



relatively high levels in 1983 and 1984… The average real short-term interest rate in the major industrial countries in 1980–84 was 5.5 per cent per annum and the average real long-term interest rate was 5.8 per cent. In contrast, average real long-term interest rates for the major industrial countries during the period 1952–65 ranged from roughly 1.5 to slightly over 3 per cent per annum. The contrast is even sharper with the experiences of the late 1970s. During 1976–79, for example, the average real long-term interest rate in the major industrial countries was 0.9 per cent per annum" (pp. 123–4).

[6] At the end of this era, an issue of the *Oxford Review of Economic Policy* on real rates confirmed: "There is a widespread impression that real interest rates have been very high since 1980 in comparison with post-Second-World-War experience. The data in [Table 11.2] confirm that this is indeed the case. Short-term real interest rates, averaging nearly 4 per cent, have been much higher and a little more stable than between 1950 and 1980. The general picture is confirmed by data on long rates as well" (Allsopp and Glynn, 1999, pp. 3-4).

[7] Using the CPI: 5.9% and 6.4%.

[8] Real figures are derived here using the CPI, given availability of monthly figures.

Given the recognition of the central importance of the long rate to economic outcomes, this interpretation suggests a far less benign trajectory of interest rates over the past 30 years and into the present.

2. Theory and policy

The CEA find theoretical justification for their 30-year decline (and to aid looking forward) in a host of the usual "real", factors:

- lower long-run growth in output and productivity;
- the global saving glut (in part driven by lower productivity growth);
- shortage of safe assets, like U.S. Treasuries; and
- lower population growth.

(On a shorter horizon they emphasise post-crisis expansionary policy, low inflation and deleveraging of private debt.)

Absolutely fundamental to Keynes's view was that the long-term rate of interest was in the gift of policymakers. This realisation dawned as he completed the drafting of his *Treatise on Money* in 1930. "The root causes of what has happened … is to be found in the high level of the market-rate of interest" (*CW* VI, 377). As Ben Broadbent (2014), Deputy Governor of the Bank of England, has recognised, Keynes proposed deliberate policy action aimed at "a very great fall in the long-term rate of interest throughout the world", including "The Bank of England and the Federal Reserve Board … buy[ing] long-dated securities either against an expansion of Central Bank money or against the sale of short-dated securities until the short-term market is saturated" (*Treatise*, *CW* VI, 386).

Only two years later he had devised the theory of liquidity preference. Keynes saw that the long-term rate of interest was not a reward for saving, but the reward for parting with the liquidity of savings (or wealth) *after* the decision to save (or rather not to consume) had been made. This reward was a psychological factor, to some extent a matter of convention, and convention could be changed. Over the 1930s and especially in World War Two, he devised increasingly sophisticated debt management and monetary mechanisms that brought the whole spectrum of interest rates under the authorities' control. The reduction in the UK rate of interest over the 1930s was a result of these deliberate actions and advice. Likewise, Roosevelt too took his cue from Keynes. Fundamentally, policy towards the monetary system was brought under public rather than private authority, under the control of democratic forces rather than "vested interests".

Fiscal policy may also have been essential to recovery, but the new monetary environment was necessary to ensure that it endured:

> "I am in favour of an admixture of public works, but my feeling is that unless you socialise the country to a degree that is unlikely, you will get to the end of the public works program, if not in one year, in two years, and therefore if you are not prepared to reduce the rate of interest and bring back private enterprise, when you get to the end of the public works program you have shot your bolt, and you are no better off" (Harris Foundation Lectures, 1931).

This statement is a very important and *categorical* refutation of those who attribute to Keynes only fiscal policy and a preference for the state over the market. (It is omitted from the published record of Keynes's work, but was recovered by Richard Kent, 2004).

With the policies successful, and recovery ensured, in 1937 he issued his fundamental warning that *dear money must be avoided "as we would hell-fire"* (Keynes, "How to avoid a slump", *The Times*, January 1937, *CW* XXI, 389, my emphasis). Standing the present consensus on its head, once cheap money was established he saw no further role for monetary policy in the day-to-day management of the economy (instead he envisaged turning on and off a tap of public works expenditures, when capacity was achieved). When war came, it was fought with interest rates set at 3 per cent in the UK and 2½ per cent in the US (in contrast to World War One, when the "hard-faced men" of the City and Wall St. profiteered from the carnage). His subsequent international initiatives at Bretton Woods and domestic plans devised in the UK Treasury were aimed at ensuring the permanent continuance of low rates into the post-war era.

The British Labour government took their cue from Keynes, but they were quickly forced to retreat after his death in April 1946. ("The forces against me, in the City and elsewhere, were very powerful and determined … I felt I could not count on a good chance of victory. I was not well armed. So I retreated", as Hugh Dalton later put it, 1954, p. 239). Then, with the 1951 Federal Reserve Accord, the US Treasury effectively allowed financial interests to reassert their authority over interest rates offered on government bonds; economists from Chicago had already begun to call the shots.[9]

Yet for some 30 years, policymakers permitted relatively low rates to prevail.

But finally, with the Volker shock and full financial liberalisation, policies holding rates down were decisively abandoned and, unsurprisingly, rates rose. These rates were the norm for 20 years, and accompanied a severe deterioration in performance, not least crisis after crisis (Germany, Japan, Scandinavia, South-East Asia etc.) that culminated in the global financial collapse and economic recession over 2007-09.

The Council of Economic Advisers may recognise that high rates are detrimental to prosperity, but really their theoretical account has interest as a passive outcome of other macro (really, micro) factors, fundamentally, of course, productivity. For Keynes high rates were the *cause* of low output, employment and incomes, but they were far more dangerous than 'just' that. Animal spirits – more precisely, excessive expectations of income – mean that high interest is not a deterrent to borrowing. The particular problem of excess borrowing then comes through price rather than quantity, for higher rates of interest are much more difficult to repay than lower. Keynes did not say it, but the outcome is expanding debt, a debt inflation (and for sure in the environment of the great depression of the 1930s he knew it, his

[9] An article in the *Federal Reserve Bank of Richmond Economic Quarterly* (Hezel and Leach, 2001) contains the reminiscences of Ralph F. Leach, "Chairman of the Executive Committee of J. P. Morgan and Morgan Guaranty Trust. Before joining the Guaranty Trust Company in 1953, he was Chief of the Government Finance Section at the Board of Governors of the Federal Reserve System" (n. 1). "Leach had graduated with an A.B. degree from the University of Chicago in 1938. At that time, Chicago had two of the great economists of the twentieth century, Frank Knight and Jacob Viner. Even at the height of the recession, they and other Chicago economists had retained a belief in free markets. Leach had absorbed that belief and made use of it while at the Board to convince the governors and others of the viability of a free market in government securities" (n. 3).

commentary on events makes that perfectly plain). On the basis of Keynes's theory, which emphasised *corporate* investment expansion and animal spirits, the global financial crisis really began at the end of the millennium. In the light of history, far from a "black swan", it was entirely unsurprising.

The subsequent reduction in corporate rates followed as a reaction to the crisis, as the authorities allowed the financial system to flood itself with money. (In the UK the vast expansion of the financial sector's balance sheet was passed over in silence, in spite of the regular, forensic official commentary on the economy.) The financial crisis of 2007-09 came as these actions could be taken no further, and the central bank and governments then took "responsibility" for monetary expansion. With quantitative easing (QE) apparently regarded as inexplicable theoretically, liquidity preference is perfectly clear cut on the operation of this process. Rates rise as a result of sharply increased liquidity preference in crisis; extending the money supply forces them back down.

With only a real theory at their disposable, the CEA's judgements about prospects for the rate of interest depend on pure speculation about real factors going forward. On a Keynes view, the trajectory of the long rate depends on policy in the wake of the unresolved crisis of indebtedness. With deflationary forces intensifying and relentless asset inflations, it is unlikely that this process – effectively, repeated demand stimulus through massive liquidity injections – can continue indefinitely.

3. Conclusion

Devised in the wake of a comparable crisis, Keynes's theory unsurprisingly offers a coherent and compelling (to me at least) explanation of the behaviour of the economy over the past 30 years as a result of a high long-term rate of interest. The actions of policymakers in the 1930s provide a blueprint for an alternative way forward, to reassert democratic control on the economy and the destiny of the world.

It is tragic – even shocking – that such high authorities as the CEA can proceed apparently oblivious to Keynes's interpretation of these matters, let alone to the more obvious events of history. They are victims to a betrayal that has the most immense implications for economics and society.

The "Keynesian" economists of the 1930s, including Paul Samuelson, Alvin Hansen, Franco Modigliani, John Hicks and James Meade, are on record opposing Keynes's approach to the rate of interest. Though in the UK it was left to Dennis Robertson[10] to administer the fatal blow, only two and a half years after Keynes had died (also amounting to one of "forces" "elsewhere" that Dalton mentioned, undermining the policy of the democratically-elected Labour government). He did so unashamedly as a matter of taste "rather" than a theoretical or analytical judgement:

> "Nowadays – I am still talking about high-brow opinion – things seem to have altered in two ways. The rate of interest has come to be regarded as of less

[10] Robertson and Keynes worked closely together in the early days, but he came to reject and vigorously oppose Keynes's eventual destination. Unfortunately for Keynes, after the war, he was in charge of economics at Cambridge University until he retired in 1957.

> importance in the causal nexus, its high *reclame* [public acclaim] of the nineteen-thirties savouring too much, to the modern taste, of an obsolescent economics of price" (Robertson, 1966 [1948], p. 188-9).

The theory that made it into the textbook and wider literature had no substantive role for the rate of interest, with liquidity preference transfigured as loanable funds (Chick and Tily, 2014). Judged on the basis of this *entirely false* account, Keynes's theory and policy has never been assessed on its own merits. Yet in spite of the crisis and various campaigns for reform of the teaching of economics, such a review continues to be rejected on the grounds that a theory rooted in mainstream analysis provides a more rigorous justification for fiscal policies to combat recession. That this position prevails beggars belief, though I should concede that even heterodox interpretations only scratch the surface of Keynes's monetary policies, and my own efforts to convince otherwise (including in this journal: Tily, 2009) have met with only limited enthusiasm.[11]

As a result, even on the failure of the restoration of the system that Keynes understood as profoundly at odds with stability, prosperity and a just society, financial authority is virtually uncontested in a material way by either academic or political forces. The economics profession needs to wake up to the impossibly high stakes of its ongoing negligence.

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11 Mainly on the part of a handful of reviewers including practicing economists and Keynes scholars, the former including interest from the Bank for International Settlements (Tily, 2012). I have been entirely unsuccessful in attracting the attention of modern-day "Keynesian" economists.

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