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Wicksell Wouldn't Blame the Central Banks

There is a market narrative gathering steam that central banks are somehow "destroying capitalism" by "suppressing interest rates." The illogic encompasses a popular new theory that low interest rates are actually deflationary, in that they keep afloat "zombie companies," that then supply "excess" goods and services which depress pricing power. Hence, keeping rates "too low" leads to *lower* inflation.

On the contrary, **low interest rates are *market-based*** – the result of political, structural, and/or demographic forces (ie "real" factors). Central banks will only court economic (and ultimately political) trouble by trying to "fight" this reality with unwarranted rate hikes.

Let's briefly unpack the following:

- If the actual rate of interest is held below the neutral rate, excess credit creation and accelerating inflation ensue. Yet, *we presently observe the opposite conditions*.
- The neutral rate of interest is determined by real, not monetary, factors
- Markets currently expect the neutral rate to remain very low for a long time
- If central banks don't acquiesce to the low level of neutral rates, they will seriously compound the problem

Interest Rates are Not "Too Low"

Let's turn to Knut Wicksell - Mr. "Neutral Rate" himself – to rebut the "zombie company" theory of low inflation: If the actual interest rate is held below the neutral interest rate, surplus profits will accrue to entrepreneurs. On the margin, this could keep afloat some "zombie company" that might otherwise go bust. But any increased supply of goods produced by the zombie company will be overwhelmed by the increased demand for goods and services, called upon in the form of "capital," to fund the increased entrepreneurial activity motivated by the sub-equilibrium interest rate.

From Wicksell's magnum opus, *Interest and Prices* (1898):

> Now let us suppose that the banks and other lenders of money lend at a different rate of interest, either lower or higher, from that which corresponds to the current value of the natural rate of interest on capital. The economic equilibrium of the system is *ipso facto* disturbed. If prices remain unchanged, entrepreneurs will in the first instance obtain a surplus profit (at the cost of the capitalists) over and above their real entrepreneur profit or wage. This will continue to accrue so long as the rate of interest remains in the same relative position. They will inevitably be induced to extend their businesses in order to exploit to the maximum extent the favourable turn of events. And the number of people becoming entrepreneurs will be abnormally increased. As a consequence, the demand for services, raw materials, and goods in general will be increased, and the prices of commodities must rise.

Keep in mind the "real" nature of the neutral interest rate in concept. The "money" borrowed to fund entrepreneurial activity is representative of real goods and services that will be borrowed for consumption today in pursuit of production and profits tomorrow:

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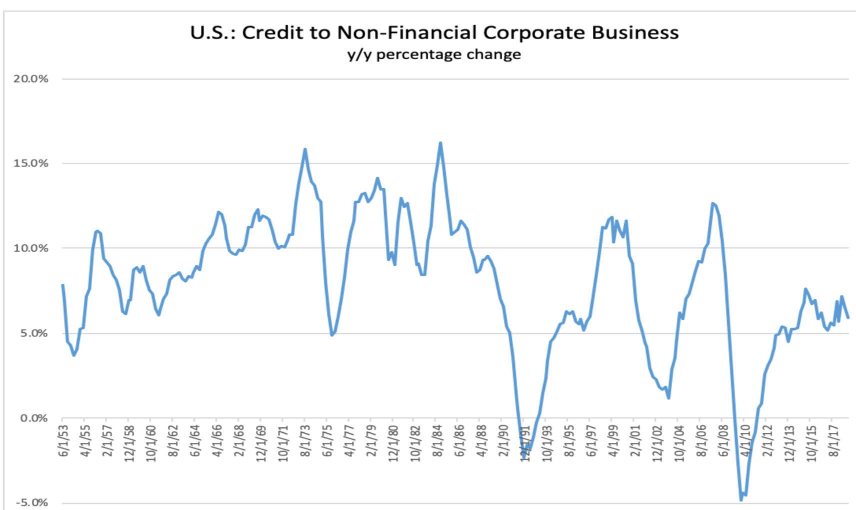
> THERE is a certain rate of interest on loans which is neutral in respect to commodity prices, and tends neither to raise nor to lower them. This is necessarily the same as the rate of interest which would be determined by supply and demand if no use were made of money and all lending were effected in the form of real capital goods. It comes to much the same thing to describe it as the current value of the *natural rate of interest on capital.*

To simplify: ceteris paribus, a lower interest rate creates an entrepreneurial impulse to future production that generates a *demand for goods and services today*, thereby increasing prices (the entrepreneur having "raised capital" for the purposes of procuring plant and equipment, paying employees, and meeting his own consumption needs). The excess profits received on the sale of those goods and services to the entrepreneur today will allow for higher prices to be paid tomorrow on the goods which the entrepreneur will ultimately bring to market. **Even the "zombie company" will be selling into a higher overall price level**.

The mechanism through which sub-neutral interest rates spur activity is above-normal credit extension. Alas, **credit extended to non-financial corporate businesses has been unusually low this cycle** in both the U.S. and the Euro Area.



Old Knut, were he alive today, would conclude that **the culprit behind persistently below-target inflation is interest rates that are too high relative to neutral**, not too low. Depressed rates of credit growth and sub-target inflation show ipso facto that **the current rate structure is not being unnaturally "suppressed"** by central banks.

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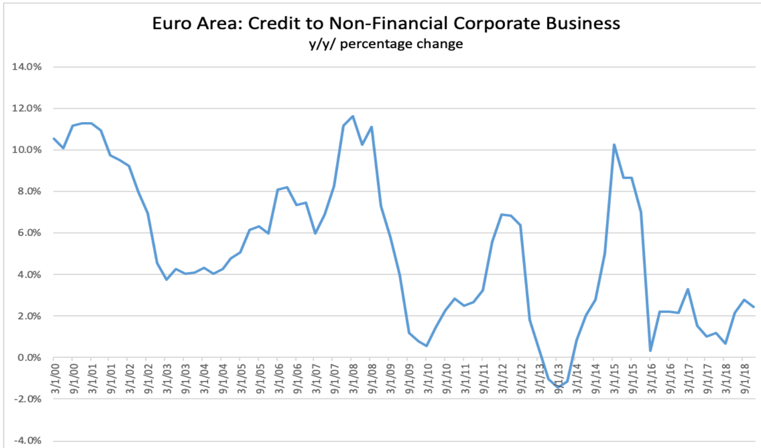
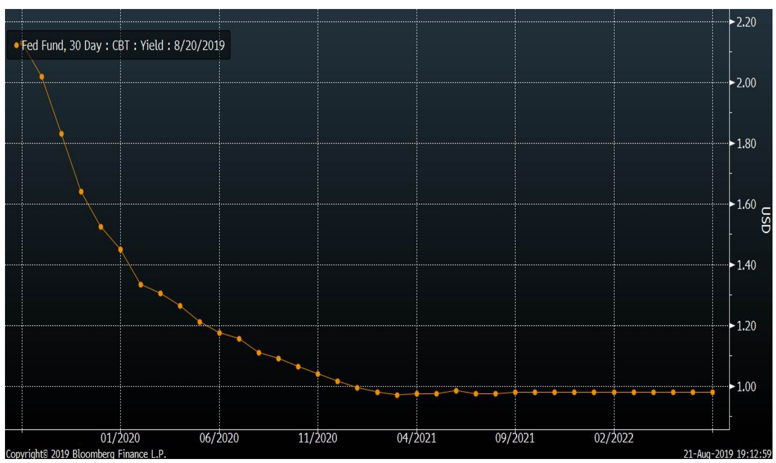
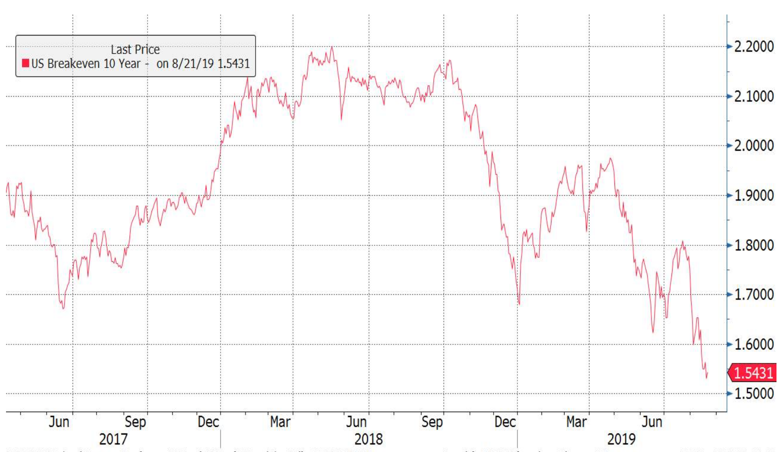


Furthermore, Interest rate markets anticipate rates staying low for a long time (sub-1.5% for the next decade):



While inflation is expected to continue to undershoot considerably:



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This is not to say that these market expectations are necessarily correct. That's what "makes a market," after all. But it is incontrovertible that the market's current best guess is that **a low neutral interest rate will persist** almost indefinitely.

<u>The Problem is "Real"</u>

In this I will agree with the doomsayers: the current level of global interest rates is sending depressing signals about the future. But blaming low rates for the depressing outlook for capitalism like blaming fevers for an Ebola outbreak.

Again, Wicksell:

> [redacted] The natural rate[1] is not fixed or unalterable in magnitude. The causes that determine it will be discussed somewhat more fully in the next chapter. In general, we may say, it depends on the efficiency of production, on the available amount of fixed and liquid capital, on the supply of labour and land, in short on all the thousand and one things which determine the current economic position of a community; and with them it constantly fluctuates.

The "thousand and one" real variables Wicksell refers to are causing the supply and demand for real capital to clear at very low rates. **Capitalism is not in trouble because rates are low. Rates are low because capitalism is in trouble**.

Yes, deteriorating demographics – which could both reduce demand for capital investment and increase the supply of savings – are likely playing some role. But it is clear that the neutral rate suffered a break lower after the global financial crisis. That couldn't have been driven by glacially-trending demographics.

Policy is paramount: high taxation and stifling regulation are critical impediments to entrepreneurial capitalism. Crisis response, including quasi-nationalization of the financial industry, served to accelerate the extant trend of interventionism in economic affairs, and give capitalism a political "black eye."

Neutral rates did appear to pick in 2009-10 until the Eurozone entered an existential crisis, to which policymakers responded with yet more interventionism and the institutionalization of a high-tax "fiscal compact." (Salvini could prove bullish for the EZ neutral rate if he cuts that Gordian Knot with an "unauthorized" tax cut).

More recently, cuts in taxes and regulation in the U.S. in 2017-18 seemed to raise the neutral interest rate a bit, only the run headlong into the Fed's insistence on speed-limiting real growth at 2% - an obvious depressant to entrepreneurial activity (<u>Fed Shackled at Neutral</u>, 7/17/19).

More recently markets are facing heavy uncertainties regarding de-globalization and the threat of an existential crisis in Greater China.

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Obviously, I can't accurately detail the "thousand and one" reasons the neutral rate might be so low. This stylized account is meant simply to highlight the **real-side nature of forces suppressing the neutral rate** and to emphasize that **raising interest rates above neutral would seriously compound the problem.** Above-neutral rates threaten a debt-deflation spiral which would very likely lead to yet more political backlash against "capitalism," new rounds of interventionism, and quite possibly the end of central banks themselves.

This is perhaps why we're seemingly always on the precipice - why the markets show no resilience at all to potential deflationary error: capitalism is in enough trouble as it is already

But don't blame low interest rates.

Conclusions

- **Rates are not being unnaturally suppressed** by central banks
- Low credit growth in an environment of low rates tells us ipso facto that **neutral rates are low**
- Deflationary pressures do NOT stem from "low interest rates propping up zombie companies"
- Deflationary pressures arise from the difficulty in achieving effectively easy monetary policy in the face of extremely low (and in Europe, negative) neutral rates
- **Low neutral rates result primarily from real-side impediments** to entrepreneurial activity
- **Central banks must acquiesce** to low neutral rates to avoid exacerbating the "crisis of capitalism"