A Criticism of Interest Rates

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Interest Rates

Rates of interest are used for levying an incentive for separation of money. This separation can be for either savings purposes or for lending. The acceptable rate of interest will always be debated, but numerous theories have been put forth. Interest rates are used to set bond prices, mortgage rates, short term commercial loans, savings rates, and other forms of savings and lending. Each rate will grow over time, as there is more uncertainty about the future, resulting in longer separation from capital. Some economists argue that time is of utmost importance when determining a proper rate of interest; others argue the rate of interest is the cost to separate from money. Frederic Bastiat expounds on the difficulties of interest:

> Although this problem appears at first sight so very simple, there is more in it than you might suppose…It would be a waste of time to seek any satisfactory explanation from the writings of economists. They have not thrown much light upon the reasons of the existence of interest. (Bastiat)

Bastiat's words ring true today, as central bank economists are constantly tinkering with interest rate levels in hopes of economic expansion. In the private markets, interest rates are calculated using the Capital Asset Pricing Model, with US Treasury notes serving as the "risk free" rate of interest (Investopedia). Whether the rate of interest is highly mathematic or created on a whim, ultimately there is a cost to pay for separation of money.

John Maynard Keynes

John Maynard Keynes is one of the more noteworthy economic theorists. In his *General Theory of Employment, Interest, and Money*, Keynes lays out a cycle of consumption being driven by spending through increased money supply (which drives interest rates downward). Keynesians celebrate two major theories with regard to interest rates:

Theory	**Definition**
Liquidity Preference	When income rises then interest rates should also rise
Marginal Efficiency of Capital	"Rate of return expected to be obtainable on money if it were invested in a *newly* produced asset"

Keynes uses the liquidity preference to help shape central banking policy. Further, "the rate of interest depends partly on the state of liquidity-preference (i.e. on the liquidity function) and partly on the quantity of money measured in terms of wage-units" (Keynes). This amount of money would then dictate the central banking rate, which would then shape the marginal efficiency of capital through income wealth. Keynes's entire interest rate theory focuses on generating income through proper interest rate management. When additional income is generated, that money can be invested towards consumption, which continues to stimulate production through demand. The Keynesian business cycle has an inherent focus on income, and the production cycle all begins with consumption. As interest rates drop, additional capital will flow into the economy and create greater wealth. This wealth can be used for consumption, which creates demand. As rates increase, borrowing is reduced, which results in less consumptive activity. During economic expansion, higher rates will not deter spending, as the economy is functioning productively.

The Austrians and their disagreement with Keynes

Alternatively, Frederick Hayek and Ludwig von Mises have their own perspective on interest rates – Mises in particular has strong thoughts on Keynesian monetary policy. While interest rates can be kept artificially low to stimulate consumption, in the long run, this creates more opportunity for malinvestment. Mises explains, “The essence of the credit-expansion boom is not overinvestment, but investment in wrong lines, i.e., malinvestment” (Mises 559). What makes interest rates so difficult is that there are two ways they are used – borrowing and saving. There are two sets of interest rate enablers, yet central banking often penalizes savers more than borrowers. Stored cash is of no importance to a central banker. This is where Keynesian rhetoric fails, and Mises et al pick up on the nature of the firm. Keynes assumes that central bankers know what’s best for the economy and has total disregard for consumers’ time preferences, but Mises refutes this:

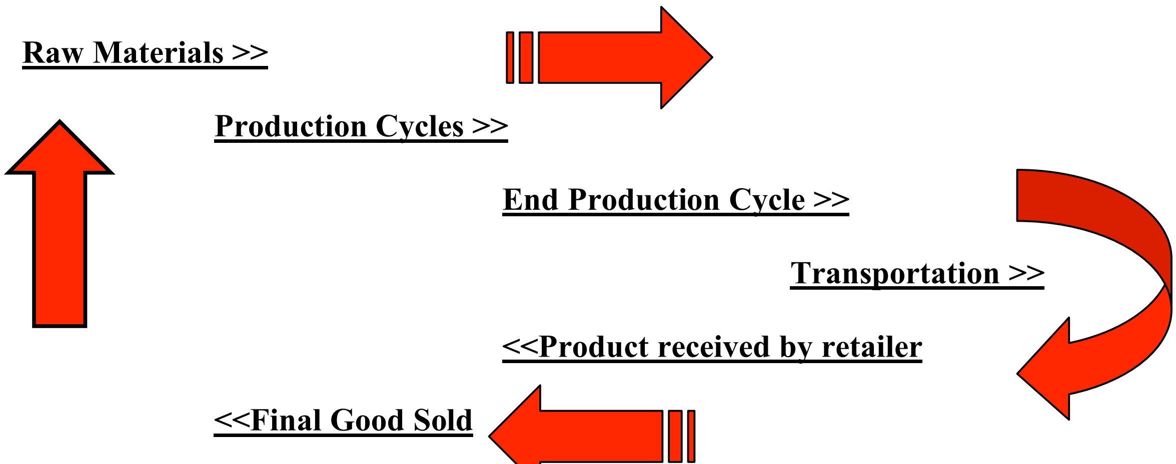
> The wavelike movement affecting the economic system, the recurrence of periods of boom which are followed by periods of depression, is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion. There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved. (Mises 572)

Mises argues that depressions and recessions are inevitable, so there is no sense in undertaking Keynesian rhetoric because it will only prolong the bust cycle. Saving is penalized in the Keynesians economy. Money spent via consumption drives further growth, and low interest environments stimulate activity. Keynes neglects to discuss the interest formed by production activity. Murray Rothbard further continues to solidify the contrasting Austrian view of price influencing interest:

> If, on the time market, 100 ounces of gold exchange for the prospect of obtaining 105 ounces of gold one year from now, then the rate of interest is approximately 5 percent per annum. This is the time-discount rate of future to present money…the *pure* rate of interest will then be the going rate of time discount, the ratio of the price of present goods to that of future goods. (Rothbard 376)

Rothbard refutes Keynes's view that loans and lending are not the only factor in determining interest rates. Rothbard continues in saying that the rate of interest is simply the rate of price spread out through various stages (371). Further, "Too many writers consider the rate of interest as only the price of loans on the loan market…the rate of interest pervades all time markets" (371). Keynesian monetary policy forces consumers into borrowing and saving for the greater good of the economy. Product and the price of goods dictate the truest rate of interest. Other scholars argue against Keynes by stating, "One of Keynes's own principal errors is his discussion of the relation of the marginal efficiency of capital to interest rates is his failure to recognize that current *interest rates* are *also* determined in large part by expectations regarding the future" (Hazlitt 158). The consensus is that Keynes does not offer evidence as to why production plays such an important role in the rate of interest. Keynesian focus relies on macroeconomic theory of economic stimulation through lending. Manufactured goods are created through numerous production stages and each stage creates value to a finished product. Additionally, as Rothbard and Hayek note, the finished good must be sold at a later date, which is in itself a rate of interest:

Classicists / Austrian (Fig. 1)



Incremental rates of interest gained throughout the process

The illustration above gives a simple view of the production cycle. Throughout each phase, interest is, in essence, accrued from raw materials to end product – during the value added periods. If raw materials for one unit of product costs $50, production of one unit costs $25, transportation costs $10, and the final good is sold for $100, there is a net $15 gain or the rate of return is 17.64%. This is the *real* rate of return on a product. Keynesian interest rate calculation is a little different, and Rothbard explains it well:

> The 'marginal efficiency of capital' *is indeed* the rate of interest! It is a price on the time market. It was precisely this 'natural' rate, rather than the loan rate, that had been a central problem of interest theory for many years. The essentials of this doctrine were set forth by Böhm-Bawerk in *Capital and Interest* and should therefore not have been surprising to Keynes. *See* John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace & Co., 1936), pp. 192–93. It is precisely this preoccupation with the relatively unimportant problems of the loan market that constitutes one of the greatest defects of the Keynesian theory of interest. (Rothbard /footnote)

Rothbard takes Keynes to task for his insistence that the loan markets are what drive the economy. In 1931, Richard Kahn created the Keynesian Multiplier, which purports that, as government spending increases, additional money will be spent by consumers as a multiple of that increase (Kahn). Eventually, the spending tapers off once the economy reaches stable equilibrium. Putting money into the hands of consumers sounds nice, but Bastiat warns against this:

> Between a good and a bad economist this constitutes the whole difference - the one takes account of the visible effect; the other takes account both of the effects which are seen, and also of those which it is necessary to foresee. Now this difference is enormous, for it almost always happens that when the immediate consequence is favourable, the ultimate consequences are fatal, and the converse. Hence it follows that the bad economist pursues a small present good, which will be followed by a great evil to come, while the true economist pursues a great good to come, - at the risk of a small present evil. (Bastiat)

Keynes's theory *assumes* that people will spend money, which will spur production. The unseen behavior is that people will store and save money or spend it to pay down debt – which is what happened during the previous housing crisis.

Under Keynesian guidance, borrowing, spending, and savings are at the mercy of central bank interest rates. During low interest rate environments, companies would be wise to engage in long term spending activities (to save on interest payments). **Savings is penalized and spending is encouraged**. Markets are not free because only spenders benefit. In a recent review, Tempelman notes the Keynesian policy:

> To make up for the shortfall in private-sector demand, Keynesians argue, governments should increase their spending and finance the extra expenditures with borrowing. The increased demand encourages businesses to hire again, which reduces unemployment. The resulting fiscal government deficits do not pose a problem because, in effect, we owe the money to ourselves, and in any event, the deficits will be less than the increase in government spending given fewer unemployment benefit payments. In addition to these fiscal policy measures, the central bank should lower interest rates. Doing so reduces the cost

> of funding investments, which encourages business activity and thus leads, in turn, to the hiring of new employees. Accommodative monetary policy also helps prevent deflation. Deflation is undesirable because lower prices encourage consumers to further reduce demand in anticipation of even lower prices. (Tempelman)

As many consumers were in debt from 2004 – 2008, monetary expansion went towards consumers paying down accrued debt. The money went right back into the financial institution issuing the original debt. Deflation may be bad for the greater economy as a whole, but for someone who is unable to afford food, gas, and housing debt, lower prices would be welcome. Keynesians reject price uncertainty; consumers don't purchase as many goods during deflation in hopes that the price will eventually bottom out. When prices go down, the Keynesian mathematical formula breaks down because speculation is undesirable.

On the contrary, had Mises or Hayek theory been used during the recent housing crisis, institutions would have failed. Lehman Brothers, Bear Stearns, Wachovia, Washington Mutual, AIG, and Citigroup would have failed. Each of those companies had inherent business units that were strong and others that were failing. Competing firms would have absorbed the good pieces and purchased troubled assets for probably pennies on the dollar. This would ostensibly shift production to other firms. Instead, governments intervened to keep companies afloat (and apparently with little disregard for the fact that senior management of failing firms put windfall profits ahead of long term risk). The differences between Keynes and Austrians are laid out:

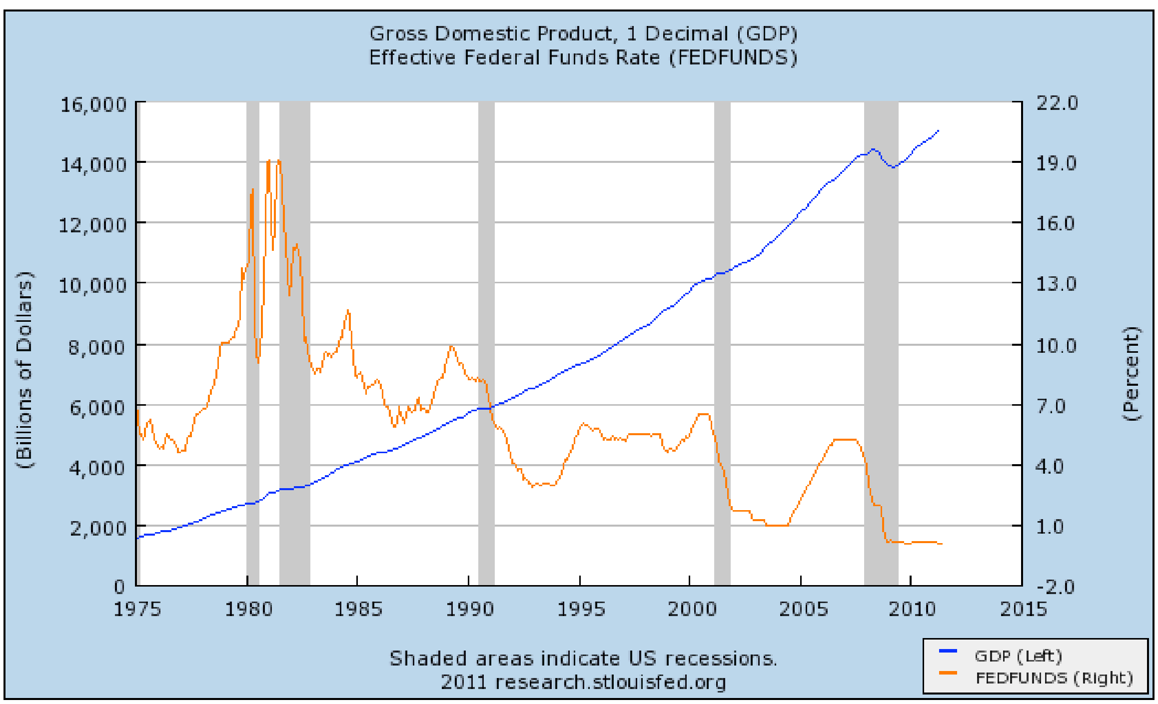
Compare and Contrast on Interest Rate theory during financial crises (Figure 2)		
	KEYNES	AUSTRIANS
Who gets saved in crises?	In Keynesian state, banks, big business, and other purveyors of rent-seeking behavior are saved are saved.	No one gets bailed out in Austrian free markets.
What happens as a result?	Under the guide of helping the consumer, big business stabilizes and windfall profits are received among the survivors. Big financial firms are able to grab cash quickly due to low rates and easy access to funds.	Smart firms with sound capital planning are able to scoop up valuable assets that remain within failed firms. Non-performing assets are acquired for pennies on the dollar.
Where is impact felt?	The impact is shared amongst all citizens. Low rates force greater long-term investment when rates are low.	Strong firms with savings can continue to perform business regardless of the rate.
When will recovery happen?	Low interest rates prevent quick recovery. Monetary stimulus trickles into market slowly while businesses reap benefits of cheap capital.	Interest rates aren't part of the equation. Thus, smart firms can continue with business. Failing firms are penalized via extensive borrowing/bad business practice.
Why do we act?	To benefit the greater economy as a whole. In reality, this rhetoric only helps politicians and rent seekers.	There is no central bank action in Austrian economies. Recoveries and Recessions are faster and shorter.
How do we act?	Keep interest rates low so everyone can help stimulate the economy. The capital markets drive the economy.	No action results in markets forming on their own.

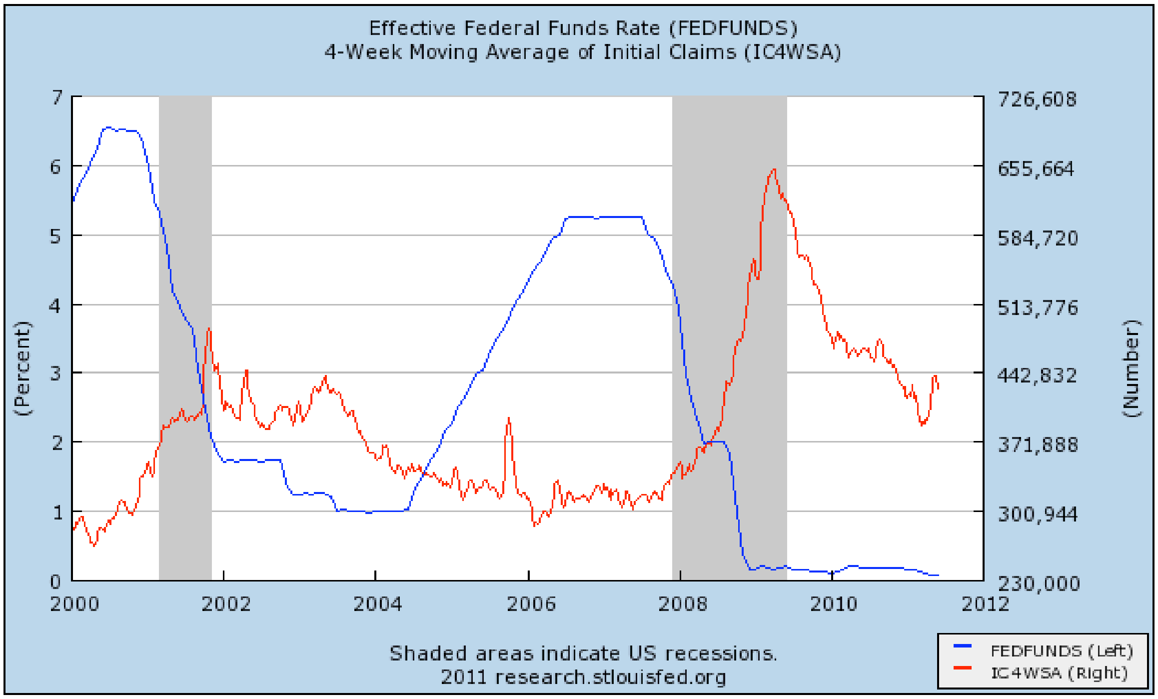
What should be done with Fannie Mae and Freddie Mac?

In 2008, the government bailed out Fannie Mae and Freddie Mac by using $400b of government funds to ensure their survival. Fannie and Freddie provide housing market stability by insuring conventional loans originated by financial institutions. By saving Fannie Mae and Freddie Mac, the government stabilized financial institutions by providing guaranteed profit to originate mortgages. According to Fannie Mae's website, "Treasury will provide us with capital as needed to correct any net worth deficiencies that we record in any quarter through 2012. The agreement is intended to ensure that we are able to continue providing liquidity and stability to the housing and mortgage markets" (Fannie Mae). In order to compete and keep markets relevant, Fannie Mae must simply offer price premiums better than the competition. Bastiat gives examples of this in his broken window theory and expounds on the result, "If you submit the most complicated Government institutions of credit to the same test, you will be convinced that they can have but on result; viz., to displace credit, not to augment it" (Bastiat). This is a price control that persuades financial institutions to guarantee loans with Fannie and Freddie – not because it's bad business sense but because all Americans have a *right* to homeownership. Politically, it makes more sense for politicians to support Fannie and Freddie because it allows more people to own a home. As the housing markets reaches a trough, central banking has used interest rate intervention to promote more home purchasing. By using the Federal Reserve Fed Funds Rate as an enabler, the Federal Reserve Bank forces businesses and consumers to make decisions about whether to make long term investments while the interest rates are cheaper. However, according to former Federal Reserve Bank chairman Alan Greenspan, the FRB did not cause the housing crisis, "If it is monetary policy that is at fault, then that can be corrected in the future, at least in principle. If, however, we are dealing with global forces beyond the control of domestic monetary policy makers, as I strongly suspect is the case, then we are facing a broader issue (Greenspan). Monetary policy can correct the economy, but according to Greenspan, there are greater concerns than the money supply.

How Would the Federal Reserve Affect Housing?

Using a St. Louis Fed graph, GDP has improved since the lowering of the Fed Funds rate (the FRB's target rate, which is manipulated via currency injection) in late 2007.

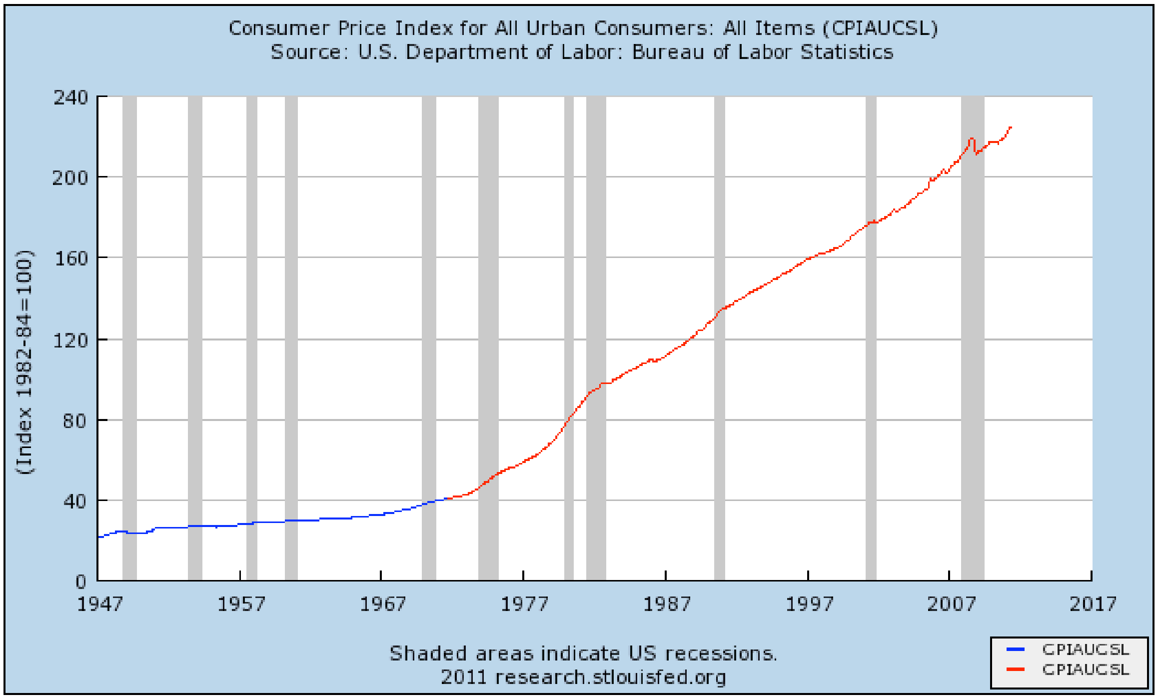




As the graphs show, government intervention has stimulated the economy as GDP is slowly rising. Employment experienced a downturn, then a slight uptick, followed by a slight downward trend. The slight upturn is interesting because it shows the workforce going through a slight shrinking period. Figure 2 (the table presented earlier) states that Keynesian states undergo a slow period of expansion as the government intervenes into markets. Mises warned about credit expansionary policy in his writings:

> What differentiates credit expansion from an increase in the supply of money as it can appear in an economy employing only commodity money and no fiduciary media at all is conditioned by divergences in the quantity of the increase and in the temporal sequence of its effects on the various parts of the market. Even a rapid increase in the production of the precious metals can never have the range which credit expansion can attain. The gold standard **was an efficacious check upon credit expansion, as it forced the banks not to exceed certain limits in their expansionist ventures** (MISES 574 [emphasis added]).

America relies on a fiat system of monetary expansion, so increasing money supply lowers the rate of interest (Schwartz). Prior to removing itself from the gold standard, the US economy experiences minor inflation:



The blue line above represents the rate of inflation while the US Dollar was pegged to the convertible price of gold ("The Day Gold Died"). Once the convertible check and balance (gold) was removed (red line), the Federal Reserve was essentially given free reign on increasing money supply.

According to a recent CNN Money article, "a reduced government role would almost certainly raise mortgage rates and other costs, since banks would have to add a cushion to cover the extra risk they'd be taking without the government backstop. Down-payment requirements would probably go up" (CNN.com). This is precisely as the Austrians detected; in the absence of governmental control, free markets would reign supreme and private firms would control the cost of money. The market rate of interest *might* go up in the absence of Fannie Mae and Freddie Mac, but there is no certainty about the true market rate because competition will keep rates from soaring. Governments have intervened into home lending so often and for so long (Multicultural lending, Low-to-Moderate income subsidies, etc.) that knowing a true rate of interest is impossible. As the article mentions, “Down-payment requirements would probably go up”; this is interesting, as financial institutions would require some way of reducing risk from home loan borrowers. This would require more savings on the part of borrowers – quite the conundrum in a Keynesian society. Under government sponsorship, Fannie and Freddie have failed, consumers have been forced to consume, and the economy went into dire straits. Elimination of Fannie and Freddie would ensure drastic change to markets, and although most people would complain of the burden involved with purchasing a house, it would be hard to argue against the safety of the investment.

People live in houses for a long time, as mortgages are often thirty years. Yglesias opines, “What more can [policymakers] do to provide people with other kinds of convenient commitment devices?” (Yglesias). By stimulating housing, the government is ostensibly denying Americas the “other commitment devices” because there is no incentive to save. Felix Salmon supports Yglesias by saying, “You’re *forced* to spend all that money on your mortgage each month; if on the other hand you rent, you’re very likely to simply spend the excess, rather than save it” (Salmon). What happens here is a cycle where the government provides affordable housing but gets upset when no one has money to *consume*.

If left to the markets, people would examine the tradeoff between owning and renting – thus managing the ability to save and spend. When people aren’t pushed into a long-term commitment because of market tendencies (malinvestment), they will generally spend excess money in the ways Keynes had intended. For the Keynesians, this is a no-win situation where government intervention runs countercyclical to efforts to provide affordable housing *for everyone*.

That Which Is Unseen - Conclusion

This tells us is that government policy is purely partisan. Banks and other firms seeking taxpayer money exhaust rent seeking behavior. If left to rent, only landlords would benefit; Mortgage Security pools would be less prevalent because owners would balance the benefits of owning versus renting. During credit expansion cycles (low interest rates), housing trended upward (2004-2007). This “bubble” resulted in windfall profits for lending institutions. When these institutions failed, they were bailed out. This is the *real* Keynesian business cycle. Laura Tyson, in a late June 2011 opinion article in the New York Times, actually argues in favor of additional stimulus: “The jobs gap warrants additional fiscal measures to increase private-sector demand and promote job creation” (Tyson). Unfortunately, economic failures are a result of public sector meddling. Lawmakers fails to see the issue with extensive regulation and increased government bloat, as “Business executives are only rational to hold back on hiring if they do not know when their customers will fully return” (Leonhardt). What once was simply a housing crisis has ballooned into a greater issue, and Washington intervention will not work forever. Interest rates may not have created the complete credit crisis, but they are used to get us out of a recession. The question is not whether they work, but whether we are using them to “guide entrepreneurs to invest their limited resources efficiently” (Murphy). It all starts with creating incentives to spend AND, more importantly, save.

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