The death of interest, inflation and the independent ce...

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I have used this chart before, and I do so again without apology. It comes from an IPPR report, but that's irrelevant to the use that I'm making of it:

What, I suggest, is that this chart shows something quite staggering. I call it the death of interest. The trend is long-term and inexorable, in my opinion. The simple fact is that the so-called 'risk-free' interest rate is disappearing.

I stress, this does not mean that interest will not be charged in the future, but to understand this it has to be appreciated that the interest rate charged on most loans is made up of two components. One is the cost of money, and since for most banks the cost of money is little different to the 'risk-free' interest rate this charge is tending towards zero over time. That's precisely because, as modern monetary theory explains, there is no cost to creating money and as a consequence there is no cost to lending it, meaning that its price should, in fact, be nothing. That is a fundamental reason why, overall, interest rates remain low now, on average, when compared to long-term norms when different money creation arrangements prevailed.

The second component is not really an interest charge at all: it is a risk premium to cover the chance that the borrower will default upon their loan obligation, and leave the lender with a bad debt. This is, of course, why many loans still carry quite exceptional interest rates when official rates are almost non-existent.

I am not, then, suggesting that we will see the disappearance of interest in the economy: as long as default risk exists there will be interest charges, but that is not the point at issue here. All that disguises is the fact that the real, risk-free, interest rate is tending towards nothing and that means that, in effect, the entire mechanism of monetary policy is now redundant.

There is another reason for this redundancy: if interest rates decline so does inflationary risk. This is a chart of long-term inflation in the UK, from the House of Commons library:

The risk-free interest rate is declining in the UK and wholly unsurprisingly so too are oscillations in inflation rates, especially if war and the world crashing out of the gold standard and the UK leaving other exchange rate mechanisms (such as the ERM) are taken out of the trend, they being the only real explanation for significant inflation hikes since the 1860s.

I have already suggested today that monetary policy now seems to be a wholly irrelevant mechanism for economic policy control, but so too, I suggest is inflation targeting. The reason is common between two: if interest rates are tending toward zero, and I think they are, then inflation is inevitably going to tend in the same direction, external shocks apart, which can never be corrected by monetary policy.

The time to bury monetarism really has arrived. And in that case the day of the independent central bank is also over.