

Monetary policy is dead: what we need is new thinking o...

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There is an article by Ruchir Sharma, who is Morgan Stanley Investment Management's chief global strategist, [in the FT today](#). In it he argues that whatever central bankers and monetarists want to suggest, interest rates cannot increase by very much at all in the global economy that we have for the simple reason that there is so much debt in that economy that to let rates rise would topple the whole edifice. This is a macroeconomic variation on the microeconomic version of the same argument that I had previously made.

I have suggested that the government cannot afford interest rates to rise by very much because the moment that they do stressed households in the UK will default on their personal loans or on their mortgages, with the consequence the banks would be at risk. Sharma looks at this from the other end of the scale and says that the only reason why asset prices have increased at the staggering rate that they have over the last two decades is because debt has fueled the artificial valuations that are driving that process. He suggests that if interest rates rise not only would repayment of the debt owing be in doubt, but the artificial asset evaluations would crumble simultaneously.

I am not sure if it makes a great deal of difference as to which explanation prevails here. I would actually suggest that both are right. Whether we are looking at something as basic as the price of domestic houses, or as complex as the pricing of international debt the issue comes down to much the same thing. Because of the long-term historic decline in interest rates, which has now been seen for a period of nearly 500 years and which has reached its apotheosis in the near zero-interest rates in the last decade, almost costless debt has encouraged people to pay excessive prices for any type of assets, many of which are ultimately in some degree of short supply, even if that short supply is artificially manufactured.

The consequence is simply stated. Despite all the huff and the puff that central bankers might proffer the truth is that they have remarkably little scope to change interest rates because any significant rise will topple the smooth operation of the financial markets for which they also have responsibility. I very strongly suspect that they know this, even if they pretend otherwise. As a result, no one should be expecting serious long-term

interest rate rises. They are simply not going to happen.

That does not mean that inflation will not happen at some time in the future though. Nor does it mean that there will be no need for action to be taken to tackle inflation. But what it does mean is that interest rate policy is never going to be the answer to the question as to how to tackle inflation again.

In that case attention needs to be given to the design of fiscal policy that can deliver the required control. This requires radical thinking about new, flexible, variable, progressive and effective taxes that can be used to suppress or stimulate demand at short notice. In the absence of absolutely any other ideas that I have ever seen on this issue I still suggest that my proposal for a financial transaction tax on all the financial flows through the bank accounts of all individuals and companies, with very low rates on those on lower earnings, progressing to higher rates as flows increase, is the answer to this question, whilst also simultaneously providing the mechanism to eliminate national insurance, which is a holy unjust tax.

A year ago I wrote this on [Social Europe](#) about such a tax. I still think that we need it:

Five decades on, a 'Tobin tax' is no longer fit for purpose. Now what should be taxed, progressively, is all financial flows.

There are reasons for saying now is not a good time to [discuss tax](#). In a great many countries demand is already weak and most taxes reduce demand. Increasing them would, in that case, reduce economic activity and so increase unemployment and corporate failures, favouring recession rather than recovery.

That, though, is precisely why we need to think about a new role for financial-transaction taxes (FTT). It may just be that this is the tax which, in contrast to all others, managing the coronavirus crisis requires.

All governments must currently run deficits to support their economies and this will remain so for a long time. Meanwhile, interest rates have ceased to be a tool for economic management: when they are already close to zero they cease to have an impact on behaviour. Both concerns, however, provide reasons why we might need an FTT.

Revenue-raising instruments

FTTs have traditionally been designed as very specific taxes on a very narrow range of financial transactions, including trades in financial commodities and currencies. The rates proposed have often been small. This has been because-oddly given the political perspective of many of those proposing them-they have been seen as revenue-raising instruments and not as [Pigovian taxes](#) designed to change behaviour significantly.

Pigovian taxes are placed on products, such as alcohol and tobacco, which generate 'negative externalities' (in those examples for public health). They are primarily intended to reduce demand, rather than to raise revenue-even if they do that too. But it would seem that the proposed social use of FTT revenues has been the primary purpose of these taxes in the eyes of their proponents, which implies that their rates and impacts must be limited. The uncomfortable truth which modern monetary theory has exposed-that tax revenue is not a precondition for social spending to take place-has not helped their cause.

The FTT we now need is very different. Precisely because monetary policy has ceased to be effective, because the use of tax in conventional fiscal policies is an extremely blunt instrument and because rapid fiscal intervention in any economy is now essential to control demand, employment and inflation-in an environment where there will be persistent government deficits-new instruments of fiscal management are required. An FTT can fulfil this role.

Financial flows

This would, however, be an FTT of a type previously very rarely used. It would be imposed on financial flows through all bank accounts in an economy, without exception. The charge would be on both debits and credits, with the deliberate intent of reducing the scope for evasion. And the tax should be designed to be significant in overall amount, acting as a possible replacement for other taxes such as payroll and social-security charges, for example, which are such an impediment to employment now.

This FTT should be significantly progressive. As the flows through the bank accounts under the control of a person increased, so would the charge. Those with average or low incomes would expect very low rates to be levied upon them. It would even be simple to make the rate negative for some, as a means of delivering income support. In contrast, those with very large financial flows would expect significant charges.

It would be appropriate for any individual to link all the accounts they had under common control for the purposes of their charge being assessed. So, for example, a person should not have to pay an FTT charge when making a payment to their mortgage account, transferring savings or paying a credit card bill. Instead, the charge should arise when real interaction with third parties took place.

Deciding how a person and their household were related might be an issue for this purpose; equally it could be an instrument for delivering social support. Transfers into and out of the country, even to related accounts, would however always be charged. Put all this together and this would

become an effective and progressive tax on consumption.

The charge would also need to be applied to business accounts, and again some progressivity could be appropriate: support for smaller businesses could be implicit in rates charged. And businesses should not object, especially if they were relieved of some of their social-security costs. The issue of cash usage would have to be considered: it would be a legal necessity to require that cash sales and purchases were declared for tax purposes, to prevent abuse.

This one aspect apart, administratively this tax would be easy: all the software to create the charge should already exist, even if some accounts are linked and even if multiple banks are involved. Since the charge would be a simple percentage of flows into and out of accounts, the calculation would be simple, as would annual aggregation to avoid unfairness if the charge in any month were excessive on a 'pay as you go' basis.

Fiscal control

This would be a progressive consumption tax-which value-added tax is not-and it would extend the tax base to financial services and transactions, which are the preserve of the wealthiest and beyond the reach of VAT. It could, therefore, be a significant tool for tackling income and wealth inequality.

But the most important element of this tax might well be the opportunity it would provide for fiscal control. It could be finessed to promote or restrain demand very rapidly, without requiring anything more than changing the rates in a relatively small number of banks' charging algorithms.

So if there were, for example, a desire to provide an immediate stimulus, rates could be reduced at short notice. Most especially, those rate changes could be targeted at particular income groups-even rendered negative for some, if desired.

Equally, if there were a need to target inflation, then FTT rates could be quickly increased to dampen demand. This is important, particularly to proponents of modern monetary theory, since it is often claimed taxes cannot be used for this purpose.

Finally, the tax could still be used to control excesses in the financial-services sector, although special rates might be required. The [Spahn variation](#) on such a tax, as it was originally recommended by James Tobin in the 1970s, has automatic stabilisers built in-increasing rates automatically in the event of financial crisis in a way that increases the costs of transactions, so as to calm

markets in panicked financial situations. The rate increase would induce calm precisely when that might be most required.

I see little point now in promoting for its own sake an FTT of the type proposed over the last five decades, when neither the economy nor economic understanding demands it. In contrast, an FTT that promotes employment, reduces inequality, can be used to deliver income support and enhances fiscal management is a tax for this moment. It is a genuinely 21st-century tax, which is needed now and in favour of which a coalition of the willing should be created.