Funding the Future

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There has been a long and ongoing debate in the FT and elsewhere about what base interest rate level the world's central bankers should settle upon in the aftermath of the fiasco of their raising rates in a forlorn attempt to tackle inflation when those increases were neither required nor ever had any impact uoon achieving that goal.

The one thing that we do know about existing targets expressed in percentage terms within the macroeconomy is that almost all of them were set either randomly or irrationally, and were then copied on the basis of blind faith by other central bankers who were gasping for precedents rather than an informed basis for decision-making. For example, the 2% inflation target was simply made up without any known justification, and the 3% target for annual deficits within the EU was another simple back-of-the-envelope figure created without any economic or econometric justification. In that case, simple reasoning is all that is required now to suggest alternative targets.

With regard to deficits, the desired target should be obvious. It is that level of deficit that is required to deliver sustainable full employment within the constraints of climate change. Quite literally, nothing else makes any sense. No one should run a macroeconomy in the interest of creating neat government finances. The macroeconomy should be run to deliver the goals of society. My suggestion is designed to do that.

Then there is inflation. There is no known rational justification for the 2% target, meaning that alternatives that might work better might make sense. Most especially, if the 2% target appears to require austerity, then it is clearly wrong. A macroeconomic target should not, by itself, force change onto a macroeconomy when that change has undesirable and unnecessary consequences. It would, therefore, appear to be appropriate to raise this rate to maybe 3%, and let the economy run at this level, instead of forcing the 2% rate that has created considerable discomfort in its delivery.

What, in that case of interest rates? Should they be, in real terms positive or negative?

My answer to that question is an unambiguous suggestion that the bank base rate should always be set to create a small negative real interest rate when compared to inflation. There are many reasons why this is the right thing to do.

First of all, it means that there should, in effect, be no net cost to government borrowing. That would seem to be an absolutely central objective of any government's macroeconomic policy.

Second, this rate also means that the net real cost of funding investment in the economy will be very low, and that is vital, most, especially when almost all investment is funded by loan finance and not by savings or equity, whatever the popular perception might be.

Third, there is the question of what savers require. As became apparent during the period of near net-zero interest rates, these are unpopular with savers, so something a little higher is beneficial, but there is no good reason at all for them to be significantly positive in real terms when cash savings serve no useful economic function within the economy as a whole once the basic target of people having a rainy day fund has been met.

So what is the answer to the question? It seems to me that if the inflation target is 3%, then base rates should be 2%.

I’m quite sure some people will disagree, but that’s my opinion, with reasons. If you disagree, please provide your reasons, or don’t bother.