Reply: Keynes on the Interest Rate and Redistribution

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After generously praising the summary of my book on Keynes, Meltzer (1996), and the book itself, Mr. Hill ventures that I rely on a passing thought and have a “muddled explanation of Keynes’s views regarding the optimal size of the capital stock.” He then offers his own explanations that draw on “left-wing neoclassical ideas.”

He is wrong on both counts. My summary of Keynes’s argument about default risk is neither muddled, as Hill claims, nor one of the many passing thoughts in Keynes’s active stream of consciousness. And what I take to be Hill’s main alternative does not, as it stands, satisfactorily explain why the capital stock is below the maximum attainable stock.

The Optimal Size of the Capital Stock

For Keynes, the optimal capital stock satiates all opportunities. Wealth owners then minimize real money holdings and maximize the size of the capital stock. He located the satiety point at a zero rate of interest but accepted that a zero rate of interest is not sufficient to assure that the capital stock reaches a maximum. To give that assurance would require “a somewhat comprehensive
socialization of investment.” (1936, p. 378) This would sustain “full employment.”

As I have pointed out many times, Keynes first proposed either socialization of most investment or state direction in the mid-1920s and, to my knowledge, never abandoned the idea.

Hill’s main criticism of my book and paper is that default risk had a modest role in Keynes’s theory. This is a narrow and incorrect reading. The double counting of default risk -- once by the borrower and once by the lender -- is a way in which uncertainty permanently raises the equilibrium interest rate. To get his main result, it is not sufficient for Keynes to show that the investment schedule would be raised by an institutional change such as state direction of investment. An increase in the investment schedule, an increase in $g$, would raise the rate of interest, ceteris paribus; Keynes wanted to lower the interest rate and, more importantly for this discussion, he wanted to offer an economic rationale for the change. He was too good an economist to believe, with many Keynesians of the 1960s and earlier, that the equilibrium rate could be changed by printing money, so he rejected that solution.

Keynes attributes lender’s (default) risk either to moral hazard or to the disappointment of expectations and uncertainty. (1936, p. 144) He calls the one voluntary, the other involuntary. To offset this risk, the borrower “will require a wider margin between his expectation of yield and the rate of interest at which he will think it worth his while to borrow; whilst the very same reason will lead the

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1This is not to be confused with latter-day meanings of full employment. Keynes’s full employment would be better described as the maximum sustainable level of employment. I will use “maximum employment” where he uses full employment. It is worth noting that Keynes described his theory as “moderately conservative in its implications.” (1936, p. 377) He is at pains to separate himself and his ideas from radical or left wing arguments like those used by Hill.
lender to require a wider margin between what he charges and the pure rate of interest in order to induce him to lend... (Ibid., p. 145) But, if the borrower and the lender are the same, this risk is internalized, so it vanishes.

Keynes offers a straight-forward economic argument based on internalizing an externality. The state can lower the interest rate by serving as borrower and lender. This argument may be empirically true or false, important or trivial. What I emphasize is that Keynes argument is sufficient for his conclusion.

It is incorrect to say, as Hill does, that this argument is unimportant because Keynes saw the critical problem as “the interest rate’s role in bringing into balance the public’s willingness to hold the stock(s) of money [and]...bonds.” Keynes discusses a general equilibrium. Money bonds, and capital must be willingly held. Keynes problem is to find the interest rate at which the economy reaches equilibrium. My argument explains why the demands for money and bonds reach equilibrium at an interest rate that is too high to achieve maximum employment. Since moral hazard and default risk are real, they cannot be reduced by the printing press. The general equilibrium has real capital and investment too low and real money balances too high. The third component of wealth, real bonds, is determined as a residual.

Again, it is not enough to claim that money balances are too high for this or that reason. The interest rate is the centerpiece of the problem; we have to explain why it reaches and remains in equilibrium at less than maximum employment. In Keynes’s words: “It was an important moment in the development of my own thought when I realized that the classical theory had given no attention at all to the problem at what point the supply of output as a whole and the demand for it would be in equilibrium. When one is trying to discover the volumes of output and employment, it must be this point of equilibrium for which one is searching.”
We can see why Keynes could accept Hicks's IS-LM schedules as useful only if investment is replaced by expected investment. Expected returns to investment must equal the rate of interest in equilibrium. And the equilibrium rate of interest in an economy with default risk must lie permanently above the rate at which the economy reaches maximum employment. Of course, the general equilibrium must satisfy stock and flow markets for all assets and components of output. That is what my model of Keynes's theory does. See, especially, Meltzer (1988, pp. 168-179).

Replication of Keynes's theory and his main result requires more, however. It must explain "at what point the supply of output as a whole and the demand for it would be in equilibrium." (1979, p. 215. Emphasis added) Keynes's answer is that the rate of interest "may fluctuate for decades about a level which is chronically too high for full employment; ... The failure of employment to attain an optimum level being in no way associated, in the minds either of the public or of authority, with the prevalence of an inappropriate range of rates of interest." (1936, p. 204)

Hill's Explanations

Hill tries two (or more) alternative explanations of the reason for insufficient equilibrium investment. First, he argues that stocks dominate flows in determining the interest rate. Without some explanation of a risk premium, this line of reasoning brings us back to the question: why doesn't the price level fall to restore equilibrium? If there is no risk premium in the interest rate, we must look to some type of liquidity trap. The Pigou - Haberler - Patinkin - real balance effect restores equilibrium in the standard model. We have explored that path; it makes
the General Theory into a (not very good) theory of depression.

Hill's discussion of incomplete markets is not sufficient either. Unless it is joined to an explanation of why markets are "incomplete," it tells us nothing about the empirical world. Transaction costs, costs of acquiring information, moral hazard -- and default risk -- are reasons markets are "incomplete."

My principal problem with this line of argument is that a world of complete markets is not a useful starting point for examining the issues Keynes discusses. A frictionless world with complete markets and full information would not suffer from what Keynes called involuntary unemployment. The rate of interest would not have a risk premium. Hill avoids these problems by simply assuming that socialization of investment is a substitute for complete markets as a means of reducing uncertainty and optimizing the capital stock. Even if this were acceptable for Keynes's generation, it is no longer.

In the past fifty years, we have seen this experiment run in both democratic and totalitarian countries. There was no problem increasing employment, at least for a time. Even in a closed economy, the problem was to maintain efficiency, growth of living standards, and the productivity of capital. The experience is too recent to require citation of cases. Just look at the number of countries on very continent that have recently privatized large parts of formerly state controlled investment and ownership to recognize the conclusions widely drawn.

Next, Hill moves in the opposite direction. He invokes differences between social and private returns. This, again, leads to the possibility that "a zero rate of interest will not necessarily ensure full employment." Once again, what prevents a falling price level and the real balance effect from restoring equilibrium? Further, Hill fails to recognize that Keynes's default risk is a source of divergence between private and social cost. It gives Keynes the sufficient condition he sought.
I seems to me disingenuous to charge that "default risk never enters center stage in Keynes's theory of interest," then offer explanations that do not enter at all. Hill is not alone in supposing he knows what Keynes should have said or wanted to say. I am content to rely on what he did say. My propositions are sufficient to get his result, as shown in Meltzer (1988).

Income Redistribution

Those who think they find a case for socialism in Keynes's work should read "Why I Am a Liberal," where he accused the Labour Party of becoming "once the oppressed, now the tyrants, whose selfish and sectional pretensions need to be bravely opposed." (1972, p. 309) He described the main political problem of his time as one of harmonizing economic efficiency, social justice and individual liberty. (Ibid., p. 311) Did these views later change? Surely not. At the end of World War II, Keynes congratulated Hayek on The Road to Serfdom and claimed to be in profound agreement with the argument.²

Hill takes issue with my statement (1996, p. 38) that Keynes held ambivalent views about income redistribution. He cites Keynes's statement (1936, p. 373) that a redistribution toward consumption "may prove positively favorable to the growth of capital."

Alas, Hill does not seem to have turned the page. For, on the very next page, Keynes writes: "I believe there is social and psychological justification for significant inequalities of income and wealth." (p. 374) He goes on to give some examples, warning prophetically that "it is better that a man should tyrannise over

²Unlike Hayek, he believed that tyranny could be avoided in an activist state with a large role for government.
his bank balance than over his fellow-citizens.” (idem.)

Keynes then goes on to justify some income redistribution. It is hard for me to see how one can read these pages without seeing that he stands first on one foot, then on the other; he is ambivalent.

But, read on. The very next paragraph explains that “the much more fundamental inference” about inequality comes from the role of the rate of interest. This passage leads up to the famous “euthanasia of the rentier.” Redistribution is brought about by satiating the capital stock. Keynes then speculates that reducing the interest rate to zero may not be enough.

Hill concludes: “the elimination of double-counted default risk would not only increase the size of the capital stock, it would also reduce inequalities of wealth and income.” That seems to accept my analysis.

References


