

RESEARCH SUMMARY

A Critique of Interest Rate–Oriented Monetary Economics: Reframing the Keynesian vs. Neo-Fisherian Debate

The debate between Keynesian and Neo-Fisherian monetary economists over whether a low-interest-rate policy is inflationary or disinflationary is largely misguided. In “[A Critique of Interest Rate–Oriented Monetary Economics](#),” Scott B. Sumner argues that interest rates are not a useful indicator of monetary policy and that central banks should consider other alternatives.

Keynesians largely hold that a central bank’s reduction in interest rates has a tendency to be reflected by a *liquidity effect*. That is, an increase in the money supply will shift rates lower, thus leading to higher inflation. This is often referred to as expansionary monetary policy. Neo-Fisherians believe there is a tendency for tight money to cause lower inflation and thus lower nominal interest rates, the so-called *Fisher effect*. This is often referred to as contractionary monetary policy.

However, Sumner argues that both groups are wrong:

- Too much weight is placed on using interest rates as a reliable policy indicator.
- Doing so has contributed to a host of monetary policy failures.
- Economists should instead treat interest rates as simply an effect or a variable affected by changes in the stance of monetary policy, not as actual policy.
- The main question is not *whether* lower rates reflect expansionary or contractionary monetary policy, but *when* they are associated with each type of monetary policy.

THE “REASONING FROM A PRICE CHANGE” FALLACY

Economists who treat interest rates as a driver of policy are committing an error known as reasoning from a price change. According to basic economic theory, rising prices can be dictated by lower supply or higher demand, thus making any effect on consumption ambiguous. Because the relation between interest rates (the price of credit) and the supply and demand for money is similarly ambiguous, the direction of rates should not be used as an indicator of expansionary or contractionary monetary policy, as lower rates could mean either.

For example, depreciation in the exchange rate is generally the result of expansionary monetary policy. If interest rates are lowered by the central bank and there is acute currency depreciation in the short term, followed by a gradual appreciation in the currency, this is expansionary policy, as long as the exchange rate ends up lower than before. However, with a contractionary monetary policy, there might be immediate currency appreciation in the short term, followed by expectations of future currency appreciation in the longer term. This would also result in lower interest rates.

REAL-WORLD EXAMPLES REFLECT BOTH OF THESE CONDITIONS

In the wake of the financial crisis in 2009, the Federal Reserve bought \$1.15 trillion of Treasury and mortgage-backed securities. This immediately bolstered inflation expectations, depressed nominal interest rates, and caused a sharp decline in the dollar exchange rate. Such a macroeconomic domino effect reflects Keynesian theory—an expansionary low-interest-rate policy leading to short-term currency depreciation.

Switzerland experienced the opposite effect in 2015 when, to combat speculative pressure on the Swiss franc, its central bank conducted a major revaluation of the currency (a 15 percent appreciation against the euro) and cut short-term interest rates below zero. But instead of causing a spike in the price level and immediate currency depreciation, this low-interest-rate policy led to continued appreciation of the franc and a subsequent drop in equity prices. In contrast to the Keynesian case outlined above, this series of events more closely reflects Neo-Fisherian theory—a contractionary low-interest-rate policy leading to both short- and long-term currency appreciation.

KEY TAKEAWAY

With interest rates so close to zero in economies across the globe, their effectiveness as policy instruments is severely limited. When combined with their misleading status as a policy indicator, owing to the “reasoning from a price change” fallacy, central banks should begin looking to alternative instruments when conducting monetary policy, such as exchange rates in smaller economies, or market forecasts of inflation or nominal GDP growth in larger economies.

In the case of the United States, the Fed should consider adopting a hybrid policy target: a weighted average of model-based inflation forecasts as well as inflation forecasts derived from asset prices. This would allow the Fed to conduct open market operations through targeting these forecasts directly, instead of using interest rates as traditionally has been the case.