A COMMENT ON "THE INTEREST RATE ENIGMA"

Alexandru Pătruți*

It is difficult to comment on an article which is well documented both in terms of the history of economic thought and current monetary policies, and professor Cerna's "*The Interest Rate Enigma*" is such an article. The author argues that in the case of a small country such as Romania, there are only two ways to foster long-term economic growth. The first is through increasing individual saving and investment, while the second refers to attracting foreign capital.

In order to prove this thesis, professor Cerna uses the classical Wicksellian concept of the "natural rate of interest" (Wicksell, 1989). This supposedly represents the interest rate at which the supply of capital in the economy will equal the demand for capital and equilibrium will be reached. According to many schools of thought (including here also the Austrian school of thought), this natural rate of interest is the main driver behind the market interest rate, i.e. the interest on the credit market[1]. The economists of the Austrian school believed that the latter interest

* Alexandru Patruti is an Assistant Lecturer for the Department of International Business and Economics Bucharest University of Economic Studies.

E-mail: alexandru.patruti@rei.ase.ro.

[1] While the natural rate of interest is an abstract concept intrinsically tied up with the idea of equilibrium, the market rate of interest represents the actual interest paid on the market. Economists claim that there are numerous situations in which the two rates can diverge considerably from one another.

rate is the main indicator behind entrepreneurial decision making. As Hayek points out (Hayek F. A., 2008, p. 264):

> *"[..] there is one medium through which the expected ultimate effect on relative prices should make itself felt immediately, and which, accordingly, should serve as a guide for the decisions of the individual entrepreneur: the rate of interest on the loan market".*

If the market rate of interest deviates from the natural rate of interest, entrepreneurs allocate resources based on a "false indicator", i.e. an indicator which does not reflect the real situation on the market, which leads considerable medium and long-term economic problems[2].

Generally, there are two ways in which the interest on the market can deviate from its natural level, respectively monetary interventions and financial sector's speculations gone wrong. The Austrian school of thought generally claims that monetary authorities are responsible for economic cycles, while Keynesians consider that speculators, guided by non-rational-herd-like-actions can underbid or overbid prices away from the tendencies of the real economy. Supposing for the moment that both schools of thought are right in their predictions, professor Cerna correctly claims that the only way to obtain sustainable economic growth is through a decrease in the natural rate of interest. This in turn can be obtained in a small country like Romania through either an increase in domestic saving or through capital inflows[3].

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[2] The main problems I am refereeing to here are economic cycles. The Austrian school of thought believes that booms and busts appear because entrepreneurs are "tricked" by interest rates to invest in the wrong sectors. They readjust the structure of production in a way which is not consistent with consumer desires.

[3] The only additional comment that we would like to make here is that we do not share the author's optimism regarding European Funds as a source of capital accumulation, as we have shown in previous works (Pătruți & Tătulescu, 2015). Although capital goods can be imported into the country with the help of such funds, it must always be kept in mind that efficiency is not the main goal of

Although the author's thesis is unattackable in my personal opinion, the role monetary authorities play in the process is somewhat underrated. It is not only that central banks do not know what the "natural rate of interest" is, as professor Cerna correctly points out, but it can be consistently argued that *they regularly keep monetary policy rates below the natural level.* High interest rates are extremely unpopular from a political point of view, thus being somewhat natural for central banks to do their best to keep them down. It is true that this is not an economic argument, but it indeed one that makes good sense. If there is one thing that the Public Choice school of thought has shown us, it is that using additional political premises in economic theory can lead to useful conclusions. Thus, it can consistently be argued that monetary authorities are a factor which *constantly deviates* the market interest rate from its equilibrium/natural level.

The evolution of monetary policy after the 2009 crisis is further proof concerning this thesis. After nominal interest rates hit rock bottom because of the financial crisis, the Fed devised a new instrument (now considered to belong to "unconventional" monetary policy), namely "forward guidance" (Federal Reserve Bank of St. Louis, 2015). If nominal interest rates are zero, the central bank loses its power to use this indicator for monetary policy. The only thigh it can do is to make *public statements* regarding its future actions in the area of interest rates, i.e. it makes promises to not raise interest rates in the future. In this case, "forward guidance" becomes an attempt to alter people's *expectations* regarding future interest rates.

Given this particular role of central banks, which constantly aim to keep interest rates below the equilibrium level because of political pressures, we can only agree with professor Cerna's thesis that if we want to have solid economic growth, we have to

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such European funding programs. They will be systematically invested in the worst possible businesses from an economic point of view, which can lead to blocking existent skilled labor in suboptimal projects.

turn our attention to the determinants of the natural interest rate. Increasing savings and attracting foreign investments must be the priorities of any country that wants sustainable economic grown.

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