

## BOOK REVIEW

# MONETARY POLICY AFTER THE GREAT RECESSION: THE ROLE OF INTEREST RATES

ARKADIUSZ SIERON

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In his second book, Arkadiusz Sieron, Assistant Professor at the University of Wrocław, embarks on an ambitious task: to investigate the failure of expansionary monetary policy to address the challenges of the 2008–09 Great Recession. An introduction, seven chapters and a final synopsis make up the main body of a text that spreads over 168 pages. Two short six-page appendices comment upon the likely future course of monetary policy and on the fitness of interest-rate cuts to respond to the COVID-19 crisis. An impressive forty-page bibliography, or about six hundred references, and a ten-page index close the book.

The first chapter examines the conventional “interest rate” channel of monetary policy. Sieron shows that it was ineffective to spur economic growth after the Great Recession and attributes its

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unsuccessfulness to the failure of lower policy rates to revive bank credit. In his assessment, factors such as borrowers' debt overhang and lenders' impaired balance sheets explain why central banks, despite lowering their policy rate aggressively, could not fuel the credit expansion that would have revived the economy: "In other words, there is no mechanical link between monetary policy and the supply of loans *and thus* economic growth." (p. 22; our emphasis)

The second chapter focuses on the newer "portfolio" channel of quantitative easing. It offers a high-level theoretical discussion, rather than a detailed context-based presentation of the specific asset purchases by the major central banks. That discussion is focused on the wealth effect and concludes that, thanks to these non-conventional interventions, monetary policy remains potent despite the zero lower bound, even though its potency is limited to effects of redistribution: "Keynesians are wrong, while monetarists are right: monetary policy does not become totally powerless when interest rates reach the zero lower bound. It affects the economy through the relative prices of assets, goods, and services." (p. 39)

The next two chapters explore, in further detail, some of the consequences of expansionary monetary policy. The third chapter discusses how a low policy rate encourages risk-taking, because of the relatively higher monetary attractiveness of risky assets (search for yield) and a stronger tolerance for higher risk: "In normal times, risk is seen as something negative, and individuals try to avoid it if possible. However, in an environment of very low interest rates, risk becomes more desirable and worth seeking" (p. 60). The fourth chapter deals with the monetary policy-driven resource misallocation through the prism of the theory and empirics of "zombification."

In the remainder of the book, Sieron offers his ideas on the broader aspects of monetary policy. The fifth chapter argues that, when setting their policy rates, central banks should not target the economy's neutral interest rate. Their own actions lower that neutral rate, which makes the target endogenously dependent and hence never achievable. Within a Wicksell-inspired analytical framework, Sieron rejects the secular stagnation hypothesis and privileges the financial-drag assumption in explaining the post-crisis economic slowdown. He draws some normative implications:

So there is no such thing as a neutral-interest rate policy. The central banks should *thus* stop setting interest rates if they are unable to get them aligned with the *natural* interest rates and allow markets to freely set interest rates. Or, given that the *neutral* interest rate is endogenous to the monetary policy it is supposed to guide, it should not serve at least as a policy benchmark. (p. 110; our emphases)

The sixth chapter reviews the impact of the negative interest rates policies conducted by some central banks in recent years, particularly as regards reduced profitability of commercial banks and negative yields on government bonds. It concludes,

...there is a lack of satisfactory theory explaining how charging for the excess reserves of commercial banks held at central banks—some economists even call it “a tax on reserves”—is supposed to revive bank lending *and then* the overall economy. The banking system itself cannot decrease the amount of reserves through granting loans.” (p. 133; our emphasis).

The last, seventh, chapter documents and discusses the rise in overall indebtedness of corporations, households and governments. Particular emphasis is put on the self-reinforcing loop between indebtedness and expansionary monetary policy, leading to higher asset prices, which—because the assets are used as required collateral for loans—inflates creditworthiness and supports further indebtedness. The analysis points out that, beyond a certain level, debt accumulation becomes a drag on economic growth:

Used wisely and in moderation, it [debt] can improve welfare, but when used imprudently and in excess, the result can be disastrous. I showed that although an increase in household debt can reflect financial deepening, in an environment of ultralow interest rates it *may* rather indicate a build-up of financial imbalances. (p. 159; our emphasis)

This very sketchy overview can only hint at Sieron’s extremely ambitious project to expand economists’ understanding of interest rates and monetary policy. The result is a widely researched text that overwhelms the reader with a multitude of conceptual and bibliographical references. This makes it a useful collection of references for economists interested in contemporary monetary topics. Sieron is not shy about his achievement: “I am not aware of another book that would so thoroughly and completely analyse the issues related to the

interest rates in the conduct of monetary policy” (p. 3).<sup>1</sup> Regardless of any merits of that claim, it would have been preferable to let the readers and posterity indulge in the praising of this work.<sup>2</sup> Yet, such a statement only begs a few immediate questions. What type of approach does the analysis follow? Does it lead to rock-solid and original conclusions that build upon existing knowledge as part of a consistent analytical framework? In what sense is it thorough and complete?<sup>3</sup> The remainder of this review will quickly show some of the pitfalls of the approach Sieron has chosen to follow.

The best way to describe that approach is to call it *eclectic ecumenism*. The book clearly aims at reaching the largest possible audience. To achieve that, the author has made the choice to address all economists, whatever their foundational premises. In practice, this boils down to applying some Austrian insights to a large corpus of other intellectual universes. As a result, the reader will not find a fully established single theoretical framework of any intellectual affiliation. The following passage, which introduces a discussion on the implications of debt, is very revealing of the *eclectic ecumenism* approach:

Credit creation has been the basis of the Austrian business cycle theory since Mises’s ([1912] 1953) *Theory of Money and Credit*. Fisher (1933) formulates a debt-deflation theory of the Great Depression. Minsky (1992) develops a financial-instability hypothesis according to which endogenously rising leverage in good times paves the way for crisis. Koo (2013) argues that a balance sheet recession and debt overhang [...]” (p. 144)

This compilation of different theoretical views, not always in mutual agreement, is characteristic of Sieron’s entire book and

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<sup>1</sup> This is not an accidental statement: “The above points do not, of course, constitute the entirety of my contributions for the theory of economics. However, they clearly show that my analysis enriches the debate on the monetary transmission mechanism.” (p. 164) Another example, among others: “However, I have greatly enriched the achievements of the Austrian school by applying its insights to the topics of zombie firms, negative interest rates, and neutral interest rates and by pointing out the importance of the risk structure of interest rates.” (p. 165)

<sup>2</sup> One needs not study theology to know that humility is the path to truth.

<sup>3</sup> A deeper question would ask whether an analysis that is thorough in its method could ever be complete in its conclusions. Would not a complete analysis imply the end of the scientific endeavor, making pointless all further research?

results in a lack of consistency. This unfortunate outcome is not helpful to the author who wants to “argue that we should blame wrong economic theories and monetary policies based on them” for the slow recovery from the Great Recession. (p. 1) Would one not need a carefully crafted theory to refute other theories step-by-step? Moreover, because of the lack of consistent framework, his analysis leads to unsubstantiated and ultimately unsound conclusions, instead of providing convincing answers.

Take for instance Sieron’s analysis of the ineffective interest rate channel. The argument boils down to claiming that monetary policy fails to contribute to economic growth in downturns only, because—in the bust—some factors, such as borrowers’ deleveraging and lenders’ restructuring, make it ineffective to ensure a bank credit expansion: “The key is that many factors besides interest rates determine demand for loans. [...]. This suggests that monetary policy in general and low interest rates in particular work differently during normal times than during crises” (p. 16). This is not an accidental statement, as evidenced by the author’s conclusion that “The mortal sin of that [traditional] view is that it assumes that monetary policy works the same way all the time” (p. 21).<sup>4</sup> The obvious, though unspoken, implication is that monetary policy *works* in periods of economic expansion. What does this conditional effectiveness mean in reality? Does it imply that monetary policy can spur genuine economic growth, or does it only lead to unsustainable malinvestments that necessarily result into a future crisis? The reader will find no clear-cut answer to that crucial question, though Sieron’s text might lead him to believe that monetary policy contributes indeed to economic growth, arguably in a potentially distorted manner: “The legacy of the Great Recession is *excess capacity* in the world” (p. 80; our emphasis). The question is decisive because, if booms imply unavoidable crises, as argued by the Austrian business cycle theory, then it is no longer permissible to distinguish between two conceptually separate contexts (growth vs. recession) for analyzing the effects of monetary policy. Furthermore, if monetary expansion is the cause of the ultimate

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<sup>4</sup> Consider also: “I showed that monetary policy is weakened or does not work as intended during recession. This means that the effectiveness of monetary policy depends on the functioning of the economic system” (p. 25).

crisis and the following bust, how could it ever provide a solution to the latter too?

The complicated, yet important, discussion of the link between monetary policy and the *neutral* interest rate in the fifth chapter is another paramount example of the dangers of *eclectic ecumenism*. Sieron starts the discussion on promising grounds, rooted in a deep-dive clarification of what Wicksell meant by the *natural* interest rate (more on the distinction between the natural and neutral rates below) and how he saw the impact of its divergence from the current interest rate. Then, the urge to include all subsequent and contemporary views, outside of a solid analytical framework, without stopping to apply a solid theoretical lens, overtakes him. The discussion continues with a mention of the leading Neo-Keynesian monetary economist Michael Woodford, before pursuing with Austrian economists, including a lengthy quote from Hayek and references to Salerno (2016) and Garrison (2006). To pay full tribute to Sieron's effort at synthesis, it is worthwhile quoting a lengthy excerpt from his text (pp. 88–90):

Similarly, for Woodford (1999, 35), who revived the ideas of Wicksell and incorporated them into modern macroeconomic modelling, the key variable in the analysis of inflationary or deflationary pressures is “the gap between the current level of the ‘natural rate’ of interest and the interest rate controlled by the central bank.”<sup>5</sup> Indeed, in the standard new-Keynesian approach, monetary policy gradually moves the riskless short-term policy rate toward its natural-rate counterpart (Cukierman 2016).<sup>6</sup>

Austrian economists reject this approach. To be sure, they agree with Wicksell's observation that in a monetary economy, the market interest

<sup>5</sup> Compare this sentence with: “Woodford's analysis revives the ideas of Wicksell (1898, 1906) within a dynamic stochastic general equilibrium model. [...] In Woodford's framework, the key variable for the analysis of ‘inflationary’ or ‘deflationary’ pressures is ‘the gap between the current level of the “natural rate” of interest and the interest rate controlled by the central bank’ (Woodford, 1999a, p. 35)” (Neiss et al. 2001, p. 4). The authors of this 2001 discussion paper, published in *Macroeconomic Dynamics* in 2003, refer to a chapter of a 1999 manuscript by Woodford, which would become his magnum opus in 2003 only. Sieron's bibliography, despite its extensiveness and the 2003 reference to Woodford, omits both the 1999 item, referenced in the main text, and this 2001 discussion paper.

<sup>6</sup> Compare this sentence with: “In the standard NK model efficient monetary policy can be viewed as using the riskless short term policy rate to gradually move this rate toward its natural rate counterpart” (Cukierman 2016, p. 4).

rate may differ from the natural rate because the demand for and supply of capital meet in the form of money, the quantity of which is altered by the banking system. [...]

[...].

It is true that the Austrian business cycle theory draws from Wicksell, as the key element of the boom-bust cycle is the divergence of the monetary rate from the natural rate. However, Austrian economists interpret the neutral/natural rate differently. They write about the “natural rate,” rather than the “neutral rate.” This is because they have in mind the interest rate that would occur on the unhampered market without credit expansion, rather than the hypothetical rate that would equalize the demand for and supply of capital in kind and at the same time ensure price stability.

[...].

Meanwhile, the mainstream economists write rather about the neutral interest rate, and they consider it not as the real yield of capital in production but as the interest rate that is consistent with full employment of resources at a nonaccelerating inflation rate. This is why, according to Salerno (2016), the mainstream economists’ perspectives are actually drawn from Keynes’s work, not from Wicksell’s.

Indeed, in the *General Theory of Employment, Interest and Money* (1936, 242–23), Keynes rejected the usefulness of the Wicksellian natural rate. He argued that there might be a natural interest rate for each hypothetical level of employment so that the economy could be in equilibrium with less than full employment. Therefore, Keynes argues that the natural rate should be replaced by the “neutral” rate of interest, that is, the interest rate, which is consistent with full employment, or more technically the interest rate “which prevails in equilibrium where output and employment are such that the elasticity of employment as a whole is zero.”<sup>7</sup>

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<sup>7</sup> Compare the last two paragraphs with:

But if we look closely at the definition of the natural rate by Bernanke, Krugman et al., we find that it is really drawn from Keynes’s work and not from Wicksell’s. For it is simply the interest rate that is consistent with full employment of resources at a zero, or non-accelerating, inflation rate. Indeed, in *The General Theory of Employment, Interest, and Money* (pp. 242–43), Keynes explicitly rejected the Wicksellian natural rate as not being analytically “very useful or significant.” He went on to suggest that the natural rate be replaced by the concept of what he called the “neutral” or “optimum” rate of interest, which is the interest rate “which prevails in equilibrium where output and employment are such that the elasticity of employment as a whole is zero”—which is a clumsy and pretentious way of describing the state of full employment or what is in today’s jargon called “potential GDP.” So for Keynes and

This compilation of views, expressed in a language that bears a disturbing resemblance to the original referenced contributions, does not help the reader improve his understanding of the topic. Despite the abovementioned reference to Salerno (2016) and his lengthy eight-page similarly compiled critical analysis of the “problems with the neutral interest rates” (p. 90–97), Sieron gives the impression of having missed something. Salerno’s crucial argument is that, at any moment, a specific rate of return on capital emerges in the economy so that the entire structure of production can be maintained with the available savings as determined by society’s inter-temporal preferences. The Austrian economists take that rate of return for a (the) *natural interest rate*. Two real-world phenomena—intertemporal preferences and production—drive and determine it. Hence, the natural interest rate is a real market phenomenon brought about by actual human action. In a monetary market economy, the prevailing nominal interest rate is its best reflection and is as imperfect as all monetary prices and ratios are. Non-market-driven changes in the money supply imply specific distortions of that reflection, which are the study object of the (Austrian) business cycle theory. In an alternative, increasingly mainstream view, the neutral/natural *rate of interest* has no existence in reality. It is a model-determined benchmark rate of interest implied by the mathematical equilibrium conditions of solving the economy-approximating model, subject to further optimality or welfare requirements. Then, the task of monetary policy would be to align the real-world interest rate, through available and new policy instruments, with that benchmark interest rate to maximize social welfare.

These two conceptions are so far apart that any attempt to analyze one with the analytical tools of the other, without questioning its very foundations, is utterly inadequate. Such an approach could bring confusion only. Take for instance Sieron’s fifth issue with the neutral rate:

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his contemporary disciples the natural or neutral rate of interest is determined wholly in financial markets and is one of the main determinants of the level of investment spending and the real rate of return on investment. (Salerno 2016, 7<sup>th</sup> paragraph)

Notice that the text following “Indeed” is an integral part of Salerno’s original contribution. In Sieron’s text, that part is presented as Sieron’s own contribution.



Fifth, the *neutral* rate may be negative. This is actually the core of the zero-lower-bound problem. If the neutral rate is below zero, but the nominal policy rate cannot turn negative, policy makers assume policy is uncomfortably tight. Hence, the need for quantitative easing and other unconventional monetary policy tools. However, in the Austrian view, the *natural* interest rate cannot never [*sic*] be negative, as it would contradict the laws of economics" (p. 95; original emphasis).

The author, first, admits the possibility of a negative neutral rate of interest, to the point of using it as a rationale for unconventional monetary policy. Yet, he seems to struggle with that idea, as he hastily reminds the reader that a negative natural interest rate would be contradicting human action. Of what avail is it to refer to the Austrian natural interest rate when discussing the "mainstream" neutral (natural) rate of interest, which is essentially distinct? Sieron should have admitted that, under some specific assumptions, New-Keynesian models of the economy indeed deliver negative neutral (natural) rates of interest. The only scientifically valid observation would then be that this conclusion is as realistic as the underlying models and assumptions.<sup>8</sup>

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<sup>8</sup> The following statement introduces the critical section on "neutral interest rates": "The consensus in the modern macroeconomics is that the neutral rate of interest is an useful benchmark for the central banks in conducting their monetary policy and that tracking this rate would stabilise the output and inflation (Barsky et al. 2014)." This is, at best, an over-statement. If consensus there is among contemporary macroeconomists from very different intellectual traditions, it is to be found in the inflation-targeting framework. This framework shows that it is optimal—in the sense of minimizing a loss function based on price volatility, output gap, or other objectives—to set the policy interest rate at such a level that actual inflation, defined as a change in a consumer prices index, equals the central bank's own informed inflation forecast. The referenced strictly New-Keynesian contribution suggests that, *by not tracking* the natural rate of interest, central banks missed an opportunity: "

Thus, these findings suggest that a considerable degree of wage and price inflation stabilization *could also have been achieved if the Federal Reserve had effectively tracked the natural rate.* [...]. Abstracting for the time being from important considerations about the implementability of such a policy (Section IV), our findings suggest that tracking the natural rate *would have* stabilized the output and inefficient gaps as well as inflation in prices and wages. (Barsky et al. 2014, pp. 40–41; our emphases)

The call for central banks to track the neutral (natural) rate is the exact opposite of what Sieron's referenced reformulation implies. Notice also that the authors

To some extent, uneasiness permeates the next chapter that deals explicitly with negative interest rates. The case is indeed disturbing: why would one lend today more than what he would recover tomorrow? After pointing out several reasons for negative bond yields,<sup>9</sup> Sieron remains in doubt and makes this astonishing statement: “What is important is that *reported* negative yields *do not necessarily* mean that issuers of such bonds [with negative yields] *may* pay back less than they borrowed” (p. 131; our emphases). The argument seems to be that yields are not negative at origination, but might turn negative later due to increased demand from investors. This only begs the question why these late investors would buy bonds at prices that are above what they are promised to get in the future. Not to mention that today there are plenty of government bonds with negative yields *already at origination*, which implies that their issuers, indeed, are paying back less than what they borrow.<sup>10</sup> Rather than minimizing the relevance of negative bond yields, Sieron could have stated his position more assertively, for instance on the grounds of a more elaborate theory of government intervention.

The highlighted methodological shortcomings in Sieron’s otherwise rich book stem largely from his *eclectic ecumenism*. The wish to speak to, and please, all economists results in an inconsistent analytical framework that eventually blurs the essential distinction between natural market phenomena and government intervention. One of Sieron’s conclusions is the recommendation that “[...], they [central banks] should limit themselves to providing liquidity in times of crises. But they definitely should not suppress market interest rates, thereby impairing their allocation and signalling functions” (p. 165). How credible is it to believe that liquidity injected in a crisis, i.e. with the purpose to avoid asset

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themselves acknowledge several factors that, despite its model-proven theoretical superiority, make that policy rule impractical.

<sup>9</sup> These reasons include the flight to safety (safe haven demand), expected currency appreciation, loss of trust in the banking system, acquisition of a security to close a transaction, speculative demand and regulation of insurance companies and pension funds (pp. 130–31). Yet, the issue remains, at least as long as cash, which is a perfect substitute to securities in all these respects, does not bear a negative yield itself.

<sup>10</sup> The numerical example in an endnote reveals that Sieron is not aware of the premium at issuance, due to which despite positive coupons, the issuers indeed “pay back less than they borrowed.”

price deflation, would not be suppressing or otherwise distorting interest rates? Sieron's statements ultimately imply that contingent circumstances, time and place dependent, would determine the nature of the consequences from changes in the money supply. Does this not boil down, indeed, to questioning the very existence of economic laws, i.e. of causal relationships that are true always and everywhere?

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