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Macroeconomic Regulation: A Third Way beyond Keynesianism and Monetarism

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Abstract: In addressing economic downturns, there are two primary approaches in Western macroeconomics: central bank money issuance and government debt issuance. The former is known as monetarism, and the latter is called Keynesianism. In fact, there is a "third path" apart from these two methods, which is to "stimulate the credit-creation ability of commercial banks". This is a new solution proposed in this paper. "Expanding the credit creation of commercial banks" can also generate a large amount of money for investment without incurring any costs and without leaving any sequelae of economic stimulus.

Keywords: macroeconomic regulation; third path; paradox of monetary policy; monetary hedging; depression caused by a collapse in the rate of return on capital

1. Limitations of Government Bond Issuance and Central Bank Money Creation

The government's investment through bond issuance is a proposition of the Keynesian school. Government bond issuance without prior tax reform will not only lead to a government debt trap but also transmit its negative impacts to the entire economy through the suppressing effect of government debt on interest rates [1]. The author has proposed the theory of the "government debt-central bank interest rate spiral": government bond issuance will suppress the central bank's interest rates, and the central bank's low-interest rates, in turn, will boost government bond issuance. Eventually, this will only result in continuously lower central bank interest rates and ever-increasing government debt. Moreover, the harm of government bond issuance will be transmitted to the entire financial system through the central bank's low-interest rates, ultimately endangering the entire economy. The central bank's money creation is a proposition of the monetarist school, and its scale is also quite limited.

2. Expand the Huge Scope for Commercial Banks to Enhance Their Credit Creation Capabilities

The amount of money created by expanding the credit creation capacity of commercial banks will be far greater than that created by the above two methods. By expanding the credit creation capacity of commercial banks, hundreds of trillions or even over a million trillion of investment capital can be created. For example, in China, the amount of base money is about 40 trillion. If the money multiplier doubles, it means an additional 40 trillion; if it triples, it means an additional 80 trillion. Even in an economic environment with a very sluggish financial sector, with 40 trillion in base money, a "total social financing scale" of over 400 trillion can be

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created, among which about 360 trillion is credit money created by commercial banks [2].

Since the birth of commercial banks, the proportion of central bank money in the total effectively-circulating money in society has been quite small. More than 90% of the effectively-circulating money in society is created through the credit of commercial banks. Keynes discovered this rule when he wrote *A Treatise on Money* last century and explained it clearly [3].

What we often hear as "lack of funds for investment" actually refers to the insufficient credit creation of commercial banks, rather than a real shortage of money. Investment is sourced from money, and money ultimately comes from the credit creation of commercial banks. To address the issue of the lack of funds for investment, the most crucial aspect is to solve the problem of commercial banks' credit creation. Only by expanding the credit creation capacity of commercial banks can a large amount of corporate investment capital be generated. Therefore, we propose that "a country's investment capacity is actually a function of the currency credit creation capacity of commercial banks". Compared with the currency credit creation of commercial banks, government bond issuance and central bank money-creation are not even in the same order of magnitude. Moreover, the vast majority of the money created through commercial banks' credit creation is invested in the real economy, and there are basically no sequelae from economic stimulus.

3. The "Paradox of Monetary Policy" and the Issue of "Monetary Hedging"

Since expanding the credit-creation capacity of commercial banks has an immediate effect on rescuing the economy, why is this approach rarely adopted worldwide? Firstly, central banks around the globe formulate monetary policies within the constraints of the quantity theory of money. *A Monetary History of the United States* also emphasizes "printing money to save the economy" rather than motivating the credit-creation of commercial banks [4]. Currently, the theory of "printing money to save the economy" has become the most mainstream theory in contemporary macroeconomics after being developed by Milton Friedman and Ben Bernanke. Although it has been opposed by scholars from the Post-Keynesian endogenous money school and the McKinnon "financial deepening" school, it still maintains its dominant position.

However, the approach of "printing money to save the economy" advocated by the monetarist school has shown poor results in reality. Printing money not only fails to stimulate the credit-creation of commercial banks but also destroys it. Moreover, it creates a "paradox of monetary policy". When the central bank intends to implement an expansionary monetary policy, the actual "effectively-circulating money" decreases. This is due to the issue of "monetary hedging". The principle and logic behind "monetary hedging" are that the central bank's expansionary monetary policy is incompatible with the incentives of credit-based financial institutions. That is, there is an incentive conflict between the central bank's monetary policy and commercial banks. At this time, the enthusiasm of credit-based financial institutions for lending declines, and their credit-creation capacity drops significantly, resulting in a decrease in the total amount of effectively-circulating money in society. As a result, instead of experiencing excessive liquidity, the overall economy falls into a liquidity trap.

In the era of low-interest rates, the decline in the credit-creation capacity of credit-based financial institutions is not only due to the decrease in their enthusiasm but also because the "narrow interest-spread" leads to a decline in their risk-resistance ability. For banks to lend out money, they have to relax risk control. However, the precondition for relaxing risk control is to widen the interest-spread. The narrower the interest-spread, the stricter the bank's risk control and the higher the loan threshold. In the low-interest-rate era, the loan threshold of banks actually increases, and banks are unable to lend out money even if they have funds. When the interest-spread of commercial banks is lower than their natural bad-debt rate, how can banks dare to issue loans?

The credit-creation capacity of banks is directly proportional to the "interest-spread" of banks. In the era when the central bank implements high-interest-rate policies, the interest-spread of banks is high, and their credit-creation capacity is strong, thus a large amount of investment capital will be created. Once the central bank starts to implement low-interest-rate policies, the credit-creation capacity of commercial banks will decline. When the bank's interest-spread is lower than its "natural bad-debt rate", theoretically, the bank's credit-creation capacity will become zero. At this time, each loan issued by the bank will result in a loss. Therefore, to expand the lending capacity of banks, interest rates must be raised. As a result, the quantitative

easing monetary policy destroys the credit-creation capacity of banks rather than strengthening it. A loose monetary policy is not a good way to rescue banks from a crisis.

The long-term implementation of loose monetary policy will lead to a decrease in the effectively circulating money. Although the central bank increases the issuance of currency and adds one or two trillion yuan of base money, due to the decline in the credit creation ability of commercial banks, it will result in a loss of hundreds of trillions of yuan in effectively circulating money. This is also the reason why loose monetary policy not only fails to rescue the economy but also causes an economic downturn.

4. Conflicts in Monetary Policy Orientations between the Quantity Theory of Money and the Theory of Monetary Credit Creation

The theoretical basis behind the loose monetary policy is the "quantity theory of money". In essence, economic policies formulated based on the quantity theory of money and the theory of monetary credit creation are in conflict. According to the quantity theory of money, the more money there is, the better. This will inevitably lead to low interest rates. However, according to the theory of monetary credit creation, only "moderately high interest rates" can effectively stimulate the credit creation ability of commercial banks.

Although Ben Shalom Bernanke proposed the "financial accelerator" theory and noticed the role of the banking crisis in the economic crisis, he failed to come up with a new theory. Moreover, his solutions reverted to those of Milton Friedman. In the end, Bernanke did not stand on the right side of history.

5. The "Quantity Theory of Money" Is the Greatest Obstacle to Emancipating the Mind

The greatest enemy of modern economics is the "quantity theory of money" [5]. The quantity theory of money advocates printing money when the economy faces deflation and withdrawing money when there is inflation. This wrong way of thinking has severely restricted people's decision-making. As can be known from our previous analysis, the central bank's money-printing conflicts with the credit creation ability of commercial banks. The central bank's money-printing will not lead to an increase in the total amount of effectively circulating money in society but rather a decrease, thus causing the money-printing policy to fail. Therefore, Milton Friedman's monetary proposition is wrong. Since the emergence of the credit creation of commercial banks, the quantity theory of money has actually long become ineffective.

However, in reality, there are too few economists who have grasped the concept of monetary credit creation. Even those economists who understand the idea of credit creation have not linked credit creation with interest rates. So when formulating policies, there is an almost one-sided inclination towards the thinking of the quantity theory of money.

6. The Consequence of the Prevalence of the Quantity Theory of Money Is the "Collapse-Style Depression of Capital Returns"

When a country's credit interest rate drops to a certain level, a "collapse-style depression of capital returns" will occur. This kind of depression mainly has four major characteristics: "banks have no profits, enterprises have no funds to use, the public has no money to spend, and the government has no tax revenue". These four situations are interlinked. If banks have no profits, enterprises will lack funds. Without sufficient funds, enterprises won't expand, and as a result, the public's income won't grow, and they will have no money to spend. If corporate investment and public income don't increase, the national tax revenue won't grow either; instead, it may even decline.

Japan was the first country in the world to implement the "quantitative easing" monetary policy, and its economy was also the first to fall into the "collapse-style depression of capital returns". The society under such a depression is a society without desires. The United States also implemented quantitative easing for a long time and was on the verge of falling into the "collapse-style depression of capital returns". However, due to the severe inflation in the US after the Russia-Ukraine conflict, it then quickly entered an interest-rate hike cycle and finally managed to avoid the depression. This has provided humanity with a case of getting out of the

"collapse-style depression of capital returns". The phenomenon that the US economy thrives as interest rates rise is difficult to explain from the perspective of modern economics, but it can be perfectly explained by the author's economic theory. Currently, the Chinese economy is at risk of sliding into the "collapse-style depression of capital returns".

7. The "Optimal Central Bank Monetary Interest Rate" Is an Interest Rate that Is Moderately High

In modern economies, there is no shortage of credit demand. Instead, there is a lack of incentives for credit-based financial institutions to explore such demand. In modern society, the supply of credit lags far behind the demand. As long as credit institutions are adequately incentivized, more credit demands will be uncovered and met, and the total social financing scale will increase. Therefore, monetary policy stimulus should be implemented from the supply-side of money, that is, by stimulating credit institutions rather than using low-interest rates to stimulate enterprises.

For modern economies, capital is the engine of the economy, and real-sector enterprises are the wheels. When the economy slows down, we should promptly restore the power of the engine rather than directly push the wheels.

Only when the "optimal central bank monetary interest rate" is implemented can the social financing scale be maximized, the quantity of effectively-operating money be maximized, and finance support the real economy to the greatest extent. If a country wants to maintain high-speed economic growth, it should implement "financial deepening" rather than "financial repression". Of course, financial deepening is not the financial liberalization advocated by scholars like McKinnon in the United States. Instead, the central bank should fix the monetary interest rate at the "optimal central bank monetary interest rate".

8. Conclusions

Given that the Keynesian and monetarist economic policies we have grown accustomed to using have become ineffective, it might be worth adopting the third approach proposed in this paper. That is, by setting the optimal central-bank monetary interest rate to enhance the credit-creation capacity of commercial banks, we can break out of the economic dilemma and maximize economic growth.

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The data presented in this study are openly available via the links provided in the data section. More detailed information can be obtained upon request to the corresponding authors.

Conflicts of Interest

The authors declare no conflict of interest.

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