Long-Run Theory

The real theory of interest is a theory of the long run.

Changing Real Interest Rate

The real interest rate changes more in the short run than the real theory of interest suggests.

Role for Money and Monetary Policy

Money and monetary policy affect the real rate of interest.

Recession

The basis for the real theory of interest is general equilibrium theory. The economy is at full employment, producing on the production possibility frontier. The slope of the production possibility frontier sets the real interest rate.

In recession, the economy does not produce on the production possibility frontier. So what sets the real interest rate?