Negative interest rates aren't just dangerous. They don't work

By Eric Grover
The American Banker
April 7, 2017

Although the Federal Reserve embarked on a long-anticipated move to increase interest rates last month, the Fed still has a ways to go before rates are normalized. The increase in the Fed funds rate to a nominal range of 0.75% to 1% set it still considerably below the rate of inflation, which was 2.7% for the 12 months ending in February.

Interest rates for most of the last decade and a half have been unnaturally low — in "real" terms the benchmark rate has already been negative — reflecting policymakers' misguided approach to try to accelerate economic activity. Economist Richard Sylla has argued that we now have the lowest interest rates in recorded history.

And yet, some other countries have gone even further, implementing negative interest rate policies. Speaking of negative rates at a congressional hearing last year, Fed Chair Janet Yellen said, "I wouldn't take those off the table."

The Federal Reserve has been heading in the direction of raising interest rates, recently increasing the Fed funds rate to a nominal range of 0.75% to

1%. But at a hearing last year, Fed Chair Janet Yellen said she had not taken negative rates “off the table.”

During the Great Depression, storied economists Irving Fischer and John Maynard Keynes entertained the idea of using negative interest rates to stimulate consumption and investment and thereby propel economic recovery. During and after the financial crisis, the notion gained currency that central banks needed to drive interest rates negative to stimulate short-term consumption and investment to pump up moribund economies.

But a negative-rate policy is a dangerous idea, and the results are sketchy in countries where they have been tried.

Today, nominal benchmark interest rates in Japan, Switzerland, Denmark and Sweden are negative. A desired result from negative rates is that savers will start spending, helping the economy grow. But counterintuitively, savings rates in some nations with negative interest rates have increased, reflecting economic anxiety, while negative-rate policies in those countries have had other unintended consequences.

Interest rates are the economy’s most important price. They dynamically allocate capital between consumption and investment today, and, in the future, between spenders and savers.

With negative rates, the idea is that forcing consumers and businesses to pay to hold cash in banks — which is a form of severe financial repression — will incent them to spend rather than save. If businesses are paid to borrow, in theory, they can justify investing immediately in all manner of projects that otherwise wouldn’t clear normal internal hurdle rates.

But there's a fly in the ointment. Negative-rate policies assume the only way for people to save is to keep their money in a bank, which sets interest-rate yields on deposits. However, as long as cash exists, savers have another option. Rather than lose money, they can get a safe 0% return by storing cash under their mattresses or in safes, thereby frustrating central banks' purpose of spurring spending. Notwithstanding the cost of transporting, safeguarding and insuring cash, it would be eminently rational for them to fill their safes chock full of $100 bills or 1,000 Swiss franc notes.

To make negative interest rates a viable policy tool for central banks, its proponents want to eliminate cash. In "The Curse of Cash", Kenneth Rogoff, a Harvard professor and former chief economist of the International Monetary Fund, advocates phasing out cash — all but coins and small bills — to reduce tax avoidance and criminal activity, and to make negative interest rates potentially an effective policy instrument.

Prices allocate resources. Interest rates allocate capital. Negative or artificially-low interest rates misallocate capital, lowering productivity and economic growth. They create asset bubbles, which eventually correct — sometimes bursting — increasing the risk of economic crises. And, negative interest rates affect wealth distribution, by punishing savers and rewarding debtors — those who hold inflating assets. Society writ large is made poorer.

Nevertheless, mortgage brokers, real estate developers and Wall Street, seeking to inflate equity-valuation multiples, benefit from low interest rates. The elephant in the room is the federal government, which is the biggest beneficiary. Artificially low interest rates hold down the cost of the

enormous and mounting U.S. debt. While many applaud saving's virtues, few lobby for higher interest rates. One shudders to contemplate a world with negative interest rates where Washington was literally paid to borrow and spend. Concentrated benefits trump widely disbursed and less visible costs.

Even advocates of central bank interventionism in sober moments acknowledge its limits. A 1999 book co-authored by then-Princeton University economist Ben Bernanke — before he became Fed chairman — made this statement: "In the long run, the central bank can affect only inflation, and not real variables such as output." In the same vein, Rogoff, in "The Curse of Cash", wrote, "Monetary policy cannot significantly affect long-run growth trends of the real economy."

Pro-growth taxes and regulation, the rule of law, sound money, technology, human capital, and sentiment or animal spirits drive sustainable, real economic growth.

Negative interest rates are an idea so foolish only an economist or a central banker could advocate them.

Eric Grover is principal at Intrepid Ventures, a corporate development and strategy consultancy.

Grover is principal at Intrepid Ventures.