Negative rates are not the fault of central banks

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It is hard to understand the obsession with limiting public debt when it is as cheap as it is today

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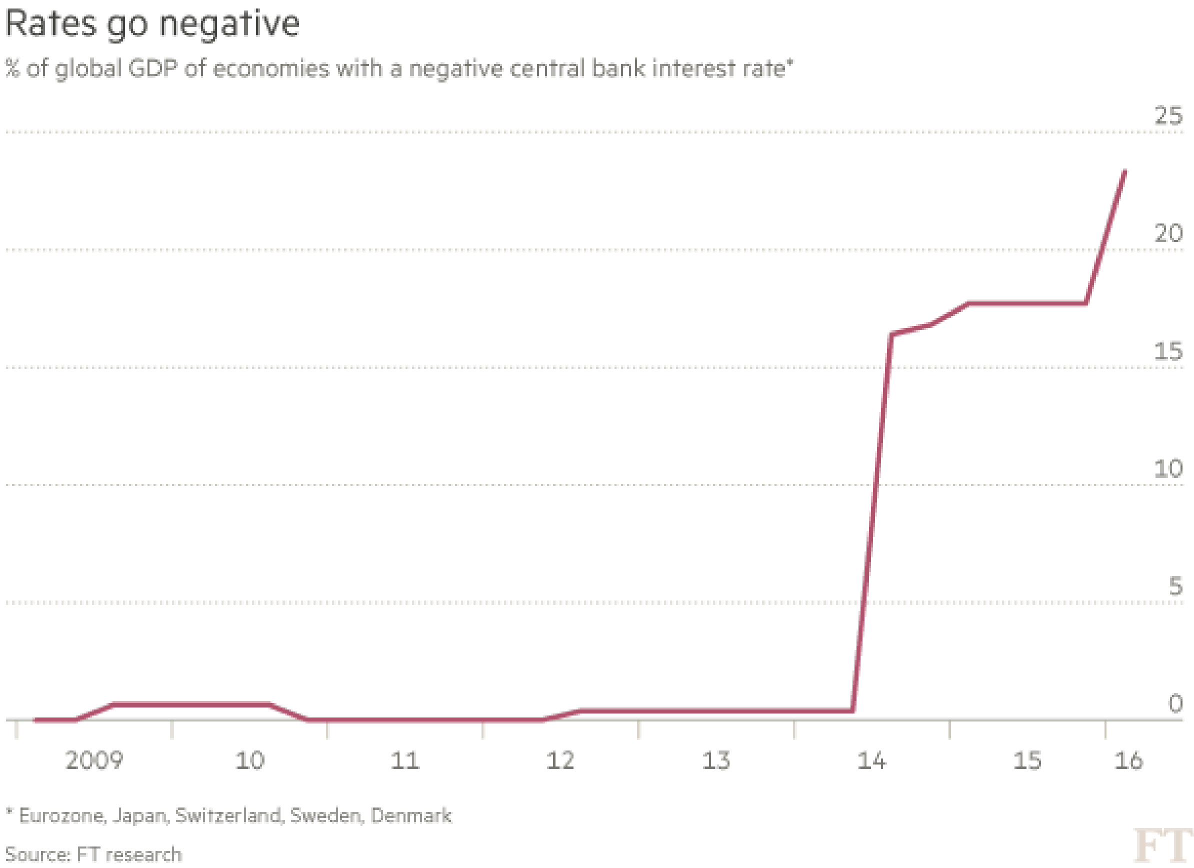
"Save the savers" is an understandable complaint by an asset manager or finance minister of a creditor nation. But this does not mean the objection makes sense. The world economy is suffering from a glut of savings relative to investment opportunities. The monetary authorities are helping to ensure that interest rates are consistent with this fact. Ultimately, market forces are determining what savers get. Alas, the market is saying that their savings are not worth much, at least at the margin.

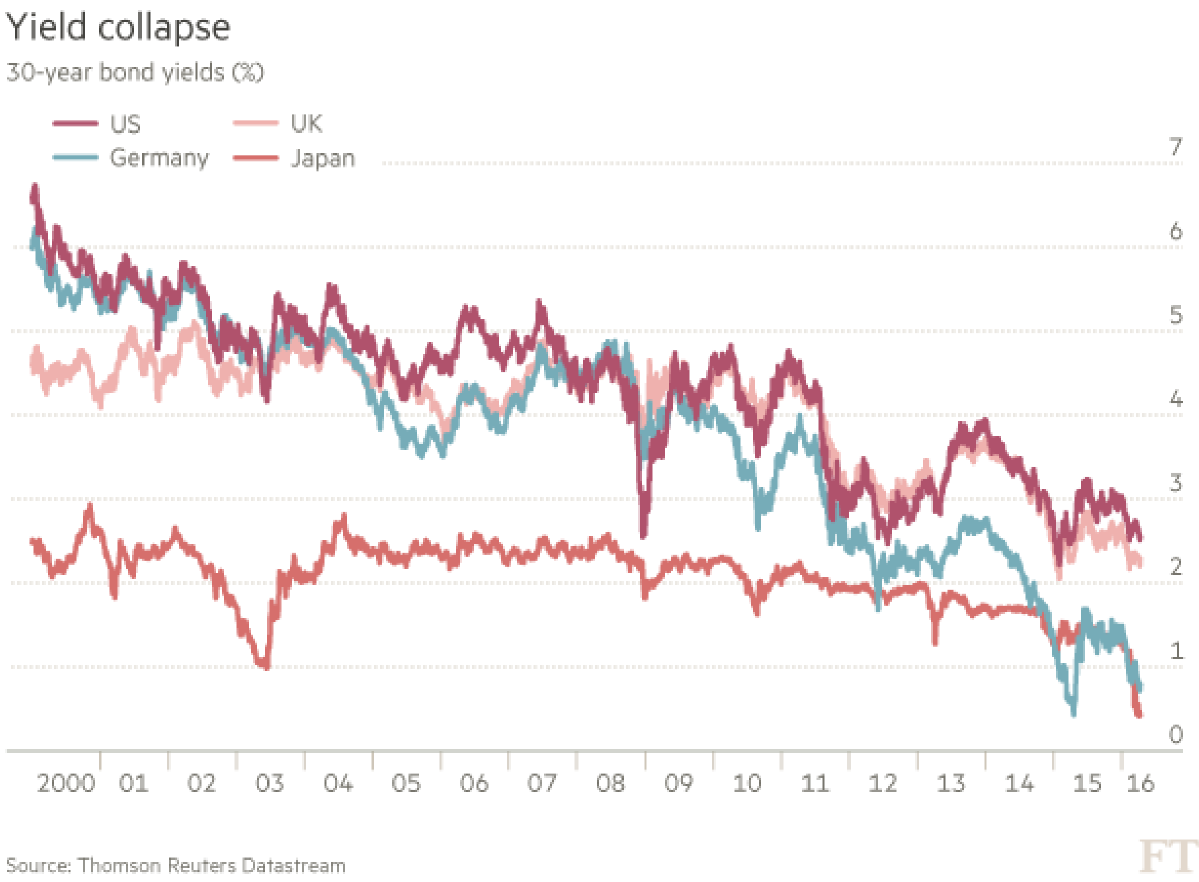
Why does such a savings glut exist? That is the important question. Given its current account surplus of almost 9 per cent of gross domestic product — that is, savings far in excess of what it absorbs domestically, even at ultra-low interest rates — Germany might ask what its domestic interest rate would be if it had to absorb this glut at home. Unfortunately, the rest of the world cannot absorb these savings easily either.

The savings glut (or investment dearth, if one prefers) is the result of developments both before and after the crisis. Even before 2007, real long-term interest rates were in decline. Since then, weak private investment, reductions in public investment, a slowing trend growth of productivity and the debt overhangs bequeathed by the crisis have interacted to lower the equilibrium real rate of interest. For a while, strong post-crisis demand in emerging economies partially offset these trends. But now that has also faded away.

Some will object that the decline in real interest rates is solely the result of monetary policy, not real forces. This is wrong. Monetary policy does indeed determine short-term nominal rates and influences longer-term ones. But the objective of price stability means that policy is aimed at balancing aggregate demand with potential supply. The central banks have merely discovered that ultra-low rates are needed to achieve this objective.

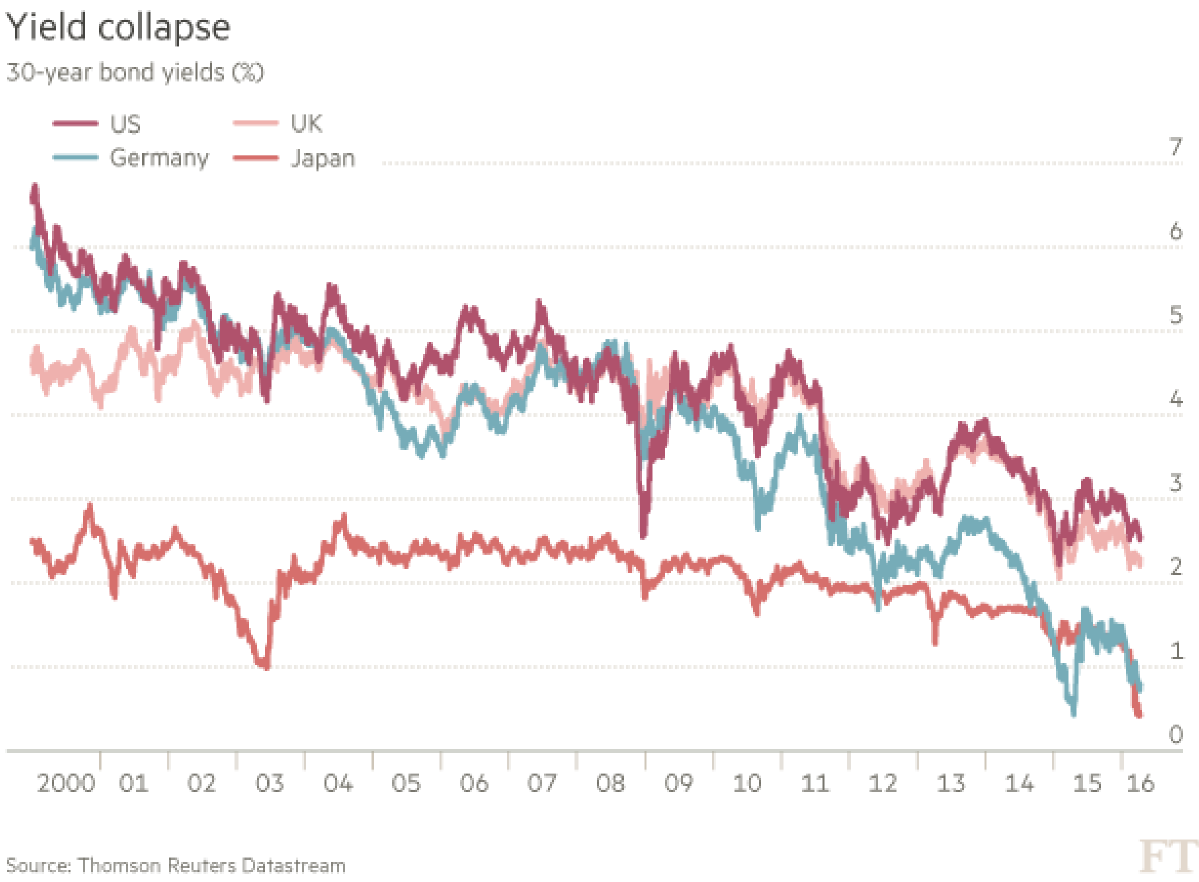


Another objection is that ultra-low, even negative, real rates are counterproductive, even in terms of demand. One rejoinder to this argument is that the ECB raised rates in 2011, with disastrous results. The broader objection is that higher rates shift incomes from debtors to creditors. It is highly likely that the former would cut spending more than the latter would raise it. Furthermore, by impairing the creditworthiness of borrowers, the policy would have two further malign effects: it would force borrowers into bankruptcy, with bad consequences for intermediaries and creditors; and it would reduce the expansion of credit. Thus, the argument that raising interest rates would be expansionary is highly implausible. Naturally, savers argue the opposite. They would, wouldn't they?



In brief, we must regard ultra-low rates as symptoms of our disease, not its cause. Yet it is right to question whether the monetary treatment employed is the best one. Here, three points can be made. One is that, given the nature of banking institutions, negative rates are unlikely to be passed on to depositors and, if so, are likely to damage the banks. A second is that there is a limit to how negative rates can go without limiting the convertibility of deposits into cash. Finally, for these reasons, this policy might do more damage than good. Even supporters agree there are limits.

It is possible to answer such criticisms. Nevertheless, such an exceptional policy could undermine confidence more than strengthen it. Would this mean monetary policy is exhausted? Not at all. Monetary policy's ability to raise inflation is essentially unlimited. The danger is rather that calibrating monetary policy is more difficult the more extreme it becomes. For this reason, fiscal policy should have come into play more aggressively. Indeed, it is hard to understand the obsession with limiting public debt when it is quite as cheap as it is today.



The best policies would be a combination of raising potential supply and sustaining aggregate demand. Important elements would be structural reforms and aggressive monetary and fiscal expansion. The International Monetary Fund argues that structural reforms work best in such an expansionary context. This is particularly true of labour market reforms. The US has been more successful in delivering a more balanced set of policies than the eurozone.

Germany always has the option of abandoning the euro. But the outcome would be a huge appreciation of the recreated D-Mark, losses on foreign assets, in domestic terms, a damaged financial sector, accelerated outward investment, deflation and hollowed-out manufacturing. Alternatively, Germany could stay inside the eurozone. But it must understand that its monetary policy cannot be for the benefit of creditors alone. A policy that stabilises the eurozone must help the debtors, too. Furthermore, the overreliance on monetary policy is a result of choices, particularly over fiscal policy, on which Germany has strongly insisted. It is also the result of excess savings, to which Germany has substantially contributed. It should stop complaining about the ECB's attempts to deal with these dilemmas and help fix problems it has, in part, itself created.