The Catastrophe Of Negative Rates

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Yesterday both Reserve Bank of India governor Raghuram Rajan and Bundesbank president Jens Weidmann broke ranks, daring to suggest that ultra-low interest rates may not be such a good thing after all. If rates were held too low for too long, warned Rajan, the risk of financial instability would be greatly heightened, a concern Weidmann said he shared. Unfortunately, that's not the half of it.

Why must we pay interest rates at all?

To see why, it may help to regress to the lecture hall. Many, many years ago, when I studied economics in Toulouse, one of the questions we addressed was this: Why must we pay interest when we borrow money? Equally, why do we insist that interest is paid to us when we lend?

The answer, I learned, is that as a lender I get paid interest to compensate me for the uncertainty of the future. Admittedly, at the time this did not strike me as a terribly important point, as I had absolutely no money that I could have lent out, and zero chance that anyone sane was likely to lend any money to me. Still, it seemed an interesting theoretical question.

Cutting interest rates brings forward future consumption

But let me assume that my distinguished professors knew what they were talking about, which seems entirely plausible, and let us accept that lenders really do receive interest payments to compensate them for an uncertain future. In that case, the lower the current rate of interest, the less incentive I have to lend, and the more I should consume today. As a result, lowering interest rates tends to bring forward consumption to the present. Conceptually therefore, cutting interest rates should lead to a higher level of economic activity today, to be paid for by a lower level of activity at some point in the future.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US NFIB small business optimism was unchanged at 96.1 in Oct	Lower than 96.4 expected; overall trend remains strong	Compensation plan & job opening components indicate that labor market remains solid
US import price index fell -10.5% YoY in Oct, from -11.3% in Sep	Lower than -9.4% expected	US$ drag likely to lessen in the coming months; we expect a gradual increase in inflation
French industrial production rose 1.8% YoY in Sep, from 1.4% in Aug	As expected; MoM data surprised to upside, up 0.1%, above -0.4% expected	Signs of a small pickup in French industry & mfg, but construction still weighs on output
Japan Eco Watchers survey current expectations rose to 48.2 in Oct, from 47.5 in Sep	Above 48 expected; outlook survey unchanged at 49.1 (below 49.3 expected)	Reduced pessimism about economy allows BoJ to remain in wait-and-watch mode

This is the heart of the Keynesian doxa, which requires interest rates to be lowered as soon as the economy slows down. That would be fine, except of course that an abnormally low rate of interest acts as a tax on the poor who save, for the benefit of the asset-owning rich. When I was a poor student, this struck me as highly regressive and inefficient, since the rich have a relatively low propensity to consume. Even today, 50 years later, I am still amazed that the Keynesians of this world, who are supposed to sit on the left of the political spectrum, so blithely pursue policies that favor the rich and flagellate the poor. However, my competence in the political field is next to zero, so perhaps it is best if I follow this sensitive subject no further.

Ultra-low interest rates are regressive...

Instead, let us continue to unravel the Keynesian logic. If interest rates are reduced to zero, then it follows that all my future consumption should be brought forward to the present, and therefore that my savings rate should fall to zero. Again, that's fine with me. I understand.

...while negative interest rates involve a fundamental logical fallacy

However, if interest rates are pushed into negative territory, we have a totally new ball game. If interest rates really are there to compensate me for an uncertain future, then in philosophical terms **negative rates must mean that the future is more certain than the present.** This is idiotic; the future cannot be more certain than the present—a logical certainty if ever there was one.

So with the European Central Bank's deposit rate at -0.2% (and the Riksbank at -0.35% and the Swiss National Bank at -0.75%), the whole of European monetary policy is based on something that is not only plainly idiotic but totally illogical to boot. How intelligent people could believe that an idiotic and illogical policy will lead to favorable results is beyond me. But then maybe I had the wrong professors all those years ago, and their influence is preventing me from seeing the truth today.

Eventually negative rates will kill growth

In a world of negative interest rates, the logical thing is to borrow money rather than to save more. This will work as long as there are savings pools left in the system. But eventually there will be no savings left. And since savings are required to fund investment, at that point capital spending will collapse, causing productivity growth to stall and economic growth to grind to a halt.

By far the biggest pools of savings today are the pension funds and the life insurance industry. With negative rates, these are doomed (see **Towards System Failure**). They are being sacrificed to allow governments to avoid reform, and perhaps to "save" the commercial banks.

The sacrifice will not work. Abraham Lincoln is supposed to have said: "You cannot help the poor by destroying the rich." It was, and still is, a very pertinent quote (even though it wasn't Lincoln who actually said it). Nevertheless, I would like to suggest a small change to make the axiom more relevant to today's world and today's central bank policies: "You cannot make the rich richer by making the poor poorer". Yet this is what the central banks are doing. Rajan and Weidmann are right to be worried.