EUROFI VIEWS MAGAZINE - BERLIN SEPTEMBER 2020

Jacques de Larosière

Former President, EUROFI

Negative interest rates cannot save indebted economies

Can interest rates be eliminated to avoid servicing monumental debts? The Covid-19 crisis, exacerbated by the consequences of having hyper-accommodative monetary policy for too long, has led to entire economies becoming over-indebted.

To deal with this situation where public leverage has broken all peacetime records, some advocate monetising the debt through central bank purchases of new bond issues and negative interest rates. This is despite the historical record which shows that debt restructurings have proven to be the most effective way to address unsustainable debts.

In the context of economic depression, low inflation and interest rates already at zero, central banks of course cannot achieve negative real interest rates. So, instead, they may want to retrieve some margin by deliberately setting negative rates. Monetary policy would then regain its traditional driving role, as it would be able to recreate negative real rates, despite a lack of inflation.

Proponents of this approach have anticipated some of the objections.

First, the liquidity trap. When rates are negative, investors tend to shun bonds to avoid the "tax" caused by negative rates. One result of this is an accumulation of savings, held in liquid assets such as banknotes or cash accounts. But these barely help foster productive investment.

Proponents of negative interest rates argue that the response to this problem is to eliminate large denomination banknotes and ensure that banks pass on the full cost of negative rates to their depositors. But should depositors be taxed and made to pay most of the cost of emerging from this crisis? That would create major economic and political problems in a country like France, where household savings historically finance about 85 per cent of national investment.

Then there is the risk of inflation. In the long run, any anti-recessionary monetary policy must eliminate the difference between potential growth and currently depressed growth rates through money creation. The risk of inflation is nonetheless considered unlikely given the scale of the Covid-19 crisis, the slow recovery, and structural forces such as ageing, unemployment and technological progress. Even if inflation does return, there will still be time to turn the tide and return to more traditional monetary policy.

Surprisingly, such proposals — which are designed to eliminate an economic fundamental, namely the price or cost of saving — fail to consider an essential question: the value of money. Money is based solely on trust. But the risk of losing that trust will loom if those responsible for it resign themselves to a role that leaves them as suppliers of an unlimited commodity rather than as vigilant guardians of its stability.

Moreover, the moral hazard of a system where indebtedness can be permanent and infinite, regardless of debtors' credit quality, poses serious moral and political problems as it nationalises risk and responsibility.

Negative rates also damage productive investment. They encourage companies to take on cheap debt to pay for share buybacks instead of investment; allow zombie companies to survive, lowering overall productivity; encourage asset bubbles; obliterate the distinction between profitable and unprofitable activities; and make little or no distinction between good or poor-quality debtors.

An economy where interest rates remain negative for decades will not inspire confidence in entrepreneurs. Paradoxically, it will create more precautionary savings. The monetisation of government debt — most of which will end up on central bank balance sheets — will also lead to creeping economic nationalisation and crowd out profitable economic activity.

Everyone knows how excessive debt can lead to crisis. We have paid the price of this causality for decades. And yet negative interest rates open the credit floodgates to both governments and the private sector. They are a source of financial instability and help to create asset bubbles.

A more reasoned policy response to over-indebtedness is clear. Undertake, where necessary, debt restructurings with a co-operative spirit and a sense of market priorities. Scrutinise public budgets and prioritise certain future expenditures, such as education, health and research.

Last, undertake the structural reforms that have been postponed for too long but are the only measures that can deliver a sound, sustainable and better future. ●