

Do Negative Interest Rates Live Up to the Hype?

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Conventional monetary policy sets out that there is a single interest rate, the neutral rate, which keeps the economy at its production potential over time. Alan Greenspan said:

“In assessing real rates, the central issue is their relationship to an equilibrium interest rate, specifically the real rate level that, if maintained, would keep the economy at its production potential over time. Rates persisting above that level, history tells us, tend to be associated with [...] disinflation [...] and rates below that level tend to be associated with eventual resource bottlenecks and rising inflation, which ultimately engender economic contraction” (Greenspan 1993, 11).

According to this view, central banks are always theoretically capable of achieving and maintaining full employment, provided that they can *hit or approximate* the neutral rate via their target policy rate (Yellen 2016).¹ In practice, however, monetary policy implementation is complicated by the so-called “liquidity trap” condition, where the economy remains below full employment despite nominal short-term interest rates being set at zero. In a liquidity trap, additional monetary easing is ineffective, as any attempt to push the overnight rate on reserves below the ‘zero (nominal) lower bound’ (“ZLB”) merely drives banks to swap their excess reserves for zero-interest earning substitutes, such as physical currency (NB: Some theorists claim that, due to the costs of holding and transporting physical cash, the ‘effective’ ZLB may in fact be somewhat below zero). Thus, when faced with a ZLB situation, the textbook prescription is to pivot from monetary easing to expansionary fiscal policy.

¹ “Although estimates vary both quantitatively and conceptually, the evidence on balance indicates that the economy's “neutral” real rate—that is, the level of the real federal funds rate that would be neither expansionary nor contractionary if the economy was operating near its potential—is likely now close to zero. [...] The neutral rate is not directly observable. However, we intuitively know that it must have run well below its historical norm in recent years because otherwise the economy would have expanded at a much more rapid pace with the nominal federal funds rate near zero”).

Over the past eight or nine years, however, elected politicians around the world have proven unable or unwilling to implement additional fiscal stimulus, despite high unemployment and near-zero interest rates.

One monetary policy response has been to propose technical changes to monetary policy implementation in order to enable the overnight interest rate to enter negative nominal territory, and thereby more closely approximate the (ostensibly negative) neutral rate necessary to restore full employment. Various solutions have been proposed to achieve this, ranging from banning higher denomination cash notes, to establishing an exchange rate between physical cash notes and central bank reserves.

To be sure, negative nominal interest rates exist or have existed in Japan and in parts of Europe. Our focus here is on the broader adoption of negative nominal interest rates as a conventional monetary policy. While it is beyond the scope of this note and the accompanying paper to evaluate the narrow technical viability of various proposals for the adoption of negative nominal rates, we suggest that the logic underlying the theory of a single neutral rate is not necessarily clear.

First, interest rate changes have a fiscal dimension, in that they affect the amount of money created by the government and spent into the economy in the form of interest payments on government liabilities. Therefore, lowering interest rates has the effect of reducing the cash payments to holders of existing government liabilities. At a macroeconomic level, this reduction in cash may more than offset any stimulative effect of lower borrowing costs.

Second, changes in the overnight interest rate can have asymmetric effects on *consumer* borrowing and deposit rates because of differences in the consumption and investment habits of savers and borrowers. In addition, banks might absorb interest rate reductions onto their own balance sheet, in the form of lower net interest margins, rather than passing them on to customers.

Beyond the uncertain economic effects, deeply negative nominal rates could create legal problems. In the US, it is uncertain whether negative nominal rates could be characterized as a tax and therefore be viewed as an exercise of fiscal power normally reserved to the legislature. Moreover, and again in the US, in the event that a central bank was granted statutory authority to impose taxes on a discretionary basis, absent a coherent limiting principle, such authorization could still raise constitutional issues concerning the non-delegation of legislative power.

Alternatively, attempts to sidestep the taxation issue by instead establishing an internal exchange rate between physical cash and digital reserves risks violating the legal principle of nominalism by retroactively modifying the nominal face value of certain government obligations vis-à-vis others with respect to their ability to be used to satisfy payments—notably payments to the government, such as taxes, fees, and fines.

Finally, negative interest rates would affect the flow of interest payments from the Treasury to the Central Bank, and, subsequently, the return of net profits from the central bank back to the Treasury. These changes, even if they are budget neutral, may affect the bargaining position of the central bank and ultimately their budgetary independence.

The public debate over negative interest rates has thus far centered around questions of technical feasibility. However, as discussed above, and in more detail in our accompanying working paper, there are economic, legal, and institutional hurdles that might hinder the adoption of negative interest rates as a conventional monetary policy tool.

References

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