Comment: The High Price of Low Rates

By Kerry Pechter *Wed, Aug 12, 2009*

A low interest rate policy, while necessary in a crisis, acts as a tax on the average person and plants the seed for the next credit crisis, according to two NBER Working Papers published in July.

If all goes as expected, Fed chairman Ben Bernanke will announce today that the Fed funds rate—the cost of overnight loans between banks—will remain at 0.25% for the foreseeable future.

In fact, some bank analysts predict that the Fed funds rate will remain close to zero until the second half of 2010.

Is that good news? It depends on your point of view. If you want to borrow money or invest in the stock market, it's probably good news. If you're a retired person who wants to eke out an inflation-adjusted return on a safe investment like a CD, it's not such good news. It's more like grand theft.

Low rates are a tax on retirees and anyone else who saves. Douglas W. Diamond, an economist at the University of Chicago Booth School of Business, told RIJ, "This is a transfer to the people who borrow, and a tax on the people who want to invest." As he put it in a paper written with colleague Raghuram G. Rajan for the National Bureau of Economic Research:

"A number of households do not participate in the financial system. Interventions 'work' by effectively taxing them more heavily, and offering the proceeds to participants in the financial system, whose preferences set interest rates.

"Note that the interventions that we are referring to could well be thought of as monetary policy interventions that are not targeted at specific banks, and are meant to bring down the real interest rate. To have effect, they must 'penalize' one set of households—those who do not participate as strongly in financial markets—in order to benefit the system." (NBER Working Paper No. 15197, July 2009).

"The government can always violate property rights and keep the banking system intact—for instance, by taxing households and gifting the proceeds to banks (or equivalently, lending to banks at rates the private market would not lend at). This sort of directed bailout would reduce household consumption while limiting project termination … Such interventions may be necessary in extremis (and is taking place even as we write)."

In another NBER Working Paper, 15138, entitled "Collective Moral Hazard, Maturity Mismatch, and Systemic Bailouts," Emmanuel Farhi of Harvard and Jean Tirole of France's Institut d'Economie Industrielle write:

"A low-interest-rate policy involves both an implicit subsidy from consumers to banks (the lower yield on savings transfers resources from consumers to borrowing institutions and is an invisible subsidy to the latter)." A 1% interest rate cuts the cost of capital by 75% relative to a 4% rate and can keep a number of highly mismatched institutions afloat."

A low rate policy also creates moral hazard. When the Fed lowers interest rates to resolve a crisis, as it did in 2001 and 2007, it creates the expectation among bankers that it will lower rates during the next crisis. Bankers feel free to take big risks by investing in illiquid assets, like mortgage-backed securities. Diamond suggests a deterrent to that.

"The only way to deter the banks from choosing too much leverage and too much liquidity during low rate environments is to make them less profitable in normal rate environments by raising rates higher than you normally would, but not so high as a to destabilize the economy," he told RIJ. He also suggested higher capital requirements during the time that rates are low to reduce the temptation to over-leverage.

Any central bank would eventually be forced to do that, Farhi and Tirole suggest in their paper, or see its reputation suffer. "Yet another cost of bailouts is the loss of reputation by the central bank. This could be modeled by introducing a tough type and soft type," they write.

"A big bailout would then reveal the type of the central bank to be soft, raising the likelihood of future bailouts and pushing banks to take on more risk, hoard less liquidity and lever up, resulting in increased economy-wide maturity mismatch and in turn larger bailouts.

"Even a central bank of the soft type would internalize these reputational costs and be more reluctant to engage in a bailout in the first place. Similarly the tough type will try to separate itself from the soft type by taking a hard line."

To paraphrase the Fed chairman's own recent comment, "When the elephants fight, the grass suffers." Retirement-bound Boomers are paying for this crisis. They paid when their 401k balances fell, they paid in lost wages when their jobs vanished, and they continue to pay by earning less on safe investments.

Their consolation may be the unemployment benefit extensions, the COBRA subsidies, the infrastructure projects, and the Cash-for-Clunkers program that the Obama administration—in the face of intense criticism—has parceled out. But, in a real sense, they paid, and continue to pay, for whatever they're getting.