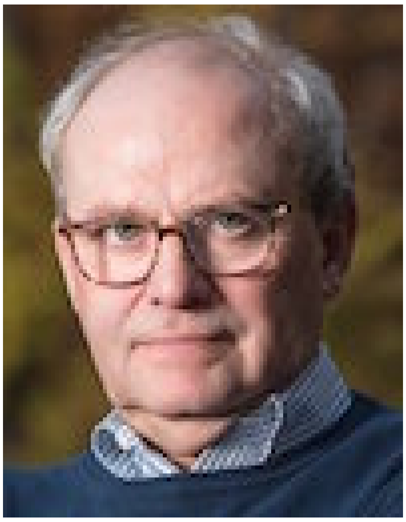
Surveying the Damage of Low Interest Rates

By Anders Aslund *Thu, Dec 14, 2017*

'Insurers seem to be doing fine, but that is because they have been cutting benefits to the point that their customers will soon wonder why they bothered to take out policies in the first place,' writes our guest columnist.



For years after the 2008 financial crisis, policymakers congratulated themselves for having averted a second Great Depression. They had responded to the global recession with the kind of Keynesian fiscal and monetary stimulus that the moment required.

But nine years have passed, and official interest rates are still hovering around zero, while growth has been mediocre. Since 2008, the European Union has grown at a dismal average annual rate of just 0.9%.

The broad Keynesian consensus that emerged immediately after the crisis has become today's prevailing economic dogma: as long as growth remains substandard and annual inflation remains below 2%, more stimulus is deemed not just appropriate, but necessary.

The arguments underlying this dogma do not hold water. For starters, measures of inflation are so poor as to be arbitrary. As Harvard's Martin Feldstein notes, governments have no good way to measure price inflation for services and new technologies, which account for an ever greater share of advanced economies' GDP, because quality in these sectors varies substantially over time. Moreover, real estate and other assets are not even included in the accounting.

The dictate that inflation must rise at an annual rate of 2% is also arbitrary. Swedish economist Knut Wicksell's century-old concept of a "natural" interest rate—at which real (inflation-adjusted) GDP growth follows a long-term average while inflation remains stable—makes sense.

But why should the inflation rate always be 2%? And why aren't services, new technologies, or, say, Chinese manufactured goods excluded from the measure of core inflation, alongside energy and food?

Given these shortcomings, it is worth asking if central banks' doctrine of "inflation targeting" will suffer the same fate as monetarism in the 1980s, when policymakers obsessed over the supply of money. As with inflation today, central bankers then had no credible way even to measure the quantity of money, let alone deliver desired monetary-policy outcomes.

We should consider the effects of large budget deficits as another dubious form of stimulus. In 2017, economic growth in the EU swung up to an annual rate of 2.3%, after member states had finally reduced their budget deficits to an average 1.5% of GDP, down from 6.4% of GDP in 2010. Apparently, the fiscal stimulus after the crisis was not all that stimulating. By contrast, tighter fiscal policies in recent years seem to have had a positive effect.

Usually, a financial crisis gives rise to major structural reforms. But neither the 2008 crisis nor the subsequent euro crisis, which was caused by excessive public debt, led to significant deleveraging or Schumpeterian creative destruction in the affected countries. Clearly, the flood of government spending alleviated the need for difficult reforms, and allowed incumbent enterprises to shore up their positions with cheap finance. Any chance at structural renewal was smothered in the crib.

Among EU countries, average public debt increased from 73% of GDP in 2009 to 86% of GDP in 2016, far above the ceiling of 60% of GDP set by the Maastricht criteria. In Southern Europe, public debts are so large that they will depress growth for years to come.

And yet the past decade of ultra-low interest rates will likely prove even more pernicious than the years of deficit spending. There is no telling when or where the next financial bubble will burst. But we would do well to heed the findings of economists such as the late Charles Kindleberger and Harvard's Kenneth Rogoff and Carmen Reinhart, and tread carefully.

After all, one can spot potential bubbles all over the place. Real estate and other asset prices are at record highs in much of the world. And the value of bitcoin in circulation has increased tenfold just this year, to $170 billion, although the cryptocurrency's underlying value remains dubious at best.

Ultra-low interest rates have also created such a scramble for higher yields that even a poor, mismanaged country like Tajikistan can sell Eurobonds. For Tajik President Emomali Rahmon, that certainly beats seeking help from the International Monetary Fund, which would demand substantial reforms. Thanks to low interest rates, Rahmon can continue to misrule his former Soviet republic as he sees fit.

The many other victims of ultra-low interest rates should be all too apparent. Middle-class savers have watched the real value of their bank deposits decline annually at a rate of about 2%, and many retirees have suffered a real decline in their pensions, which are invested in safe assets and thus yield minimal returns.

The same is also true for many forms of insurance. Insurers themselves seem to be doing fine, but that is because they have been cutting benefits to the point that their customers will soon wonder why they bothered to take out policies in the first place.

Even banks are beleaguered. In advanced economies, traditional lenders are now subject to such a mass of regulation that they have had to withdraw from foreign activities. Not surprisingly, less regulated intermediaries in the shadow banking system have stepped in to seize much of their business.

Traditionally, the banking business centered around attracting deposits and issuing loans. But as a result of "low-for-long" interest rates, that share of banking has become ever smaller, and banks have had to charge ever-higher fees for various other financial services.

Moreover, low interest rates have diverted money toward less transparent and more speculative financial institutions, such as private-equity and hedge funds. Such institutions thrive on cheap credit, which enjoys more favorable treatment than equity financing under most Western tax regimes.

The benefits of low interest rates have accrued not to the population at large, and certainly not to the middle class, but to billionaires—the top 0.1%. The global wealth gap has widened significantly in the past decade alone, and especially in the US, where billionaires pay little to nothing in taxes thanks to special rules such as “carried interest.” And under the new Republican tax plan, they will pay even less.

The question now is whether Western institutions are strong enough to contain the global plutocracy that low interest rates have wrought.

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