

# The Positive Side of Negative Interest Rates

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by David Ranson

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*John Maynard Keynes said, “When my information changes I alter my conclusions. What do you do, sir?”<sup>1</sup> For Keynesians and non-Keynesians alike, it is excellent advice — essential, in fact — and it applies in spades to the mounting confusion about negative interest rates.*



Dallas Headquarters:  
14180 Dallas Parkway, Suite 350  
Dallas, TX 75254  
972.386.6272

[www.ncpa.org](http://www.ncpa.org)

Washington Office:  
202.830.0177  
[governmentsrelations@ncpa.org](mailto:governmentsrelations@ncpa.org)



One major point on which Keynes eventually would have had to change his mind was his 1936 comment, long uncontroversial, that “the rate of interest is never negative.”<sup>2</sup> By February 2016, one-year government bond yields in 12 out of 15 developed countries were negative. Even five-year bond yields were negative in the majority of these countries.<sup>3</sup> [See Figure I.]

The idea that \$1,000 to be received a year from now could be worth more than \$1,000 in the bag today is counter to common intuition. A present dollar has a different value than a future dollar. When inflation is sufficiently high, a future dollar is almost worthless. But by the same logic, when prices are consistently falling, a future dollar could be more valuable than a present dollar.

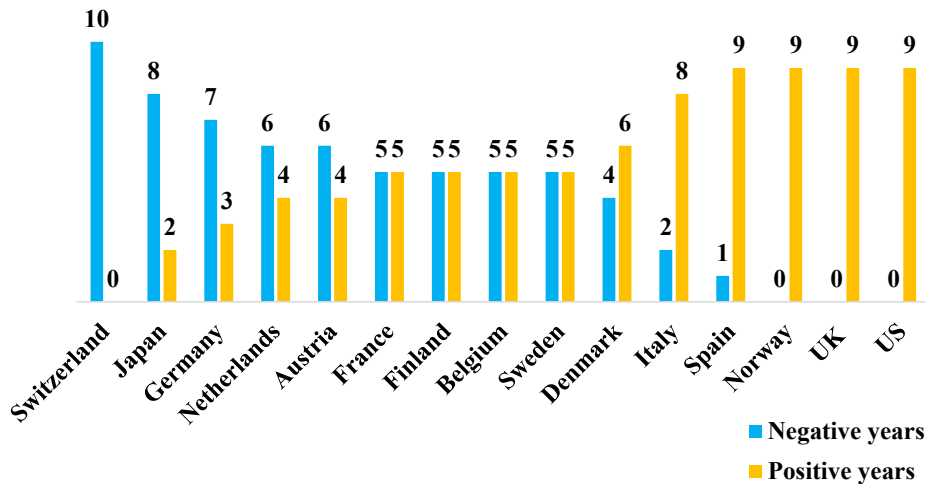
**Negative Rates — Natural and Unnatural.** Ignoring central-bank interference for a moment, the higher the sustained rate of inflation, the higher the interest rate that will accompany it. Symmetrically, negative interest rates should be associated with negative inflation (deflation). Negative inflation is unusual and has almost never been sustained for long periods of time. That explains why episodes of negative interest rates are so rare, and why their potential existence was unrecognized for so long. Although Keynes did not live to see it, interest rates *ought* to be negative at a sufficiently high rate of price level decline.

Switzerland pointed the way to naturally negative interest rates. To their own surprise, the Swiss accomplished it by maintaining an exceptionally strong currency, now roughly at par with the dollar. Life went on. As Figure II shows, deflation is well established there [see Figure II].

It is hard to imagine any idea as counter to classical economics as the Federal Reserve’s doctrine of “stimulative” zero interest-rate policy (ZIRP).<sup>4</sup> Zero interest-rate policies have been tried since 2008 and found wanting. It was only after the Fed ended quantitative easing (QE) that any true improvement in the labor market — as measured by the employment-population ratio — occurred.<sup>5</sup>

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**Figure I**  
Yields in Government Bonds (percent)



Source: BlackRock Investment Institute, Thomson Reuters, February 3, 2016.

Many Fed critics object to negative interest rates on the grounds that they are inherently unnatural. But this view misses the connection with deflation. True, negative rates can result from ever more strenuous efforts by central banks to force down their interest-rate targets. That is what weak-currency regimes like the euro zone and, most recently, Japan, have been up to.

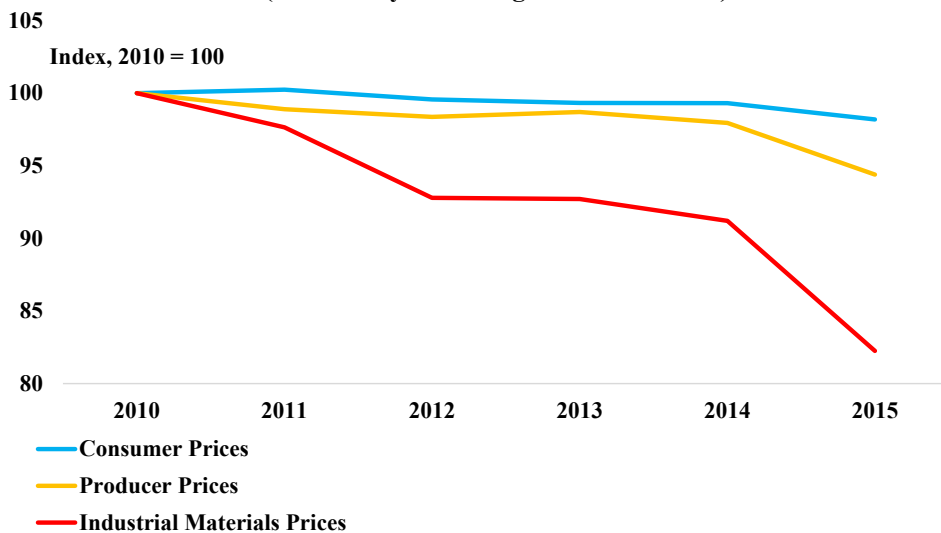
In that context, negative rates really are unnatural — just a bit more unnatural than zero rates, in fact.

Since ZIRP and QE were first introduced, the U.S. inflation situation has turned upside down. In 2008 the U.S. economy was past the midpoint of a decade-long inflation during which the gold value of the dollar fell by two-thirds and commodity markets accordingly soared. Extraordinarily, policymakers were able to avoid acknowledging this because the foundation of official inflation data, the Consumer Price Index, had been neutered over the past few decades to make inflationary or deflationary surprises nearly invisible.<sup>6</sup>

According to estimates by HCWE & Co., free credit markets would have set nominal interest rates during that period around 7 percent if real interest rates had been normal.<sup>7</sup>

This inflationary swing in the dollar ended abruptly in late 2011, for obscure reasons.<sup>8</sup> Since that time the gold value of the dollar has rebounded about

**Figure II**  
Deflation in Switzerland  
(Calendar-year average data from 2010)



Data: Swiss consumer price index and producer price index for all commodities (Swiss Federal Bureau of Statistics) and USD prices of raw industrial materials (Reuters Bridge Commodity Research Bureau) converted to Swiss francs.

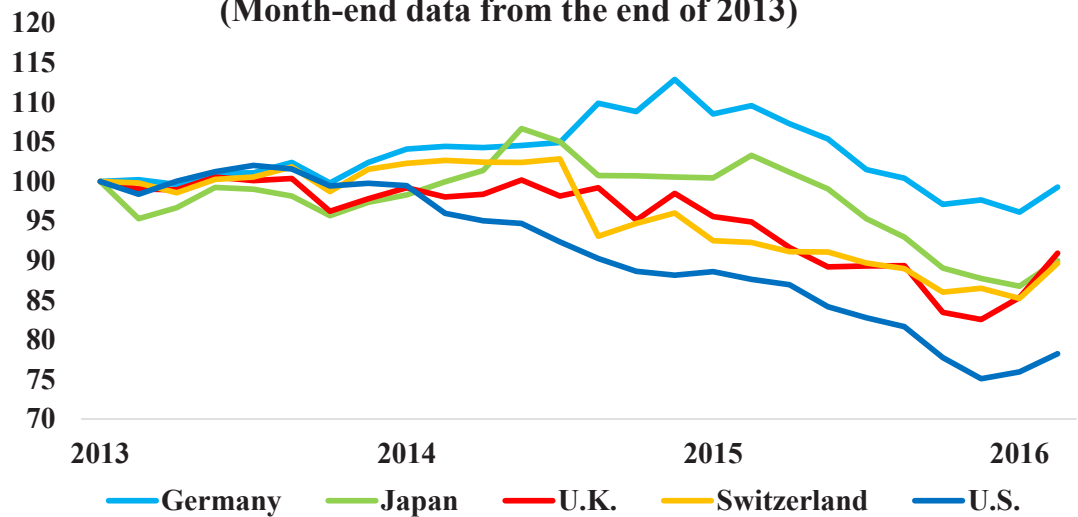
10 percent a year, accompanied naturally by plunging commodity prices. The only timely information about the general level of prices comes from the price performance of commodities and capital assets, because that is where markets are liquid; elsewhere, prices are “sticky.” In that limited but vital sense, actual inflation in the dollar zone has been negative for some time [see Figure III]. Based on the price behavior of commodities and capital markets, HCWE & Co. estimates that U.S. inflation has been negative in recent years: perhaps as low as -5 percent or -10 percent.<sup>9</sup> If markets were to build this situation into their expectations, nominal short-term interest rates should be negative too.

With this in mind, it is possible to imagine the United States following the Swiss lead.

**The Economics of Negative Interest Rates.** Since the dollar was decoupled from gold and allowed to float in 1970, economic logic has been obliged to treat the nominal interest rate and the real rate as separate and distinct. Only under the gold standard could the difference between them be treated as close to constant. Now the difference varies according to the expected rate of inflation or deflation. This is variable; indeed, a great deal more so today than in the past. With an unstable dollar and a fluctuating price for gold over the past few decades, we have been swinging back and forth between (usually) positive and (occasionally) negative inflation. High inflation is bad for the economy, but the damage is greater still when the central bank will not permit commensurately high interest rates to allow the rational allocation of credit (or, as when Paul Volcker headed the Federal Reserve, hold interest rates higher still in the hope of crushing the inflation itself).

One of the chief “market signals” which induce capital to flow to its highest and best use is the real interest rate. A distorted real rate, whether high, low or negative, induces capital to flow to inferior uses.<sup>10</sup> All of this follows, at least, from what the classical economists taught. The pivotal question is the freedom with which what Adam Smith called the Invisible Hand is allowed to exercise its power. A negative real rate is truly a drag on the credit markets and the economy. Indeed, any real rate that the central bank has pushed below its natural level — even if still positive — is a drag.

**Figure III**  
**Industrial Commodity-price Inflation in Different Currency Zones**  
 (Month-end data from the end of 2013)



Month-end price index for raw industrial commodities (Reuters Bridge Community Research Bureau). Indexes are estimated for each currency zone by the by conversion to local currency at the corresponding exchange rate.

The same thing cannot be said about a negative nominal rate — it depends. If the nominal rate were to go below zero as a result of a central bank pushing the real rate down even further than before, the economic drag would be worse. But that may not ALWAYS be the reason for a negative nominal rate. Nominal rates can go below zero under completely different conditions. If the expected rate of inflation falls below zero, it is possible to have a negative nominal rate and a positive real rate at the same time.

So downward pressure on U.S. nominal rates no longer implies that real rates are artificially low. The inflation environment has morphed into a situation in which the imposed nominal rate is now too high. By holding to a target around one-half percent, the Fed has pushed the real rate above its natural level without realizing it. The distortion has swung from one direction to the other. Overly low real rates misallocate credit and capital, but it is not too easy to forget that — in other ways — so do overly high real rates.

Switzerland’s experience illustrates the distinction. The Swiss currency has long been one of the strongest anywhere, and inflation has been low and sometimes

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negative for years. It is negative right now, but it is mostly market forces that drove Swiss nominal interest rates below zero: a situation that resulted from currency strength, not the “easy money” still being sought by policymakers in the euro zone and Japan.<sup>11</sup> Indeed, in these hitherto rare cases where prices are consistently on the decline, it is natural for nominal rates to be negative.

**Investment Conclusions.** Low interest rates have adverse economic consequences to the extent that they are imposed on a credit market which would have reached its own equilibrium at a higher rate. But while difficult to adapt to institutionally, low rates are not in themselves bad for the economy. Indeed, the same can be said of high interest rates; financial markets cannot operate efficiently unless rates are in line with expected inflation and, at times, deflation.

There are mental, cultural and institutional barriers to negative interest rates. But are there economic barriers? No, however inconsistent it may seem at first, there is no inherent conflict between opposing the Fed’s former zero interest-rate policy and cautiously welcoming negative interest rates, in the event that deflationary conditions last.

*David Ranson is a senior fellow with the National Center for Policy Analysis and president and director of research at HCWE & Co.*

## Notes

1. A remark that shows how “un-Keynesian” Keynes was. For other versions of what he might have said, see <http://quoteinvestigator.com/2011/07/22/keynes-change-mind/>.
2. John Maynard Keynes, “The General Theory of the Rate of Interest,” chapter 13, *The General Theory of Employment, Interest, and Money* (London: Macmillan, 1936).
3. “Negative Yields in Government Bond Markets,” Thomson Reuters, February 3, 2016.
4. “Feeding the financial industry’s addiction,” *The Capitalist Perspective*, HCWE & Co., September 27, 2007.
5. “Seeing through the fog: a better way to track unemployment,” *Economy Watch*, HCWE & Co., July 12, 2012.
6. How “headline” inflation has evolved toward meaninglessness,” *Interest-Rate Outlook*, HCWE & Co., November 21, 2012.
7. See “Where would interest rates be if financial repression were lifted?” *Interest-Rate Outlook*, HCWE & Co., October 31, 2014.
8. See “Three days in April: gold and Fed policy,” *Interest-Rate Outlook*, HCWE & Co., April 23, 2013.
9. “Disinflation — ‘lowflation’ — deflation ... and performance!” *Economy Watch*, HCWE & Co., updated edition, January 28, 2016.
10. See “Accommodative interest rates don’t result in what you think,” *Interest-Rate Outlook*, HCWE & Co., October 15, 2015. A broader analysis of interest-rate policy and credit-market distortion appears in “Easy money is hard going for the economy,” a 16-minute HCWE webcast posted December 3, 2015, at <http://www.hcwe.com/wc/WC-1215-FULL/WC-1215-FULL.html>.