The Telegraph

Negative interest rates are a calamitous misadventure

When the debt-laden world faces the next global downturn, it will need the full power of helicopter money, not interest rate gimmicks

Helicopter money is dangerous, but so are negative interest rates. The trick is to pick the lesser poison Photo: AP

By Ambrose Evans-Pritchard

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The world's central banks should take a deep breath and step back from the calamitous misadventure of negative interest rates.

Whatever theoretical profit can be mined from this thin seam, it is entirely overwhelmed by the slow ruin of the banking system.

Huw Van Steenis, from Morgan Stanley, calls negative rates (NIRP) a **"dangerous experiment"** that undermines the mechanism of quantitative easing rather than reinforcing it, and ultimately induces banks to shrink their loan books - the exact opposite of what is intended.

• Negative rates a 'dangerous experiment' as monetary policy hits buffers

The market verdict on the Bank of Japan and the European Central Bank speaks for itself. Bank equities have crashed by 32pc in Japan and by 26pc in the eurozone since early December.

"Financial markets increasingly view these experimental moves as desperate," said Scott Mather, from the giant bond fund Pimco.

The policy blunder is creating a false fear that central banks have run out ammunition. It is distracting attention from the real failings of the global policy regime: lack of willingness to launch a New Deal and inject money directly into the veins of the real economy through fiscal stimulus when needed, and arguably to do so with turbo-charged effect through central bank transfers rather than debt issuance.

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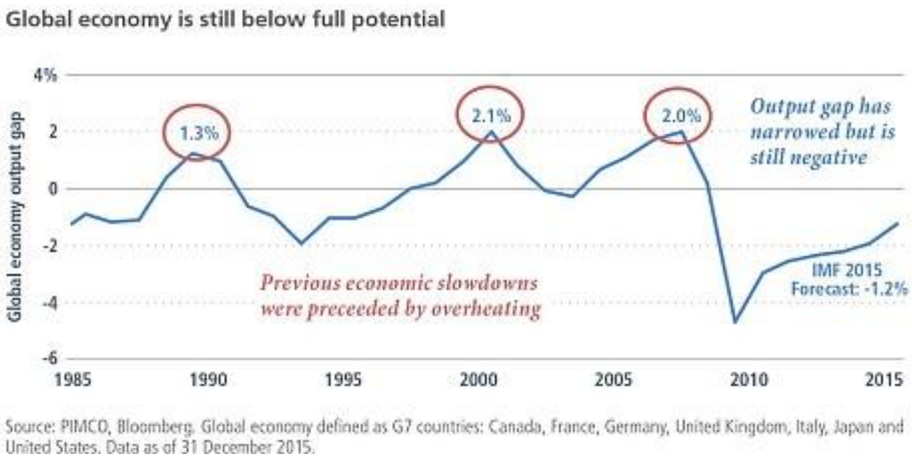
Narayana Kocherlakota, ex-head of the Minneapolis Federal Reserve, **reluctantly backs** NIRP as deep as -3pc but calls it a **"gigantic fiscal policy failure"** that central banks must resort to such absurdities.

Roughly $7 trillion of debt is trading at negative rates. Western states can borrow for next to nothing until the 2030s, yet they refuse to repair their crumbling infrastructure and invest in their future dynamism from fear of fiscal deficits.

Mr Kocherlakota wants it done by old-fashioned borrowing. If you are worried about high debt ratios it can equally be done by "helicopter money", a plan **proposed** by Adair (Lord) Turner at a forum of the International Monetary Fund in November.

Let me be clear, I think the market ructions of recent weeks are a false alarm. We are not on the cusp of a global recession, and it is a first-order fallacy to suppose that a glut of cheap oil is bad for growth. The Atlanta Fed's instant tracker of US growth for the first quarter has jumped to 2.7pc. China's broad credit to the real economy reached a 33-month high of 14.6pc in January.

Global recessions typically begin when the world economy is running at 2pc above its natural speed limit, as you can see from the Pimco chart below. This forces the authorities to jam on the brakes to prevent overheating. We are nowhere near this level today. IMF data suggest that the global "output gap" is -1.2pc, leaving masses of headroom.

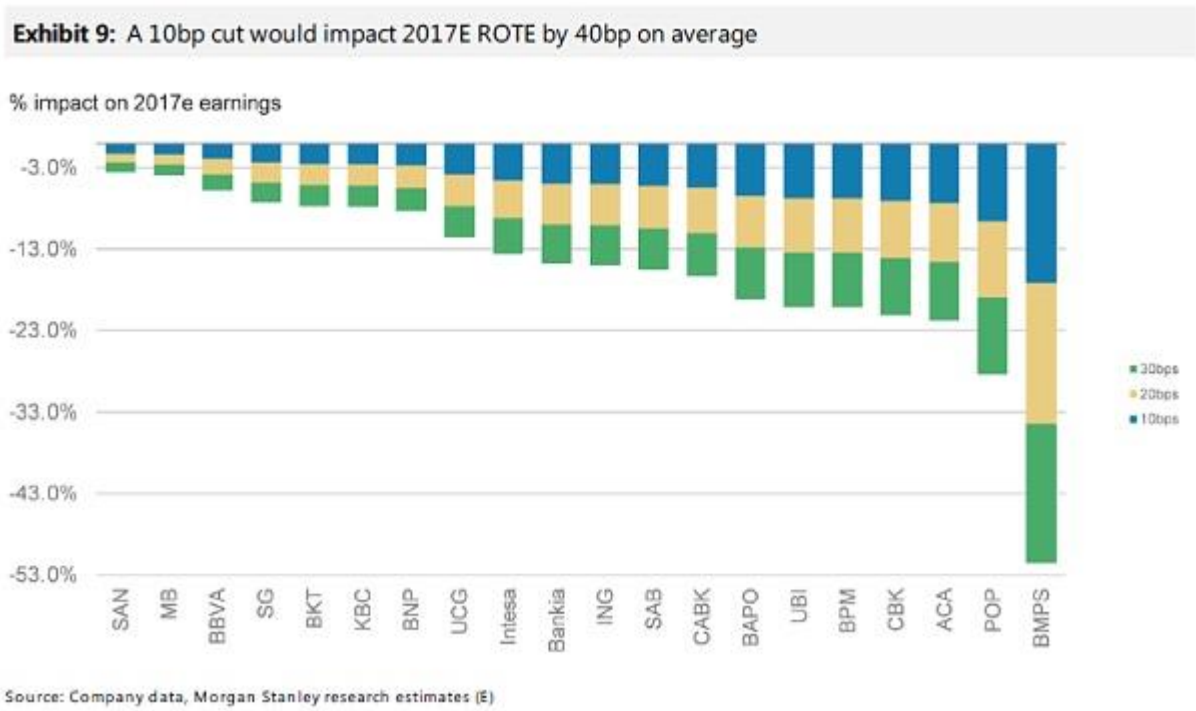


Yet this year's tremor is a foretaste of what to expect when the current global cycle really does sputter out - perhaps in 2017 - and we face the post-QE reckoning and the end of the China bubble with worldwide debt levels some 36pc of GDP higher than during the Lehman boom. Historically, it takes 300 to 500 basis points of rate cuts to break the fall once a global recession sets in, and that we do not have.

The Bank of Japan and the ECB appear determined to double down with even deeper negative rates over coming weeks, even though critics warn that NIRP is entrenching the deflation-trap by pulling down long-term bond yields and jamming the signalling system of financial markets.

They have already pulled away the trap floor on long-term bond rates, inadvertently causing a fresh rush into these safe-haven assets as funds sniff the prospect of much lower yields. Japan's 10-year rates fell below zero last week. This is hardly the way to arrest the deflation psychology of the Japanese people.

The distortions are now grotesque. The one-year euribor rate used in Spain to price floating mortgages (98pc of the total) is -0.012pc. This eats up the net interest margins of banks since they dare not charge depositors a fee, not yet at least. "It's not healthy, it's not sustainable, it's mad," said José María Roldán, head of the Spanish Banking Association.



Damage to bank earnings from each 10 basis point cut in rates

The German Council of Economic Experts said negative rates are devastating for German savings banks, Landesbanken and credit cooperatives, which rely on interest income for almost 80pc of total earnings.

Morgan Stanley said that once negative rates fall below 0.2pc, the damage to bank earnings goes "exponential" and ultimately endangers the whole system of free banking in Europe that we take for granted.

The policy is a tax on excess bank reserves and "effectively a tax on QE itself". The more the ECB steps up QE, the more it increases those excess reserves and the greater the burden on banks caused by negative rates. The construction is becoming absurd.

Worse yet, negative rates are a creeping threat to civil liberties since the only way to enforce such a regime over time is to abolish cash, for otherwise people will move their savings beyond reach. Mao Zedong briefly flirted with the idea during the Cultural

Revolution in his bid to destroy every vestige of China's ancient culture, but even he recoiled.

The eurozone already plans to eliminate the €500 note - allegedly to hurt organized crime - and from there it is a slide down the scales to notes in daily use and then to curbs on quasi-money.

Exhibit 27: Euro Area Financial Stress on the Rise Albeit from Low Levels

It is a step to Franklin Roosevelt's gold embargo and Emergency Banking Act of 1933, when Americans were ordered to hand over their bullion or face 10 years in prison.

One policymaker in Davos this year let slip that drastic action to scrap cash would be needed to fight a decade-long war against "secular stagnation" once rates test the limits of -1pc or -2pc.

The Bank of England's Andrew Haldane floated the idea in a speech **last September**, suggesting that central banks may have to take radical action to circumvent the constraints of the "lower zero-bound".

Mr Haldane said NIRP reinforced by electronic money is a safer course than going down the "most slippery of slopes" by printing money to cover government spending.

Here he is wrong. As Lord Turner argues, there is nothing inherently more slippery about direct monetary financing of fiscal stimulus than any other crisis measure. "Everything we are doing is risky," he says.

One can hardly claim that chronic use of QE to inflate asset prices and to stoke more credit is sound practice, or socially just.

A monetary policy committee can calibrate what is judged to be the proper level of debt monetisation needed to avert deflation in exactly the same way as the MPC or the FOMC calibrate interest rates.

The money creation must be permanent to avoid "Ricardian Equivalence", where people anticipate that more spending now merely mean more debt in the future.

All debt accumulated by central banks under QE should be converted to perpetual non-interest bearing debt, and preferably burned on a pyre in public squares to the sound of trumpets to drive home the message that the debt has been eliminated forever. This will pre-empt the panic that might occur among investors and politicians should public debt ever cross some arbitrary totemic level.

Any New Deal should be funded in the same way - partly or in whole - with the same vow that the debt will never be repaid. The money creation should continue at the therapeutic dose until the objective is achieved.

There is no technical objection to this form of "fiscal dominance", as monetary guru Lars Svensson **told the IMF** forum. All that is missing is political will.

Needless to say, the eurozone cannot venture down this path. Maastricht prohibits the ECB from overt financing of deficits and any such thinking in Frankfurt would lead to a court challenge and destroy German consent for monetary union. This augurs ill, because they will need it.

Thankfully, those of us with our own currencies, central banks and fully sovereign governments always have the means to prevent the collapse of nominal GDP and to avert debt-deflation. We can run out of wit: we can never run out of monetary ammunition.