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[Negative Interest Rates]

It would be wrong to abandon the policy of negative rates

The alternatives are deeply unattractive, writes Kenneth Rogoff

Large denomination notes should be phased out as a priority, says Kenneth Rogoff

by: **Kenneth Rogoff**

The mixed results from experiments with negative interest rate policy in Europe and Japan have led many to conclude that the idea is ill begotten and should be abandoned. To do so would be a serious mistake.

The negative rate policies that are in place certainly have significant limits and it is not clear how much more can be done in the short term. However, policy could be made far more effective in the long run, once a host of institutional constraints are dealt with. The thorniest problem is avoiding a run into zero-interest cash if interest rates become too negative but even this is far from an insurmountable obstacle, given time.

In what could turn out to be a protracted era of low "normal" interest rates, the benefits of clearing the way for effective negative rate policy are potentially significant. If central banks had been able to adopt such policies at the height of the financial crisis, for example, it is likely this would have helped stem the fall in employment, output and asset prices.

True, Janet Yellen, Federal Reserve chair, has argued that the US central bank should not need to rely on negative interest rates to fight the next deep recession. Unconventional monetary policy tools such as quantitative easing and forward guidance should be enough, she believes, if applied widely.

One hopes she is right, given there will probably not be time to lay the foundations for effective negative rate policy before the next recession hits. Unfortunately, based on the academic literature and the experience of the past seven years, there is little reason to believe that is the case.

Some people argue that negative interest rates are unnatural and unprecedented. This is certainly an emotive topic but we should at least get the facts straight. Negative rates are not unprecedented in any meaningful sense. Before paper currency, monarchs routinely debased money, for example by introducing coins with a lower silver content and using these to repay debts.

The problem of the zero lower bound — the idea that interest rates could not go lower — only really emerged with paper currency, but then governments simply turned to the printing press to debase currency in real terms through inflation. To say that real interest rates caused by inflation are unfortunate but negative nominal rates are unnatural is to promulgate financial illiteracy.

The case for negative rate policy becomes all the stronger when one looks at other proposals for stimulating the economy when the zero lower bound constraint is binding. Of course, there is fiscal policy (and everyone agrees on the desirability of debt-financed infrastructure spending).

Beyond that, there is a swath of policies economists might ordinarily consider highly counterproductive but which can sometimes make sense when monetary policy is unable to generate inflation. These include calls for greater protectionism because it raises prices; backpedaling on structural reform because greater efficiency lowers prices, and an outsize role for the government in private credit markets.

But surely protectionism and negative structural reform are potentially far more dangerous than effective negative interest rate policy, were the latter possible? Clear-headed macroeconomic policymaking is hard enough in normal times. It is far more difficult when the zero lower bound clouds the horizon.

The steps that need to be taken are clear enough, particularly phasing out the large denomination notes that would be at the centre of any run into cash. This ought to be done anyway as a measure to reduce crime and tax evasion.

Whenever the next financial crisis comes, central banks should not have to be asking themselves again why they did not think more about the zero lower bound beforehand. The time to get ready is now.

The writer is author of ‘The Curse of Cash’