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Monetary Policy - Nothing to Fear About Negative Interest Rates

NARAYANA KOCHERLAKOTA
Bloomberg

The world's central banks are increasingly employing a controversial method to stimulate economic growth: negative interest rates. I'm convinced that this can be a valuable tool, but its power depends a lot on how it's used.

First,some context. A bond that promises to pay $1,000 in a year's time is said to have a negative interest rate if its current price exceeds $1,000. Economists used to think that nobody would pay such a price: After all, anyone could guarantee themselves $1,000 in a year simply by holding a $1,000 bill. As it turns out, though, cash is costly to store and costly to secure, so people will accept negative interest on other investments -as low as minus 0.75% -for prolonged periods of time. Hence, by taking interest rates into negative territory, central banks can give people and companies an added incentive to spend money now before its value erodes, potentially providing a temporary boost to the economy.

QUICK TAKE ON NEGATIVE INTEREST RATES

I recently participated in a conference at the Brookings Institution in Washington, DC, where economists examined the impact of negative interest rates in the euro area, Denmark and Switzerland. The broad conclusion: There's nothing special about going below zero. The effect of moving from 0.5% to 0.25% seems to be roughly the same as moving from minus

0.25 to minus 0.5. Both will spur spending and both will leads banks and insurance companies to complain to central banks about declining profitability.

That said communication matters. Central banks have typically displayed a great deal of reluctance to employ negative interest rates. The US Federal Reserve, for example, avoided doing so even in the depths of the last recession. This reluctance can make going below zero look like an act of desperation, damaging confidence in the economy . That's arguably why the Bank of Japan's move in January to lower its policy rate slightly into negative territory hasn't been as effective as expected. The Fed risks falling into the same trap by insisting that negative interest rates are not under consideration, even though the rate it pays on bank reserves remains very close to zero.

Communication is particularly important given the trepidation with which people and their elected representatives often view negative interest rates. Here, Denmark's experience is instructive. The Danish central bank has found it easier than some others to generate political support and even pass legislation to employ negative interest rates. The key difference is that Danes understand and fully support the central bank's goal of maintaining a stable exchange rate between the Danish krone and the euro. The Fed and other central banks will face fewer political obstacles in implementing negative interest rates if they do more to ensure that their mandates enjoy similarly broad public support.

Negative interest rates could eventually become an even more powerful tool. Some economists -such as University of Michigan economist Miles Kimball, who presented at the Brookings conference -point out that central banks are capable of taking rates as far below zero as they deem necessary. To increase the cost of holding currency, for example, they could charge banks a fee to change it into electronic central bank money.

Economically useful as such an option would be, central bankers must recognise that the prospect of being charged, say 6% a year just to hold cash could unsettle people. For such a policy to work as intended, officials would have to do a lot of explaining ahead of time -communication that could have the added benefit of ensuring that the public understands the central bank's goals and supports its methods of achieving them.