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Inequality Perils from Lower Interest Rates

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We contend here that:

- The current ease in Western monetary policies is at a recent high but likely going further, especially in Europe.
- These policies have become increasingly ineffective in fostering robust or equitable growth.
- Negative effects of ultra-low rates have been underestimated and are greater than generally thought, especially in increasing inequality.
- Therefore, a new mix of monetary/fiscal policies with a long-term structural focus is called for.

We recognize the extraordinary monetary ease measures have been used successfully during and after the Great Recession of 2008-9. We also recognize that the prevailing low interest rates are the result, not just of easy Central Bank monetary policies, but of well-known international forces such as globalization, automation, changing demographics, and excess savings.

What we question is the wisdom of sustained continuation of these monetary policies now. We believe that lower rates, with apologies to Sir Thomas More, are not a "policy for all seasons." Currently, often the negative effects, and the uncertainties, that arise from a continued move to the monetary terra incognita, of negative rates in Europe, outweigh the positives. There are major questions about their effectiveness now, in part as these come on the heels of forty years of widespread declines.

We believe that the adverse effects, or the considerable range of uncertainties, detailed below, of additional rate cuts right now in most countries far outweigh the purported benefits. We posit therefore that a new economic construct is required, with substantially different monetary and fiscal policies, in order to foster the faster and more equitably distributed growth that the world needs. We specifically argue that rather than additional lowering of rates, we should use the current low rate environment we have to more effectively strengthen long term growth.

In Present Circumstances Sustained Reliance on Lower Rates Actually is likely to Increase Risks and Inequality

Low rates are likely to increase risks and inequality due to:

- Severe misallocation of capital, as the hunger for yield drives investors to riskier assets, with an outcome likely fully visible only when a stress event occurs. While US banks and many companies here are generally in sound shape, the so-called shadow banking area is opaque and may well harbor significant risks. And so-called "zombie" companies in several countries are propped up by the low rates.

- Sovereign borrowers have been encouraged by low rates to fund deficits well beyond what they would contemplate if debt service costs were higher. Excessive sovereign borrowings have been cited by market observers as a possible source of the next bubble and its subsequent undoing.

- Low rates have been one of the least understood factors behind the well documented increase in inequality. Lower rates have helped increase dramatically the value of financial assets and real estate, that are held generally by the upper income quartiles, far more than the tepid growth of wages. They also depress savings income on less sophisticated deposits and reduce many types of pension fund returns - threatening their promised payouts as well as causing similar issues for insurance companies. All of these have disproportionately adverse consequences for both middle- and lower-income groups, including both many retirees, the number of which is growing as populations age, and, ironically, as well for the younger generation with few financial assets.

And with What Result?

There is increasing questioning of the benefits of current monetary ease. Some 13 former central banking leaders expressed publicly their dissent from the latest easing moves by the European Central Bank (ECB). Several note the sharply reduced room for future maneuver by many of the world's Central Banks if/when the next recession occurs.

In the US, in recent years, growth has been sub-optimal, even with monetary ease. Equities are at record highs, bond markets have been liquid and welcoming to borrowers, showing no need for Fed help. Banks are generally sound and have excess reserves. Using these criteria, continued monetary ease appears superfluous. The argument for ease is that this is needed to boost growth and boost inflation and preempt a future economic downturn. We question the true impact. More and more dollars of debt are necessary for every dollar of growth and for pushing up a resistant inflation. Monetary ease, successful in the past, now increasingly seems like whipping a tiring horse. It hurts and doesn't work well.

Do What Instead?

Many of the fundamental causes of slow growth are beyond the immediate reach of fiscal and monetary policies in most countries. But what could be helpful is to change the mix and character of these policies. We advocate a focus on long-term investment-mobilizing fiscal policy. By this, we mean creating a federal capital budget, separate from and in addition to the current budget, for major projects, preferably in private/public partnership form. These projects would be for infrastructure, education, retraining, and R&D through, for instance, the National Science Foundation. Long-term benefits would be material. This is hardly a new proposal, but it would be very sad indeed if we missed the opportunity to move forward now that we have this historic convergence of major needs and the ideal financial conditions with which to finance them -- with very long-term bonds at such low rates.

This is one proposal. If there is at least some acceptance of our views on the deficiencies and perverse effects of current directions of monetary policy, then, hopefully, many other constructive ideas will come forward.

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