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April 25, 2016

ECON 520

Term Paper

It has been almost nine years since the beginning of the Great Recession and about seven since the official end of the recession, yet the U.S. and the rest of the world face issues of slow economic growth. In some cases, countries are even facing the very really real possibility of another recession. In the face of this slow economic growth and volatility in both the financial and commodity markets, leaders and central banks are looking for methods to encourage bank lending and consumer spending. In the United States and around the world this involved huge tax cuts and increased government spending as well as large levels of quantitative easing and other monetary policies aimed at lowering interest rates. At the present, many central banks find themselves in a position where lackluster growth is worrisome, but they have very few options left with which to tackle the situation. As a result, some countries have decided to experiment with negative interest rates. However, because negative interest rates have never really been implemented before there are many varying opinions as to whether or not this solution will actually be beneficial or detrimental to the economies of these countries.

According to a World Bank report, the European Central Bank (ECB), Danish National Bank (DNB), the Swiss Riksbank, and the Swiss National Bank (SNB) have all adopted negative interest rates with the goal of forcing banks to lend money (3). Even Janet Yellen has mentioned the fact that the Fed could adopt negative interest rates even though it is highly unlikely (Derby, n.p.). Many arguments for negative interest rates focus on the ideas of liquidity, lending, and

spending. However, the discussion of charging people for holding their money began well before the Great Recession. "In the late 19th century, the German economist Silvio Gesell argued for a tax on holding money. He was concerned that during times of financial stress, people hoard money rather than lend it. John Maynard Keynes approvingly cited the idea of a carrying tax on money." (Mankiw, n.p.). The idea even came up well before the first negative interest rates were implemented in Denmark in 2012. An article in the New York Times written in 2009 discussed the benefits of the Fed setting a negative target interest rate arguing that at these rates people would chose to spend rather than save, an increase in aggregate demand, which is exactly what central banks wanted and still want to do. (Mankiw, n.p.) Recently, the Wall Street Journal confirms that, in theory, negative interest rates can be good to a point in that they make lending between banks as well as lending to the customers of banks cheaper (Forelle, n.p.). Support for negative interest rates continues after they have been implemented by many people including Jose Vinals, the director of the money and capital markets department at the IMF, who in an interview argued that despite the arguments against and the consequences of negative interest rates, the economies of countries which have implemented them would be far worse off if they had not imposed those rates. He says that negative interest rates are just another tool which central banks can use in order to support the economy. He also argues that asset quality of banks and the economic situations of many countries would be far worse if low and negative interest rates had not been put in place. He says that interest rates could, in fact, go lower and the threshold only comes when people "switch massively to cash" (BloombergBusiness). Although he does argue for negative interest rates, Vinals mentions that it is important for central banks to weigh whether the benefits of adopting these negative interest rates will outweigh the costs in their own situation. According to the Economist, this caused exchange rates to fall and caused

investors to dump these currencies for others such as the USD ("Negative Creep", n.p.). This has an upside in that it promotes exporting of goods which increases GDP and has another possible positive effect of increasing lackluster and below-target inflation level. Clearly, the argument for negative interest rates focuses mainly on the fact that it is one of the few options left that could possibly have a beneficial impact on economic conditions.

Although there is a lot of good that could come from negative interest rates for countries that are in dire need of economic stimulation, there is a very vocal opposition to negative interest rates which stresses that there is a huge and costly downside to implementing them. For example, the devaluation of currency mentioned earlier also means that imports become more expensive. In manufacturing countries where raw goods come from abroad this could prove to be catastrophic. In fact, Mark Carney, governor of the Bank of England, argued that negative interest rates are not the proper response to recent economic struggles because the depreciation of currency is 'no free lunch' and because he believes that current policy needs to focus on reforms rather than 'moving scarce demand from one country to another' (Cancian, n.p.). Moreover, many people argue that continued negative interest will cause banks to see decreasing profits. Those people believe that, in order to make up for money lost, banks will actually begin to start charging customers for their deposits. According to the Economist, this has actually already started happening in Europe; European banks who are being charged for their reserves are passing on those charges to large accounts. The banks started by charging these large companies because that it would impractical for them to remove their money from these accounts, so they are more willing to pay that money than individuals would be. However, opponents to negative interest rates argue that if interest rates were to go too far into the negative or last too long, then banks would be forced to start charging individuals and some people might

make the decision to start saving their money under their mattresses which would be even more detrimental to the economy ("Nope to NIRP", n.p.). According to a report in the national newspaper of Japan, "sales of mini-vaults have gone up after the Bank of Japan announced its negative interest rate policy" (Maley, n.p.). Although people's reactions to such policies can be a bit irrational and funny, this is an important part of the argument against negative interest rates. As many opponents of negative interest rates make clear, the theory works up until banks and people start behaving in ways that were not expected, which realistically happens almost all the time. In Japan and Europe, negative interest rates have not really been in place long enough to know what kind of impact they will have on the economy; however, opponents of negative interest rates believe that results so far show that the benefits do not outweigh the costs. Many investors in Japan as well as Warren Buffet in the United States see negative interest rates as cause for concern because they distort the markets. Buffet and other investors believe this is a good time to invest in the United States which is why US currency has been on the rise; meanwhile, investors have shied away from countries with negative interest rates because they are afraid of what the effects might be (Whitehouse, n.p.). It seems as though many people who are against negative interest rates are mostly concerned with the long-term effects of the policy. Those who oppose negative interest rates may not deny the possible benefits of negative interest rates in the short-run, but they are more concerned about the long-run issues of negative interest rates on the economies of individual countries as well as the global economy.

One of my economics teachers in high school told me that an economist does not care why it rains, just that it is raining. By that he meant that even though economics is seen as a science, economists have to think differently than scientists. This is especially true when it comes to implementing monetary policy because there is no science to it. As Jose Vinals

discussed in his interview, the central bank, when weighing negative interest rates, has to take both sides of this economic argument and determine which will outweigh the other before even worrying about anything else. The arguments for and against negative interest rates are all based on sound economic theory. Theory supports that negative interest rates can indeed stimulate the economy to an extent but that they also have the potential of damaging the economy. Ultimately, the argument will really boil down to what actually happens in these countries as a result of the implementation of negative interest rates which will have a lot to do with the reaction of banks and individuals to the policy and whether or not the central bank is able to prevent the detrimental side effects from occurring.

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