Opinion **Free Lunch**

Free Lunch: Keep flooring it

Who's afraid of low interest rates?

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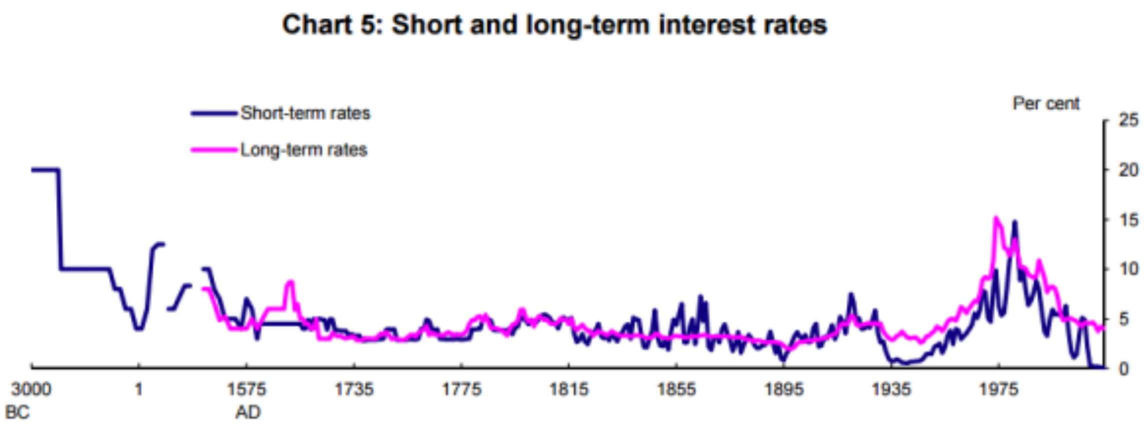
Tightening temptations

It has become fashionable in certain circles to see low interest rates as a Bad Thing. The Bank for International Settlements is a longstanding Jeremiah in that respect. The tone in the latest BIS annual report is fairly cautious, but the message as transmitted to the press is stark: beware of monetary policy that is too loose too long. The FT reports the BIS as "[urging] central banks to move more swiftly towards normalising monetary policy". The WSJ quotes the BIS head of research as warning that "these [low] rates don't appear to be fully consistent with lasting financial stability".

The Bank of England's chief economist Andrew Haldane, too, has given a mildly agonised speech on how interest rates have become "stuck" at low levels - the lowest, he has managed to establish, that they have been in 5,000(!) years. We reproduce Haldane's delightful chart of very, very long-term interest rates below:



"Stuck" is a figure of speech, of course - at least as far as policy rates go, which central banks can put up whenever they like. The question is whether they should.

There are some logical pitfalls that are important to avoid here. Both the BIS and Haldane attribute the record-low rates to pessimism, uncertainty and economic malaise. Rates are low, they think, because a lack of confidence in the future make many want to save while few want to invest. That may be true. But it obviously does not follow that raising rates would boost confidence, lower savings and increase investment: the opposite is likely. Haldane is quite clear about this and rightly leans towards keeping rates "lower for longer". In a very useful table (see the last page of his speech), he shows that when countries have tightened rates prematurely, they have often had to reverse course and reduce them to even lower levels than before.

Then there is the possibility that low rates are not bad news at all. Haldane's colleague Minouche Shafik suggests that a large part of the fall in long-term UK interest rates comes from a reduction in the "term premium" - that is to say, the additional return investors have to be paid to hold long-term bonds rather than rolling over short-term bonds for the same length of time. Ben Bernanke, the former chairman of the Federal Reserve, has also attributed low US rates to falling term premiums. But a lower term premium indicates that investors are feeling more, not less, certain about what the future brings.

Why, then, is the BIS so worried about low rates? The annual report reinforces its earlier research that too much credit can be bad for growth in the long run. This is because credit booms tend to favour sectors where productivity grows slowly, if at all. But we should be wary of treating interest rates as the tool of choice to control the quantity (as opposed to the price) of credit. That, as Bernanke has also pointed out, distracts monetary policy from managing broader economic factors such as employment and inflation. Besides, a proper understanding of how banks work - of how they create money out of nothing on their own discretion - suggests that central bank interest rates may have much less power over credit growth than is commonly thought. The better tool is "macroprudential" regulation of how banks use this power. The BIS is right to worry that lax finance harms growth, but wrong to see this as a reason to raise interest rates.

Other readables

- Economist Branko Milanovic, bumps into Michael Sarris on holiday in Greece. Sarris was finance minister in Cyprus when it introduced capital controls. Milanovic has put their conversation on the Greek crisis on his blog.
- San Francisco Fed researchers find that the conventional wisdom that the poor spend much more of their income than the rich - and so redistribution can boost growth by increasing demand - may be wrong. Note, though, that this only addresses the Keynesian rationale of stimulating demand through redistribution - it does not undermine the IMF's recent finding that less inequality improves the growth rate of productive capacity.
- In a video, FT leader writer Giles Wilkes and I discuss how we would vote in Sunday's Greek referendum.

Numbers news

- Italian borrowing costs have jumped by about 1 percentage point in the last few months:

- Meanwhile, in that other government debt crisis... the Wonkblog tells you what you need to know about Puerto Rico.

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