



The Madness of Negative Interest Rates

By Richard W. Rahn

IF GOVERNMENT CAN BORROW MONEY FOR FREE, WHY BOTHER COLLECTING TAXES?

Would you like for the bank to give you a check each month for your mortgage interest payment rather than you paying the bank interest? As mad as that question seems, the fact is that some homeowners in Denmark are now receiving checks each month because their mortgages have negative (below zero) interest rates. A negative interest rate is the situation in which the lenders pay you to borrow money from them. A number of central banks now have negative interest rates, including Japan, the European Central Bank, Sweden, Denmark, Switzerland and others — all done in the hope of increasing inflation (which is more madness). The chairman of the U.S. Federal Reserve has said she is not ruling out negative interest rates.

Negative, zero or very low interest rates encourage people to buy much more expensive homes than they normally would, which is to their benefit until interest rates rise. Despite stagnant economies many European cities are experiencing a rapid rise in home prices largely because of low interest rate

policies. This real estate bubble cannot be sustained, so at some point it is going to all come crashing down.

If governments can borrow at negative or close to zero interest rates and endlessly roll over their debts, it makes no sense to tax. Just borrow all of the money and get rid of the cost of complying with the tax code, the costs of tax collection by the government and, most importantly, the disincentives for work, saving and investment resulting from the tax system.

When students study basic finance, they learn that if the risk-adjusted rate of return on investment exceeds the cost of the money to finance the investment, the investment should be made, and vice-versa. For instance, if a fast food store owner's analysis shows that the rate of return on an investment of opening a new store after inflation, taxes and adjusting for the likely risks is going to be 10 percent and he can borrow money at 3 percent, it makes sense to make the investment. The problem is that, in the real world, only governments and large or politically connected companies can borrow at the very low rates. Most smaller and entrepreneurial businesses and consumers have to pay far higher rates, because of the perceived additional risk and the cost of servicing the loans. Entrepreneurial businesses create most of the new jobs, but the monetary and regulatory policy bias against them reduces their ability to do so. The rate of new business growth has fallen in the United States but is still greater than that in Europe, where the negative and low interest fad has gone even further.

The proponents of more government spending often refer to their spending plans as "investments" that will pay for themselves in the future from better infrastructure, a more secure population owing to defense and anti-crime spending, a better-educated work force and a healthier population. But many government expenditures not only do not pay for themselves but actually reduce growth and job creation. If the proponents of more government spending really believe

their rhetoric that spending has a positive rate of return, then they should be in favor of more government borrowing and less taxing — when interest rates are very low or negative. If government spending on average provides a positive 3 percent rate of return to society and the cost of borrowing is near zero, why tax at all?

If this sounds a bit mad to you, it shows that you have not totally lost your grip on reality. It is the central bankers and politicians who are in denial. A few government programs actually do have positive benefits, but most do not. Studies showed that the interstate highway system, despite cost overruns, had a net positive benefit by greatly reducing transportation costs and improving highway safety. Government programs to teach children to read and write and basic arithmetic have huge long-run net benefits, even when poorly administered. Even at normal interest rates, it makes sense to borrow for such programs. On the flip side, most government spending is not cost-effective, particularly income transfer programs, and it makes no sense to borrow or tax for such programs.

Negative or low interest rates from central bank actions misallocate capital from its highest and most productive uses, resulting in lower economic growth and job creation. The present madness began with the mistaken belief that monetary policy could be used to solve problems caused by too much government spending, taxation and regulation. At some point, there will not be enough savers to continue to agree to accept negative rates on their savings (after inflation) to support all of the government spending, and the game will be over. And those responsible for the madness will blame others.

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