

Top of Mind

Excerpt from Top of Mind Issue 32: Negative Interest Rates: Helpful or Harmful?

February 27, 2015

Interview with Lars E.O. Svensson

Lars E.O. Svensson was Deputy Governor of Sveriges Riksbank, the central bank of Sweden, from 2007 to 2013. Prior to his appointment, he advised the Riksbank for over 15 years while teaching at Stockholm University and later at Princeton University. He has been a member of the Monetary Policy Advisory Board and the Economic Advisory Panel of the Federal Reserve Bank of New York. He is currently Visiting Professor at the Stockholm School of Economics and Affiliated Professor at Stockholm University. Below, he argues that central banks must use every tool in their toolkit – including negative rates – to avoid deflation and normalize resource utilization.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs



Allison Nathan: Is there an effective zero lower bound? If not, how far can central banks move rates into negative territory?

Lars E.O. Svensson: As I argued in a speech in June 2009 in Washington, D.C., the effective lower bound for the policy rate is negative, not zero, and it is soft, not hard. How far into the negative range the policy rate can go depends on

the negative interest rate at which firms and the public would start hoarding paper currency in large amounts. One might think that paper currency pays a zero interest rate, but the effective return is actually negative, due to administrative and storage costs including crime prevention measures. In 2009, my view was that the policy rate could definitely go down to -25 basis points and probably to -50 basis points without much paper currency hoarding. Now the Swiss National Bank and Denmark's National Bank have pushed rates down further to -75 basis points. It will be interesting to see if that works or if that is going too far. The fact is that central banks have good and high-frequency data on currency in circulation so they would see within a few weeks if the demand for paper currency is increasing rapidly. If it turns out that suddenly there is a lot of demand for paper currency, then the central banks may have to backtrack, but there is nothing wrong with experimenting to see what works. I would nevertheless be surprised if central banks can go much further than -75 basis points.

Allison Nathan: Why have central banks pushed rates into negative territory?

Lars E.O. Svensson: Simply to make monetary policy more expansionary. Inflation and resource utilization are too low and unemployment is too high, so central banks need to do whatever

they can to stimulate the economy, including going as far as possible with negative policy rates. The fact is that in the current situation, the neutral real interest rate – the real policy rate you need to get to full employment in a year or two – is most likely negative and maybe as low as -2%. As long as the real policy rate is above this neutral rate, monetary policy is actually somewhat contractionary. Given that inflation is approaching zero in several advanced economies, a zero policy rate leaves the real policy rates close to zero, still above the likely neutral rate. So central banks must push policy rates into negative territory in pursuit of more expansionary policy.

“Given how critical the situation has become, particularly in Europe, central banks must try all that they can to ease policy and escape zero inflation and even deflation.”

Allison Nathan: Was implementing negative rates in Sweden and in other European countries the right move?

Lars E.O. Svensson: In Sweden, pushing negative rates into negative territory was definitely the right thing to do. The problem is that it is still too little and much too late. Sweden is in its current unfortunate situation because policy was tightened dramatically and prematurely in the summer of 2010 and subsequently loosened much too slowly. Without that tightening in the summer of 2010 and the slow loosening thereafter, inflation would likely have been much closer to the target and unemployment substantially lower today, potentially averting the need for zero or negative policy rates now. But better late than never. The other European countries would also likely have benefitted from negative rates sooner. Broadly speaking, where inflation is low and

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unemployment is high, monetary policy should be very expansionary.

Allison Nathan: Will negative rates work in stimulating the economy?

Lars E.O. Svensson: We don't know. We want these negative rates to be passed onto the markets and to firms and consumers and investors. Paper currency hoarding could prevent this from happening and reduce the stimulus from negative rates. And banks may be reluctant to impose negative rates on depositors, so the policy may be less effective than we would like it to be. But given how critical the situation has become, particularly in Europe, central banks must try all that they can to ease policy and escape zero inflation and even deflation.

Allison Nathan: What are the drawbacks to negative rates and how concerned are you about them?

Lars E.O. Svensson: A few years ago, negative rates were a new idea that no one had really tried, and there were all kinds of counterarguments of why they would not be possible, including that banks' software were not programmed to handle negative rates. Of course, now everyone has had time to prepare for negative rates, and some central banks have shown that they are possible – there is nothing magic about going below zero.

There is perhaps some risk that bank profits might suffer unless banks can pass on negative rates to their depositors. In Sweden, however, the four major banks form an oligopoly and make cozy profits at all times, in recessions as well as in booms. In most cases, I don't think that negative rates would prove counter-productive in terms of lending, nor do I think that profits would fall low enough to threaten financial stability.

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Another potential problem cited by some is the idea that very low or negative rates prompt too much search for yield and excessive risk-taking. However, increased risk-taking is generally desirable when you are trying to stimulate the economy. Overall, there is probably still too little risk-taking in many economies post the Global Financial Crisis, not too much. And this contributes to investment and activity being too low. Of course, leverage and risk-taking must not be excessive. They must be closely monitored, and sufficient capital and liquidity buffers must be in place to safeguard financial stability. But I don't see such potential problems as reason for not conducting a policy with low or negative rates. Instead, I see them as reasons to be very observant and prepared to use macro-prudential policy to address any problems if necessary.

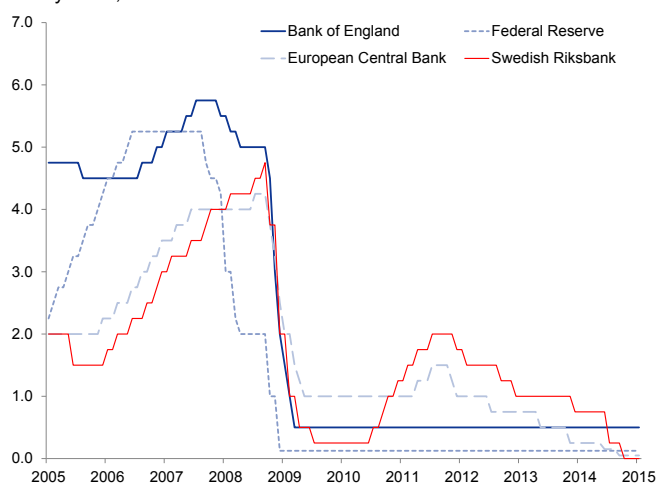
Allison Nathan: Would other monetary policy tools be more effective and/or less costly than negative rates in achieving the same central bank goals?

Lars E.O. Svensson: My view is that one should not just use one tool; one should not be afraid to use several tools in the hope that at least some of them work, including low/negative rates, forward guidance, balance sheet policies such as asset purchases, and also, when appropriate, exchange rate policies such as currency floors and foreign exchange interventions.

Exchange rate policy as was used by the Swiss National Bank and is currently used by the Czech National Bank is controversial because some consider it a zero-sum game. It is true that all countries cannot depreciate their currencies against each other. But all countries can conduct more expansionary monetary policies through conventional or unconventional means. Monetary policy is not a zero-sum game. If one can use exchange rate policies to increase inflation expectations and thereby lower the real policy rate, this is just more expansionary monetary policy with the exchange rate as an instrument instead of the policy rate. The Czech experience may be a good example of this; since depreciating the currency and introducing a currency floor in November 2013, unemployment fell and inflation excluding taxes increased during 2014.

The ups and downs of European rates

Policy rates, %



Source: Central banks, Haver Analytics.

Allison Nathan: What else should European central banks be doing?

Lars E.O. Svensson: The risks of monetary policy being too tight are definitely larger in the current situation than the risks of policy being too easy. In particular, no central bank should repeat the Riksbank's mistake of a premature exit. Also, central banks should not be nervous about overshooting their inflation targets for a few years in order to improve resource utilization and reduce unemployment towards long-run sustainable rates.

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Allison Nathan: Would you describe yourself as an optimist or a pessimist in terms of whether central bank actions will allow the major struggling economies to avoid a prolonged period of low growth and low inflation or deflation?

Lars E.O. Svensson: I believe that the Fed and the Bank of England have likely been sufficiently aggressive for conditions in the US and Britain to continue to improve and to eventually make exit from very low policy rates possible. But I think the Euro area and a few other economies will likely require zero or negative rates for quite a long time. In general, I believe that these central bank

policies will work as long as policymakers are willing to take them far enough. Policymakers need to take risks; this is not a time for passive or cautious policy. If central banks behave sufficiently aggressively, I am relatively optimistic that these economies will get out of their current situation. If central banks are hesitant or more passive, then I think we could be stuck for quite a while.

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