**Why Negative Interest Rates Will Fail**

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It is now just a matter of time before the [US central bank](http://www.washingtonsblog.com/2016/02/bohica-negative-rates-coming-america.html) follows the central banks of Japan, the EU, Denmark, [Sweden](http://uk.businessinsider.com/deflation-sweden-negative-interest-rates-failure-2016-2?r=US&IR=T) and Switzerland in setting negative rates on [reserve deposits](http://www.washingtonsblog.com/2016/01/negative-interest-rates-sign-desperation.html).

The goal of such rates is to force banks to lend their excess reserves. The assumption is that such lending will boost aggregate demand and help struggling [economies recover](http://www.foxbusiness.com/features/2016/02/09/former-fed-president-urges-negative-interest-rates.html). Using the same central bank logic as in 2008, the solution to a debt problem is to add on [more debt](http://www.businessinsider.com/goldman-sachs-says-us-corporate-debt-levels-have-doubled-since-2008-2015-11?r=UK&IR=T). Yet, there is an old adage: you can bring a horse to water but you cannot make him drink! With the world economy sinking into recession, few banks have credit-worthy customers and many banks are having difficulties collecting on existing loans.

Italy’s non-performing loans have gone from about 5 percent in 2010 to over [15 percent](http://www.ft.com/intl/cms/s/af047134-c509-11e5-808f-8231cd71622e,Authorised=false.html?siteedition=uk&_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2Faf047134-c509-11e5-808f-8231cd71622e.html%3Fsiteedition%3Duk&_i_referer=&classification=conditional_standard&iab=barrier-app#axzz3zqlg503K) today. The shale oil bust has left many US banks with over a trillion dollars of highly risky energy loans on [their books](http://money.cnn.com/2016/01/18/investing/oil-crash-wall-street-banks-jpmorgan/). The very low interest rate environment in Japan and the EU has done little to spur demand in an environment full of malinvestments and growing government constraints.

Central bank policies have also driven government bond yields into negative territory. Nearly [$7 trillion](http://www.zerohedge.com/news/2016-02-09/7-trillion-bonds-now-have-negative-yields) of government bonds are currently trading at negative rates.

But, economic theory presupposes that negative rates are an impossibility. After all, why would you buy a one-year treasury bill for $1,005 that will get you $1,000 in a year, when you can stuff your mattress with the $1,005 and still have $1,005 in a year? Some would say that storing money is costly and risky, but that is also true for most assets.

The reason is actually quite simple and shows how distortive monetary policy has become worldwide: It makes sense to purchase a bill for $1,005 *if* you intend to sell it before it matures to the central bank for more than $1,005. In today’s world, the central bank is often ultimately expected to purchase the bill and lose money on it. It’s just another type of debt monetization.

(And it is, by the way, something the Germans emphatically wanted to avoid when the ECB was initially created.)

**We Just Need to Print More Money!**

The real problem is the way monetary policy is taught in almost every undergraduate and graduate program in the world. Pick up any macroeconomics textbook and it will explain how interest rates are determined by the demand and supply of liquidity. The economy is treated as a car, and interest rates are viewed as the gas petal. When reality does not match up with the model, today’s economist, instead of questioning the model and theory, assumes that more of the same will ultimately force reality into the model.

The problem arises from a fundamental misunderstanding about the role of interest rates. Mises in 1912 had this to say about our current enlightened view on money:

[This view of money] regards interest as a compensation of the temporary relinquishing of money in the broader sense — a view, indeed, of unsurpassable naiveté. Scientific critics have been perfectly justified in treating it with contempt; it is scarcely worth even cursory mention. But it is impossible to refrain from pointing out that these very views on the nature of interest holds an important place in popular opinion, and that they are continually being propounded afresh and recommended as a basis for measures of banking policy.

In fact, interest rates reflect the ratio of the value assigned to current consumption relative to the value assigned to future consumption. That is, money isn’t just some commodity that can solve our problems if we just create more of it. Money serves a key function of coordinating output with demand across time.

So, the more you interfere with interest rates, the more you create a misalignment between demand and supply across time, and the greater will be the adjustment to realign output with demand to return the economy to sustainable economic growth with rising standards of living (see [here](https://www.mises.ca/confusion-about-interest-rates-part-1/) and [here](https://www.mises.ca/confusions-about-interest-rates-part-2/)). Negative rates will only ensure an ever greater misalignment between output and demand.

As with Japan, Western economies that pursue a long-term policy of low or negative interest rates can expect decades of low growth unless these “unorthodox” monetary policies are rapidly abandoned. Recessions are not a problem of insufficient demand. They are a problem of supply being misaligned with demand.

**The War on Cash**

Meanwhile, a goal of some of the attendees at Davos and [others](http://www.zerohedge.com/news/2015-09-18/bank-england-economist-calls-cash-ban-urges-negative-rates) has been to push the world toward a cashless society since an increase in cash holdings would limit the effectiveness of negative rates. They know that if they eliminate cash, central banks will have greater control over the money supply and the ability to guide the economy toward their macroeconomic goals.

As long as there is physical cash, people will hold cash in times of uncertainty. It is a wise alternative when all other options seem unproductive or irrational — and keeping cash in a bank at a time of negative rates is, all things being equal, irrational. Central banks, not surprisingly, would therefore like to take away the ability to hold cash outside the banking system. Worst of all, people who hold cash outside the system might be saving it instead of spending it. Naturally, from the Keynesian perspective, this must be stopped.

This is just the latest frontier in the radical monetary policy we’ve been increasingly witnessing since the 2008 financial crisis. The best monetary policy, however, is no monetary policy at all, and central bankers should take an extended holiday so that the world economy can finally heal itself.