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When Is a Monetary “Stimulus” Not a Stimulus?

By Ronald McKinnon

At near zero interest rates, the U.S. recovery from the subprime mortgage crisis of 2008 lacks luster. Pundits are particularly concerned with the depressed level of employment. Eschewing traditional monetary targets, the Federal Reserve vows to keep short-term interest rates near zero until the unemployment rate, currently 7.8 percent, falls below 6.5 percent of the labor force. A laudable goal politically no doubt, but otherwise very dubious in the sense that the Fed might further harm the financial system in pursuing it.

For bringing savers and investors together, textbooks distinguish between direct and indirect finance. One downside of keeping interest rates so low

is that financial intermediation—or indirect finance—throughout the U.S. economy is being undermined.

When nonfinancial companies are fairly large so that their names are recognized and credit worthiness is fairly easily assessed, direct finance works well. Even in the U.S. economy’s current sluggish recovery the equity and bond markets are flourishing, although contracted interest rates are remarkably low.

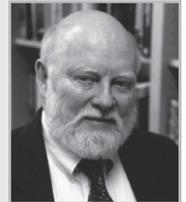
However, indirect finance—through banks and other financial intermediaries—is being squeezed out.

First, by keeping short rates close to zero, long rates—currently at about 1.8 percent for

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10-year Treasuries—will continue to fall. (Remember that the long rate today is just the mean of expected short rates in the future plus a liquidity premium.) Because banks and money market mutual funds traditionally borrow short and lend long, this avenue for making profits is closing.

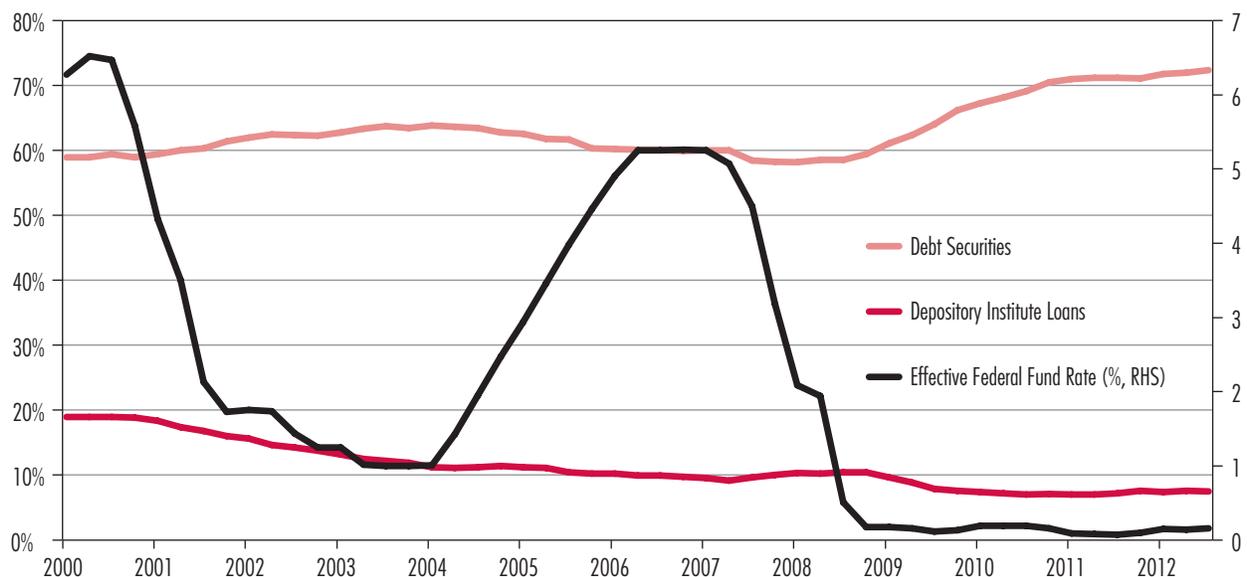
Second, even at a fixed term to maturity, this compression of interest rates toward zero interferes with bank-based lending. Consider a bank accepting deposits and making new loans of just three months'

duration. The traditional spread between loan and deposit rates is about three percentage points—enough to cover a bank's administrative costs and risk. With this spread, the bank can then lend to small- and medium-sized enterprises with higher administrative costs per dollar lent. The bank could also mix these with larger loans to established corporate enterprises to increase the safety of its overall loan portfolio.

However, as interest rates are compressed toward zero, larger corporate borrowers

find they can issue short-term commercial bills directly to savers. The current interest rate on blue-chip commercial bills is less than 1 percent whereas the prime loan rate of banks is 3.5 percent—enough to cover the higher costs of servicing small borrowers. So larger corporate issuers of “safe” commercial bills desert the banks to place the bills with final savers—other corporations with excess cash or money market mutual funds. For nonfinancial corporations, Figure 1 shows the proportion of bank finance falling from almost 20

Figure 1. Debt Securities and Loan Financing of U.S. Nonfinancial Corporate Business



percent in 2000 to less than 10 percent in 2012.

This leaves a typical smaller bank with a riskier portfolio of loans to small- and medium-sized enterprises facing an explicitly or implicitly higher capital constraint. That is, the bank now feels it must either hold more capital to guard against the risk of default or shrink the size of its loan portfolio.

Initially, money market mutual funds (MMMF) that buy commercial bills or other short-dated money market instruments

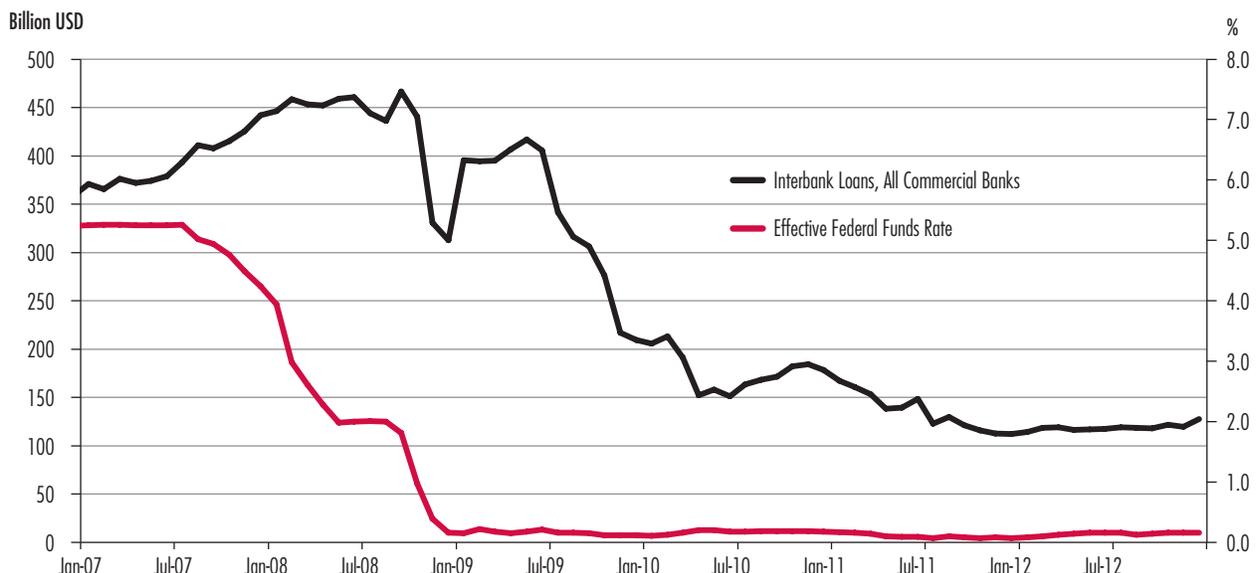
would seem to become more attractive than banks as interest rates fall. However, if short-term interest rates approach zero, even MMMF get into trouble for fear of “breaking the buck.” When the average yield on, say, commercial bills in an MMMF portfolio becomes very low, even a small negative random shock to returns on that portfolio will not cover payments to depositors. With transparent accounting, MMMF “depositors” might get only 99 cents back on each dollar invested. Sponsors of these funds, often banks, are

paranoid about the reputational cost of breaking the buck—so they may either close them or limit new deposits.

The upshot is that blue-chip nonfinancial firms choose to hold excess “cash” rather than try to lend it out for a derisory yield—as we now observe.

In parallel, financial firms, such as commercial banks, will also choose to operate with excess “cash”—mainly reserves held on deposit with Fed—when interest rates are very low. Retail bank lending involves making risky forward

Figure 2. U.S. Commercial Bank and Interbank Loans vs. Effective Federal Funds Rate



commitments. A line of credit to an operating business represents such a commitment, but it is risky to the bank because of the uncertainty of if and when the credit line is drawn down.

However, a well-functioning interbank market—without counter-party risk but with positive interest rates—mitigates that risk. If a bank suddenly finds that its retail customers want to draw down their credit lines simultaneously, the bank can enter the interbank market and borrow heavily to avoid a liquidity squeeze. So even illiquid but solvent banks can cover their forward commitments.

But as the risk-free federal funds rate approaches zero, the interbank market seizes up. Banks with excess reserves become reluctant to part with them for a derisory yield. Figure 2 shows the collapse in interbank trading after the Fed drove the interbank rate to virtually zero on December 2008. Outstanding interbank lending fell from about \$450

billion in 2008 to less than \$150 billion at the end of 2012. In parallel, commercial bank lending fell sharply after 2008, thus deepening the recession. Only two years later did commercial lending begin to increase—while, in 2013, it is still less than its 2008 peak.

Moreover, it is very hard to judge how much of this weak recovery in bank lending is productive. If the cost of money to the banks is near zero, many are tempted to “evergreen”—keep rolling over loans to enterprises that would otherwise go bankrupt, in order to avoid showing bad loans on the banks’ books. Evergreening became prevalent in low-interest Japan in the mid-1990s. “We confirm that zombie dominated industries exhibit more depressed job creation and destruction, and lower productivity” (Caballero, Hoshi and Kashnap, 2008, p.1).

In summary, Steve Hanke (2013, p. 232) describes the current situation:

“In short, the Fed’s zero interest rate has exacerbated

a credit crunch that has been holding back the economy. The only way out of this trap is for the Fed to abandon the conventional wisdom that zero interest rates stimulate the creation of credit.”

One false way out, recommended by many economists, is to advocate an increase in the economy’s inflation target while keeping nominal interest rates near zero. The ostensible rationale is that by increasing inflation expectations one can make the “real” interest rate negative and so stimulate investment—irrespective of whether the domestic financial system is distorted. But this seductive argument still leaves the stultification of domestic financial intermediation in place—with possible evergreening, associated with zero nominal interest rates.

The Abe government in Japan has raised its inflation target to 2 percent per year despite the mildly falling price level of

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recent years. But with nominal interest rates close to zero, the Bank of Japan lacks credibility in implementing its inflation strategy unless its “talk” causes the yen to depreciate—which it did from about 80 yen to more than 90 per dollar in December 2012. But, in slack economic times, such an exchange-rate-led monetary expansion brings charges of “beggar-thy-neighbor” or “currency war” against Japan. Moreover, it fails to eliminate the blockages to domestic financial intermediation within Japan associated with near zero nominal rates—while it introduces more uncertainty about the actual future rate of inflation. Both deter investment and domestic consumption.

In the world economy, the broader currency war question emanates directly from the Fed’s zero interest rate policy. At the center of the world dollar standard, the United States has

greater discretionary power over interest rates than other countries (McKinnon, 2013). But when the Fed sets short rates at zero, this unleashes a flood of hot money into surrounding countries— particularly higher growth emerging markets, such as China or Brazil, whose natural rates of interest are much higher. To prevent or slow their currencies from appreciating, since 2002 they have had to intervene heavily to buy dollars with base money and so have lost control over their domestic monies and generally have inflated faster than in the United States itself.

What is the solution? The only way out of this trap for both the United States and world economies is for the U.S. Federal Reserve to begin gradually increasing the federal funds rates to some modest positive level— say, 2 percent. If followed by the European Central Bank, the

Bank of England, and the Bank of Japan, undue movements in their exchange rates against the dollar would be damped. As bank-based financial intermediation for investment by small- and medium- sized enterprises increased, aggregate output and employment would be stimulated, along with money growth in the hands of households and (nonbank) firms.

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