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Zero Interest Rates in the United States Provoke World Monetary Instability and Constrict the U.S. Economy

by Ronald I. McKinnon

The international dollar standard is malfunctioning. The Fed's reduction of the interest rate on Federal Funds to virtually zero in December 2008 (a move that was followed by other industrial countries) exacerbated the wide interest rate differentials with emerging markets and provoked world monetary instability by inducing massive hot money outflows by carry traders into Asia and Latin America. A "carry trader" is one who exploits interest rate differentials across countries by borrowing in low interest rate currencies to invest in currency domains with higher interest rates.

What Causes World Monetary Instability?

Over the past decade, speculative money flooding into higher interest rate emerging markets by carry traders has provoked domestic inflation and caused local currencies to be overvalued. When emerging market currency exchange rates are not tied down by official parities, their ongoing appreciation induces more hot money inflows. Neglecting the exchange risks involved, carry traders then see a double benefit: The higher interest rates in emerging markets combine with the capital gain as their investment currencies

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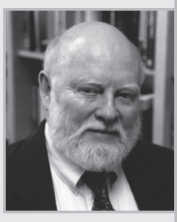
About The Author



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appreciate against the dollar.

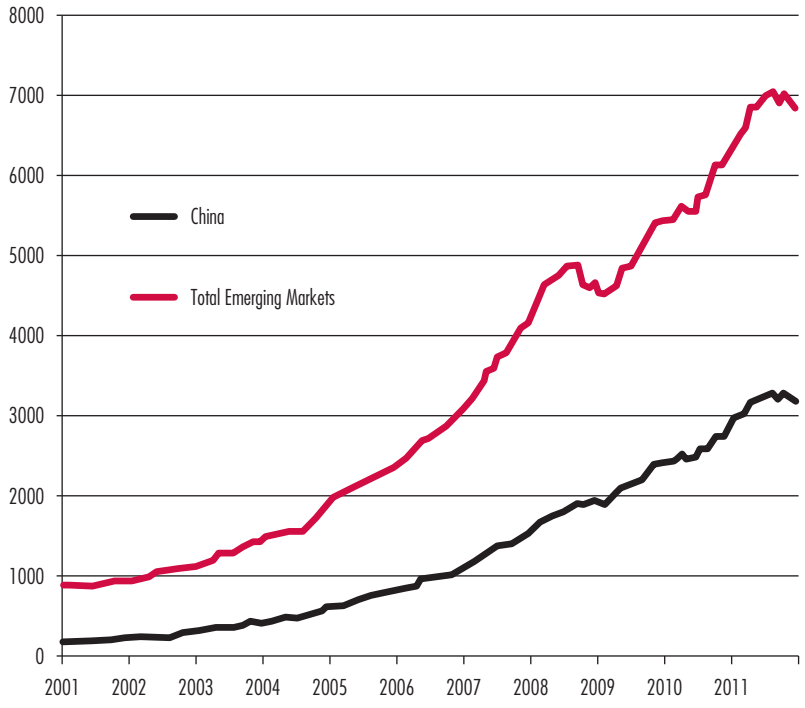
To prevent or limit emerging market currencies from appreciating, emerging market central banks sell their local currency and buy dollars. In the presence of ongoing carry trades, however, emerging market central banks need to keep intervening to prevent continuing appreciation. This foreign exchange pressure leads to the violation of the theorem that a floating exchange rate gives monetary independence to central banks.

From 2001 to 2011, interventions by central banks in emerging markets were massive: Emerging market foreign exchange reserves increased sixfold—from $1 trillion to $7 trillion during the period (Figure 1). Although the People's Republic of China (PRC) accounted for about half of this huge buildup, the combined interventions of large emerging markets—Brazil, India, Indonesia, and Russia, and a host of smaller ones—were equally important.

The sharp buildup of emerging market foreign exchange reserves with concomitant increases in domestic base monies was too big to be fully offset by sterilizing domestic money issue through selling central bank bonds or raising reserve requirements on domestic commercial banks The resulting loss of monetary control in the emerging markets has led to worldwide bubbles in commodity prices and to inflation that is generally higher than in developed market economies. This higher inflation occurred despite the fact that, since 2002, emerging market currencies, on average, appreciated against the currencies of developed countries.

The disruption in emerging markets could be partially justified if zero interest rates on short-term dollar assets had helped the United States recover from the 2008–2009 subprime mortgage crisis. However, evidence suggests otherwise.

Figure 1
Emerging Markets and the PRC, Foreign Exchange Reserves ($ billion)



Source: International Financial Statistics

How is the U.S. economy constricted?

Conventional thinking has it that the lower the interest rate, the more opportunities there are for credit to expand. But this is true only when interest rates—particularly interbank interest rates—are comfortably above zero. Banks with good retail lending opportunities typically lend by opening credit lines to non-bank customers. But these credit lines are open-ended in the sense that the commercial borrower can choose when—and by how much—to draw on the credit line (subject to some maximum limit of course). Open-ended credit creates uncertainty for the bank since it is difficult to know what its future cash positions will be. An illiquid bank could be in trouble if its customers simultaneously decided to draw down their credit lines.

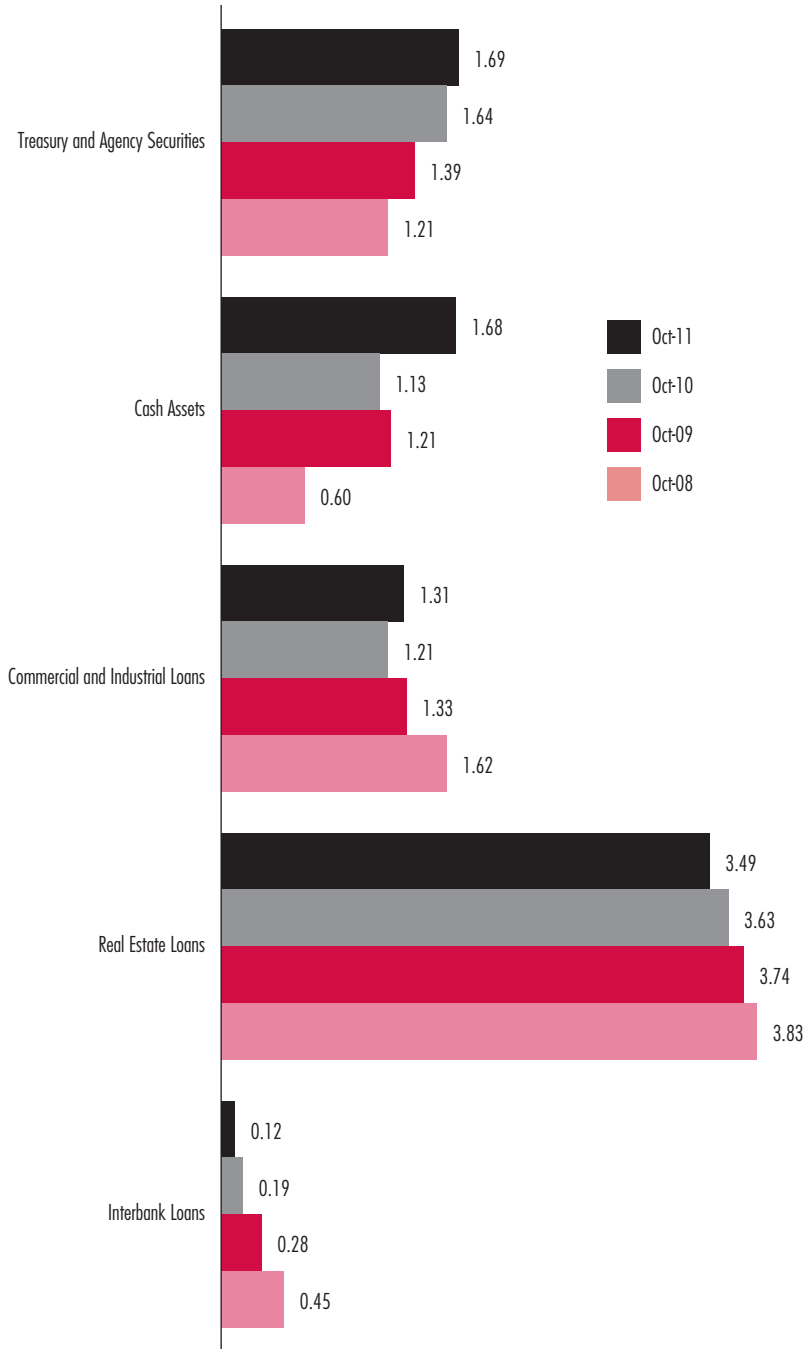
However, if the "retail" bank has easy access to the "wholesale" interbank market, its liquidity is much improved. To cover unexpected liquidity shortfalls—it could borrow, with few or no credit checks, from banks with excess reserves. But if the prevailing interbank lending rate is close to zero (as it is now), then large banks with surplus reserves become loathe to part with their reserves for a derisory yield. In this case, smaller banks, which collectively are big lenders to small and medium-sized enterprises (SMEs), cannot easily bid for funds at an interest rate significantly above the prevailing interbank rate without inadvertently signaling that they might be in trouble, i.e., distressed borrowers. Indeed, counterparty risk in smaller banks remains substantial, as about 100 failed in 2011 in the United States.

The U.S. system of bank intermediation is essentially broken. Figure 2 shows the sharp fall in interbank lending: Interbank loans outstanding in October 2011 were only one-quarter of their level in October 2008. The U.S. recovery has been weak into 2012—with bank credit and employment languishing or increasing only slowly. Figure 2 shows that "Commercial and Industrial Loans" were significantly less in 2011 than in 2008; instead, banks loaded up with "Treasury and Agency Securities."

But the damage that near zero interest rates has done to financial intermediation in the United States is more general than that seen just in banking statistics. Money market mutual funds attract "depositors" who believe they can withdraw their deposits to get virtually instant liquidity. But as the yields on the short-term liquid assets of these funds approach zero, a small negative shock could cause any of them to "break the buck" if marked to market. That is, a customer trying to withdraw from his account might get only 99 cents on the dollar. Banks and other sponsors of money market mutual funds are paranoid about the reputational risks of breaking the buck. So they have closed, are closing, money market mutual funds both in Europe (in euro) and in the United States (in dollars).

When short-term interest rates are kept close to zero indefinitely, this inevitably drags down long rates. A well-known principle of finance is that today's long rates are just expected future short rates plus a liquidity premium. And when Fed Chairman Ben Bernanke drove short rates to zero in December 2008, the yield

Figure 2
Holdings of Bank Assets at Commercial Banks in the US ($ trillion)



Source: Federal Reserve Economic Data

on the 10-year U.S. Treasury bond was 4 percent. By July 2012, the 10-year yield had fallen to 1.45 percent—and one can expect it to fall further if short rates remain frozen near zero.

In the medium and longer term, pension funds have been very important financial intermediaries. However, it is well known that defined benefit pension funds everywhere are in serious trouble. In California, most public-sector pension funds have assumed a nominal yield of 7.5 percent on their assets. So default is in prospect as well as in the increasingly numerous California cities and towns that are being forced into bankruptcy because they cannot meet their pension fund obligations.

What is the solution?

Reform efforts should focus much more on international monetary harmonization that limits interest differentials while accepting the need for exchange rate buffers, such as capital controls, to limit hot money flows.

If interest differentials are too wide, capital controls will always fail. The first item on the G-20 agenda should be to

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abandon monetary policies by the mature industrial economies, led by the United States, which set interest rates near zero. This would lessen the incentive of central banks in emerging markets to keep their interest rates low despite the inflationary pressure that they face and despite the fact that their "natural" rates of interest are higher. The Fed must be the leader in raising interest rates in mature economies because, under the asymmetrical world dollar standard, it has the greatest autonomy in monetary policy.

U.S. officials point to the stagnant U.S. economy as the reason they want to keep domestic interest rates as low as possible—even zero. They must be convinced that this common view is mistaken and that raising short-term interest rates on dollar assets from zero to modest levels—say 2 percent—jointly with their peer central banks in developed countries is in America's own best interests, as well as those of the rest of the world. The longer the Fed's zero interest rate policy stays in place, the more difficult it becomes to get out of the resulting liquidity trap and restore a more normal flow of financial intermediation within the United States so as to avoid perpetual stagnation.

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