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U.S. Exit Strategies and Zero Interest Rates

By *Ronald McKinnon*¹

Since the credit crunch and global downturn in 2008, governments everywhere have responded to the shortfall in aggregate demand in a standard textbook Keynesian fashion. To degrees, they have adopted fiscal stimuli: ramping up government expenditures and cutting taxes. Central banks followed the lead of the U.S. Federal Reserve by driving short-term interest rates toward zero; almost exactly zero for overnight interbank rates in the U.S., Japan, and Canada, and generally less than 1 percent in Europe into the fall of 2009.

In a statement on September 23, 2009, the Fed repeated that it would keep its benchmark overnight interest rate at virtually zero for an “extended period.” But are these near-zero interest rates

the appropriate policy response?

In late 2009, with partial recovery, or at least a noticeable slowing, of the global downturn, a rather heated debate on exit strategies has emerged. The G-20 finance ministers agreed on “the need for a transparent and credible process for withdrawing the extraordinary fiscal, monetary and financial sector support as recovery becomes firmly secured.” But how and when to start withdrawing the support remains controversial.

One group sees unsustainable fiscal deficits and the extraordinary overhang of excess bank reserves as a portent of a monetary explosion and looming inflation. Indeed some commod-

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His books have been translated into many European and Asian languages, and he has been a consultant to central banks and finance ministries the world over—including international agencies such as the World Bank and International Monetary Fund.

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ity markets—notably gold and oil—seem to be frothy, and the dollar is weak again. They argue for withdrawing the stimulus.

Countering this, a second group points to high and possibly still rising unemployment in the U.S. and Europe, coupled with excess capacity, as an effective barrier to any near-term outbreak of inflation in 2009—or even 2010. In the aggregate, they see potential supply still looking much higher than demand. This group worries that any withdrawal of stimulus now would be premature—much as in the Great Depression, when U.S. fiscal and monetary retrenchment in 1937 cut short a nascent economic recovery after 1933.

How best can we sort out these competing arguments? By disaggregating the U.S. stimulus package into its relevant components, one can identify some elements that can and should be exited immediately without undermining—and perhaps even strengthening—the expansionary impact of the whole regime. Here I focus on monetary policy; because the world is still largely on a dollar standard, what the Fed does strongly influences other central banks around the world.

The key point is that the Fed should raise short-term interest rates from near zero to modest levels—say 2 percent. Long

10- or 30-year bond rates would be largely unaffected or could even fall. But in the current zero-interest liquidity trap, such a modest increase in short rates has distinct advantages:

1. In the huge but still constricted wholesale interbank market, constraints on borrowing or lending at medium terms to maturity would be largely relaxed. Only then can general bank credit at “retail” i.e. to firms and households increase. Surprisingly, retail bank credit in the both the U.S. and Europe is still declining.
2. The sharp weakening of the dollar against the euro and other important currencies from March to October 2009 would be curbed, thus preventing a new dollar carry trade that diverts American bank lending to foreigners.
3. China, having led world recovery—or at least the Asian part of it—with a massive expansion of domestic bank credit and fiscal stimulus, could better rebalance its economy. It could become more restrictive with slightly higher interest rates without again being deluged with inflows of hot money from the U.S.

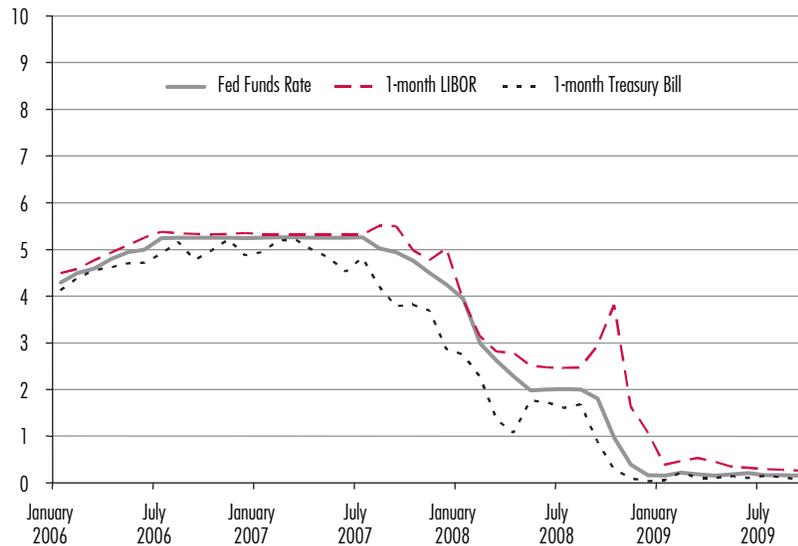
In this short policy brief on what is a large and complex subject, I will discuss just the first—and the least self-evident of the three points.

Wholesale Interbank Markets: Counterparty Risk and Zero Short-Term Interest Rates

In the current crisis, the Keynesian response of stimulating aggregate demand through easy money and loose fiscal policy is correct to a point. But flooding the system with excess liquidity that drives short-term interest rates to near zero has been a serious mistake. By the end of 2008, the interest rates on federal funds and short-term Treasury Bills were virtually zero—where they remain today (Figure 1). In this liquidity trap, the interbank market remains almost paralyzed so that further Fed injections of liquidity simply led to a buildup of excess reserves in U.S. commercial banks without stimulating new lending to households and nonbank firms.

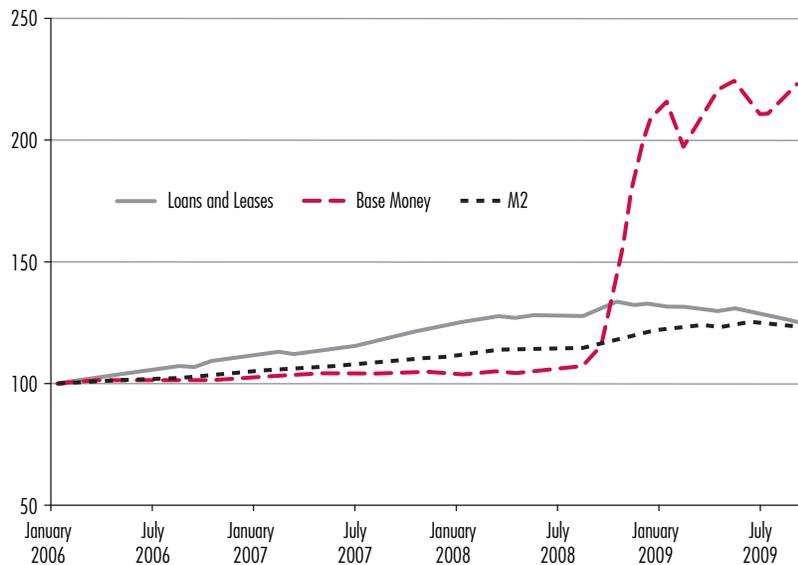
After the financial panic began in July 2008, Figure 2 shows that the Fed responded by more than doubling the stock of base money, which reflects the huge increase in commercial bank reserves from the Fed’s extraordinary purchases of financial assets from the private sector.

Figure 1 – U.S. Short-term Interest Rates (%)



Source: Federal Reserve Economic Data and *globalfinancialdata.com*

Figure 2 – Loans and Leases of U.S. Commercial Banks, Base Money and M2 (2006 Jan = 100)



Source: Federal Reserve Economic Data

However, M2—a broad measure of deposits held by the nonbank public—only increased a modest 5 percent, reflecting an offsetting large fall in the base money multiplier. Most disappointing of all, Figure 2 also shows that retail bank lending declined—and continues to decline so far in 2009. Insofar as U.S. commercial banks did slightly increase their net assets as the counterpart of the modest increase in M2, it was to buy securities such as government bonds or mortgages fully insured by the government. But increased working capital for businesses, especially small and medium-sized, languished despite the gargantuan efforts of the Fed to expand the size of the banking system.

Why was it a mistake for the Fed to flood the system with so much liquidity that short-term interest rates were driven toward zero? In line with textbook economic theory, the Fed focused mainly on the shortfall in aggregate demand rather than on the underlying supply constraint on credit availability. However, starting from a position where interest rates are already very low, say 2 percent as in early 2008, reducing them to zero has only a second-order effect on expanding aggregate demand. But going from 2 percent to zero has a first-order effect of tightening the credit constraint

on the supply side. Although in 2009 the economy may show a “dead cat bounce” from supercharging aggregate demand through fiscal policy, leaving the fed funds rate at zero makes it impossible for the resumption of normal bank credit to support investment growth in future years.

Because credit is an input into working capital, a credit constraint acts very much like a supply constraint on physical capital. In either case, dumping more liquidity into the system does not increase output. But why should congestion in the wholesale interbank market constrain banks who see good retail lending opportunities? Why don't such banks just raise their interest rates to final (retail) borrowers enough to maintain their profit margins and willingness to lend?

This is an important and not generally understood point. Retail lending involves making risky *forward* commitments, much like transacting in forward markets in foreign exchange. For example, a bank might open a line of credit to a well-known corporate customer that could be drawn upon over the next year. But below some well-defined maximum, the customer chooses when to draw it down, and by how much.

The willingness of banks to make such forward commitments to lend to nonbank firms and

households depends very much on the wholesale interbank market. If the wholesale interbank market works smoothly without counterparty risk at positive interest rates, then even currently illiquid banks can make forward loan commitments to their retail customers. If such a bank happens to be still illiquid when a corporate customer suddenly draws down its credit line, the bank can cover its retail commitment by bidding for funds in the wholesale market at close to the “risk-free” interest rate. Because the riskiness of making forward retail loan commitments is thereby reduced, the bank's willingness to do more retail lending increases. (Otherwise, without participating in the interbank market, each commercial bank would have to hold much higher liquid reserves against its potential retail lending opportunities.)

Now suppose some upsetting event, such as a crash in home prices makes all mortgage-related assets on bank balance sheets suspect. Then counterparty risk becomes acute, and banks become less willing to lend to each other unsecured. Because the LIBOR market is unsecured, one very rough measure of counterparty risk from the U.S. housing crash is the difference between the federal funds rate, which is fully secured by repo agreements

based mainly on Treasury bonds as the collateral, and the unsecured LIBOR. Figure 1 shows that before mid-2007 (when the crisis began), the one-month LIBOR rate closely tracked the federal funds rate. Then after mid-2007, LIBOR began to edge above the federal funds rate before spiking sharply in late summer and fall of 2008 to more than 200 basis points above the federal funds rate. With the benefit of hindsight, we know that this was the most acute phase of last year's financial panic when interbank trading dried up. Thus, in 2008, the main constraint on interbank trading was counterparty risk.

Governments everywhere responded to the panic by pumping more equity into banks, greatly expanding the ambit of their deposit insurance, and opening up various central bank discount windows for distress borrowers. This gigantic effort seems to have reduced counterparty risk, the fear of bank failure, in interbank trading. Figure 1 shows the one-month LIBOR rate coming down close to the federal funds rate, now near zero, by mid-2009.

In 2009, however, with counterparty risk in abeyance but not completely vanquished, the zero interest rate policy



became an important supply-side constraint on the resumption of normal interbank trading. Positive rates of interest at all terms to maturity are necessary for restoring normal borrowing and lending in the wholesale interbank market. Only then will banks that are liquid, i.e., have excess reserves but no good future lending opportunities at retail, lend to those that are illiquid—i.e., those with good retail lending opportunities in domestic or foreign trade but no excess reserves. But if the risk-free federal funds rate is close to zero, banks with excess reserves will not bother parting with them for a derisory yield.

Interest rates don't have to be very high to unblock private interbank markets—just 1 to 2 percent. However, banks with surplus reserves but without good retail lending opportunities need some profit margin for them to play their vital intermediary role of lending to illiquid banks with better retail opportunities. Otherwise the Federal Reserve itself has to be the intermediary by using the (excess) reserves of the commercial banks lodged with it to lend directly to the private sector—for example, by buying commercial bills directly from large corporations. Apart from the potential undesirable political biases in government

direct lending, small- and medium-sized firms—which cannot issue marketable commercial bills—are still left starved for even normal bank credit.

I have made a distinction between “illiquid” and “liquid” banks without specifying much in the way of an institutional framework for distinguishing between the two classes. Indeed, banks that are illiquid in any one period need not be in the next. Being illiquid seems pejorative, but it is not if, at any point in time, it includes banks with the better (forward) retail lending opportunities. Also, with the government's massive injections of new equity into large banks, their counterparty risk may have been substantially eliminated—as shown by the convergence of LIBOR to the federal funds rate in 2009.

However, residual counterparty risk could still be lodged in smaller U.S. banks among which there have been numerous failures so far in 2009. Indeed, LIBOR only reflects average interest rates for trade among the world's 20 or so largest banks in London. It need not reflect the plight of smaller banks, which have not been beneficiaries of government largess. But smaller banks are the natural lenders to small- and medium-sized enterprises, which seem the most stressed in the current

downturn. Thus, Figure 2 could reflect a huge build-up of excess reserves concentrated in large banks while, simultaneously, many small- and medium-sized banks—without easy access to the interbank market—reduce their (retail) lending thus making a robust recovery in the United States impossible.

International Implications

The international consequences of zero-interest-rate policies are also negative. With interbank markets in the U.S. and Europe congested, forward foreign exchange markets become more difficult to organize. Without forward cover, exporters and importers find it more difficult to secure normal letters of credit. In the financial panic of 2008, foreign trade imploded much more than domestic trade.

In addition, the Fed's zero-interest-rate strategy inevitably weakens the dollar in the foreign exchanges. Besides complicating the management of recovery in other countries facing inflows of hot money from the United States, it heightens the long-term inflationary threat to the United States itself. The American position at the center of the world dollar standard is further jeopardized when foreign holdings of dollar exchange reserves bear only a derisory low yield as the dollar depreciates.