

Low Interest Rates Have Benefits ... and Costs

By Kevin L. Kliesen

In late December 2007, most economists realized that the economy was slowing. However, very few predicted an outright recession. Like most professional forecasters, the Federal Open Market Committee (FOMC) initially underestimated the severity of the recession. In January 2008, the FOMC projected that the unemployment rate in the fourth quarter of 2010 would average 5 percent.¹ But by the end of 2008, with the economy in the midst of a deep recession, the unemployment rate had risen to about 7.5 percent; a year later, it reached 10 percent.

Some economists believe that banks and other financial institutions tend to take greater risks when rates are maintained at very low rates for a lengthy period of time.

The Fed employed a dual-track response to the recession and financial crisis. On the one hand, it adopted some unconventional policies, such as the purchase of \$1.25 trillion of mortgage-backed securities.² On the other hand, the FOMC reduced its interest rate target to near zero in December 2008 and then signaled its intention to maintain a low-interest rate environment for an “extended period.” This policy action is reminiscent of the 2003-2004 episode, when the FOMC kept its federal funds target rate at 1 percent from June 2003 to June 2004.

Recently, some economists have begun to discuss the costs and benefits of maintaining extremely low short-term interest rates for an extended period.³

Benefits of Low Interest Rates

In a market economy, resources tend to flow to activities that maximize their

returns for the risks borne by the lender. Interest rates (adjusted for expected inflation and other risks) serve as market signals of these rates of return. Although returns will differ across industries, the economy also has a natural rate of interest that depends on those factors that help to determine its long-run average rate of growth, such as the nation’s saving and investment rates.⁴ During times when economic activity weakens, monetary policy can push its interest rate target (adjusted for inflation) temporarily below the economy’s

natural rate, which lowers the real cost of borrowing. This is sometimes known as “leaning against the wind.”⁵

To most economists, the primary benefit of low interest rates is its stimulative effect on economic activity. By reducing interest rates, the Fed can help spur business spending on capital goods—which also helps the economy’s long-term performance—and can help spur household expenditures on homes or consumer durables like automobiles.⁶ For example, home sales are generally higher when mortgage rates are 5 percent than if they are 10 percent.

A second benefit of low interest rates is improving bank balance sheets and banks’ capacity to lend. During the financial crisis, many banks, particularly some of the largest banks, were found to be undercapitalized, which limited their ability to make loans during the initial stages of the recovery.



By keeping short-term interest rates low, the Fed helps recapitalize the banking system by helping to raise the industry’s net interest margin (NIM), which boosts its retained earnings and, thus, its capital.⁷ Between the fourth quarter of 2008, when the FOMC reduced its federal funds target rate to virtually zero, and the first quarter of 2010, the NIM increased by 21 percent, its highest level in more than seven years. Yet, the amount of commercial and industrial loans on bank balance sheets declined by nearly 25 percent from its peak in October 2008 to June 2010. This suggests that perhaps other factors are helping to restrain bank lending.

A third benefit of low interest rates is that they can raise asset prices. When the Fed increases the money supply, the public finds itself with more money balances than it wants to hold. In response, people use these excess balances to increase their purchase of goods and services, as well as of assets like houses or corporate equities. Increased demand for these assets, all else equal, raises their price.⁸

The lowering of interest rates to raise asset prices can be a double-edged sword. On the one hand, higher asset prices increase the wealth of households (which can boost spending) and lowers the cost of financing capital purchases for business. On the other

hand, low interest rates encourage excess borrowing and higher debt levels.

Costs of Low Interest Rates

Just as there are benefits, there are costs associated with keeping interest rates below this natural level for an extended period of time. Some argue that the extended period of low interest rates (below its natural rate) from June 2003 to June 2004 was a key contributor to the housing boom and the marked increase in the household debt relative to after-tax incomes.⁹ Without a strong commitment to control inflation over the long run, the risk of higher inflation is one potential cost of the Fed's keeping the real federal funds rate below the economy's natural interest rate. For example, some point to the 1970s, when the Fed did not raise interest rates fast enough or high enough to prevent what became known as the Great Inflation.

Other costs are associated with very low interest rates. First, low interest rates provide a powerful incentive to spend rather than save. In the short-term, this may not matter much, but over a longer period of time, low interest rates penalize savers and those who rely heavily on interest income. Since peaking at \$1.33 trillion in the third quarter of 2008, personal interest income has declined by \$128 billion, or 9.6 percent.

A second cost of very low interest rates flows from the first. In a world of very low real returns, individuals and investors begin to seek out higher yielding assets. Since the FOMC moved to a near-zero federal funds target rate, yields on 10-year Treasury securities have fallen, on net, to less than 3 percent, while money market rates have fallen below 1 percent. Of course, existing bondholders have seen significant capital appreciation over this period. However, those desiring higher nominal rates might instead be tempted to seek out more speculative, higher-yielding investments.

In 2003-2004, many investors, facing similar choices, chose to invest heavily in subprime mortgage-backed securities since they were perceived at the time to offer relatively high risk-adjusted returns. When economic resources finance more speculative activities, the risk of a financial crisis increases—particularly if excess amounts of leverage are used in the process. In this

vein, some economists believe that banks and other financial institutions tend to take greater risks when rates are maintained at very low levels for a lengthy period of time.¹⁰

Economists have identified a few other costs associated with very low interest rates. First, if short-term interest rates are low relative to long-term rates, banks and other financial institutions may overinvest in long-term assets, such as Treasury securities. If interest rates rise unexpectedly, the value of those assets will fall (bond prices and yields move in opposite directions), exposing banks to substantial losses. Second, low short-term interest rates reduce the profitability of money market funds, which are key providers of short-term credit for many large firms. (An example is the commercial paper market.) From early January 2009 to early August 2010, total assets of money market mutual funds declined from a little more than \$3.9 trillion to about \$2.8 trillion.

Finally, St. Louis Fed President James Bullard has argued that the Fed's promise to keep interest rates low for an "extended period" may lead to a Japanese-style deflationary economy.¹¹ This might occur in the event of a shock that pushes inflation down to extremely low levels—maybe below zero. With the Fed unable to lower rates below zero, actual and expected deflation might persist, which, all else equal, would increase the real cost of servicing debt (that is, incomes fall relative to debt). 

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. Go to <http://research.stlouisfed.org/econ/kliesen/> to see more of his work.

ENDNOTES

- ¹ These projections are the mid-point (average) of the central tendency of the FOMC's economic projections. The central tendency excludes the three highest and three lowest projections.
- ² The purchase of mortgage-backed securities (MBS) was a key factor in the more than doubling of the value of assets on the Fed's balance sheet. This action is sometimes referred to as quantitative easing.
- ³ See the Bank for International Settlements (BIS) 2010 *Annual Report* and Rajan.
- ⁴ In this case, investment refers to expenditures by businesses on equipment, software and structures. This excludes human capital, which economists also consider to be of key importance in generating long-term economic growth.
- ⁵ See Gavin for a nontechnical discussion of the theory linking the real interest rate and consumption spending. In this framework, the real rate should be negative if consumption is falling.
- ⁶ By lowering short-term interest rates, the Fed tends to reduce long-term interest rates, such as mortgage rates or long-term corporate bond rates. However, this effect can be offset if markets perceive that the FOMC's actions increase the expected long-term inflation rate.
- ⁷ The net interest margin (NIM) is the difference between the interest expense a bank pays (its cost of funds) and the interest income a bank receives on the loans it makes.
- ⁸ This is the standard monetarist explanation, but there are other explanations. See Mishkin for a summary.
- ⁹ See Taylor, as well as Bernanke's rebuttal.
- ¹⁰ See Jimenez, Ongena and Peydro.
- ¹¹ See Bullard.

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