

The world still needs the central banks to bail us out of trouble but the impact of monetary policy is complicated in a world of zero or near-zero interest-rate policy (ZIRP) and negative interest-rate policy (NIRP).

Money presents us with three alternatives: we can spend it, save it or invest it. Most households and governments do the first; financial institutions take the third option; and virtually no one saves. Except Asia, obviously.

In 2008, spending and investment froze during the global financial crisis (GFC). This forced central banks and governments to ultimately adopt unorthodox and largely unprecedented strategies. Two tools were available to governments: fiscal stimulus and looser monetary policy. Most governments adopted a mix of both.

However, there are political and financial limits to fiscal policy, particularly as governments grew increasingly overextended during the GFC. Consequently, since 2008, monetary policy has largely displaced fiscal policy as means of generating economic stimulus. Except in Sydney, at the Reserve Bank of Australia (RBA).

ZIRP it. ZIRP it good

The Bank of Japan (BoJ) was the [first to adopt ZIRP](#), as it sought to deal with the aftershocks of the Heisei recession of the early 1990s. This was referred to as Japan's "lost decade", as it experienced stagnant growth, a condition still bedeviling the country today, despite the best efforts of [Abenomics](#).

As the global financial crisis emerged throughout 2007–08, the US Federal Reserve, the European Central Bank (ECB) and the Bank of England sank hundreds of billions of their respective currencies into their foundering financial sectors. The People's Bank of China injected massive liquidity into Chinese markets.

In Australia, the RBA slashed interest rates, with deep successive cuts in 2008–09. Looser monetary policy was matched by the Rudd government's significant fiscal expansion to prevent

the collapse of consumer spending.

The reason behind this fiscal pump priming, combined with the dramatic monetary measures, was clear: in late 2008, credit markets froze. Admittedly, there is much debate about how long and to what extent this occurred. However, the fear of contagion was so palpable that the interbank lending market experienced systemic dysfunction and, at the very least, [credit rationing](#) took place.

The problem for central banks is that they have relatively few monetary tools available to them. The traditional lever to prevent overheating is to exert monetary discipline by raising interest rates, thus increasing the cost of credit.

Conversely, under the crisis conditions of the GFC, the central banks slashed interest rates to encourage consumption. However, the US Federal Reserve, the Bank of Japan, the Bank of England and the European Central Bank reached their lower limits faster than the RBA, which never adopted ZIRP.

But that may be about to change. The RBA's cash rate is at a historic low of 1.75%, and the bank may cut further as the Australian economy plateaus, combined with the uncertainty wrought by Brexit.

The new normal

Make no mistake: ZIRP and even perhaps NIRP are the new normal. Just ask Janet Yellen. When the Federal Reserve chairman increased US interest rates by 0.25% in December 2015, the markets reacted savagely. It was the first Federal Reserve (Fed) rate rise since 2006.

Fourteen months earlier, Yellen had tapered off the US's third quantitative easing program (QE3), ending it on schedule in October 2014. Between 2008 and 2014, the Fed had purchased over US\$4.5 trillion in government bonds and mortgage-backed securities in three rounds of QE, plus a fourth program, Operation Twist (2011–12).

The outcome was an avalanche of “free” money. Why “free”? Because, in the long run, the real cost of the capital for commercial banks was zero, or less than zero.

The Fed was effectively printing money (although [it's more complex than that](#)). The effects were clear: the US central bank was reflate the American economy, and by extension the global economy, by injecting massive amounts of liquidity into the system in an attempt to ameliorate the worst effects of the 2008–09 financial crisis.

US Fed moves this year

No one on the markets was surprised by the central bank's December 2015 rate rise. The clear objective was to return some semblance of normality to global interest rates.

The problem is it didn't work. The tapering-off of QE in late 2014 meant that the last sugar hits of stimulus were wearing off in 2015.

The Yellen rate rise, plus the clear intention of the Fed to incrementally drive rates higher, spooked the markets. In May this year, undeterred by gloomy US jobs figures, Yellen indicated that she would [seek to raise US interest rates](#) “gradually” and “over time” as US growth continued to improve. Her concern was that adherence to ZIRP would ultimately bite in the form of inflation.

Not anymore. Brexit has seen to that. It was one of the factors behind the Fed committee's decision to keep interest rates on hold in mid-June.

ZIRP – or something approximating it – is becoming the “new normal” because cheap money has become structural; the global financial system is now structured around the persistence of low-cost credit. NIRP is thus the logical continuum of this downward interest rate spiral.

Negative interest rates

Until recently, most macroeconomic textbooks argued that zero was rock bottom for interest rates. The GFC shifted the goalposts.

In a world of low rates, what else can the RBA and central banks do?

Written by The Conversation

This is where NIRP enters the picture: negative interest rates. How do they work? Typically, commercial banks will park their money in their accounts with the central bank, or in private markets, such as the [London Interbank Offered Rate \(LIBOR\)](#). Thus, their money never sleeps and earns interest 24/7, even when bank doors are shut.

But NIRP is different. Negative rates mean [depositors pay for the privilege](#) of a bank to hold their money. Which means depositors are better off holding the cash than placing the funds on deposit. Japan has [experienced the results](#) of a NIRP first-hand.

There is a method in this madness: the G7 central banks want commercial banks to lend, not to accumulate piles of cash. Consequently, the policy effect of both ZIRP and NIRP is to stimulate business and consumer lending in order to drive real economic activity. With piles of cash looking for investment placements, the shadow banking system of financial intermediaries may also drive enterprise investment.

However, ZIRP and NIRP are blunt instruments; the perverse outcomes of the stimulus programs of the US Fed, the Bank of Japan and the European Central Bank were artificially inflated stockmarkets and various sector bubbles (such as real estate, classic cars).

The combination of ZIRP and QE may have also created a “liquidity trap”. This means that central banks’ QE injections caused only a sugar rush and did not inflate prices, as one would normally expect from a significant expansion of the monetary base.

Instead, many developed countries have experienced multiple recessions and a prolonged period of deflation. In April this year, the Australian economy experienced deflation for the first time since the GFC, which compelled the RBA to make its most recent 0.25% cut in May 2016.

Yellen knows the global economy cannot retain ZIRP indefinitely. But, ironically, all of the central banks are caught in their own liquidity trap: unable to relinquish ZIRP for fear of market catastrophe; unwilling to abandon QE entirely as “the new normal” demands fresh injections of virtually cost-free credit.

A lack of interest

The Australian economy has done quite well by having interest rates above the OECD average, particularly since the GFC. This has encouraged significant foreign investment flows into Australia as global investors seek somewhere – anywhere – to park their cash as other safe-haven government bonds, such as the US, Japan and Germany, are in ZIRP or NIRP territory. It also doesn't hurt that Australia's major banks and government bonds [are blue-chip-rated](#)

. And Australian sovereign bonds have [excellent yields](#) too.

If ZIRP is the new normal, that matters to the Reserve Bank of Australia. It also matters to all Australian home buyers, businesses, banks, pensioners, investors, students and credit card holders. Everyone, in other words.

ZIRP has created hordes of winners: mortgage interest rates are at historic lows. Property buyers who borrowed when rates were relatively high (at, say, 6-7%) are now paying less than 4%. Credit card rates are still astronomically high (20–21% or more), but balance transfer rates are zero. New credit issues in terms of consumer debt represented by unsecured loans (which is what a credit card is) have a real capital cost of zero. This is virtually unprecedented.

But ZIRP or near-ZIRP produces many losers as well. There is no incentive to save because rates are so low. Hoarding cash makes no sense.

Global surplus capacity reinforces deflation as both goods and commoditised services are cheap. Wages are terminal. Pension funds' margins are smaller, thus expanding future liabilities and reducing the value of current superannuation yields.

In a world of ZIRP, is it any wonder that all of this cheap or (effectively) free cash has been stuffed into the global stock exchange and real estate markets, creating not only a double bubble, but double trouble?

The best things in life are free

QE is like heroin: the first hit is always free. The commercial banks got their first hit in 2008 and the prospect of going cold turkey sends them into paroxysms of fear.

The problem is that the dealers – the central banks – have started using their own product and are just as hopelessly addicted to both ZIRP and QE. To rudely cut off supply would destroy their own markets.

The RBA is not immune to the elixir of ZIRP. No central bank wants to assume responsibility for a recessionary economy; the RBA took enough heat for its monetary policy mismanagement of 1989-90, which induced the 1990s recession.

Unlike the Fed, the RBA is not about to fire up the printing presses and engage in rounds of QE, if it runs out of tools and is compelled to adopt ZIRP. The RBA is too conservative to engage in such policy in any case.

But this conservatism has a direct impact upon federal government fiscal policy, irrespective of whether the LNP or the ALP is in power. From Rudd to Turnbull, Treasury has been forced to increase its borrowing time and time again, blowing out the forward fiscal projections year after year.

No government has delivered a surplus because it is no longer possible. The RBA is partly responsible for this because, rather than expanding its balance sheet via QE, it has forced Canberra to accumulate government debt of more than \$AU400 billion, which the overburdened Australian taxpayer will pay for.

Like most drug deals, this will not end well.

Remy Davison's Chair is funded by the EU Commission.

Read more <http://theconversation.com/in-a-world-of-low-rates-what-else-can-the-rba-and-cent>

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