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The High Costs of Very Low Interest Rates

By JOHN C. MICHAELSON

> Money that should be invested to create jobs is instead funding government debt, while worried consumers sit on the sidelines.

The prevailing view among economists, policy makers and Federal Reserve Board governors is that a zero or near-zero short-term interest rate stimulates the economy – the lower the rate, the better. It is time to re-examine this conventional wisdom. In fact, lowering interest rates too much may not stimulate recovery, but actually slow it. Yes, there are benefits from zero rates, but not nearly enough to outweigh their pernicious consequences.

In the first place, the Fed's policy of zero or near-zero interest rates means negligible returns on savings. Consumers thus have less to spend and those nearing retirement need to save more. The owners or managers of pension plans, foundations, trusts and the like must also make higher contributions to make up for lower investment earnings in order to meet their obligations. In the case of public pension plans, these higher contributions contribute to local and state fiscal crises.

Meanwhile, banks are able to make adequate returns by borrowing at near-zero rates and investing almost risk free and without effort in longer-term government debt, federal government-guaranteed debt, or in relatively riskless investment-grade debt – all at 3% to 4%. They have little incentive to go out and make loans to job-creating businesses that might have a higher yield but entail significant risk and effort.

In human terms, the Fed's policy means emergency room nurses in Texas work longer hours to make up for low yields on CDs, dairy farmers in Iowa forgo equipment purchases to save more for retirement, charities for the homeless in Manhattan reduce services as foundations cut grants, and local governments from Albany to Sacramento close libraries to fund pension plan deficits.

The Fed and the U.S. Treasury are unable for many reasons to directly inject sufficient capital into the banking system to restore it to health. Thus the primary goal of the Fed's policy is to provide nearly free capital to banks as a backdoor way of recapitalizing them. Secondarily, the low interest rate policy is intended to stimulate consumption, increase lending and spur investments to create jobs.

But the beneficiaries of the Fed's wealth transfer are not following the playbook. Overleveraged consumers are not spending or buying homes, and financial institutions are not increasing job-creating lending. Many companies are generating record returns for shareholders (and repaying TARP funds to lessen government oversight), but they are not investing.

True enough, large, creditworthy or too-big-to-fail companies are able to borrow at very low rates. But this is not leading to materially increased investment. Almost every large company chief financial officer will tell you that slightly cheaper credit has little impact on most investment decisions. Increased demand and growth prospects are far more important. Meanwhile, U.S. corporations are sitting on nearly $2 trillion in cash.

What is especially frustrating is that supporters of 0% interest rates have a stark example of the policy's failure staring them in the face: Japan. Following the bursting of its credit bubble in 1990, Japan eventually brought its equivalent of the Fed rate down to a then-unprecedented 0.25%. The nation proceeded to suffer a "Lost Decade" of economic stagnation that has never really ended.

It is accepted wisdom among economists that this happened despite the stimulative benefit of 0% rates, and that the Bank of Japan's colossal mistake was not bringing them down fast enough. Fed Chairman Ben Bernanke has studied the Japanese crash and believes this interpretation. He does not question whether 0% rates contributed to the Lost Decade.

In fact, Japan got caught in a cycle in which 0% interest rates led to anemic private consumption and investment. The Japanese government then made up for this private-sector shortfall by borrowing and spending. National debt ballooned, eventually making it perilous to raise rates because of the higher costs of servicing the debt – thus trapping Japan in a cycle of depressed consumption and investment, prompting yet more spending and borrowing to keep the economy afloat.

The U.S. is not Japan; our economy is far more resilient and remains the most dynamic in the world. But the U.S. is in danger of entering the same cycle as Japan as the economy falters and pressure builds for another round of stimulus spending financed by more government borrowing. To avoid this trap, and to encourage private-sector demand growth to stimulate productive lending, the Fed should begin to raise short-term rates.

From a public policy perspective, rising short-term rates means that more funds will flow to borrowers who will invest them in job-creating activities and increase consumption. And from a recovery perspective, increased returns on cash will cause Americans to feel more confident about their economic future.

Paying higher rates to attract deposits will force banks to look for lending opportunities beyond government type credits. Investors, companies and banks will also become less tolerant of underperforming assets and seek to move those assets more swiftly to superior owners and operators, creating additional efficiencies and job-creating growth.

Yes, there are risks. But first of all, I am recommending raising short-term rates only – and only from near zero to a reasonably low level. Second, the current policy is not working. Contrary to conventional wisdom, raising short-term interest rates from current levels would increase consumption, productive lending and job-creating investment, helping to restore confidence and get the long-awaited recovery going.

Mr. Michaelson is co-founder of Imperium Partners Group, LLC, an investment manager based in New York City.