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WEEKLY ECONOMIC COMMENTARY

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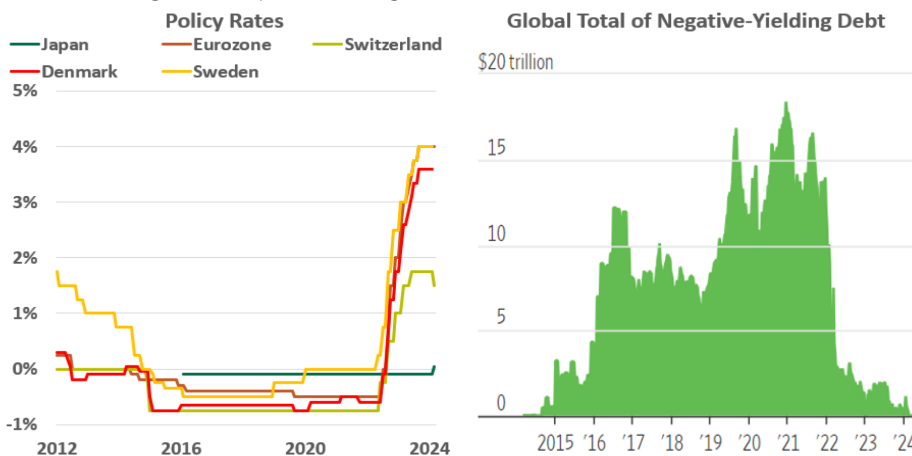
Silvio Gesell was an early 20th-century economist who was described by John Maynard Keynes as “a strange, unduly neglected prophet.” To stimulate demand, Gesell recommended measures that would make it costly to save. He suggested paper money with an expiration date, allowing extensions only if a fee was paid. Gesell’s ideas were deemed polemical back then; they didn’t even get a fair hearing during the Great Depression.

Nearly a century later, Gesell’s work provided the theoretical basis for an extended period of negative interest rates in many countries. Earlier this month, that era came to a close, inviting retrospection.

During economic downturns, central banks lower rates to revive growth. But in the aftermath of the 2008 financial crisis, even very low rates weren’t enough to boost activity in many markets. So, some central banks tried to extend their efforts by breaking the zero lower bound.

The concept is simple: If savers have to pay to store their money, instead of being paid, they will be more likely to spend. Negative borrowing rates should boost capital investment by businesses. Negative yields on sovereign bonds should also mean less demand for both a country’s debt and also its currency, which improves its terms of trade. All of these things can help economic growth.



Sources: Haver Analytics, WSJ, FactSet

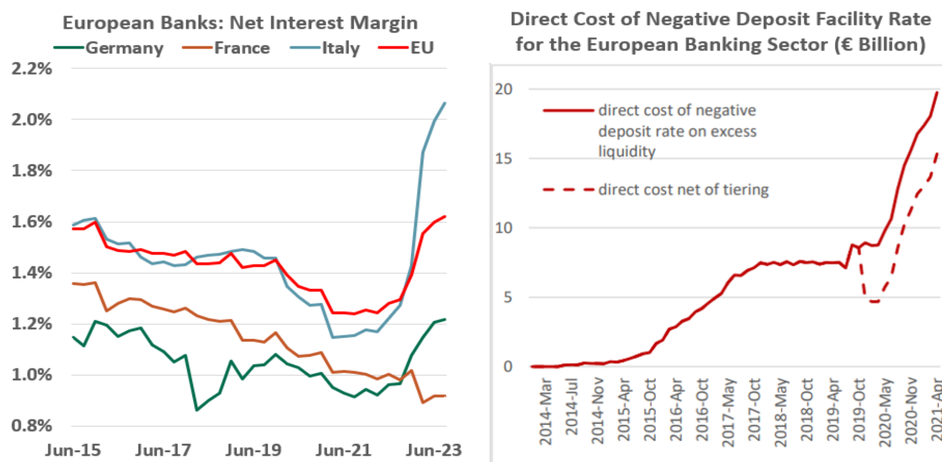
Denmark was the first country to impose negative rates on deposits held by commercial banks in 2012. The European Central Bank (ECB) adopted a negative interest rate policy (NIRP) in 2014. Other European central banks followed in the ECB’s footsteps. The Bank of Japan (BoJ) became the last one to join the club eight years ago.

In a 2021 study, the International Monetary Fund concluded that NIRP "eased financial conditions" and "has likely supported growth and inflation." The research found that lending in the eurozone was declining prior in the 2010s, but negative rates helped boost volumes in the following years.

Negative rates hindered banks and the flow of credit.

Other work reached very different conclusions. Negative rates damaged the earnings of European banks: the direct cost of holding liquidity rose significantly to €15 billion a year. Financial institutions were reluctant to begin charging their depositors (which would have been required if deposit rates were negative) for the fear of losing their balances.

A paper by the Organization for Economic Co-operation and Development (OECD) concluded that NIRP in the eurozone had an adverse effect on bank profitability. Lower profitability limits capital bases and credit growth, contrary to the objectives of a NIRP. Another study showed that bank lending was weaker in countries with negative interest rates than in markets that did not implement the policy, due to tight net interest margins.



Sources: European Banking Authority, European Parliament

Negative interest rates may also have facilitated the buildup of public debt that has occurred over the past fifteen years. For a long while, European governments were getting paid by investors for the privilege of keeping their money safe. More borrowing was actually favorable to annual budget deficits. Aggressive fiscal policy was not only painless, but it was also profitable.

Those who borrow at variable rates should, of course, be aware that their costs will fluctuate with the business cycle. But many sovereigns have been squeezed as monetary policy normalized. The austerity measures that Europe has had to follow have limited their economies.

NIRP and the associated low yields on risk-free assets also induced a shift in investor portfolios towards riskier assets like equities and real estate. The search for higher returns fueled more risk-taking in the eurozone, leading to a convergence in sovereign credit spreads. Pension funds' asset allocations, which are traditionally heavy on bonds, were also distorted by NIRP. Many stretched their risk appetites and acquired private assets, which have proven difficult to exit as rates have returned to more normal levels.

During the period of NIRP in Japan, investors turned to the equity market for higher returns, one of the factors that drove the Nikkei 225 index to its highest level in three decades. Similarly, the housing markets in Sweden and Denmark experienced a boom following the implementation of negative interest rates, with prices soaring to unprecedented levels. While the consequences of asset price excesses haven't appeared yet, the risks of a significant correction are not negligible.

The Federal Reserve chose not to join the NIRP club. There were concerns that financial systems might not be able to handle negative rates, and Fed leaders had a much stronger belief in quantitative easing (QE). Research on the efficacy of QE is mixed, and is it isn't altogether easy to unwind. The long-term effects of running a very large central balance sheet are still not clear.

What sounded good in theory did not work in practice.

Despite years of negative rates, growth in the Japanese and European economies remained lackluster with inflation below central banks' 2% targets. It was the disruptions caused by the pandemic and the Ukraine war that ultimately helped central banks hit their goals.

The grand experiment with negative interest rates ended in March when the Bank of Japan raised rates for the first time in 17 years. The experience is certain to be studied for many years to come, but the early conclusions seem to suggest that zero should be reestablished as the lower bound for interest rates.

More Fuzzy Math

Last week, the U.S. Congress completed work on the country's budget for fiscal year 2024. Good thing: the government's fiscal year is almost halfway over.

After all the hand-wringing (and near-shut downs) over increasing deficits, the outline calls for nearly $6.5 trillion in spending this year. That represents more than 23% of the country's gross domestic product (GDP). The Congressional Budget Office projects a shortfall of $1.5 trillion (5.6% of GDP) for this fiscal year. Both of these levels are very high by historical standards.

This outcome might give one the impression that legislators have no limits when it comes to budgeting and borrowing. That may be overly harsh, but the way Congress views major programs may be in need of an overhaul.

When initiatives are proposed, they are subject to "scoring," which estimates their impact on the budget. At a basic level, measures are judged by the direct effect they have on revenue or spending. Under this "static" approach, a tax cut or spending increase would be viewed as increasing annual deficits.

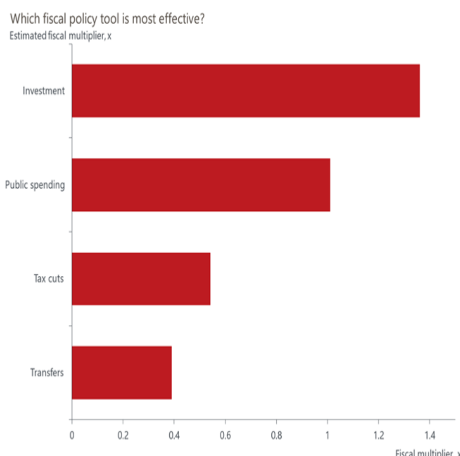
But those who support these proposals contend that they would generate increased levels of economic growth, broadening the tax base and producing additional revenue. In an attempt to capture these effects, "dynamic" scoring can be used. The dynamic part refers to after-effects that might make the analysis more comprehensive, such as the favorable impact of lower tax rates on economic growth. The case for a more interactive approach can be found here.

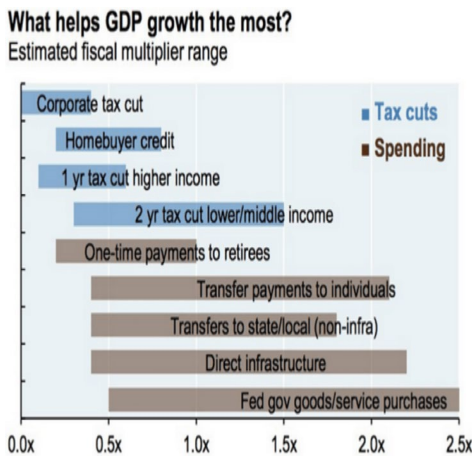
While theoretically meritorious, performing dynamic scoring is extraordinarily difficult. For example, if taxes are cut, the heightened level of activity could threaten to become inflationary. In that event, the central bank might tighten monetary policy to cool things down, which would restrain the economy and tax collections. Slower growth might prompt higher unemployment, which might prompt the central bank to ease, and so on. The circular relationship between economic variables makes analyzing policy changes challenging.

Even with a full inventory of causes and effects, calculating their magnitudes is very difficult. The science (if it can be called that) focuses on "fiscal multipliers," which relate the cost of a policy to the amount of economic activity it generates. A fiscal multiplier of more than one signifies the program generates incremental output that exceeds its cost. (It should be noted that this is not the same as saying that the program "pays for itself," since incremental tax revenue is far less than incremental national income.)

Models that estimate fiscal multipliers have a large margin of error, and different models may come up with vastly different conclusions. Political leanings may steer the assumptions used to evaluate policies dynamically.

The range of uncertainty surrounding the process allows sponsors to claim that almost any initiative will be budget friendly. That was the case with the Tax Cuts and Jobs Act (TCJA) of 2017, and it was the case for the major spending programs passed by the Congress in 2022.





Sources: Oxford Economics, Gechert (2015), Congressional Budget Office

Claims that tax and spending programs will pay for themselves have proven inaccurate.

Verifying these claims is almost impossible. Retrospective studies have to hold a range of other economic influences constant to focus solely on the impact of a specific program. That is exceptionally hard to do. Further, outcomes have to be judged against what would have occurred in the absence of the legislation, which is not directly observable.

To some, the ultimate scoring is the national debt, which is in an uncomfortable place. It seems clear that some or all of the analysis surrounding recent tax and spending legislation was overly optimistic. We will be paying for those mis-projections for a long time. With major fiscal decisions on the horizon (including next year's consideration of whether to extend some aspects of the TCJA), a much more conservative approach to projecting outcomes would be sensible.

In the years ahead, we might want to familiarize ourselves with mathematical functions other than multiplication. Some addition and subtraction may be needed to put us on a more sustainable fiscal path.

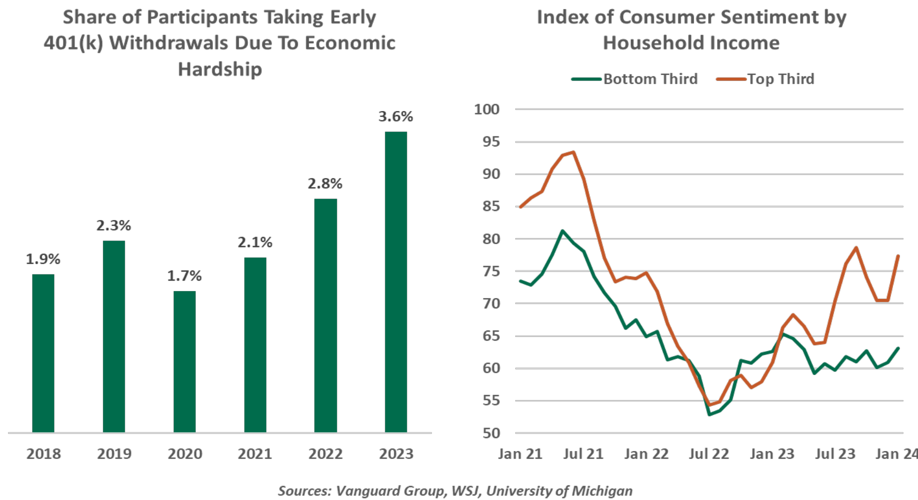
Symptoms of Stress

The plural of *anecdote* is not *data*. Broad macro trends will contain and obscure a multitude of micro stories within. But when a refrain is repeated widely, it merits investigation.

In recent months, we have noticed growing murmurs about consumers falling behind. Reports of slower spending have come from recent corporate earnings calls:

- Restaurant CEO: "…signs of some consumers trading down within our brands."
- Apparel CEO: "And in the U.S.…the consumer…is a little soft coming into the year."
- Hardware CFO: "The home improvement market still faces headwinds as we look ahead to fiscal 2024."

Evidence of overstretched households is also emerging from the financial planning sector. In 2023, 3.6% of 401(k) account holders took an early withdrawal for economic hardship. These withdrawals require demonstrating an "immediate and heavy" financial need in order to not be taxed at punitive rates.



Sources: Vanguard Group, WSJ, University of Michigan

Not everyone is feeling today's favorable economic conditions.

The core of our soft landing call has been favorable employment prospects, but not everyone who is still working is feeling well about the economy. The University of Michigan Consumer Sentiment Index reached a record low as inflation peaked in summer 2022. While sentiment across income strata fell uniformly, consumers in the bottom third of the income distribution are still dour, while higher earners have become more upbeat.

Lower-income households are not enjoying wealth effects from high house prices and the equity rally, while they still must contend with a higher cost of living. Combined with rising consumer credit delinquency, evidence of a bifurcated recovery is mounting.

Expansions are healthiest when the broadest range of cohorts are progressing. The growing divergence of experience in the U.S. hasn't yet threatened our soft landing call. But we'd feel more confident in that outlook if the cushion under the cycle was a little wider.

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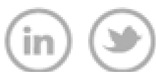

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