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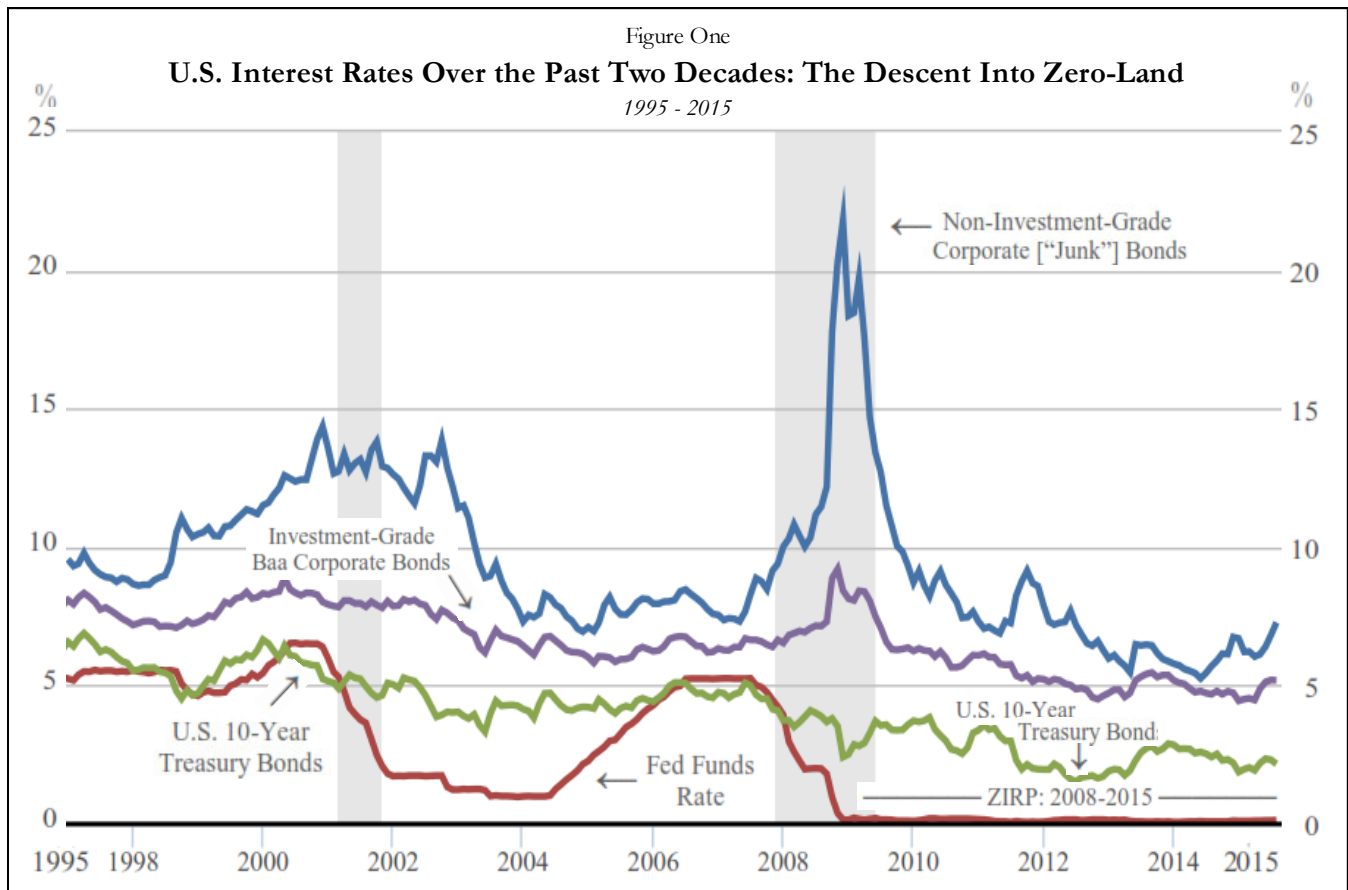
ZIRPs Make Credit (and Prosperity) Scarce, Not Plentiful

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After misleading markets for months, with the claim that it would finally raise the near-seven-year-old, near-zero Fed Funds rate in September, the Fed last week reneged, on the grounds that the global economy

was too weak for it.¹ A rise of merely 25 basis points can undermine global economic growth? That's silly – and no less so than the claim that the Fed's zero-interest rate policy (ZIRP) has "stimulated" economic (or credit)



¹ We weren't surprised, though; Fed officials, we've shown, have a record of being untrustworthy on rate policy, mostly because they're uninformed and uneducated (two defects that are typical of central planners). Yes, they've all got degrees from top schools, but that's not necessarily the same as being educated (learning economic-monetary truths). False doctrines are still widely taught at most universities, including the elite ones. Mark Twain's famous advice is applicable: "I never let schooling interfere with my education." See "Perma-ZIRP: Why the Fed Won't 'Normalize' Rates in our Lifetime," *The Capitalist Advisor*, March 20, 2015. See also "Should Investors Trust Forecasts of Fed Policy Made by Fed Policymakers? Connecting the Dots in FOMC Projections," *The Capitalist Advisor*, April 28, 2014. Worse, Fed officials – who insist that their decision-making isn't rigid or rule-based but instead myopic and "data-dependent" – rely on data which aren't very reliable; see "Should Investors Trust Economic Data?" *Investment Focus*, December 20, 2013.

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growth. All major central banks have imposed ZIRPs in recent years (Figure Six, page 8); economic growth has been weak not *despite* ZIRPs but in part *because* of them.

Japan was the first to try ZIRP, in the late 1990s, roughly a decade after the Bank of Japan tanked Japanese equities (and economy) with a deliberate inversion of the yield curve, to “pop” an alleged “bubble.” Not coincidentally, Japan has stagnated for 15 years, and its public debt is now 250% of GDP (versus 70% in 1989). Yet no one blames ZIRP (or chronic deficit spending); on the contrary, most economists and policy-makers demand more of it, for ever-longer periods, and insist that equity-economic damage would come not from ZIRP’s continuance but rather from its phase-out.

Many factors enter into decisions by producers about whether to produce or not, whether to produce more or less, what things to produce versus others, where to produce, and how: expected rates of return, access to inputs, taxes, regulations, etc. Credit is one of the key factors – often a crucial one. It entails saving and investing, lending and borrowing, at interest rates that (if market-based) reflect not only credit risk but real rates of return and expected inflation. Like other market prices, interest rates work best when left free to equilibrate supply and demand; when flexible, they serve as accurate signals for savers (lenders) and investors (borrowers). ZIRPs run counter to all of this. They not only distort the market for inter-bank reserves, but artificially depress all interest rates (see Figure One, page 1).²

“In times of political confusion and under arbitrary government, many will prefer to keep their capital inactive, concealed and unproductive, either of profit or gratification, rather than run the risk of its display. This latter evil is never felt under good government. The interference of authority is not the road to affluence, which results from activity of production, seconded by the spirit of frugality and of frugality tending to accumulation of capital.”

— Jean-Baptiste Say, *Treatise on Political Economy* (1803, p. 389).

The error in believing ZIRPs must necessarily “stimulate” economies (and that their removal must harm them) reflects a one-sided focus – a focus almost exclusively on the *demand* side of the credit market, to the neglect of the *supply* side. Those who borrow and spend are said to be more likely to spend at lower than higher interest rates; so surely low interest rates – perhaps even near-zero (ZIRP) – will boost spending and the economy. Who can possibly complain about *that* “logic”? Well, *suppliers* can complain – and rightly so.

Who are the suppliers in the credit market? Savers, lenders, investors. Why should they be happy with a near-zero return, especially when it persists for years on end, interminably? Are they somehow *compelled* to save, lend and invest? No (not yet) They must have *incentivize* to do so. As ZIRPs artificially depress *all* interest rates³ (Figure One, page 1), they deter the supply of credit.

The main source of the “ZIRP stimulates” error is the continued dominance of *demand-side* (Keynesian) economics. That school was discredited, starting in the late 1970s, because it

caused (then couldn’t explain) simultaneously high rates of inflation and unemployment (*aka*, “stagflation”), but due to faculty tenure (and other inertias), it’s still prominent in universities, worldwide – hence also at business schools, banks, brokerage firms, asset managers, forecasting firms, and financial media. The partiality and myopia of the demand-side approach causes people to ignore, downplay, or dismiss the role of savers, lenders, and investors in the productive process; indeed, a main tenet of Keynesian economics is that economies stall and stagnate because there’s *too much* saving/investing

² We don’t deny, of course, that from a *total return* basis, while bond yields were *declining*, due to ZIRP, it was a boon to bondholders; but yields matter too, and now, being at record-low levels, there’s far less incentive to hold bonds, not only because yields are inordinately low, but because of the greater likelihood (and fear) that rates will rise, causing capital losses. Holders of Japanese government bonds have faced this dilemma (and disincentive) for more than a decade.

³ To the extent a ZIRP accompanies lower short-term T-Bill rates (as it usually does), it allows anyone to safely and profitably “borrow short and lend long” – *i.e.*, profit by earning the inordinately wide spread between (initially higher) bond and (lower) bill yields. This provides a bid to bonds, which lowers their yield and flattens the yield curve, providing even more return (besides the spread) due to the (capital) gain from the bond-holding. Thus it’s false to say (as is common) that central banks have no control whatsoever over long-term yields; they have some control, but not as much as they do over short-term rates. For ways to trade the curve, see Andrew P. Shook, “Yield Curve Spread Trades: Opportunities & Applications,” CME Group, June 2013 (<http://tinyurl.com/qxyae8e>).

relative to consumption/spending. In this context, with this (false) interpretation, the Keynesians certainly don't want to *incentivize* the saver/lender/bondholder/rentier – they want to *euthanize* him.⁴ ZIRPs help accomplish that aim. But then ZIRPs also help accomplish economic stagnation, regardless of how Keynesians try to excuse their utter futility.

Figure Two helps illustrate the case – and the problem with ZIRP. In a free market the supply and demand for (some type of) credit is equilibrated by an interest rate.⁵ All else equal, suppliers of such credit will supply more of it at higher interest rates and less of it at lower interest rates, so the supply curve is *upward-sloping*. Meanwhile, demanders of credit will want less of it at higher interest rates but more of it at lower interest rates – so the demand curve is *downward-sloping*. At their intersection (equilibrium) exists an *equality* (or balance) between quantities of credit supplied and demanded. In equilibrium there's neither a credit *surplus* (resulting from *too-high* an interest rate) nor a credit *shortage* (resulting from *too-low* an interest rate). Temporary surpluses are cured by a decline in interest rates toward equilibrium, while temporary shortages are cured by a rise in rates, again toward equilibrium. Moreover, an increase in credit supply (*aka*, "savings"), all else constant, lowers the interest rate (the supply curve shifts downward and to the right), while a decrease in supply raises it (the supply curve shifts upward and to

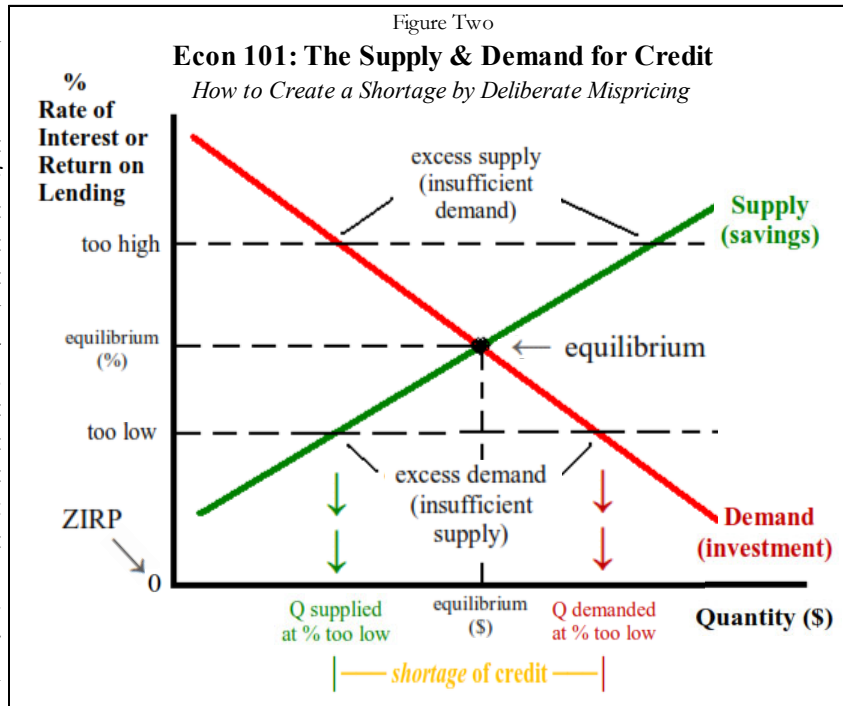
the left). Similarly with demand. All else unchanged, an increase in the demand for credit (*aka*, "investment") raises the interest rate (the demand curve shifts upward and to the right), while a decrease in credit demand lowers it (the demand curve shifts downward and to the left).

So far so good. But what does a ZIRP do? It's a form of government price control in the money market, which has ripple effects through to the credit market. Yes, a ZIRP technically

pertains *only* to a central bank's official policy rate, and to the market for inter-bank funds (to settle and maintain reserves), but that's always been true of an "official" rate. It's never been a truly free market rate. But as long as official central bank policy rates haven't strayed too far from what the market rate would be, the magnitude of the distortion could be limited. Not so when the rate is held at

zero – and for more than five years – and by not just one central bank but by *all* of the major central banks.

Policy rates of this kind – perma-ZIRP – artificially lower other rates and amount to widespread price controls in the credit market, but of a specific type. Figure Two makes clear that a ZIRP causes a *shortage* of credit, as quantify demand *exceeds* quantity supplied. Keynesians and central bankers in recent years have complained that lending and economic activity haven't been vibrant "despite" interminable ZIRPs, but in fact the stagnation



⁴ This was Keynes's advice in the last chapter (#24) of his book, *The General Theory of Employment, Interest, and Money* (1936), the book upon which most university economics textbooks ever since (starting with Paul Samuelson's) have been based (read Chapter 24 here: <http://tinyurl.com/qbbygx8>). Paul Krugman, today's leading Keynesian and the Nobel Prize winner in economics in 2008, advises likewise (note "rentiers" = bondholders): Paul Krugman, "The Euthanasia of the Rentier," *New York Times*, January 22, 2014 (<http://tinyurl.com/npkbooa>). For a critique, see Richard M. Salsman, "Greece's Disgraceful Debt Default – and Calls to 'Euthanize' Bondholders," *Forbes.com*, March 20, 2012 (<http://tinyurl.com/84ew4pj>).

⁵ Note: interest rates are *not* the price (or value) of money but rather the price (or value) of *credit*. The value of money is its purchasing power, what it can buy in terms of real goods and services. To believe interest rates are the price of money is to believe money-printing can lower interest rates; that's not so (and usually the reverse is true, due to "inflation premiums"). That in recent years we've seen vast reserve-creation yet low rates of inflation and interest rates reflects a higher demand for money balances (*i.e.*, hoarding) and ZIRP. See "Why Inflation Has Been Low Despite Rapid Money-Supply Growth," *The Capitalist Advisor*, January 31, 2014 and "Fed Policy Mirrors the Bank of Japan – and Thus Depresses T-Bond Yields," *Investment Focus*, August 20, 2010.

has been caused in large part precisely by their interminable ZIRPs. The cure would be to raise interest rates, to incentivize savers and lenders; but the myopic demand-siders, always fearing that savings are a “leakage” from “aggregate demand” (consumption) don’t dare do it. A policy which would, in fact, *stimulate*, they presume would only *depress*. Central bankers with this demand-side bias never consider raising rates to *encourage* economic growth and its prerequisites (saving, lending, investing), but only as a means to *curb* it, on the false (Phillips Curve) assumption that fast growth causes inflation or asset “bubbles.”

Late-19th century British economist Alfred Marshall famously used the analogy of supply-demand curves as two blades of a pair of scissors: just as a single blade was insufficient to cut paper, so neither demand nor supply alone are sufficient to establish an equilibrium “market clearing” price. In today’s context, those who try to analyze the possible impact of interest rates from the angle of demand alone are doing pseudo-analysis that just won’t cut it. No wonder they are baffled, amid ridiculously low interest rates, wondering why credit that’s so urgently wanted just isn’t forthcoming.

Take a look at the growth rate of credit in the U.S., illustrated in aggregate form, for all five main sectors, over the past half century (Figure Three, page 5). We can see how credit expands robustly during economic expansions but less quickly just prior to and during recessions (shaded areas). Despite swings in the rate of growth, not until the aftermath of the last U.S. recession – the “Great Recession” of 2007-2009 – did credit actually decline (by -2%, at its worst), before recovering. Despite a resumption of positive growth in credit in recent years, the growth has been anemic (less than 5%), compared to history. It’s not implausible that this historical outlier in credit growth has something to do with the Fed’s ZIRP; its most radical, unorthodox price-control scheme has coin-

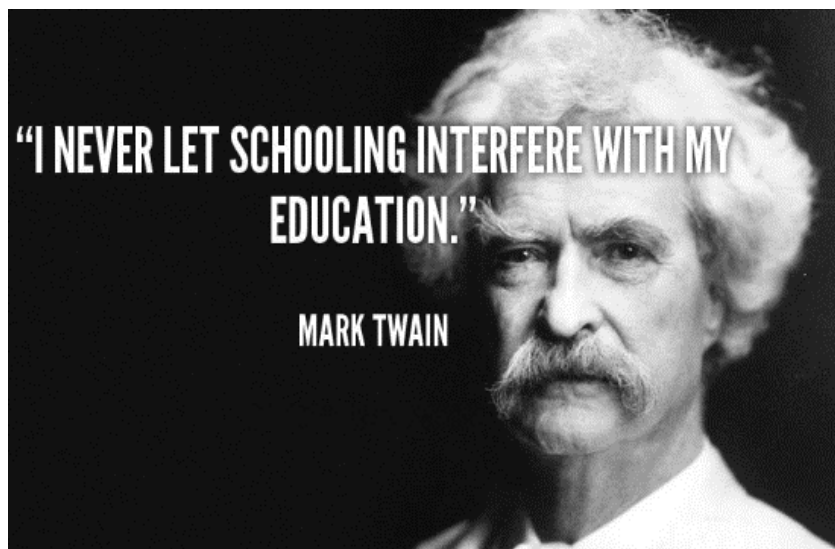
ceded with severely depressed credit creation, but it hardly seems coincidental, given that we also have a sound theory of artificially-low interest rates depressing credit creation.

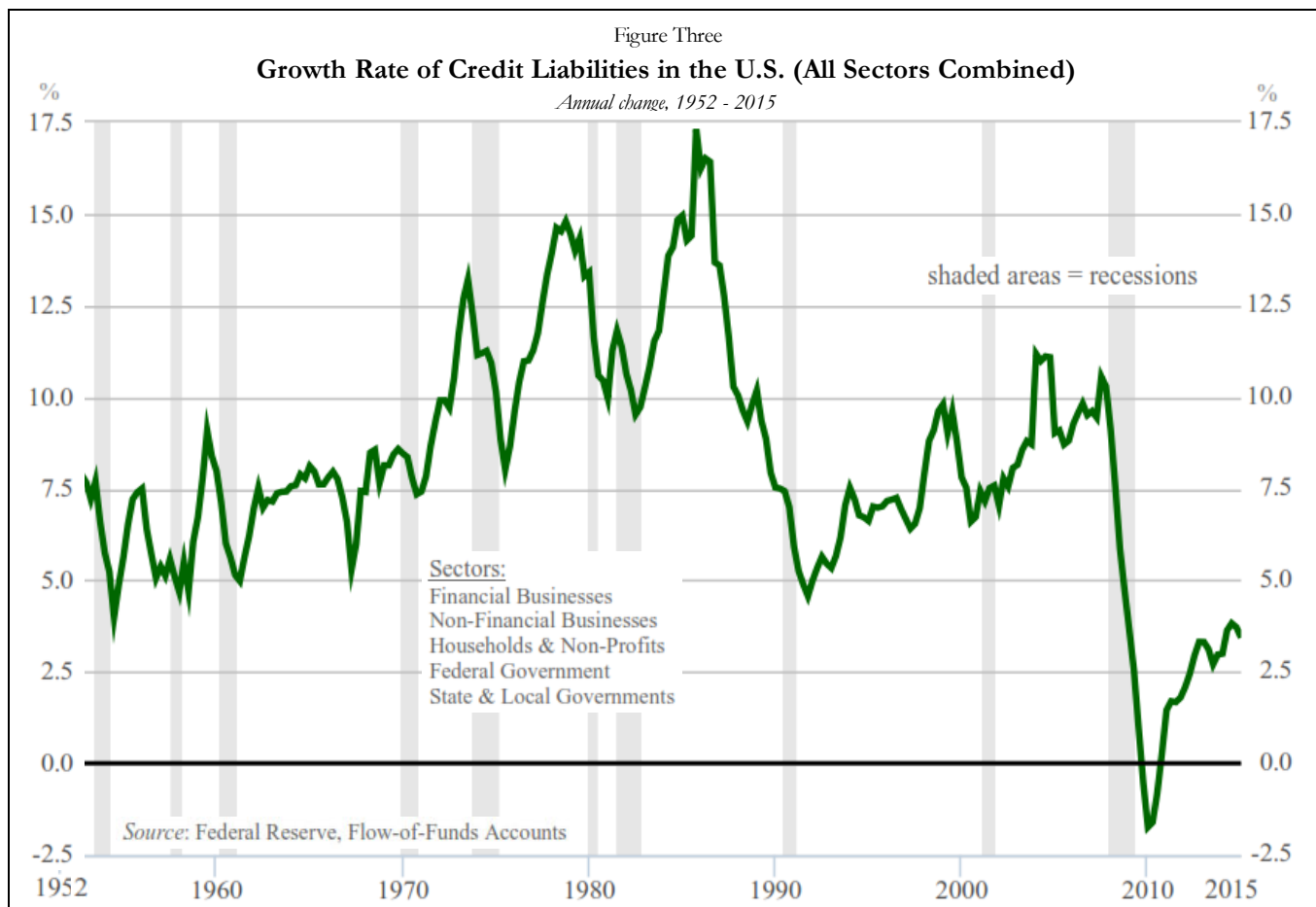
Since the aggregate measure in Figure Three (page 5) lumps together borrowing from government and business, we disaggregate the data in Figure Four (page 6). Wealth creation comes from business, not government, so if the recent, depressed trend in Figure Three is due mainly to a drop-off in credit creation for business relative to government, that would even better account for the recent sub-par rates of economic growth this far into the expansion (six years). Indeed, we see in Figure Four how the biggest declines in credit in recent years were suffered in the business sectors, while the government sector, comparatively, obtained a virtual flood of credit (matching huge budget deficits). Notice the 12% decline in credit for “financial business” in 2010 and lesser but still negative numbers from 2011 to 2013. Lesser declines were seen for non-financial business and households. But again, this is unprecedented, at least over the past half century. Despite a resumption of growth in credit for the business sector in recent years, it’s been very slow growth (less than 5%), compared to history. Again, it’s reasonable to attribute this perfor-

mance to a prolonged ZIRP.

mance to a prolonged ZIRP.

Shifting focus now away from *growth rates* in credit aggregates over the past *five* decades to *levels* of credit over just the last *two* decades, we can see (in Figure Five, page 7) that credit for financial business peaked at roughly \$18 trillion in 2009 and then plunged by 21%, to \$14.2 trillion in 2012, before recovering slowly to only \$15 trillion at present (still 17% below the peak in 2009). Credit for non-financial businesses also peaked in 2009 (at \$10.6 trillion), before declining mildly to \$10 trillion in 2011,





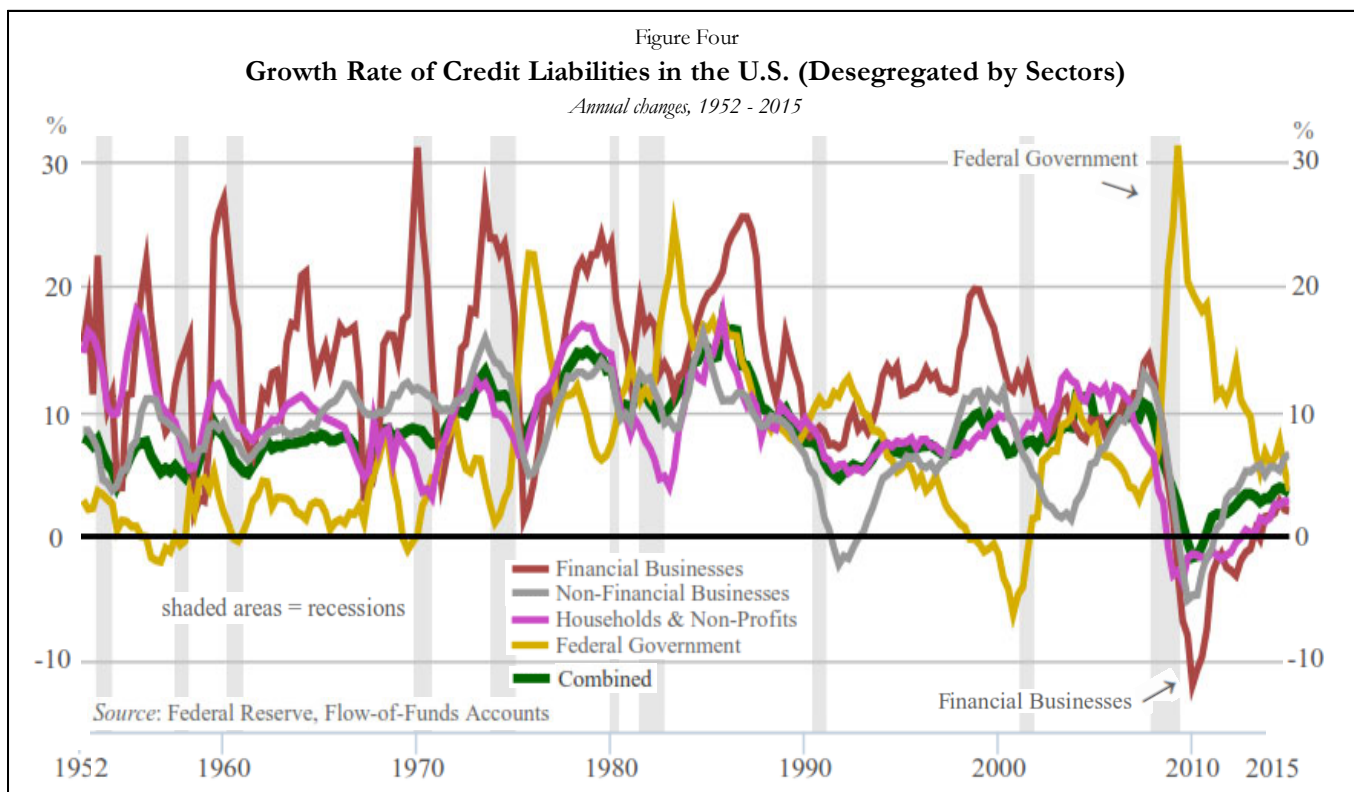
but its subsequent recovering, to \$12.2 trillion this year, surpass its prior peak.

The most disturbing aspect of Figure Five is the fact that credit to the U.S. federal government (the publicly-held share of the national debt) climbed steadily and doubled between 2007 (\$6 trillion) and 2015 (more than \$14 trillion). Credit to Washington now *exceeds* credit to non-financial business, by \$2 trillion. Which one produces wealth? No wonder the expansion of the past five years hasn't been vigorous; but of course Keynesians *applaud* deficit-spending booms and national debt build-ups, as means of saving and stimulating the economy, when all else fails. Things would have been far worse, they say, had government credit not displaced business credit. Yet economic growth was both steady and more

robust in the decade after 1995, when credit for business expanded relative to credit for government.

Here and there, one can find a study or essay that says roughly what we're saying here.⁶ But these are far and few between, and certainly aren't influencing central bank policy-making for the better. The many central banks that have been stuck in ZIRPs (see, for example, Figure Six, page 8) should be raising policy rates slowly but steadily, as soon as possible, and explaining the (prosperity) rationale for doing so. If rates reached 3% after a year or so, that would be just fine; markets would react well – *unless*, of course, the moves were explained on demand-side grounds (wherein central banks raise policy rates not because economic and credit growth are too weak but instead “too strong”).

⁶ See, most notably, Richard Dobbs, Susan Lund, Tim Koller, and Ari Shwayder. “QE and Ultra-Low Interest Rates: Distributional Effects and Risks,” Discussion Paper, McKinsey Global Institute, McKinsey & Company, November 2013. See also an excellent (and prescient) essay by John Tamny, “The Fed’s ‘Loose’ Monetary Stance Is Making Credit Tight,” *Forbes.com*, April 10, 2011 (<http://tinyurl.com/qx7y95p>). Excerpt: “If the dollar is the world’s most important price, the cost of credit comes in a close second. When interest rates are allowed to float free of central bank intervention, the happy consequence of such a market-driven price is that in reaching natural levels conceived in the marketplace, the supply of and demand for credit is equalized. . . . Thanks to the Fed’s naive efforts to create an artificial credit outcome through its imposition of a below-market rate for short-term credit, the latter has paradoxically become less plentiful. . . . As such, the rate set by the Fed is bringing great harm to the savers whose savings would in a normal world be supplied to job-creating entrepreneurs. . . . The answer to this problem is happily quite simple: the Fed must float the short rate for credit that it currently sets, and in doing so, let rates rise to the level that equalizes the needs of lenders and borrowers.”



Sadly, this isn't likely to happen – any more than it happened for the Bank of Japan, once it traversed a ZIRP Road for more than a few years; now it's realized perhaps, that in truth it's the Road to Perdition. Why then are so many other monetary central planners taking this ruinous road and staying on it, exit after exit after exit? Because they're central planners; it's what they do. Stupid, stubborn things. Consider a report issued earlier this year by economists at the Fed; they say that one of three scenarios for Fed policy is a permanent, Japan-style ZIRP. Here's how they put it, finishing with the line: *"policymakers will not want to raise interest rates."*

Within the Federal Reserve System, this situation (ZIRP) is considered temporary and the FOMC is now debating strategies that would return both the balance sheet and the policy rate to normal. . . . The third scenario assumes the Fed keeps the policy rate at or near zero permanently. The credibility for the two percent inflation objective is dominated by credibility for its ZIRP. We use Japanese data from 1995 to 2007 to estimate the ZIRP model. . . . A ZIRP can be a trap if inflation is below target, the economy is recovering, and policymakers believe that promising to hold interest rates low in the future will raise inflation. . . . In a growing economy, the ZIRP regime

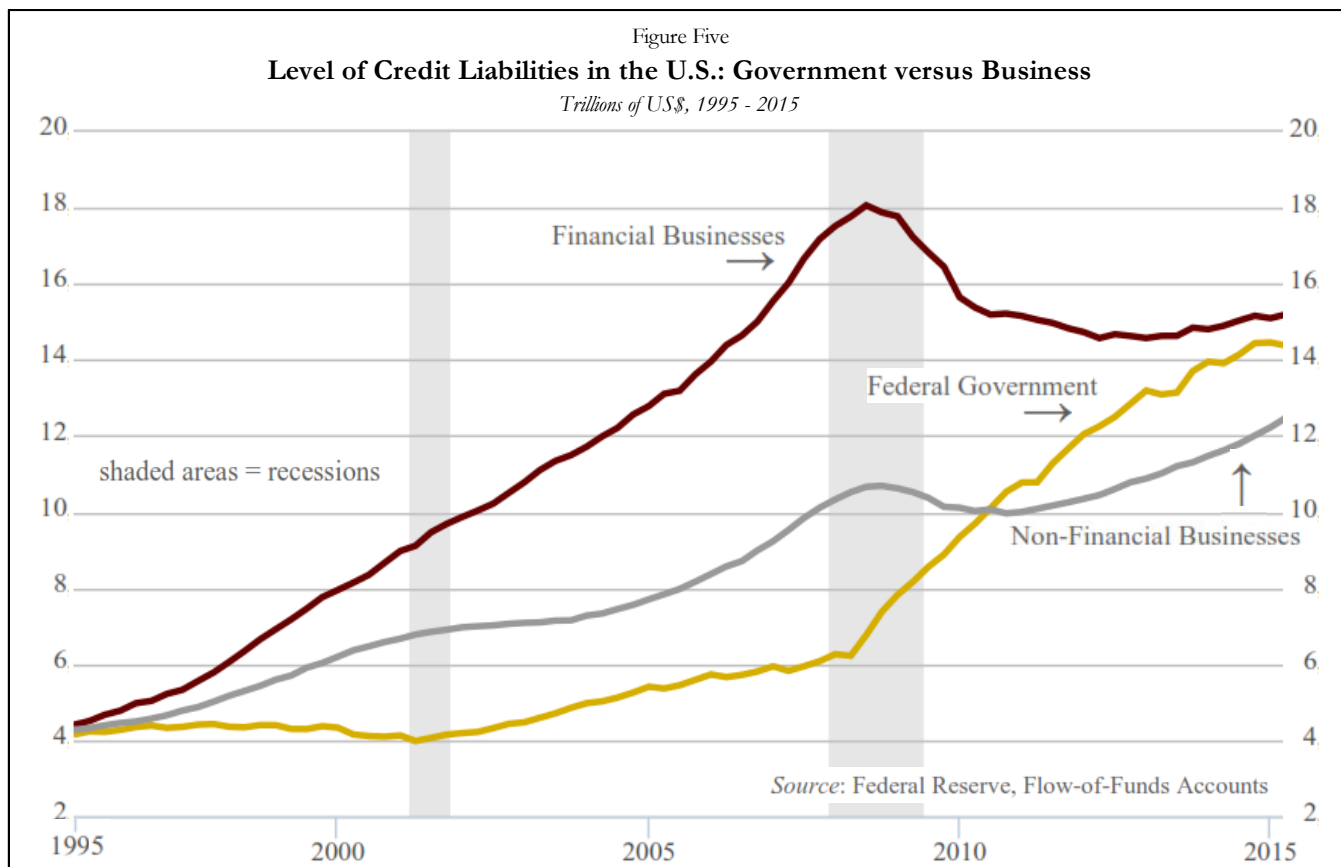
will lead to negative inflation. Policymakers will not want to raise interest rates because many believe that even small increases can have large negative effects on the real economy.⁷

What might this mean? Consider: Japan already has had a ZIRP for fifteen years, amid prolonged stagnation; the U.S. has had a ZIRP for "only" seven years; if the Fed were to match the duration of the Bank of Japan's idiocy and stubbornness, it would persist with a ZIRP until at least 2023. That's a lot of U.S. economic stagnation to (not) look forward to.

The obtuseness with which this challenge is greeted by conventional but influential academics, policymakers and advisors can be astounding, at times. Here's what we're given by Harvard professor and former U.S. Treasury secretary Larry Summers (a Keynesian), who acknowledges the stagnation, then advises the very policies that have caused it:

U.S. economic growth has averaged only 2% over the last five years despite having started from **highly depressed state**. . . . If a financial crisis represents a kind of power failure one would expect growth to accelerate after its resolution as those who could not

⁷ See Diana A. Cooke and William T. Gavin, "Three Scenarios for Interest Rates in the Transition to Normalcy," *Review*, 1Q2015 (Vol. 91, No. 1), Federal Reserve Bank of St. Louis, pp. 1-24 (<http://research.stlouisfed.org/publications/review/article/10336>).



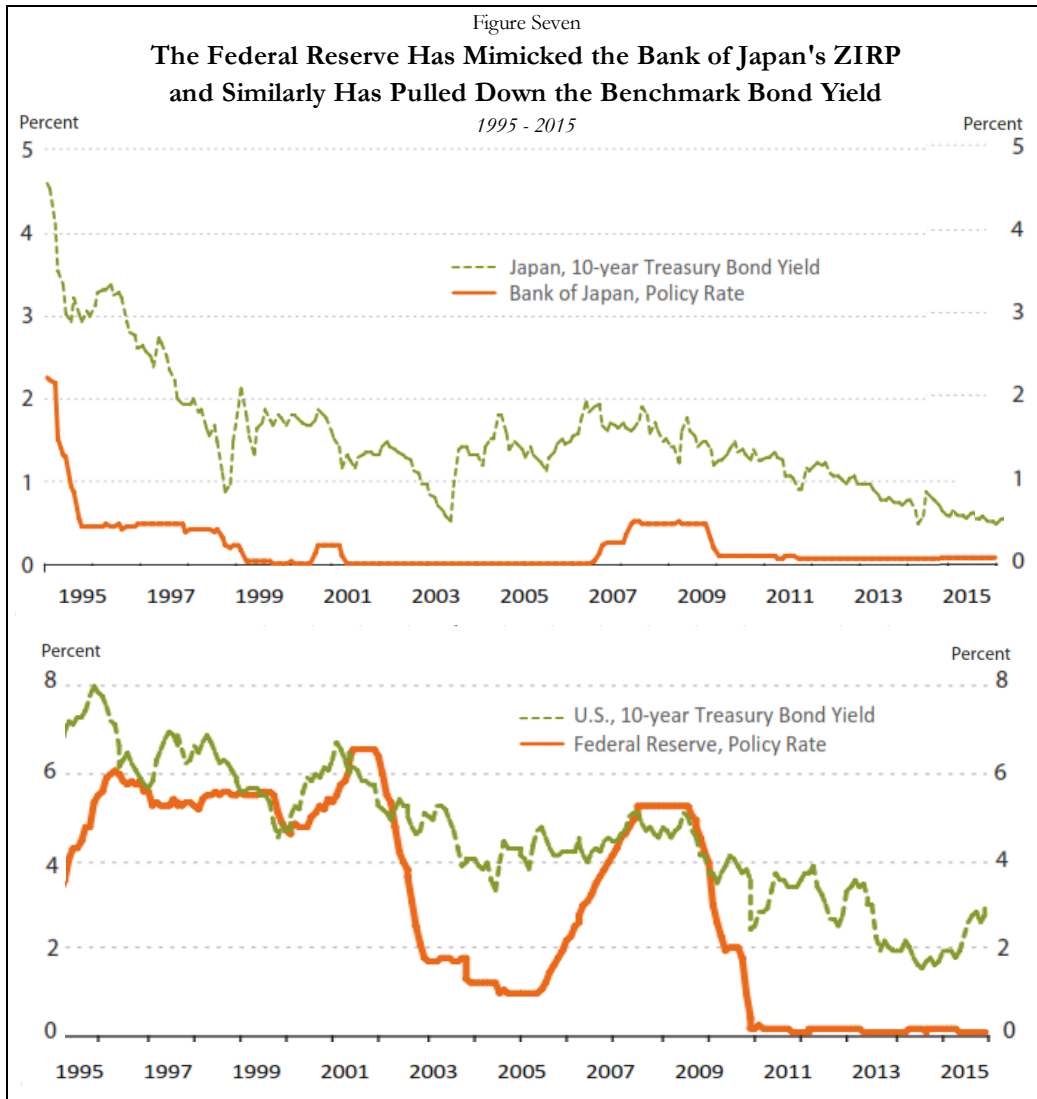
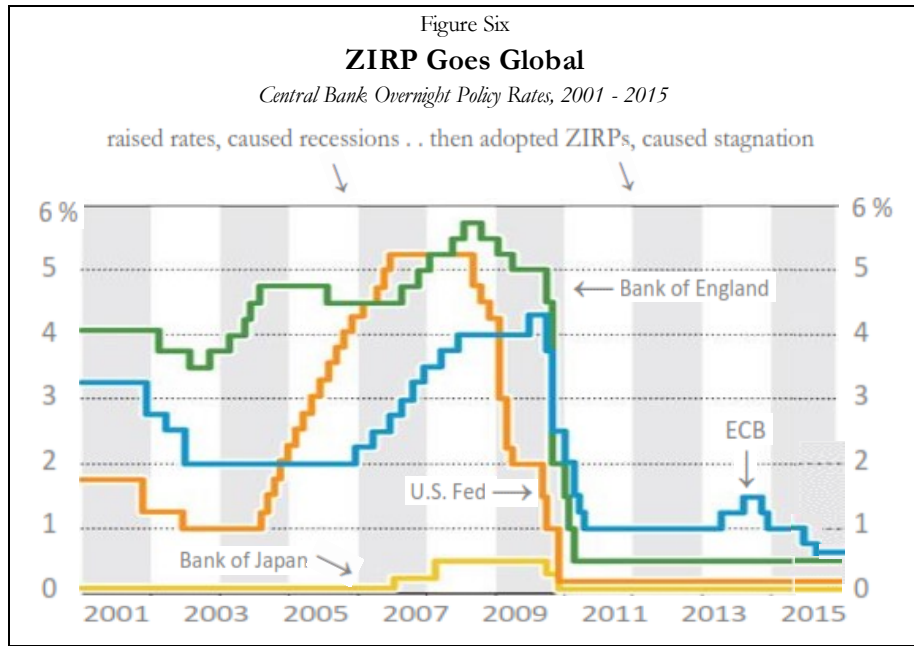
express demand because of a **lack of credit** were enabled to do so. . . . A decline in the “full employment real interest rate” – FERIR, for short – coupled with low inflation could indefinitely prevent the attainment of full employment. I argue that even if it were possible for the FERIR to be attained, this might involve substantial financial instability. . . . **The possibility exists that no attainable interest rate will permit the balancing of saving and investment at full employment.** . . . The case made here, if valid, is troubling. It suggests that monetary policy as currently structured and operated may have difficulty maintaining a posture of full employment and production at potential. . . . There are **two possible strategies for addressing** [the] pernicious impact [of secular stagnation]. The first is to find ways to further **reduce real interest rates** . . . The alternative is to raise [aggregate] demand by increasing investment and **reducing saving** (emphasis added).⁸

Upon observing persistent economic stagnation, Summers-qua-Professor chooses to jettison the law of sup-

ply and demand in credit (“no attainable interest rate will permit the balancing of saving and investment”); then Summers-qua-Policymaker calls for even *lower* interest rates than now exist and policies to *reduce savings* further (*i.e.*, reduce the supply of credit). Unable to see outside the dark little Keynesian box where he resides, Summers (and, no doubt, legions of his students and colleagues around the globe) is befuddled about the persistent stagnation, yet offers the same bad policy advice that got us into this mess in the first place.

That Keynesian economics was discredited in the 1970s, both in academia and in practice, didn’t prevent its revival over the past decade. The financial crises and recessions of the 2007-2009 were blamed, falsely, on some alleged global embrace of “free market fundamentalism” and supply-side policies; in truth, that combination is what revived prosperity in 1980s and 1990s. Demand-side economic policy has caused the last, sorry decade, and sadly, it’s the policy that still predominates today.

⁸ Lawrence H. Summers, “Reflections on the New ‘Secular Stagnation Hypothesis,’” *VOXEU*, October 30, 2014 (<http://www.voxeu.org/article/larry-summers-secular-stagnation>).



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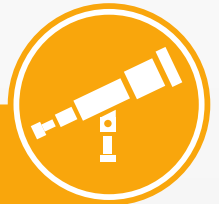


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Richard Salsman is founder, president and chief market strategist. Prior to IFI he was senior economist at H.C. Wainwright Economics, Inc. (1993-1999) and from 1981 to 1992 a banker and capital markets specialist at the Bank of New York and Citibank. Mr. Salsman has authored numerous articles and is an expert in market history, economics, forecasting, and investment strategy. His work has appeared in the Wall Street Journal, Investor's Business Daily, Barron's, Forbes, National Post (Canada) and the Economist. In addition, he has authored three books—Gold and Liberty (1995), Breaking the Banks: Central Banking Problems and Free Banking Solutions (1990), The Political Economy of Public Debt: Three Centuries of Theory and Evidence (2017) —plus many chapters in edited books. Salsman speaks regularly at conferences, investment gatherings and universities. He earned his B.A. in Law and Economics from Bowdoin College (1981), his M.B.A. in Economics from the Stern School of Business at NYU (1988), and his Ph.D. from Duke University in Political Economy (2012). In 1993 he earned the designation of Chartered Financial Analyst (CFA) from the Association for Investment Management and Research.

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