Negative interest rates to remain important. Narayana Kocherlakota, former Minneapolis Fed CEO

Negative interest rates will likely remain an important issue among economists and central bankers, says the University of Rochester's professor Narayana Kocherlakota, former president and CEO of the Federal Reserve Bank of Minneapolis

"But the trick will be to harness low rates to boost consumer expectations and spending," Kocherlakota told the audience at the Asian Development Bank Institute's Annual Conference on the implications of ultra-low and negative interest rates for Asia last December.

He argues there are good reasons for rates to remain at the lower bound for long periods of time, and reducing rates to zero could have large benefits.

Japan, Kocherlakota points out, has been at or near-zero-bound rates for nearly 2 decades, and the US Federal Reserve was at lower-bound rates for 7 years before raising them at the end of 2015.

Kocherlakota thinks one should expect stays at the zero-lower-bound to be long.

People have come to expect financial crises and take a long time to return to normal levels of consumption.

> Suppose that after the financial crisis, conditions normalize, except for one thing: people now believe that a financial crisis, with its associated large decline in economic activity, is much more likely. That belief increases the precautionary demand for savings and lowers the demand for current consumption.
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> People are also concerned about downside risk to their consumption profiles. Assocaited here with a possibly a financial crisis leading to a very sharp decline in aggregate activity, which may well not be shared evenly across everyone in the population. If you're at higher risk of being unemployed, this is going to have an even bigger impact on your demand for savings and lowering your demand for current consumption.

Kocherlakota said central banks can and should offset the decline in consumption by lowering target interest rates, but if the decline in demand is sufficiently large, then the central bank could again be constrained by the zero-lower-bound interest rate.

> Even though you've cleaned up the financial crisis and stemmed the panic in financial markets, the increased fear of a future financial crisis could lead to subdued economic activity, even though, apparently, market conditions have normalized.

He says that his experience at the Fed in Minneapolis was that fear could last a very long time, and even after markets normalize, people's fears and beliefs about the likelihood of future financial crises may not return to where they were before the crisis hit.

> Now, this fear period is likely to be self-enforcing. As it lasts longer and longer, people will increasingly see future financial crises as being associated with near-permanent declines in economic activity. That will lead to further cutbacks in their demand for spending and further downward pressure on economic activity during what I'm calling a fear period.

Kocherlakota continues:

> We often think that the benefit of lower rates by a 10 or 25 or 50 basis points is unlikely to be large. I want to emphasize that the benefit of a slight reduction in that lower bound could be considerable, if households believe that the central bank is likely to be constrained by that lower bound for many years. So, put it in another way, reducing lower bound by 50 basis points has a large stimulative effect on current consumption because it makes post-lift-off consumption a lot more expensive. Another way to say the same thing is, what matters is bond prices, not the average yield on a bond. And so, if that bond price gets a lot more expensive, you're becoming more expensive by consumption in a post-lift-off world. You're going to spend it today instead.

That was the University of Rochester's Professor Narayana Kocherlakota, former president and CEO of the Federal Reserve Bank of Minneapolis, speaking at the Asian Development Bank Institute's Annual Conference on the implications of ultra-low and negative interest rates for Asia last december. For more information about the annual conference, visit us at ADBI. org.