Are Low Interest Rates Good for the Economy?

Interest rates have fallen to historic lows since the beginning of the Great Recession in the fourth quarter of 2007. With the federal funds rate near zero and saving rate less than one percent, the thirty-year fixed mortgage rate has dropped to about four percent. The rationale for pushing interest rates down is to induce firms to finance capital investment and business expansion. Likewise, low interest rates encourage real estate investors to buy property and property-owners to refinance existing loans.
However, rock-bottom interest rates have not stimulated the investment demand. In fact, real private non-residential fixed investment dropped from $1.6 trillion in the fourth quarter of 2007 to $1.5 trillion in the third quarter of 2011. Similarly, real private residential fixed investment fell from $523 billion to $326 billion during the same time period.

![Real Private Nonresidential Fixed Investment, 3 Decimal: Billions of Cha](http://www.Economagic.com/)

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In spite of such ultra-low interest rates, the economy has remained sluggish with near double-digit unemployment rate, dim consumer confidence, weak consumer spending, tight business and real estate lending, escalating housing foreclosure, and mounting federal budget deficit and national debt.

Indeed, the economy has fallen into a “liquidity trap,” a condition that reverses many of the conventional rules of economic policy. A signature characteristic of this trap is a situation where short-term interest rates fall to near zero and further expansion of the monetary base fails to spur economic growth and job creation. Moreover, households prefer to hoard money because of low interest rates paid of personal saving accounts. Furthermore, the credit market becomes increasingly tight as banks hesitate to finance business and real estate loans at low interest rates, but high risks of default.
Paul Krugman has argued that almost all advanced countries, including the United States, the Euro-zone, and Japan, have fallen in a “liquidity trap.” Kurgman has noted that tripling of the U.S. monetary base between 2008 and 2011 failed to produce any significant effect on U.S. domestic price indices or dollar-denominated commodity prices.¹

In light of actions of the Federal Reserve Board (the Fed) of buying long-term Treasury securities to keep interest rates low, Thomas Hoenig, President of the Kansas City Fed, commented that keeping interest rates at record lows is a "dangerous gamble" that could hinder future economic growth by unleashing inflation pressures and creating new speculative bubbles. Indeed, critics blame the Fed under the leadership of Alan Greenspan for keeping interest rates low for a long period of time after the 2001 recession. Such low rates created a housing bubble that eventually burst and plunged the economy into a severe recession in late 2007.²

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Notes

1 Krugman, Paul, "How much of the world is in a liquidity trap?". The New York Times, March 17, 2010