Written by **Bob Adelmann** on May 4, 2015

Do Negative Interest Rates Portend a Negative Economy?

Last Thursday the London *Daily Telegraph's* assistant editor, Jeremy Warner, reported an astonishing statistic: Almost a third of all government debt in the eurozone is paying negative interest rates. That's more than $2 trillion in government bonds, and, it appears, investors are happy that they aren't paying even more.

Fifty percent of French bonds now trade with a negative yield, while 70 percent of Germany's bonds trade at a negative yield. More remarkably, in Spain, which was on the verge of insolvency just a few years ago, 17 percent of its government bonds now trade with a negative yield.

This is counterintuitive, which explains why Keynesians, those who believe that "demand" in an economy can be artificially increased by manipulating taxes and the money supply, have no explanation for it. In theory, the cheaper money is, the more will be demanded. If an investor can borrow at one percent and earn five percent, why wouldn't he?

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He would, if he could find a place to earn five percent. But most places don't pay five percent, and those that do pay that amount have enormous downside risks. It's the old question: What's more important: the return on your money, or the return of your money?

As Warner explained, "The whole purpose of QE — quantitative easing (i.e., printing money to buy government bonds) — [is] to depress the yield on government bonds to the point where investors are forced to seek higher risk alternatives." But what if there aren't any alternatives? What if stocks are so overpriced that a crash is perceived to be imminent? What if the bond market is so overbought that a correction must take place, perhaps sooner than later? Warner wrote:

> The flip side of the cheap money story is soaring asset prices. The bond market bubble is just the half of it: since other assets are priced relative to bonds, just about everything else has been going up as well.
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> Eventually, there will be a massive correction, in which creditors will suffer sickening losses.

Investors aren't stupid. They didn't gain control of millions and billions in assets by being foolish. They can see what's coming, and they're finding every hidey-hole they can to wait out the coming storm. The last thing they're doing is investing in the economy.

In a healthy economy, demand for capital is strong. Often borrowing makes sense, as the return on the projected investment exceeds, sometimes greatly, the cost of borrowing. But what happens if those opportunities have evaporated? What if small business owners aren't willing to take risks with their capital, or take what they could borrow, due to fear and uncertainty? Jana Randow, in her effort to explain the conundrum at Bloomberg, nailed it: "Negative interest rates are a sign of desperation." In the face of high risk and great uncertainty, investors look for the safest place to put their capital. At present the safest place is in government bonds, even if they have to pay for the privilege.

Mark Hendrickson, an economics professor and a blogger at *Forbes*, had trouble explaining the concept to his students: “Who in their right mind would invest in a financial instrument that would guarantee a loss of principal?” At first blush, it makes no sense: “We have the spectacle of widespread acceptance of a nominally negative return on [a] paper-denominated currency that the relevant central bank is actively trying to depreciate.”

What this spectacle portends is the destruction of the capitalist system. When the safest place to put money is in bonds issued by a government whose central bank is determined to boost its economy through beggar-thy-neighbor policies of reducing the value of its currency to make its products more attractive abroad, it reflects, as Hendrickson put it, “a weird and alarming symptom of profound economic dysfunction.”

Interest rates, in normal times, are the market’s signals to investors upon which they base their investment decisions. But without those signals, or worse, without signals that mean anything, the economy will “stall” (using Hillary Clinton’s word). “Today,” wrote Hendrickson, “those vitally important market signals are mangled, broken, shattered.”

In the eurozone it all comes back to Greece. If Greece is unable to write off (stiff) most of its creditors through forgiveness, it is preparing to leave the EU. If forgiveness is granted, it’s a per se admission of insolvency. If such forgiveness is granted it’s also a clear signal to Italy, Portugal, and Spain that they will be able to do the same: bankruptcy on the installment plan. At some point Germany, the strongest economy in the EU, will refuse to go along, and that will end the union. It’s just a matter of time.

With that as background, who would make long-term bets in a short-term world? As economist Gary North expressed it, it’s a deadly spiral: “This spells the death of economic growth. It spells a decline in tax receipts. It hastens the Great Default.”

A graduate of an Ivy League school and a former investment advisor, Bob is a regular contributor to The New American *magazine and blogs frequently at www.LightFromTheRight.com, primarily on economics and politics.*