September 28, 2023

°252

An Interest Rate Cap Would Not Be a Good Idea

Currently, rising interest rates are making life difficult for borrowers. Anyone who has debts with flexible interest rates or wants to buy an apartment must expect interest rates of 4% and more. Two years ago, it was often less than half that. The situation is similar for people who take out a loan to buy a car or who simply overdraw their account. In Austria, there have now been calls for the government to intervene and introduce an interest rate cap. Interest on overdrafts on a checking account should be limited to a maximum of 5%, and the maximum interest rate for real estate loans should be 3%. What are we to make of this?

Higher Interest Rates Serve to Combat Inflation

First, it is worth remembering why interest rates are currently rising. The main reason is that the European Central Bank needs to fight inflation. It raises interest rates so that private households buy less real estate, fewer houses are built, demand for construction services wanes, and ultimately the prices for these services fall. Raising interest rates is also supposed to lead to less consumer borrowing, less demand for consumer goods, and at least less rapid increases in the prices of those goods as well. Preventing monetary policy interest rate hikes from reaching households that take on debt by imposing a government interest rate cap impairs the effect of monetary policy and makes it more difficult to fight inflation.

Whether an interest rate cap has this effect, however, i.e., whether it really increases lending, depends on its design. The simplest form of interest rate cap would simply prohibit banks from lending at higher rates. In this case, banks would react by lending less, at least when there is competition in credit markets. In this case, fighting inflation would be more likely to be supported, but it would achieve the opposite of what Austrian policymakers are proposing. What they want is not to exclude households from credit, but to facilitate access. That is why their proposal is not limited to interest rate regulation alone. In Austria, the interest rate cap is to be designed as a subsidy. A government subsidy is to bridge the difference between the interest rate charged by banks and the level of the interest rate cap. They want to finance this subsidy with an additional profit tax on banks. With this design, households would actually receive more loans. However, this may lead to disincentives. If banks know that the difference between the interest they charge and the interest cap will be paid, they have incentives to charge very high interest rates. There is no way to completely avoid this misaligned incentive. But it can be taken into account when designing the interest rate cap, for example by limiting the recipients of the subsidized loans, the loan amount, and the maximum subsidy to, say, 2%.

Interest Rate Cap Could Reduce Austria's Competitiveness

In terms of fighting inflation, this would mean that the government would counter the central bank's efforts to restrict lending by raising interest rates. How would monetary policy respond? One possibility is that it would raise interest rates even higher. This would not reach household borrowers because of the interest rate cap, but it would reach businesses all the more. They would reduce investment and possibly cut employment. The burden of fighting inflation by reducing demand for goods would be spread over fewer shoulders. Since Austria is a small country, however, it is unlikely that the European Central Bank would react in that way. It is guided by inflation in the euro area as a whole, not inflation in individual member states. Inflation in the euro area as a whole would hardly be affected by the Austrian interest rate cap. For Austria, however, the consequences would be noticeable. The country would live with higher inflation for a longer period than without the interest rate cap. This has macroeconomically problematic consequences. Austria's price competitiveness in internationally tradable goods and in tourism would decline.

Better to Target Support

Moreover, there would be the consequence of the additional profit tax on banks. Introducing situation-dependent special taxes for banks would increase uncertainty for companies overall and undermine confidence in the predictability of Austria's tax policy. Especially for banks, such a tax may entail stability risks, as the announcement of a similar tax in Italy has shown. If policymakers want to help households in distress due to the sudden rise in interest rates, what instruments should they use? It would be possible to provide for a hardship rule under which households that cannot bear rising mortgage rates themselves would receive government aid. This would be much more fiscally advantageous and better targeted than an interest rate cap. And it would prevent the interest subsidy from driving up inflation. People on low incomes have the keenest interest in seeing the fight against inflation succeed.

Clemens Fuest
Professor of Public Economics and Finance
President of the ifo Institute

Published under the title "Ein Zinsdeckel wäre keine gute Idee", Der Standard, August 17, 2023