

Central banks are still testing the limits to how low interest rates can go

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In June of last year the European Central Bank reduced its benchmark interest rate, at which it lends to commercial banks, to 0.15% and its deposit rate, which it pays to banks on their reserves, to -0.1%. For a central bank that was once cautious about unconventional measures, setting a negative interest rate was a bold move. The ECB was in effect charging commercial banks to hold their excess deposits at the central bank, in the hope that this would drive down borrowing costs more generally.

Three months later, the ECB cut the deposit rate again, to -0.2%. When the ECB's rate-setting council next meets, on December 3rd, it is widely expected to trim the deposit rate even further, as well as to approve more "quantitative easing" or QE (the creation of money to buy bonds). In a recent speech Mr Draghi claimed that the ECB's unconventional policies over the past 18 months had been the "dominant force" in spurring the euro-zone economy and staving off deflation. Lending by banks is slowly reviving. Even so, he suggested, deficient inflation and lingering concerns about the strength of recovery justify further action.

Not so long ago, the lowest possible interest rate was thought to be zero. There is a ready alternative to keeping money in banks: holding it as cash. Mattresses do not charge for storing notes. Depositors might tolerate small fees, to avoid the cost and hassle of making other arrangements—but most had assumed their tolerance would be limited. "We are now at the lower bound," Mario Draghi, the ECB's boss, said after the last cut. He now seems to be reconsidering—but how low can the ECB go?

The ECB is not alone in testing the lower bound to interest rates. Denmark's central bank has set its main policy rate below zero for

much of the past three years to repel capital inflows that had threatened its exchange-rate peg with the euro. In January the Swiss National Bank abandoned its attempts to stop the franc from appreciating against the euro by printing and selling francs in vast quantities; instead it resorted to negative interest rates to deter investors from buying francs. Sweden's central bank, the Riksbank, took its main policy rate negative in February, to weaken the krona, make imports more expensive and thus push inflation closer to its target of 2%.

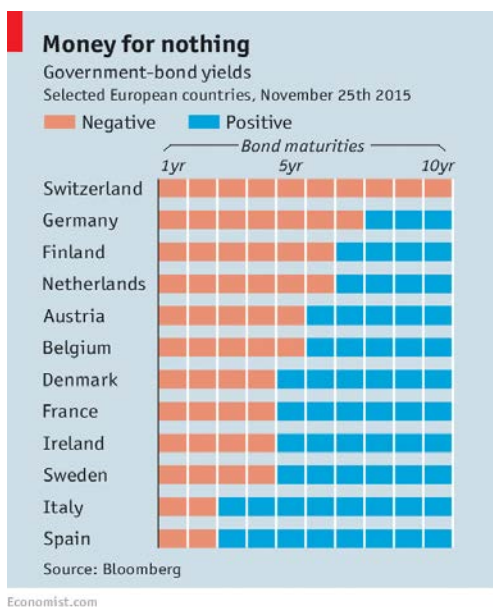
For all these countries, it is the exchange rate against the euro that matters most. To suppress their currencies, their central banks must offer interest rates that are further below zero than the ECB's. The deposit rate in Denmark and in Switzerland is -0.75%. In Sweden it is -1.1%.

This has not caused commercial banks to swap their reserves at the central bank for cash, as theory would suggest. That is because to do so would itself be costly. To settle payments, banks must move vast sums between themselves each day. The costs of counting, storing, moving and insuring lorry-loads of banknotes apparently trumps the smallish charge Europe's central banks are levying to hold electronic deposits. The other possible use for banks' reserves is to lend them to other banks, but they are already awash with the excess liquidity created by QE.

The deposit rate at central banks sets a floor for the cost of overnight loans more generally, which is why short-term money-market rates have also turned negative. Indeed, negative policy rates and money creation through central-bank purchases of bonds or foreign currencies have dragged the yields on sovereign bonds into the red all over Europe

(see chart). That in turn has pulled down the interest rates charged by banks for new loans.

Banks have passed on some of the cost of negative rates to their corporate clients. For them, too, the cost of moving and storing large stocks of cash is prohibitive; the obvious alternative—buying safe and liquid bonds—also now comes at a cost, thanks to negative yields.



This week Alternative Bank Schweiz, a tiny Swiss outfit, said it would be forced to levy negative rates on personal accounts from January. Most banks, however, have shielded retail customers from such charges, on the assumption they would move their accounts elsewhere. As a consequence, overall bank deposits have been stable. The banks have simply absorbed the cost of deposits at the central bank, which has dented profits. A further cut in the ECB's deposit rate of 0.2 percentage points could squeeze the net profits of European banks by 6%, according to Autonomous Research.

As interest rates creep further into the red, economists' prescriptions have become bolder. In a speech in September Andy Haldane, the chief economist of the Bank of England,

outlined a range of options to allow rates to go lower still. The most radical would be to get rid of the mattress option by abolishing cash altogether. Ken Rogoff of Harvard University calculates that there is \$4,000 of currency in circulation for every person in America. Much of it is used to hide transactions from tax authorities or the police. Abolishing it would curb such activities, as well as helping central bankers.

Yet depositors might still find ways to safeguard their savings. Switching to foreign currency or precious metals would be an obvious option. As Kenneth Garbade and Jamie McAndrews of the Federal Reserve Bank of New York point out, taxpayers could make advance payments to the taxman and subsequently claim them back. Depositors could withdraw funds in the form of bankers' drafts (certified cheques) to use as a store of value. Such drafts might even become a form of parallel currency, since they are transferable. Any form of pre-paid card, such as urban-transport passes, gift vouchers or mobile-phone SIMs could double up as zero-yielding assets. If interest rates became deeply negative, it would turn business conventions upside down. Companies would seek to make payments quickly and receive them slowly. Their inventories would grow fatter.

In practice, euro-zone banks are the ones on the front-line of negative rates. That is sparking worries that, if rates go too low, they might harm the economy. Banks that are nervous about the stability of their deposits are less likely to lend, says Huw van Steenis of Morgan Stanley, an investment bank. Yet pushing rates lower still is also likely further to weaken the euro against the dollar, especially as the Federal Reserve seems set to raise its main interest rate on December 16th. That may even be the ECB's main motive—just as suppressing their currencies is the explicit aim of the other members of the negative-rate club.