Negative rates: Desperate gimmick or vital strategy?

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February 20, 2016 – *The Globe and Mail*

For thousands of years, savers were paid to deposit money. Over the past few months, that time-honoured practice has been flipped on its head.

Around the world, interest rates are going negative.

An astounding 27 per cent of the global government bond market is now trading at subzero rates, meaning that investors are effectively having to pay for the privilege of stockpiling wealth. In Europe and Japan, regulators are forcing commercial banks to hand over fees if they want to keep money on deposit with central banks. Policy makers in Canada and the United States acknowledge that they, too, are looking at the idea of pushing some interest rates into negative territory.

The financial world's lurch into the uncharted land of negative interest rates is shattering expectations and driving fierce debates. Promoters of negative interest rate policies – NIRP, in trendy speak – say subzero rates are a brilliant way to restart stalled economies. Critics retort that the notion of having to pay to save amounts to a perversion of the natural order and a war on thrift. They say it's a mad experiment that will gut banks' profits and lead to market chaos.

"Policy makers may have significantly underestimated the economic risks," Scott Mather, one of the chief investment officers at bond giant Pimco, warned last week.

Negative rates, in their simplest form, are simply a charge on savers. For instance, euro zone banks now have to pay a fee of 0.3 per cent a year to the European Central Bank for the privilege of parking money there. The intent is to discourage hoarding of cash and drive the commercial banks to do more lending, all of which should help to stimulate the European economy.

Supporters argue that NIRP encourages more spending, more investment and more growth as people seek to evade the corrosive effect of negative rates on their savings.

Skeptics aren't buying it. They say negative rates are a desperate gimmick concocted by financial engineers who are running short of ideas to revive growth after years of failed attempts. The critics point to the recent swoon in European banking stocks as an example of the potential damage. Banks, they argue, can't prosper in a world where negative rates pinch their income from loans and bonds, and they have to pay central banks to store their reserves.

"Recently, negative interest rates have become the favourite tool of central bankers dealing with weaker-than-expected economic growth," writes Ian de Verteuil, a strategist with CIBC World Markets who numbers among the skeptics. "So far, the impact seems to be weakened currencies, falling share prices and little else."

Defenders of NIRP insist the program simply needs time to take hold. The real problem, they maintain, is the timid way that subzero policies have been rolled out.

Central banks, according to these proponents, should trumpet negative rates. Policy makers should vow – loudly and aggressively – to stick with NIRP until expectations have been reshaped and the economy is booming once again.

"Here's the wrong way [for central banks] to communicate: Keep saying that negative is a purely emergency setting that will be abandoned shortly," writes Narayana

Kocherlakota, a former president of the Minneapolis Federal Reserve Bank who now teaches economics at the University of Rochester. "Here's the right way to communicate: Keep saying that all available tools, including negative interest rates, will be used as is needed to return employment and inflation to desirable levels as rapidly as possible."

The brawl over negative interest rates is likely to become even more ferocious in the months ahead as policy makers continue to search for ways to spur stubbornly slow growth. Six years after the financial crisis ended – at least, in theory – the global economy is still whimpering.

In the final few months of last year, Japan's economy contracted while the euro zone and Canada eked out barely perceptible gains. The United States reported disappointing growth, while concerns mounted over China's decelerating economic trajectory.

One barometer of investors' growing anxiety is the growing prevalence of negative yields in the bond market. Negative yields occur when bond buyers figure it's better to accept a small but sure loss rather than take a gamble on riskier bets. Those buyers drive up the price of a bond to the point where its payout is less than its cost – perhaps because they figure an economic slowdown is imminent and they want a refuge, perhaps because they're betting on deflation, or perhaps because they suspect rates will drop even lower and they will be able to sell at a profit.

Over the past year and a half, negative bond yields have spread. At the end of January, more than $5.5-trillion (U.S.) of government debt, or about a quarter of the sovereign bond universe tracked by JPMorgan, was providing a subzero payout. Panicky investors have demonstrated their enthusiastic willingness to accept negative yields on government bonds from stable countries such as Switzerland, Germany, the Netherlands and Japan, even for maturities of five years or more. For that matter, bonds from highly rated companies, such as Nestlé and Shell, have briefly traded at negative yields in recent weeks.

Investors' mania for squirrelling away money in perceived havens is sapping demand from the real economy. An excessive propensity to save in ultrasafe assets may be a key factor in the persistently slow growth that has dogged the world ever since the financial crisis. Hence, the need for some strategy that will encourage more spending and more investment in goods and services.

The predominant strategy, for several years now, has consisted of chopping the short-term policy rates directly controlled by central banks to zero or just slightly above. Low rates stimulate the economy by making it more attractive to spend and easier to borrow. Low rates also boost asset prices and help to drive down the value of a country's currency, thereby helping its exports.

But near-zero policy rates have so far failed to spark anything more than lacklustre growth, even when coupled with other unconventional monetary stimulus, such as quantitative easing programs, in which central banks purchase massive amounts of government bonds. That's why some central banks have decided to go a step further and take rates below zero to shock economies back into gear.

"There has never been anything wrong in theory with charging negative rates," says Nick Rowe, a professor of economics at Carleton University and an authority on monetary policy. "The objection was always this notion that people would just withdraw their money from the bank and go to cash, which pays zero interest but at least doesn't impose a negative rate."

However, a rush to paper money hasn't materialized in the countries that have imposed negative rates, perhaps because the rates have been only mildly negative. Especially for large institutions that deal in massive amounts of money, it has been easier to endure slightly negative rates rather than deal with all the hassles involved with setting up and managing a warehouse full of paper bills.

The European Central Bank became the first major central bank to go subzero in June, 2014. Switzerland and Denmark have followed suit, as has Sweden (which briefly experimented with negative rates in 2009 and has since re-installed them). Japan joined the negative-rate club just days ago.

While the details differ, all the negative rates are small – most are a fraction of a percentage point. They are directly applied only to commercial banks and only to a relatively small slice of their money. Commercial banks are free to pass on the pain to their customers, but they haven't, at least so far.

North American central bankers say they are taking a close look at similar schemes. Stephen Poloz, Governor of the Bank of Canada, delivered a speech in December in which he mulled the potential for taking Canada's key rate to minus 0.5 per cent, although he emphasized such a move wasn't imminent. Janet Yellen, chair of the Federal Reserve, has also acknowledged that policy makers have at least considered the possibility of negative rates in the United States.

Canada could become part of the world's subzero fraternity within the next two years, according to a recent report from Citigroup. "In the Czech Republic, Norway and perhaps Canada, a negative policy rate is not part of our central scenario, but the risk of a negative policy rate is material," wrote economist Ebrahim Rahbari and colleagues.

The prospect of widespread negative rates appalls Bay Street and Wall Street. Analysts worry that banks will be forced to swallow the pain of subzero monetary policy because financial institutions won't be able to pass on the negative rates to depositors without scaring customers into the safety of paper money.

Negative rates are a "dangerous experiment," according to Huw van Steenis, an analyst at Morgan Stanley who warns in a recent report that they will erode banks' profitability. The push below zero signals "policy exhaustion," says Chris Xiao at Merrill Lynch. The moves in Switzerland and the euro zone have so far failed to boost growth, notes Christopher Swann, a strategist at UBS Wealth Management.

Some observers worry about possible dangers to international trade. "Negative interest rates represent another escalation of the so-called currency wars," warns Mr. Mather of Pimco, who is concerned that some central banks are using subzero rates as a way to devalue their currencies and boost exports.

For his part, Mr. de Verteuil of CIBC cautions that subzero rates could lead to a stampede out of money market funds. "We aren't sure whether individual investors will be prepared to pay to own a money market fund – but we highly doubt it," he writes. Since those funds play an important role in buying companies' short-term debt, the result could be a severe crimping of lending to the corporate sector.

Economists acknowledge that it's administratively tricky to impose negative rates, but they don't see the problems as insurmountable. Prof. Rowe argues that the important factor for any lender is the spread between its deposit rates and its lending rates, not whether those rates happen to be negative or positive.

"It's relatively simple for a bank to adjust its business model to still make money with negative rates," agrees Miles Kimball, a professor of economics at the University of Michigan. A long-time advocate for negative rates, he argues that policy makers should be far more aggressive in pushing down lending costs.

He says banks should realize their real enemy is the current new normal of anemic growth. The failure of the global economy to revive after years of zero-rate therapy is conclusive evidence that stronger medicine is necessary, he argues. “If you don’t take the right dosage of a drug, it doesn’t work.”

Both Europe and Japan should immediately push rates even lower, he says. While negative rates of, say, minus 2 per cent or even lower might shock observers at first, they would be in keeping with what history tells us is necessary.

In the past, central banks have often dropped rates by six percentage points or more to bring about recoveries. The only way to achieve a similar effect in today’s low-rate environment would be to take rates strongly negative.

Wouldn’t that unfairly punish ordinary mom-and-pop savers? Not at all, he says. “Savers would be far better off if we had brief periods of deep negative rates that would quickly restore growth, rather than long periods – like now – of near-zero rates, where nobody makes any real return for years.”

To be sure, not everyone might welcome the details of how Prof. Kimball plans to lower interest rates far below zero. To avoid the possibility that savers would flock to cash rather than take a beating on the “electronic” currency in their bank account, he would impose a discount on folding money.

“Paper currency could still continue to exist, but prices would be set in terms of electronic dollars (or abroad, electronic euros or yen), with paper dollars potentially being exchanged at a discount compared to electronic dollars,” he writes.

A situation where paper money might not be worth its face value would be disturbing for most people and it’s not the only disquieting aspect of a subzero strategy.

Negative Rate World would be a place where it would make sense to stockpile cheques rather than deposit them in your bank account, where people would rush to prepay bills rather than leave money lingering in their savings account.

And, yes, in an extreme case, it could be a world where people get paid to borrow – where a business would be able to take out a $1-million loan and pay back only $900,000.

Prof. Kimball acknowledges that there are big psychological barriers to negative rates, and suggests there would be ways to get around the worst side effects. Ideally, he says, negative rates would apply mostly to institutional and business accounts while leaving most ordinary savers and borrowers untouched.

“Our monetary system does change every 50 years or so, so change is possible,” he says. “People never thought we would go off the gold standard, but we did.”

As disruptive as negative rates might seem, he argues they are vital to restart growth. Most of Bay Street would bitterly disagree.

Whichever side wins this argument is likely to shape the course of monetary policy for years to come.

EXPLAINER

What are negative interest rates?

They’re normal banking turned inside out. Instead of being paid for depositing money, a saver is penalized by being forced to pay a fee.

That sounds painful. Who’s being hit by negative rates?

So far, the savers getting dinged are primarily commercial banks in Europe and Japan. They are now being charged for parking money with their respective central banks. In theory, the commercial banks could turn around and pass on the fees to their ordinary mom-and-pop depositors, although they haven’t done so to date.

What's the idea behind negative rates?

They give banks an incentive to lend money rather than hoard it. More lending means more economic activity.

How big are negative rates?

So far, not very. The European Central Bank, for instance, charges 0.30 per cent on the money that euro zone banks park in its coffers.

Could rates turn even more negative?

Possibly. Economists always thought rates on deposits could not dip too far below zero or depositors would simply flee to the safety of cash. But more and more money is now stored in electronic formats and dealing in paper bills has become an increasing hassle, especially for larger transactions. Since it's relatively easy to charge negative rates on electronic deposits, it may be possible to push rates lower than anyone thought just a few years ago.

What's the likely impact on ordinary savers?

So long as negative rates remain small, commercial banks will probably swallow them for fear of driving away customers. But if rates turn even more negative, financial institutions may decide to pass on the pain and start imposing fees on ordinary savers. Sadly, though, it's unlikely that typical households will ever be paid to take out a loan – at least, not unless rates go far more negative than they are now.

Are subzero rates a trend?

Yes indeed. Sweden and Switzerland had experimented with them for short periods in the past, but things really got going when the European Central Bank instituted negative rates on bank deposits in 2014. The subzero club has now grown to include five members: the ECB, Sweden, Switzerland, Denmark and Japan.

Are more countries likely to give it a whirl?

Apparently so. A recent Citigroup report predicts Israel will be the next to go negative, and says the Czech Republic, Norway and Canada may all follow suit within the next couple of years. Central bankers in both Canada and the United States have acknowledged that they have looked at the idea.

All of this sounds rather radical. Is it?

That's a matter of definition. Nick Rowe, a professor of economics at Carleton University in Ottawa, points out that a century ago the German thinker Silvio Gesell was already talking up the idea of a stamp tax on paper money that would act like a negative interest rate. But if you're asking whether Bay Street and Wall Street hate the notion, the answer is yes.

Why do analysts dislike the idea?

One big worry is that negative rates will erode bank profits because they won't be able to pass on the impact of negative rates to customers.

Are those worries justified?

Bank stocks in Europe and Japan have been weak. At least part of that is nearly certainly the result of fears about the impact of negative rates.

THE SUBZERO CLUB

Denmark: The Danes, who peg their currency to the euro, want to discourage speculators from driving the value of the krone outside of prescribed limits. To foil speculation, Denmark's central bank began to impose negative rates on commercial banks' deposits in July, 2012. The rate has at times returned to positive territory, but now stands at negative 0.75 per cent.

European Central Bank: In June, 2014, the central bank for the 19 countries of the euro zone began charging negative 0.1 per cent on the overnight money that commercial banks had deposited with it. The ECB has since lowered the rate to negative 0.3 per cent and may push it even further into negative territory next month.

Sweden: Sweden was the first country in recent history to impose negative rates. In July, 2009, to help cushion the impact of the financial crisis, the country's central bank took its deposit rate down to negative 0.25 per cent. The rate returned to positive territory in September, 2010, but turned negative again in July, 2014. The deposit rate is now negative 1.25 per cent.

Switzerland: In 1972, the Swiss imposed charges on deposits by non-residents that pushed returns into negative territory, and kept doing so at times until 1978. In December, 2014, the Swiss returned to subzero territory, this time by slapping a negative 0.25-per-cent rate on so-called sight deposits, the cash-like holdings of commercial banks at the central bank. The rate has since been lowered to negative 0.75 per cent.

Japan: The newest member of the negative-rate club, Japan announced on Jan. 29 that it would cut a key interest rate to negative 0.1 per cent. However, the negative rate, which came into effect on Tuesday, only applies to new bank reserves that result from the central bank's program of asset purchases.

Canada: In early December, Bank of Canada Governor Stephen Poloz delivered a speech in which he said the central bank could lower its key rate to negative 0.5 per cent "in the unlikely event that the economy was hit with another major shock." Mr. Poloz's presentation was the first time the central bank had acknowledged that its rates could dip below zero.

United States: Janet Yellen, chair of the Federal Reserve, told a congressional hearing earlier this month that the Fed is studying negative rates as an option if the economy were to falter. However, she added that the Fed had previously studied the idea in 2010 and concluded that subzero rates would not work well.