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In Distorted European Markets, Negative Rates Pose Risks

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Among the various monetary distortions that laid the groundwork for last week's rout in European bonds, perhaps the most insidious and dangerous is the unprecedented experience of negative interest rates.

Horizons
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COMMENTARY

By penalizing deposits, negative rates directly threaten the integrity of the financial system and pose a serious challenge for central bankers in the region. In fact, concerns about their potentially destructive impact are as good an explanation as any for why European Central Bank President Mario Draghi caused bond yields to spike when he indicated on Wednesday that he wasn't bothered about volatility in that market.

Yet the problem stems directly from central bank policy, and specifically that of the ECB.

Gripped by a cycle of tit-for-tat monetary easing policies and a stealth currency war that has been marked by a falling euro, various central banks in Europe now charge banks to lend money to them. Moreover, a few commercial banks are passing on those costs to their institutional clients by doing the same.

These are uncharted waters. In fact, economists once believed it was impossible to “breach the zero bound.” In this unknown territory, it’s not hard to imagine things going wrong, which is perhaps why central bankers like Mr. Draghi may have mixed feelings about what they have wrought. On the one hand, they want weaker currencies and easier credit conditions, but on the other, they’re letting the market know they’re happy with higher bond and deposit rates.

The biggest fear with negative rates is that at some point savers might yank money from bank accounts and store it in cold, hard cash. After all, 0% interest on banknotes beats making payments to one of the Swiss banks now charging institutions to deposit funds. Quite conveniently, too, the Swiss franc comes in denominations as high as 1,000 francs.

No such exodus has so far happened. But the mere presence of a paper money option means depositors have an escape route. It’s why some economists speculate that governments could in the future abandon paper cash and issue digital currencies, which can be taxed without provoking a bank run into cash.

No one knows where the tipping point lies, but there must be a level where the cost of depositing money with a bank exceeds the costs of custody and inconvenience of cash. Arguably, crossing that point could trigger a systemic crisis.

“Some central banks are perilously close to having investors and financial institutions switch to holding cash in lieu of government bonds or bank deposits that pay negative rates of return,” warns Eswar Prasad, a professor from Cornell University and a Brookings Institution economist. That’s because zero rates are “materially and psychologically preferable to the topsy-turvy situation of paying governments for the privilege of holding their bonds or paying banks for the privilege of keeping deposits with them.”

Monetary authorities in Sweden, Denmark and Switzerland have so far viewed these risks as worth taking when compared with the loss of economic competitiveness caused by exchange-rate appreciation as investors flee the euro. Those central banks have tried to use negative rates to ward off the influx of money. However, with the ECB also charging banks an overnight deposit rate of -0.2%, spending 60 billion euros a month on bond-buying, and talking about increasing that “quantitative easing” program in the summer, the eurozone outflows have continued.

Negative rates could pose a solvency challenge for certain money market funds and insurance companies, which typically hold large, fluid deposits at banks and might not earn enough on other low-yielding instruments to cover the charges. It's one reason central banks "cannot hold negative interest rates indefinitely," says Bret Barker, managing director of fixed income at TCW, which has $182.5 billion under management. "It will eventually begin to crush the money market itself."

There are also forecasting problems. To guide monetary policy, central banks rely on econometric models that assume predictable relationships between interest rates, savings, investment, and the supply and velocity of money. Nowhere do these models contemplate negative interest rates.

Already, negative rates and yields have "created problems with legal contracts [and] had accounting and tax payment/credit implications" while "posing challenges for banking technology, adds Andrew Milligan, head of global strategy at Standard Life Investments, with $383 billion under management.

Yet the system has survived. And with any luck, negative rates won't be around for long. Following Friday's solid jobs report, the Federal Reserve is on track to raise rates, while improvements in the eurozone economy could lead the ECB to moderate its monetary expansion program. If these trends boost the dollar and euro and soften the Swiss franc, Swedish krona and Danish krone, the latter's central banks might start to raise rates.

Alternatively, investors might just learn to live with negative rates, treating them as a reasonable cost for convenience that is mitigated by very low inflation.

As Peter Crane, President of Crane Data Money Fund Intelligence points out, "It's only in the last 50 years that people have gotten paid to put their money in custody. For hundreds of years the king charged you to keep your money safe, or banks charged you."

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