THE CONVERSATION

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ECB’s negative rates experiment will buy time, but brings danger

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Why so negative? Mario Draghi at the ECB. Arne Dedert/EPA

When the European Central Bank unveiled a handful of unconventional monetary policies recently, one above all grabbed the attention. The inception of targeted long-term refinancing operations, preparatory work to buy asset back securities and the suspension of the fine-tuning operation to sterilise its liquidity injections have their fans among economists, but it was the decision to impose negative interest rates on bank deposits that made the most waves.

A negative nominal rate in this case is essentially a tax on banks which decide to hold on to capital rather than dispersing it into the wider economy. It comes as the ECB fears the risk of deflation has become very serious and is doubtful about the economic outlook.

There are two main ways negative nominal rates might work. First, investors can interpret these monetary policies as implying a lower path for future short-term interest rates, which reduces the expectations of long-term interest rates. Theorists call it the signalling channel.

Second, the central bank might manage to induce bankers to reshuffle their portfolios towards riskier assets or investments. The target is any bank in the first place, but the hope is that everyone will do the same. This is called “the portfolio balance channel”. The former channel requires the action to be credible and the central bank to be fully committed. The latter means more risk-taking and the creation of genuine belief that the potential payoff on risky assets is getting more attractive after all.

But will it really work?

Well, negative rates should force money to circulate. In particular, it should discourage banks from hoarding cash at the central bank, while at the same time it should encourage banks to lend to individuals and businesses. In turn, that should push investors to divert money into other assets (bonds, equities and so on) thus boosting the economy. But it is hard to believe that there will be a one-to-one transmission from the banking system into the broad economy. Imagine the reactions of bank customers should negative rates be passed down to their deposit accounts (a few banks are already doing this on some accounts denominated in certain currencies).

What we can expect is that the ECB measures should to some degree bring down longer term interest rates, increase the prices of riskier securities, and lead to a depreciation in the euro. This has already happened, at least partially. The euro lost 50 basis points against the US dollar within a few minutes when Draghi announced these new measures. Since then the euro has approached lows against the dollar not seen since February.

Lessons from the past?

There are some precedents for this kind of central bank move. During the 1970s, the Swiss franc was exposed to strong upward pressure and, among other things, the Swiss National Bank introduced a commission charge on the deposits of non-residents. This can be regarded as a special example of negative interest rates. More recently, two central banks in Europe, Sweden's Riksbank and the Danmarks Nationalbank, set their term deposit rate at negative values. But even if these cases look more similar to what the ECB has put in place, it is not clear if we can learn anything from the Swedish and Danish experiences. This is a comparison between small, open economies and a huge and complex framework such as the Eurozone whose financial system and real economies are fragmented and desynchronized. Look at it this way and the ECB's negative rate policy is a unique and real-time experiment.

There has been much talk of the potential benefits of the ECB move, but what of the potential drawbacks and flaws?

The first that springs to mind is that banks and individuals with the means to do so will seek to mitigate, or even profit from negative rates. Most individuals will probably stick with their banks regardless and the convenience of cheques, electronic transfers and other banking services. But the more sophisticated players – banks and other financial firms – can easily find ways to get round negative rates. For instance, an international bank can park its excess cash at other central banks rather than at the ECB, or it can use overnight and relatively risk-free lending to hoard liquidity safely.

Other dangers stemming from negative rates are too much risk-taking and inefficient capital allocations. The classic example is the rise of asset bubbles – in some countries, equity indices and real estate prices are already at historical records. It can also discourage long-term saving and distort asset pricing. From the point of view of international partners, unconventional measures such as negative nominal interest rates can be seen as forms of protectionism – this is why the words "currency war" and "beggar thy neighbour" have been in frequent use recently.

Buying time

The important question we should ask ourselves is why the ECB had to introduce this additional package after more than six years of an already ultra-accommodative stance? Why are banks reluctant to lend or invest liquidity that can be easily obtained at no cost? What are the fundamental reasons for the malfunction of the monetary transmission in the Eurosystem?

It can be argued that banks have superior information about their customers' credit worthiness and about investment opportunities on financial markets. Either they cannot or do not want to invest. Let us mention just two structural issues. First, new regulatory frameworks force banks to reduce their debt ratios and to consider risk and liquidity needs more carefully. Of course, much more financial stability is necessary but it has to get through an adjustment process.

Second, investing in some public debt securities with an implicit state or central bank's guarantee can be easier and more profitable. The enormous cost of bailing out the financial sector still weighs on the public and private sectors that in many countries were already highly indebted before the crisis. It turns out that banks find more attractive a “carry trade”, that is, borrowing cheaply at the ECB or in wholesale markets and investing in sovereign bonds issued by European peripheral countries offering high yields.

Accommodative monetary policies have certainly helped to prevent disorderly deleveraging and default during the financial crisis. Additionally, monetary easing and unconventional measures such as negative nominal interest rates can help to buy time in order to repair the balance sheets of the banking system, the private and public sectors. But it is not the cure.