Talking point

Growing doubts about negative interest rate policy

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The debate about whether a negative interest rate policy (NIRP) helps or hinders the transmission mechanism of monetary policy continues to rage. The BIS and many others – including us* – long ago issued warnings about throwing open the monetary floodgates and the side effects of negative central-bank interest rates, and now Mark Carney, the governor of the Bank of England, has also clearly rejected negative interest rates, despite using all the means at his disposal to prevent the UK economy from sliding into recession after the Brexit shock. The package of measures he launched in August significantly exceeded market expectations, but Carney has ruled out negative interest rates, referring to the adverse impact on the capital markets.

However, IMF analysts defend the ECB's negative deposit rate**, not least because they, like the ECB, still put a Keynesian interpretation on the weak growth that has now persisted in the eurozone for almost a decade, seeing it as a problem of lack of demand, which can be tackled by adopting an expansionary fiscal policy and an ultra-loose monetary policy. In its latest report on the eurozone, the IMF describes the overall effect of NIRP as positive thanks to less constrained borrowing terms and a moderate expansion in lending. According to the IMF, a further benefit brought by NIRP is the 'signal channel'. This enables a central bank to manipulate the markets' expectations for monetary policy in the very long term and thus – in the case of the ECB – further flatten the yield curve, although this is likely to be, at most, a secondary effect, given the massive QE purchases carried out by the ECB and other central banks. However, the discussion about the side effects of NIRP, which (according to the IMF!) have not yet arisen or have been more than offset by other factors, actually occupies more space in the IMF's analysis than the presentation of the positive effects.

The fact that the IMF's assessment is still positive is primarily based on theoretical considerations.

The central bank is using negative deposit rates to try to prevent the money supply that it has created from disappearing into speculators' pockets, a situation which Keynes described as the liquidity trap, and which makes monetary policy ineffective. If the holding of cash is now penalised by negative interest rates, it could be possible to escape from the liquidity trap by encouraging banks to lend, companies to invest and consumers to spend.

Like the ECB, the IMF also says that negative nominal interest rates can prevent excessively high real interest rates, which result from excessively low inflation, from unduly depressing demand. What is known as the 'natural' rate of interest plays a key role in this approach. It describes the level of interest rates at which monetary policy fails to change the growth or inflation rates.

The crux of the liquidity trap formulated by Keynes is the non-linear way in which lending reacts to excessively low interest rates. Hoping that penalty interest rates will bring everything back on track is questionable at the very least. The theory of a lower natural rate of interest – a favourite argument of monetary policy makers – should also be treated with caution. Quantification of the concept, which was formulated by K. Wicksell more than a century ago, requires knowledge of an economy's trend growth rate after the temporary effects of shocks have receded. A glance at the ex-post revision of the current estimates of trend growth shows just how unreliable these figures are. Moreover, the arguments of monetary policy makers are, in some regards, circular: If the output shortfall does not decrease and inflation does not increase, despite lower interest rates, this can – according to this logic – only mean that the natural rate of interest must be even lower. This elegantly ignores all of the more structural reasons for the current weak levels of growth and capital investment, such as balance sheet problems at banks and in companies. Indeed a recent Working paper by Taylor/Wieland argues exactly in that direction by suggesting that the omission of regulatory changes and changes in monetary policy in these models might have resulted in the statistical artefact of a reduction of the equilibrium interest rate.***

The IMF did indeed affirm the adverse effects of NIRP on banks' interest margins and profitability. In this regard, the countries in focus are those where lending rates are mainly variable (Italy, Portugal and Spain) and/or those where the competitive situation makes it difficult to reduce interest rates on a disproportionately high proportion of customer deposits (Germany, Italy, Portugal and Spain). The large number of countries in which NIRP is causing problems raises the question of where the ECB's policy is supposed to have a beneficial effect.

However, the IMF estimates that the impact on profitability in the eurozone has been fairly low so far, with a 50bp cut in the key rate reducing banks' net interest margin by just 7bp. But even the IMF admits that the effect might have been underestimated in the past and, moreover, may have increased following the introduction of negative deposit rates.

It is certainly pointless to get into a debate about a few basis points in such estimates, especially because the connections between cause and effect in times of NIRP have probably changed significantly compared with in the past. However, such estimates are not very helpful when it comes to assessing NIRP either.

In addition to the potentially drastic long-term effects of NIRP (which the IMF also recognises), there are two main points that we believe should be excluded from the analysis:

Firstly, the channel of trust, which plays a considerable role in the transmission of monetary policy decisions to the real economy, is completely ignored. Surveys and anecdotal evidence indicate that, in the northern eurozone countries at least, ECB policy is increasingly causing uncertainty and resulting in a wait-and-see stance rather than more capital investment or consumer spending.

Secondly, in the same report from the IMF, just a few pages before the article on NIRP, there is an essay that reveals that the current weak level of capital investment in the eurozone is at least partly due to debt levels remaining high, especially in small and medium-sized enterprises. NIRP reduces the incentive to change this, both for lenders – because of lower profits resulting from falling interest margins – and for borrowers, whose interest expense continues to decline. The eurozone's anaemic growth is likely to persist if companies do not write off their misinvestments and banks their non-performing loans. Negative interest rates will only prolong this process with evergreen and zombie loans.

* The ECB must change course, dbStandpunkt, Deutsche Bank Research, June 8, 2016.

** Euro Area Policies, Selected Issues, IMF, July 2016.

*** Finding the Equilibrium Real Interest Rate in a Fog of Policy Deviations, John B. Taylor, Volker Wieland, April 2016

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