Bloomberg QuickTake

Less Than Zero

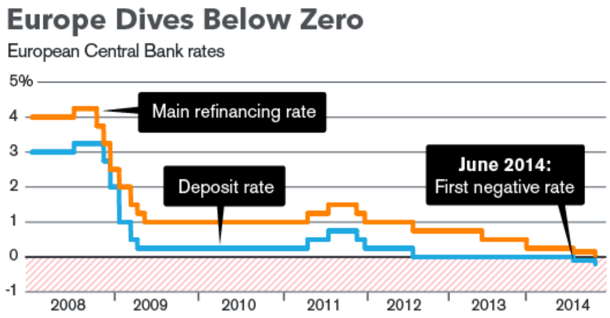
When Interest Rates Go Negative

By Jana Randow | Updated Feb 25, 2015 5:47 AM EST

Imagine a bank that pays negative interest. Depositors are actually charged to keep their money in an account. Crazy as it sounds, several of Europe's central banks have cut key interest rates below zero. For some, it's a bid to reinvigorate an economy with other options exhausted. Others want to push foreigners to move their money somewhere else. Either way, it's an unorthodox choice that has created distortions in financial markets. It's strategy that could ultimately backfire.

The Situation

The European Central Bank chose to experiment with negative rates before turning to a bond-buying program like those used in the U.S. and Japan. It was the first major central bank to venture into negative territory and its deposit rate reached minus 0.2 percent in September, when President Mario Draghi said it had reached the "lower bound." A deposit rate below zero effectively punishes banks that hoard cash at the central bank instead of extending loans to businesses or to weaker lenders. Policy makers are trying to prevent a slide into deflation, or a spiral of falling prices that could derail the recovery. That's also the goal in Sweden, which is using a similar combination of negative rates and bond-buying. Denmark pushed rates deeper into negative territory to make its currency less attractive to hold and protect its peg to the euro. Switzerland moved to its first negative deposit rate since the 1970s in January. Since central banks rates provide a benchmark for all borrowing costs across a country's economy, yields on a range of fixed-income securities – including government bonds of countries like France and Germany – also slipped below zero. Banks are reluctant to pass on negative rates to retail depositors for fear of losing customers, even though that hurts their profit.



SOURCE: EUROPEAN CENTRAL BANK

The Background

Negative interest rates are a sign of desperation, a signal that traditional policy options have proved ineffective and new limits need to be explored. Rates below zero have been used by a handful of smaller central banks in recent years, though never in an economy as large as the euro area. While there is no guarantee that negative rates will be able to achieve what they are meant to do, Draghi pledged during the height of Europe's sovereign debt crisis in 2012 to do "whatever it takes" to save the area's common currency, signaling the ECB's willingness to be innovative. The euro zone is grappling with a shortage of credit and unemployment near its highest level since the currency bloc was formed in 1999.

The Argument

In theory, interest rates below zero should reduce borrowing costs for companies and households, driving demand for loans. In practice, there's a risk that the policy might do more harm than good. Janet Yellen, the U.S. Federal Reserve chair, said at her confirmation hearing in November 2013 that even a deposit rate that's positive but close to zero could disrupt the money markets that help fund financial institutions. If banks make retail customers pay to hold their money, funds could flee and end up under the mattress instead. When banks absorb the costs of negative rates themselves, it squeezes the profit margin between their lending and deposit rates, and might make them *even less* willing to lend. Banks such as UBS have complained that negative rates are crimping their earnings and some are starting to charge large depositors for holding their cash. Ever-lower rates are also raising concern that countries are engaged in a currency war of competitive devaluations as investors shift their money to places where it earns more.

THE REFERENCE SHELF

Blog posts from Francesco Papadia, a former director general for market operations at the ECB, on whether the central bank should have negative rates, and a discussion about where rates could go.

A May, 2014 interview with Peter Praet, a member of the ECB's executive board on policy options published in Die Zeit.

A speech by Benoit Coeure, a member of the ECB Executive Board, on monetary policy and the challenges of the zero lower bound.

A Bloomberg News article outlining the pros and cons of a deposit rate of zero or below and a QuickTake on the ECB's options for some form of quantitative easing.

An ECB research paper on non-standard monetary policy and a Bank of England study of negative rates.

A paper by Charles Goodhart, a former member of the Bank of England's Monetary Policy Committee, arguing a negative rate on excess reserves would depress sovereign bond yields.

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