ON OUR MINDS

The Folly of Negative Interest Rates

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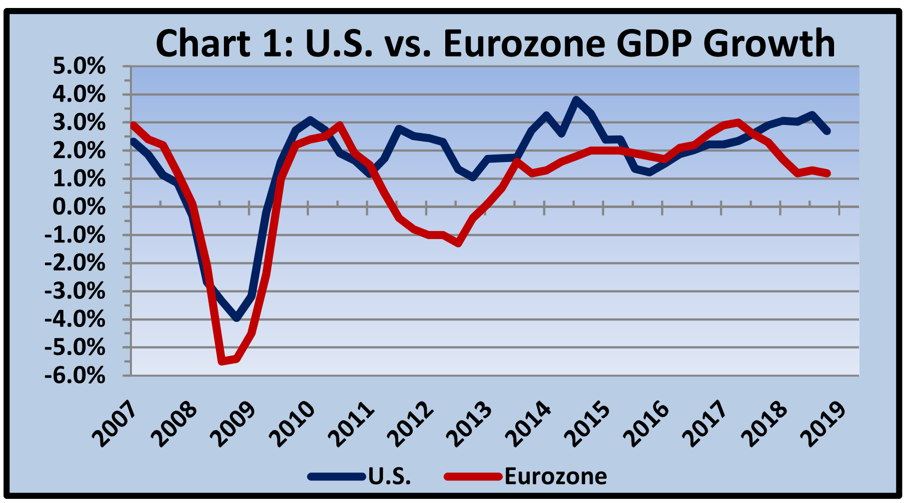
Central bankers by their nature tend to be cautious, moving incrementally and allowing the passage of time before evaluating the results of their policies. Five years is a long time to wait, however, especially when policies are controversial and there has been little evidence that they have worked. Yet that is exactly the situation facing the European Central Bank as its leaders gather this week to evaluate its options.

In 2014, ECB President Mario Draghi established a negative "deposit rate," the benchmark interest rate that the ECB pays on reserves stashed there by commercial banks. The theory was that charging banks (rather than paying them) to keep money at the ECB would motivate them to withdraw those funds and use them to write more loans; it was also assumed that the ultra-low cost of money would lead individuals and businesses to borrow more, injecting energy into the Continent's economy and reviving growth.



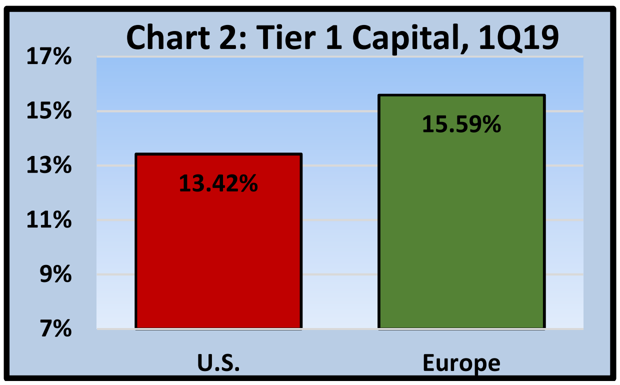
Sources: Commerce Department; European Central Bank

Did it work? In a word, no. Chart 1 shows that after the ECB introduced negative rates in 2014, GDP growth held steady at about 2% for two years before turning up a bit in 2016. But by 2017, any lingering stimulus effect had completely worn off with no residual lasting positive impact. In the past two years, Europe's economy has stumbled badly even as the U.S. maintained nearly 3% growth.[1] So what happened, and what lessons should the ECB learn as it contemplates what to do at its meeting this week?

[1] This was not the ECB's first big mistake. When the ECB raised interest rates prematurely after the 2008 recession, Europe's economy fell into a second recession while the American economy (guided by a more accommodative Federal Reserve that kept overnight interest rates near zero) maintained its upward trajectory.

The ECB has been barking up the wrong tree. The central bank's analysts and economists have consistently assumed that the basic problem is a malaise among consumers and businesses, something that could be cured by making money cheaper to borrow. Yet a few basis points one way or the other doesn't fundamentally alter the basic economics of a given business investment, nor does it make a new car dramatically cheaper for an individual to purchase. The problem is not the price of money.

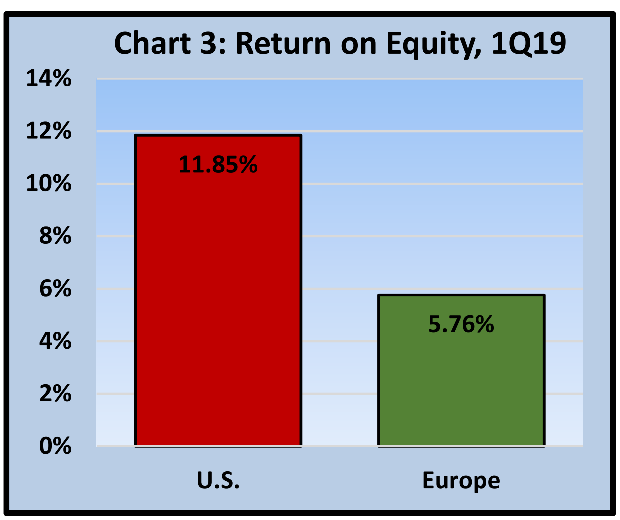
Instead, the problem today is that Europe's banks are fundamentally unhealthy, and the ECB negative-rates policy is exacerbating the situation rather than curing it. A few comparisons to American banks tell the story effectively.

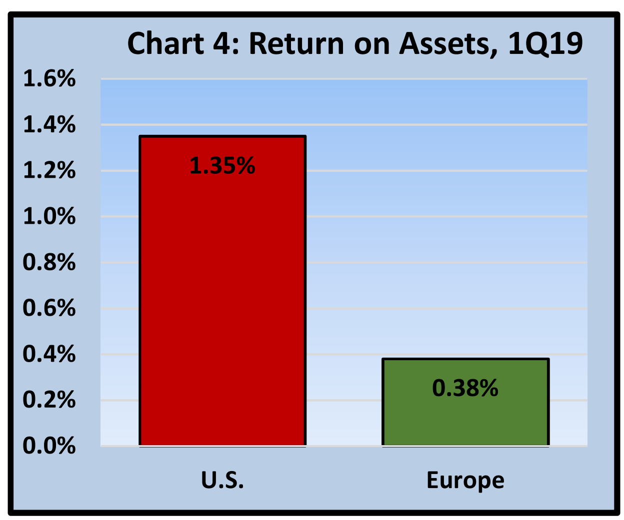


Sources: Federal Reserve; European Central Bank

On the surface, it appears that Europe's banks are doing fine. Their "Tier 1 Capital" ratios – a measure of their equity and reserves in comparison to their risk assets (loans) – are typically higher than those of American banks, as shown in Chart 2; this gives the European banks more resilience against a sudden market downturn. This isn't surprising, inasmuch as the rules governing European banks require higher equity reserves.

The problems show up in Charts 3 and 4, which show that Europe's banks are not nearly as profitable as their counterparts in the United States. Returns on assets and equity are both weak: Ultra-low and negative interest rates are bad for bank profitability. Banks don't earn much interest income from loans with lower interest rates, and they actually lose money on funds they park at the ECB; yet they can't offset those losses by charging consumers or businesses for deposits. In short, the ECB's negative-rates policy has crushed bank profit margins.





Sources: Federal Reserve; European Central Bank

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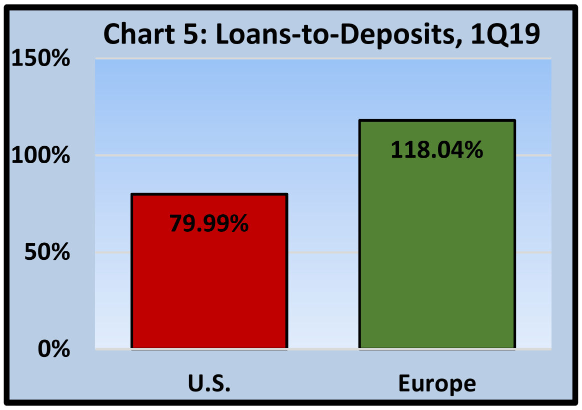
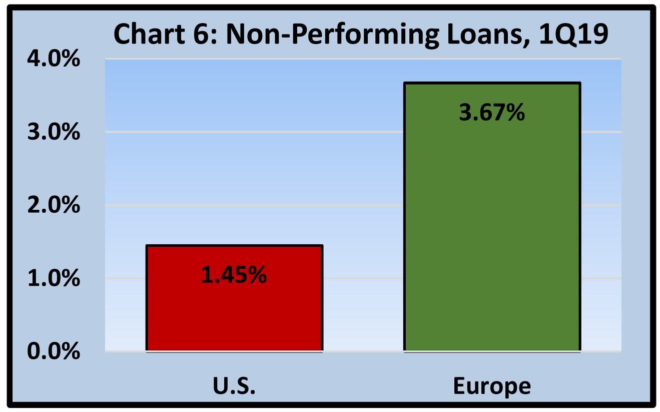
Commercial banks have done what they can to improve their profitability. Within regulatory limits, they have tried to leverage their depositors' money aggressively: Chart 5 shows that European banks' loans-to-deposits ratios are almost 40 percentage points higher than those of their American counterparts. In pushing to get more leverage our of their depositors' money, the European banks have taken on more credit risk and more liquidity risk.





Sources: Federal Reserve; FDIC; European Central Bank

Chart 6 shows that these risks haven't worked out, as "non-performing" loans are a much bigger problem for European banks than they are for American banks. It's a good thing the European banks have higher Tier 1 Capital ratios, because they also have more bad loans to cover. Many of these loans date to the 2008 recession, but most are more recent. In short, the ECB's negative-rate policies have pushed Europe's banks to write bad loans and hamstring their balance sheets.

The ECB's misguided strategy has adversely affected Europe's economy in other ways, too. Among other things, negative interest rates threaten to bankrupt pension plans by artificially inflating the size of future obligations and concurrently reducing current income. Anyone living on a fixed income is put at a double risk, as cash flow falls and the risk of principal price erosion grows. Income inequality could worsen, as lower rates inflate the value of equities (helping affluent asset owners) while hurting workers. And as negative rates spread into private-sector debt (some European corporations have issued debt with negative rates, and in Denmark you can get a home mortgage with a negative rate), an inflationary spiral is conceivable if unlikely.

The effects of the ECB's persistence have infected global markets, too. After the Fed started raising interest rates in 2015, the differential between U.S. and European interest rates grew ever wider, fueling a huge rally in the value of the U.S. dollar.[2] Today, the difference in interest rates is astonishingly large, as shown in Chart 7. At any maturity date, American Treasury debt has better credit quality and yields at least two percentage points better than German (or almost any other European) sovereign debt: Treasuries are both cheaper *and* better. Investors have noticed, pulling money out of Europe and investing here instead. That phenomenon has underpinned a huge rally in Treasury bond prices and helped sustain the bull market in American stocks, too – all the while undermining Europe's economy and financial system.

[2] Brexit also helped the dollar, as the British pound was eviscerated due to concerns that the Bank of England would need to cut rates and inject liquidity to save Britain's economy in the event of a no-deal "hard Brexit."

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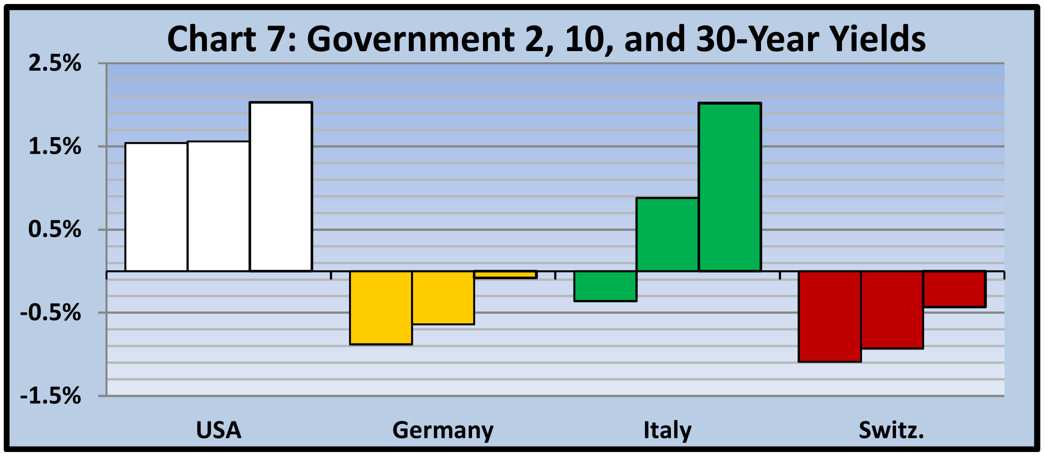

Source: FactSet

So what can the ECB do to help the banks instead of harm them? Europe's economy is being held back by two specific problems in its banking system: First, negative interest rates are damaging the banks' profitability and therefore their soundness; and second, bad loans are strangling their ability to use their capital more effectively to promote growth. Meanwhile, low rates are driving money out of Europe and into the U.S.

It's time for the European Central Bank to admit failure and change course. Yet press reports indicate that the bank is likely this week to double down on its failed strategy, with a further cut in the overnight deposit rate and a resumption of the ECB's purchases of long-term bonds. After five years of ineffectiveness and failure, it's hard to see how this approach will help Europe's banks or Europe's economy.

Far better would have been a plan to divest the commercial banks of their bad loans, setting up a "bad" bank within the ECB that could absorb the non-performing assets and enable Europe's commercial banks to begin lending anew. This is not a novel idea: The Federal Reserve did this in 2009, revitalizing American banks and successfully rebuilding the U.S. financial system.

The time is right for a change, as Mr. Draghi will turn the reins over to President-Elect Christine Lagarde on November 1. Although Ms. Lagarde warned last week about the need to avert the costs of "unorthodox" ECB policies, most observers don't expect her to turn the ECB in a fundamentally new direction; she is perceived as a cautious lawyer and as a diplomat, not as a change agent. *Meet the new boss, same as the old boss?* If so, investors won't get fooled again.

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