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Best Consumed Below Zero?

When ECB President Mario Draghi was asked at a recent press conference if the central bank would consider a negative deposit rate, Draghi answered that the institution has approached the question "with an open mind." This topic is fascinating in terms of alternative options in monetary policy as well as the possible geopolitical ramifications if a major currency country undertakes a below-zero rate program. Looking back at recent history, there are two examples of European countries that have instituted negative term deposit rates since the 2008 crisis. Denmark first utilized a negative deposit rate of -0.2% in July 2012 and then adjusted it in January 2013 to slightly less negative, but it has remained at -0.1% since. Sweden employed a negative term rate between July 2009 and September 2010. In both cases, the rate cut was a reaction to the appreciating currency due to large capital flows out of the Eurozone and into the perceived safety of non-Eurozone European Union countries.

We will turn our attention to Denmark to study its decision to undertake the below-zero rate, the specifics of the situation that prompted it and the effects of the negative rate on financial conditions and the broader economy. We will then briefly look at the possibility of a below-zero rate policy for the ECB and, most importantly, the geopolitical ramifications of the decision by the world's second largest currency block to ease into unknown consequences of negative rates to stimulate the economy.

To be (in the EU) or not to be (in the Eurozone)

Denmark's position in the land between the European Union and the Eurozone is an interesting one. Denmark was an early entrant into the EU. The country is strongly influenced by Germany, its largest trading partner. Economically, the country is affected by the health of the German markets. Separately, the U.K. and Denmark have often had the same political approach toward the reach of EU policies as they have both opted out of the Eurozone. In fact, the U.K. and Denmark are the only two EU countries that are not required by law to join the Eurozone at some point in time. Although Denmark has not adopted the euro, the country's monetary policy is closely tied to the currency block's monetary policy. The main focus of the Danish central bank, along with facilitating financial settlements, is to maintain the currency peg against the euro. The peg has a relatively narrow range of 2.25% that the Danes support by either changing the repo rate or selling and buying their local currency, the krone. The Danish central bank does not conduct independent rate policy, usually only changing rates in response to changes in ECB rates. Danish monetary policy is also unusual since it does not have an outright inflation or unemployment target, but rather aims to control prices and economic growth by binding itself to the Eurozone area. The pegged exchange rate accomplishes this goal without sacrificing sovereignty.

Rates come in two flavors. The real interest rate is the nominal rate minus the expected inflation rate. Depending on the inflation expectations, this rate could be negative. The nominal rate refers to the periodic payments received by the investor relative to either the bond's face value or market price. Usually the nominal rate is not negative, although there are specialty bonds that carry a negative yield or circumstances relating to sudden and immeasurable economic events. Most of the negative rates occur for the same reasons that very low rates exist—fear or uncertainty.

Currency peg in danger

When the Eurozone crisis emerged, risk capital poured out of the region in search of a safer hiding place. Despite the severely over-leveraged consumer and a burst housing bubble, Denmark's government finances were on a relatively more stable footing than the rest of Europe. The Eurozone break-up concerns drove money out of the peripheral countries, while speculation of increasing restrictions to capital flows out of the core EU countries forced money to look for independent European currency-backed assets. The large safety-seeking capital inflows caused excess liquidity in the financial system and an appreciating krone. The Danish central bank sold krone at auction but was not able to weaken the currency. The crucial event that allowed for rates to fall below zero was the ECB's rate decision in July 2012. Earlier in the month, the ECB lowered its deposit facility rate and its fixed term rate by more than forecast, which prompted the Danish central bank to lower its rates to maintain the currency peg. In fact, the Danish central bank lowered its term deposit rate by the same amount as the ECB. However, the Danish rate was already lower than the Eurozone rate, and the rate cut pushed the Danish rate into negative territory. In fact, the Danish central bank had previously made two separate rate cuts earlier in the year, in addition to selling krone in attempts to normalize the peg.

In effect, the central bank was charging banks to park money in its vaults. A deposit rate below zero requires banks to pay to place deposits with the central bank, and this "fee" in turn discourages krone-based assets. By making the central deposit rate less attractive, the central bank was able to suppress capital inflows and weaken the krone against the euro.

The Danish central bank sets three policy rates. The main policy tool is the overnight repo rate, as this is what most financial institutions use. It has been consistently positive. The bank also sets a term deposit rate and a lending rate. The bank lowered the 14-day term deposit rate below zero, which had very important psychological and symbolic value to market participants, but since only a small proportion of the financial system's funds are placed in the term rate products, it had a somewhat muted effect on the markets. The central bank set its 14-day term at -0.2%, while the overnight repo rate was set at +0.2%. Conventional wisdom holds that cash rates below zero would not exist as rational investors would choose to hold currency. However, in times of turmoil, investors accept negative yields as a fee for safety.

The bank maintained the -0.2% rate until January 2013, when it raised it to -0.1% and has maintained it there ever since. The latest ECB rate cut in November 2013 was the first time since 2008 that the Danish central bank did not follow suit in lowering rates. Denmark's deposit rate is at -0.1% compared to zero at the ECB level. Although the central bank has indicated that

there is no lower limit for deposit rates, the nominal lending rates will be kept positive.

Effects on the economy

The largest (unintended) consequence from the negative rate policy has been the declining interest income for banks. Lending has almost disappeared, but we note that Denmark had also gone through a lending and housing boom leading up to 2008 and had consequently seen lethargic lending. Additionally, since the banks are not earning interest on the funds deposited with the central bank, they may increase fees on lending and other activities to make up for lost income. Essentially, the negative rate functions as a tax on banks.

Separately, negative rates work against the ECB's Long Term Refinancing Operation (LTRO) funds. LTRO was instituted to increase liquidity; however, due to a declining set of investment opportunities and stricter credit criteria, banks have been holding the funds as excess liquidity rather than lending out the funds. Below-zero deposit rates mean that banks have to pay to maintain this excess cash and incentivize institutions to repay their excess deposits rather than give up margin to maintain them. Thus, the most direct effect is the decline in bank interest income.

The other key effect of negative rates is the deceleration of velocity of money and decoupling of the deposit and lending rates. The logic goes that a lower interest rate should lower the cost of capital for businesses and households. However, the uncertainty of growth slowed the velocity of money and did not have the desired money multiplier effect on consumption. Before the 2008 crisis, changes in CD rates were almost entirely passed through to the retail side. After the crisis, however, the pass-through effect was substantially severed. One Danish central bank study estimated that the change in rates prior to the 2008 crisis was pass-through 98% for deposit rates offered to households and 92% for corporations. Following the crisis, the central bank estimated that the household deposit rate pass-through effect fell to 50%, while corporations fell to 80%.[1] Thus, the reduction in CD rates only has a marginal effect on lending rates.

It is true that the appreciating currency made the Danish economy less competitive, but that was not the deciding factor behind the decision to lower rates. Sure, the negative rate has helped Danish exporters through the lower currency, but the flip side is the costs to the banking system.

What could the ECB do?

An appreciating currency makes a country's export sector less competitive and generally slows its economic growth. To weaken a currency, a country has three options. First, it can follow Denmark's lead, offering a lower deposit rate to make its domestic currency-based assets less attractive. Second, the country can do what the Fed is trying to move toward—offering extended forward guidance and then signaling a low-rate environment for the long run. Third, it can infinitely expand its balance sheet, selling its own currency and buying up foreign currency. The last option could create inflation, which would also aid a high labor cost region in adjusting its cost.

If the ECB chooses to implement negative rates, it would do so for stimulative purposes. By offering a negative rate, it would weaken its currency. The weaker currency would make the area more competitive on an international scale, absent

[1] Nordea Research, April 30, 2013. http://research.nordeamarkets.com/en/files/negative-rates-April13.pdf

retaliation from other central banks. We note that the Danish rate cut was motivated purely by the currency peg.

Many major central banks have exhausted the tools of conventional monetary policy. Looking at the unconventional policy options, negative rates may prove to be more potent than QE, given its ability to depreciate currency. Specifically, this would greatly benefit the manufacturing and export sector, but it would only work if foreign central banks do not respond with their own currency weakening policies. However, this kind of unconventional policy has never been undertaken for stimulative reasons in a major currency economy.

Before cutting rates below zero, there are still several devices left in the central bank's tool box. Although the ECB's deposit facility rate is zero, the main repo rate stands at 0.25%. The central bank would likely cut the repo rate to zero before moving interest rates below zero, in the absence of a sudden and unexpected recession. Additionally, strengthened and extended forward guidance is another likely option.

Ramifications

The geopolitical consequence to this possible unprecedented move in the second most important global currency could potentially lead to an international currency war. Retaliation could include conventional and unconventional monetary easing, tariff barriers, quotas and other "beggar thy neighbor" policies.

Governments outside of the Eurozone would not be happy with the decision to overtly weaken the euro. Other central banks could engage in either outright or covert currency weakening policies. We expect most nations would, at least initially, resist the efforts to appreciate their currencies.

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