The Days Are Numbered for Negative Policy Rates in Europe

The political costs of the tactic outweigh the benefits.

June 2020

Tomasz Wieladek
International Economist

KEY INSIGHTS

- Despite using many other tools to deal with the coronavirus-led recession, central banks have been reluctant to cut rates further into negative territory.
- This is most likely because we have reached the political reversal rate of negative rates—the point at which the cost of cutting further outweighs the benefits.
- As such, we have likely seen the last of negative rates as a policy tool, for the time being at least.

Faced with the biggest economic shock since World War II, European central banks have deployed their entire toolkits in response to the coronavirus-led recession—with the notable exception of cutting rates further into negative territory. Given that in previous crises central banks have used everything at their disposal to deal with economic downturns, their apparent reluctance to push rates deeper into negative territory this time is a strong signal that we have probably seen the last of this policy for now. This is likely because central banks have hit the reversal rate—the point at which further cuts in the policy rate begin to reverse their intended effect.

The Benefits of Cutting Interest Rates Into Negative Territory

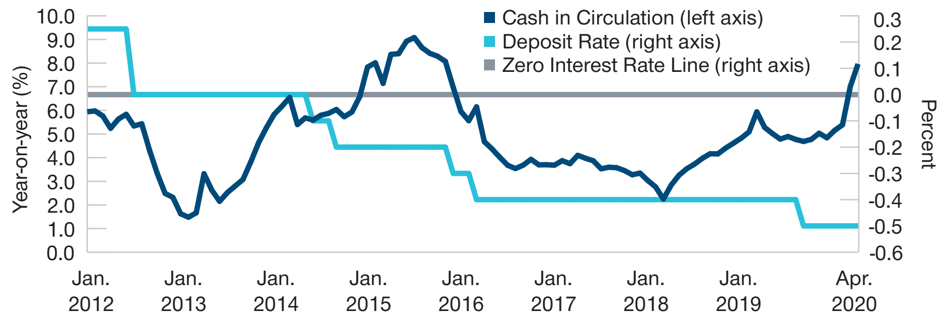
Although cutting the central bank policy rate below zero is probably not as powerful as cutting interest rates from positive territory toward zero, it is still likely to have an impact. It affects the macroeconomy in three main ways: first, because a negative deposit rate means that commercial banks are charged to hold deposits at the central bank, providing a strong incentive to cut lending rates and support credit expansion; second, because negative rates can be used to defend against currency appreciation; and third, because if the policy rate is expected to remain in negative territory for some time, rates fall across the yield curve—decreasing the cost of government and market-based private sector finance.

On the flipside, the main risk of deploying negative rates is hitting the reversal rate, where the costs of cutting rates begin to outweigh the benefits. Although there is no precise measure of the reversal rate, it is generally agreed that it can take three forms: economic, financial, and political. Here, I assess whether the reversal rate has been reached in any of these forms.

> ...European central banks have deployed their entire toolkits... with the notable exception of cutting rates further...

No Evidence That Economic Reversal Rate Has Been Hit

(Fig. 1) Money demand has not risen significantly since 2014



As of April 30, 2020.
Source: European Central Bank/Haver Analytics.

The Three Types of Reversal Rate

The economic reversal rate is the point at which households/firms start to withdraw their money from bank accounts and hold it in cash, which pays an interest rate of zero. Customers will likely pay a very small fee for storing their savings in a secure location as it is difficult to stash lots of cash under the mattress, but if that fee begins to rise, they may reconsider. The use of cash grew when the European Central Bank (ECB) first moved rates into negative territory in 2014, but this may well have reflected the beginning of the ECB's asset purchases, which were financed by a large expansion of the money supply. There is currently no evidence, neither in theory nor practice, that the economic reversal rate has been reached in the eurozone.

The second reversal rate central banks worry about is the financial system reversal rate. Normally, lower central bank policy rates lead to lower deposit rates, which in turn allow banks to lower lending rates as well. However, if a bank cannot pass on a negative rate to customers directly, because charging retail depositors appears controversial, an alternative way to maintain profits is to raise the lending rate. When banks raise lending rates to maintain profitability, the financial system reversal rate has been hit.

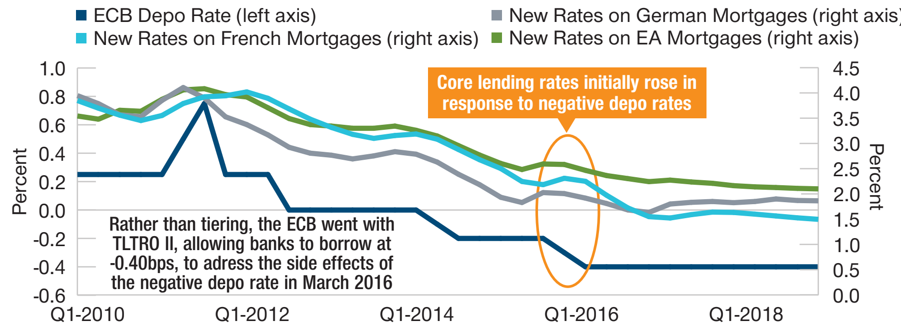
This likely happened when the ECB lowered the deposit rate to -0.40 basis points in March 2016. To mitigate this, the ECB introduced the targeted longer-term refinancing operations (TLTROs) in 2016, then the two-tier remuneration system in September 2019. These tools will likely prevent the financial system refinancing rate from being hit this time around.

The political reversal rate—the point at which the political cost of cutting rates outweighs the benefits—is less widely recognized and discussed than the economic and financial reversal rates, but it should also be considered. Monetary policy always has a redistributive element from savers to borrowers since this is partly how monetary policy works; however, it is plausible that pushing rates into negative territory will have greater political implications than reducing policy rates to zero. Negative interest rates are a challenge to the idea that savings should be rewarded, especially in countries where saving is a strong cultural trait. The fact that Alternative für Deutschland, currently the largest opposition party in the German parliament, was founded with the idea of a German euro exit suggests a degree of political resistance against ECB policies—as does the fact that the German term "strafzinsen" ("penalty interest rate") surged in terms

> If passed on to retail depositors, negative interest rates function like a tax.

Lending Rates Have Not Spiked Since 2016

(Fig. 2) ECB measures have reduced risk of hitting financial reversal rate



As of April 30, 2020.
Depo Rate = deposit rate.
Sources: ECB Statistical Warehouse and T. Rowe Price.

of Google searches in 2019, when it was expected that the ECB would cut the deposit rate further into negative territory.

If passed on to retail depositors, negative interest rates function like a tax. As such, it may be argued that negative rates are effectively a form of fiscal policy and, therefore, should be decided by elected representatives rather than independent central banks, in line with the historical slogan "No taxation without representation." Indeed, the German Federal Constitutional Court's ruling that the ECB's bond-buying program partly violates the German constitution clearly indicates that such concerns are not purely academic. Cutting policy rates too deep into negative territory may leave commercial banks no choice but to pass them on to retail depositors. This could eventually raise legal risks, which central banks would likely want to avoid.

Non-Policy Negative Rates Remain Possible

I believe that we have reached the end of the road for negative policy rates in Europe because the political costs of additional cuts could outweigh the benefits—in other words, because the political reversal rate has been hit. Monetary policymakers must always balance the costs and benefits of each tool at their disposal—a rational central bank will typically choose the instrument that has the greatest impact and, ideally, the least cost. Today, quantitative easing very likely provides a better cost/benefit relationship and a greater overall effect on the macroeconomy than negative interest rates.

However, while negative policy rates are unlikely, it is possible that central banks will resort to subsidies to support commercial bank lending operations. Such subsidies would take the form of greater negative rates on funding facilities at the central bank—in other words, the commercial bank would have to pay back less than they borrowed. This type of negative rate is a possibility going forward, especially because it does not come with the political costs of moving policy rates into negative territory. Indeed, this is exactly what the ECB did at the April 2020 meeting of its governing council when it lowered the rate on TLTROs from -0.5% to -1% without touching the policy rate.

The Market Implications of the End of Negative Rates

The central bank policy rate is the anchor of the risk-free government bond yield curve. While financial markets continue to price negative rate cuts, our analysis suggests they are unlikely. Historically, when long-term bond yields have rallied to yields lower than the policy rate, this indicated the onset of a recession and a cutting cycle.

As the recession slowly recedes from view, our analysis suggests that there are limits in the degree to which risk-free core bond yields can rally beyond current policy rates.

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—T. Rowe Price International Ltd ("TRPIL") is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (FSP Licence Number 31935), authorised to provide "intermediary services" to South African investors.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2020 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc.

ID0003364 (06/2020)
202006-1204894