Federal Financial Analytics, Inc.

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When Depositors Pay Banks and Banks Pay Borrowers: New Report Analyzes the Financial-Stability Risk of Negative Interest Rates

Federal Financial Analytics finds that ultra-low rates pose significant systemic risk that could be especially vulnerable in current, fragile market conditions – sudden shock to new credit, funding flows into physical cash/virtual currency, MMF disruption, panic yield-chasing

WASHINGTON, DC, September 8, 2015 - A new report today lays out what would happen if the Federal Reserve is forced to go below the zero-lower bound (ZLB) in nominal interest rates by slow growth or market stress. Federal Financial Analytics, Inc. (FedFin) makes it clear that the Federal Reserve devoutly hopes policy actions that force nominal rates below the ZLB are a last-ditch action, but market turmoil and the looming U.S. fiscal-policy crisis make below-ZLB rates all too possible. If the FRB allows rates to fall below the ZLB, pushes them there, or is powerless to stop it, then severe financial-market stress is virtually assured, the FedFin report concludes.

"The Federal Reserve has no ammunition left with which to handle crises or promote growth. We are already in a market struggling with negative real rates," said FedFin managing partner Karen Shaw Petrou. "We all know this in the rates we get from banks and those we are charged for high-quality loans," she continued. "What happens if negative rates are no longer real, but also nominal – that is, when we have to pay banks to safeguard our money and – at least in theory – banks pay us to borrow? No one knows because it's never happened here before, but the consequences are grave and warrant immediate, careful central-bank consideration and urgent protective action by financial-services firms and their customers."

Key points in the new FedFin study include:

- Rates below the ZLB are not hypothetical because key policy-makers are considering them given the inability of the Federal Reserve to drop rates from current levels or acquire still more assets in any QE4 exercise.
- Negative rates could lead to a sudden reversal in the fundamental structure of financial intermediation (which would have far-reaching economic impact even if only short-lived). Bankers are unlikely to make new loans if they must pay borrowers to take them, with any sudden drop in credit availability undermining economic recovery. Depositors forced to pay banks to safeguard funds could shift them to physical cash (leading to risk of loss or theft) or the uncertain status of virtual currencies. Panic buying of real property would prove destabilizing.
- Banks now hold $2.5 trillion in excess reserves at the Federal Reserve. A drop in the interest paid on them would send shock waves through U.S. banks, especially if negative rates create few safe-haven alternative assets and new funds cannot be lent out for productive purposes due to negative rates.
- Capital markets are ill-prepared for negative rates because the cost of borrowing and that of assets are turned upside down. Many market-risk models do not anticipate this, meaning that capital may not be deployed for unprecedented stress.
- Yield-chasing incentives – already a source of severe systemic risk due to negative real rates – would become still more frantic if markets are forced to reckon with nominal negativity that immediately drives net interest margins and related profitability measurement.

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