

Believe it or not!

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This is not from Ripley's world of "Believe it or Not", but from the economic world!

Would you believe there are five central banks (Bank of Japan, European Central Bank (ECB) for the 19 member strong Eurozone, Denmark's Nationalbanken, Swiss National Bank, and Sweden's Riksbank) with a negative interest rate policy (NIRP)?

Would you believe Saudi Arabia (the largest exporter of oil with 16% share of the world's oil reserves and leader of the Organization of Petroleum Exporting Countries), having been downgraded by credit rating agencies with "a negative outlook", might seek a loan from IMF?

Students of money and banking know that central banks under the fixed exchange rate regime, including those of Fiji, Samoa, the Solomon Islands, Tonga and Vanuatu have twin objectives. These are internal and external stability: inflation not exceeding 3% to 3.5%; and comfortable levels of reserves equivalent to imports of four to five months for defending their respective exchange rates.

Those under flexible exchange rate regimes, especially advanced countries, have only one objective: inflation target of 2% per annum, as exchange rate flexibility automatically corrects balance of payments disequilibrium. Of course there are exceptions, such as Papua New Guinea (PNG) in our region, which do not like exchange rate depreciating. Towards fixing the desired exchange rate, the central bank of PNG intervenes in the foreign exchange market through buying the domestic currency and selling foreign currency. Of course, the degree of success of intervention of intervention depends on the availability foreign reserves.

Recession

In all advanced countries, notably in Eurozone, Japan, and UK, it is recession time: low inflation and low interest rate; some time zero inflation!

In a deflationary economy, no investors would be willing to invest. Banks would not be interested in lending in an economy with falling prices, as they are not certain whether they will get their loans ever repaid.

Since these countries are so afraid of Keynesian remedies of expansionary fiscal policies and budget deficits, they embraced monetarism: that is, money is the primary determinant of gross domestic product. Ever since 2008, which witnessed the collapse of Lehman Brothers, central banks began pumping in money, through unorthodox measures ranging from buying bad debts to large scale quantitative easing (QE) programmes. These led to fall in interest rates (with policy rate of major central banks at zero percent), encouraging investment in bonds and securities. Not in real physical investment: because of continuously falling prices: deflation!

One unconventional policy to another

If a lender charges a borrower a positive interest rate for a loan, it means the borrower has to pay interest charge to him after one year. If the interest rate is only zero percent, it is an interest free loan. On the other hand, if the lender has a negative interest rate, it is the lender who has to incur the charge, and the borrower gains.

If a central bank accepts deposits from banks for keeping their excess reserves, and gives a positive interest rate on such deposits, that is a gain for banks; if it levies a negative interest rate, the banks have to make the payment to central bank for keeping their deposits.

That is the lender is now paying the borrowers!

That is what Andrew Walker of BBC would call this bizarre world of negative interest rates as “Alice in Financial Wonderland.”

For example, under the National Disaster Rehab Facility, RBF provides refinancing at 0.5% to banks for providing Winston Cyclone affected people housing loans up to F\$5,000 and the interest rate to be charged is 4.5%. Suppose the central bank has a minus 0.5% interest rate, the interest rate charged by banks for housing loans has to be 4%. That is, banks would pass on the gain to the borrower seeking a housing loan.

The whole idea behind NIRP is to make banks lend more by reducing interest rate and pass on the gains to borrowers and encourage more lending by banks.

Denmark’s central bank, known as Nationalbanken was the first to go negative to defend its long term peg with the euro. Its objective was to weaken its currency, the kroner against the euro, as the latter was getting weaker since ECB adopted a lower interest rate for fighting recession. Denmark experienced capital inflows from the Eurozone. There was no other way to stem the inflows.

However, the ECB was the first major bank in the world to start with NIRP in 2014. It began to charge banks minus 0.1% for parking their funds. The latest rate is now minus 0.4%.

Will NIRP encourage more lending?

That is doubtful.

It is the profitability of lending that matters for banks. If banks were to pass on the NIRP to borrowers, the profitability margin would gradually decline. They would then prefer to sit on liquidity. The savers, as lenders to banks, would also hesitate since deposit rates would come down. They will have to sit on cash!

So the picture is not encouraging.

However, it is strongly believed that NIRP would work through asset prices. One asset is foreign exchange. The price of foreign exchange, as domestic interest rate relative to those of other countries would decline, would also go down. A depreciating currency would make the country's exports more attractive. Exports would begin to increase. Further, a depreciating currency would make imports more expensive and inflation would rise.

That is what the economies suffering from falling price levels, want: they want the price level to pick up any way and increase.

A good argument indeed! But, it has not worked in the case of Japan. Japan, which has a negative interest rate of 1% has been experiencing an increase in the value of yen. Instead of yen outflows, there is an inflow. Yen touched new highs! Japan is a safe haven for currencies under stress elsewhere. The China slowdown is one cause.

Growing skepticism

The initial enthusiasm for NIRP seems to have evaporated.

The central bank governors gathering in Washington, D.C for the IMF's annual Spring Meeting will have to do some thinking. There is a limit to monetarism. The governors would prefer governments to play a greater role: expansionary fiscal policies and implement structural reforms.

How about the second, "Believe it or not story: IMF Loan for Saudi Arabia?"
That is for next week.

Stay tuned!

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