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Negative rates

A bridge too far for the Fed?

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Contents

Summary

- While the Fed's preference against negative policy rates has remained unchanged since the Global Financial Crisis, the central bank's main rationale has shifted from avoiding damage to money market mutual funds (during the Global Financial Crisis) to avoiding damage to bank profitability and lending (during the Covid-crisis). However, the obstacles do not seem insurmountable, so negative policy rates remain a possibility for the Fed, although they are likely to try other options before resorting to negative rates.
- There is still room for additional asset purchases, reinforced forward guidance and extending the special lending facilities. And during the October 2019 discussion of the FOMC it seemed that the Committee would rather start some kind of yield curve control than resorting to negative policy rates. Therefore, given our current economic outlook, we stick to forecasting Fed policy rates at the zero lower bound in the coming years.
- Nevertheless, if the current toolkit is no longer sufficient, and preferred options such as yield curve control fail to do the job, the obstacles to negative policy rates do not appear insurmountable. By then the unanimous rejection of negative rates by the FOMC participants could falter. What's more, if President Trump is re-elected, he could nominate a new Fed Chair who would be willing to lead the US into negative policy rate territory in 2022.

Introduction

Last week, on Thursday, the implied rate from federal funds futures turned negative at longer horizons. Since the Fed has repeated stated that negative policy rates were a bridge too far, it needed to make this point clear again to the markets. Indeed, several FOMC participants publicly spoke out against negative rates. Then on Wednesday this week, Fed Chairman Powell made an appearance for the Peterson Institute for International Economics . In his prepared speech he did not mention negative rates specifically, but in the discussion with Adam Posen after the speech, Powell said that the Committee's view on negative rates had not changed and 'this is not something that we are looking at.' Powell stressed the (rare) unanimity of the FOMC on negative rates during the October 2019 meeting when this topic was discussed. The two reasons for not going into negative territory he gave were that the current tools – forward guidance, asset purchases and special lending facilities – work and that the evidence on the effectiveness of negative rates was mixed. He said that the issue really is the concern over interrupting the intermediation process: it could reduce bank profitability and thereby the availability of credit to the economy. So as widely expected, the Fed Chairman pushed back against increasing speculation on negative policy rates in the US.

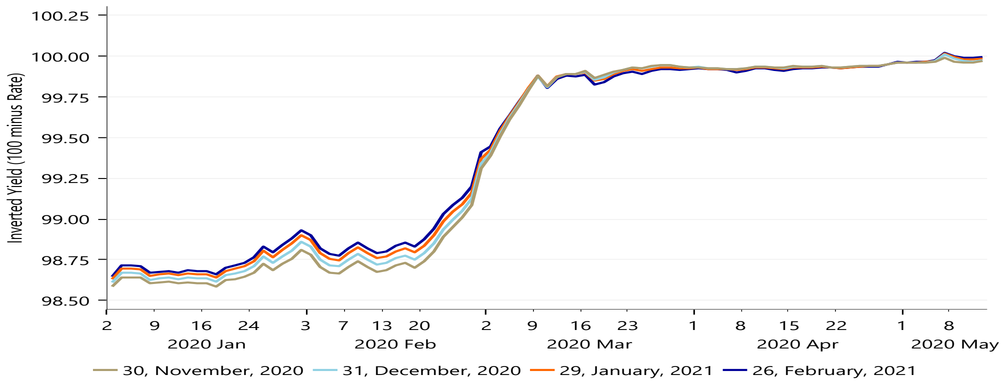
In this special we take a closer look at the relationship between negative implied rates and market expectations of negative policy rates, the Fed's view of negative rates and how it is developing, the communication challenge for the Fed, and the possibilities for President Trump to get negative policy rates higher on the Fed's agenda.

Do implied rates reflect market expectations? And does it matter?

The first question we should ask ourselves is whether negative implied rates (Figure 1) really reflect market expectations of negative policy rates. After all, this is the assumption that is often implicitly made. However, with the effective federal funds rate close to zero (Figure 2), it only takes a small negative term premium or a minor pricing dislocation to push the implied policy rate into negative territory. So in the current circumstances, a slightly negative implied rate does not necessarily mean that markets expect the Fed to resort to a negative policy rate.

The second question is: does it matter if negative implied rates reflect market expectations of negative policy rates or not? Well, actually for the Fed it does not. In the absence of a widely accepted model that would correct for term premia and a range of possible pricing dislocations, the possibility that markets are expecting negative policy rates if the implied rate is negative cannot be ruled out. And this then forces the Fed to forcefully dispel the notion of going into negative territory, as we have seen in recent days. We will return to this topic when we discuss the Fed's communication challenge, but now we turn to the Fed's aversion to negative rates.

Figure 1: CBOT federal funds future 30-day



Source: Macrobond

Fed's view on negative rates: same preferences, but shifting rationales

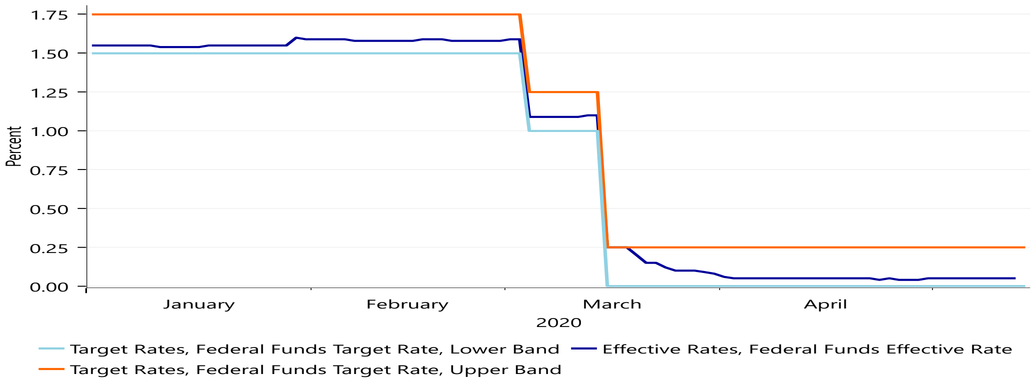
When we think back of the previous crisis, it is important to note that the Fed crossed many lines during the Global Financial Crisis (GFC), but never brought its policy rates into negative territory. This shows the Fed's aversion to taking its policy rates subzero. When the Fed staff considered negative rates in 2010, besides legal and operational obstacles, its main concern was the impact of negative policy rates on money market mutual funds. At the time, US money market mutual funds guaranteed their investors that they could always withdraw the full amount they had invested. If not, the fund was 'breaking the buck,' and this could lead to massive withdrawals from other funds as well, similar to a bank run. In 2010, the Fed staff was concerned that with negative short-term interest rates money market mutual funds were likely to break the buck or shut down. Money market mutual funds play an important role in the US financial ecosystem, providing short-term funding for banks and corporates, as we found out recently when the CP markets froze up. A collapse of these funds would be highly disruptive to the financial system. So the Fed never took policy rates into negative territory.

It is clear from Powell's remarks that the Fed is still reluctant to consider negative policy rates. However, it seems the rationale has shifted from avoiding damage to money market mutual funds (during the GFC) to avoiding damage to bank profitability and lending (during the Covid-crisis).

This may reflect money market reform which has reduced the 'breaking the buck' problem to a smaller segment of money market mutual funds. Since the 2016, money market mutual funds are required by the SEC to display floating net asset values instead of a constant net asset value of $1.00 per share, which implies that they are no longer promising not to break the buck. In other words, investors know in advance that these funds no longer give the guarantee that investors can take out each dollar they put in the fund at any time. This means that the Fed's fear of money market mutual funds of breaking the buck has been mitigated. However, it has not disappeared completely, because the SEC's requirement does not apply to government MMFs (money market mutual funds that consist mostly of government securities or cash) and prime funds focused on retail investors.

The Fed's concern for bank profitability stems from the idea that banks cannot pass on the negative rates (they would pay) on reserves at the Fed to their clients. This would make it then difficult for banks to obtain funding, let alone lend to households and businesses. Thus in order to obtain funding banks would bear the costs themselves, and bank profits would be squeezed. In turn, this would also undermine bank lending to the economy. However, while it may be difficult for a bank to let retail clients pay for depositing money at the bank, in practice most US bank funding comes from wholesale clients, who would rather pay a fee than holding currency. So this problem does not appear to be insurmountable, so we cannot rule out completely that the Fed will at some point in the future take policy rates into negative territory. However, it is clear from the Fed's current objections that they are likely to exhaust all other options before going negative.

Figure 2: Effective federal funds rate



Source: Macrobond

Communication challenge for the Fed

Independent of whether negative implied rates from fed funds futures (or other instruments) reflect market expectations, a negative term premium or pricing dislocations, it will force the Fed to come out more strongly against negative policy rates. Even if negative implied rates were caused by other factors than market expectations, they would reinforce expectations of negative rates. Especially, if the Fed would not come out forcefully against the prospect of negative policy rates at a time of negative implied rates.

In fact, in several minutes of the FOMC it has become clear that they are concerned about market expectations of negative policy rates. For example, we earlier highlighted that the most recent minutes, of the meeting on March 15, mention that 'A few participants also remarked that lowering the target range to the ELB (=effective lower bound) could increase the likelihood that some market interest rates turn negative, or foster investor expectations of negative policy rates.

Such expectations would run counter to participants' previously expressed views that they would prefer to use other monetary policy tools to provide further accommodation at the ELB.'

The reference to earlier expressed views could reflect the FOMC meeting of October last year when the Fed staff[1] gave a briefing on negative rates and as we highlighted at the time the minutes showed that 'All participants judged that negative interest rates currently did not appear to be an attractive monetary policy tool in the United States.' The FOMC participants thought that the evidence on the beneficial effects of negative policy rates abroad was mixed, and that is was unclear what effect they might have on the willingness of financial intermediaries to lend and on the spending plans of households and businesses. Participants noted that negative interest rates would entail risks of introducing 'significant complexity or distortions' to the financial system. In particular, some participants cautioned that the financial system in the US is considerably different than in those other countries and negative rates could have more significant adverse effects on market functioning and financial stability than abroad. However, we also highlighted at the time that participants did not rule out the possibility that circumstances could arise in which it might be appropriate to reassess the potential role of negative interest rates as a policy tool.

More recently, in his testimony to Congress on February 11, Fed Chairman Powell said that 'When you have negative rates, you wind up creating downward pressure on bank profitability, which limits credit expansion.' On Wednesday, at the Peterson Institute webinar, he repeated this key point.

A Gift for Trump

On Wednesday, President Trump called Jerome Powell his 'most improved player' when he talked to reporters during a meeting with the governors of Colorado and North Dakota. However, Trump also said that he is still at odds with Powell over his stance on negative interest rates. In fact, on Tuesday, President Trump tweeted: 'As long as other countries are receiving the benefits of Negative Rates, the USA should also accept the "GIFT". Big numbers!'

With the current FOMC evidently averse to negative rates, this is not likely to spur the Fed into negative rate action. In fact, doing that now would look like succumbing to pressure from the White House, an impression that the Fed wants to avoid. However, if Trump is re-elected in November he would have the opportunity for a more effective campaign for negative policy rates by 2022. On February 5, 2022, Powell's four year term as Chairman of the Fed expires. This would be President Trump's chance to get a new Chairman appointed[2] who would be willing to take the Fed into negative territory. Of course, the Chairman would have to persuade the FOMC -which at present is unanimously against negative rates -, but it would certainly create a new dynamic if the Chairman were pushing for negative rates. What's more, by then the current toolkit may turn out to be insufficient and so may the Fed's preferred options such as yield curve control. But this would require an economic slump that is worse than we are currently forecasting.

In the meantime, there are still two vacancies at the Board of Governors, which should have 7 members but now only has 5. Note that with a new Chairman – and assuming that Powell will voluntarily give up his Board seat if not reappointed as Chairman, as is the practice – 3 out of 7 members of the Board could be selected on negative rates. However, Trump nominees Judy Shelton and Christopher Waller have already indicated that they are averse to negative rates. This

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[1] The Fed staff noted that although the evidence abroad so far suggested that negative rates had provided accommodation in those countries, there were also indications of adverse side effects. Moreover, the US financial system is very different and therefore the foreign experience may not be a useful guide for the US.

[2] Of course, the Senate would have to approve the appointment, but by then negative rates may have become less controversial than now if the economy is still in a slump.

fits with Trump's general pattern to come up with nominees for the Fed that do not share his preferences on monetary policy. Perhaps with the next Fed Chair he could break this pattern.

Conclusion

While the Fed's preference against negative policy rates has remained unchanged since the GFC, the central bank's rationale has shifted from avoiding damage to money market mutual funds to avoiding damage to banks. However, the obstacles do not seem insurmountable, so negative policy rates remain a possibility for the Fed, although they are likely to try other options before resorting to negative rates. There is still room for additional asset purchases, reinforced forward guidance and extending the special lending facilities. And during the October 2019 discussion of the FOMC it seemed that the Committee would rather start some kind of yield curve control rather than resorting to negative policy rates. Therefore, given our current economic outlook, we stick to forecasting Fed policy rates at the zero lower bound in the coming years.

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Table 1: Rabobank forecast of federal funds rate path

FOMC meeting	*Decision*	*Target range for the federal funds rate (%)*
29 Jan 2020		1.50-1.75
2 Mar 2020 (Emergency meeting)	50 bps cut	1.00-1.25
15 Mar 2020 (Emergency meeting)	100 bps cut	0.00-0.25
23 Mar 2020 (Notation vote)		0.00-0.25
31 Mar 2020 (Notation vote)		0.00-0.25
29 Apr 2020		0.00-0.25
10 June 2020		0.00-0.25
29 July 2020		0.00-0.25
16 Sept 2020		0.00-0.25
5 Nov 2020		0.00-0.25
16 Dec 2020		0.00-0.25

Source: Rabobank

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