Macro Theme

Central Banks: Giving up on negative rates?

Nordea Markets - Analysts
Torbjörn Isaksson, Chief Analyst
+46 8 407 91 01
torbjorn.isaksson@nordea.com

Inge Klaver, Analyst
+46 720848268
inge.klaver@nordea.com

Jan Størup Nielsen, Chief Analyst
+45 5 547 15 40
jan.storup.nielsen@nordea.com

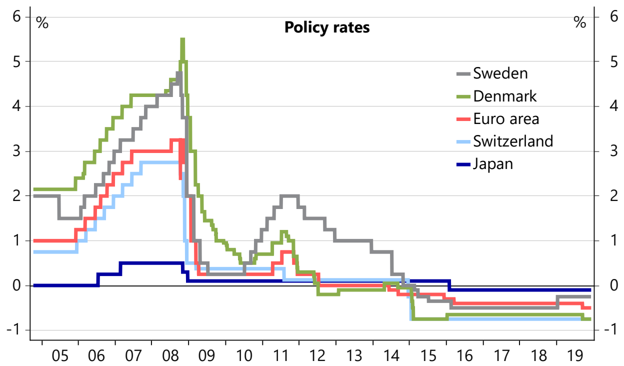
A prolonged period of slow growth and subdued inflation has led several central banks to implement seemingly extraordinary policy measures, including negative rates. As the Nordic countries (except for Norway) have been at the forefront of this regime, we use the region as a case study on negative rates to decide whether the below-zero regime is in its final act or if it will remain in the central banks' toolboxes.

Negative rates have spread across Europe, with Denmark as the frontrunner taking its policy rate below zero back in 2012, followed by the euro area in 2014, and Sweden and Switzerland in 2015. Initially, negative policy rates were seen as a temporary instrument for handling an extraordinary situation. However, the lower and the longer negative interest rates are in place, the more likely it is that they will create unwarranted effects – effects that could ultimately run counter to the reason for introducing them in the first place.

The first clear example of a central bank giving up on negative interest rates is Sweden, where the Riksbank has recently signalled it is exiting negative rates with a hike from -0.25% to 0% scheduled in December. It is still rather unclear why the Riksbank has decided to move out of negative territory now, when there is muted price pressure and slowing growth. Presumably, the reason is concerns about the unintended effects of negative rates on the economy.

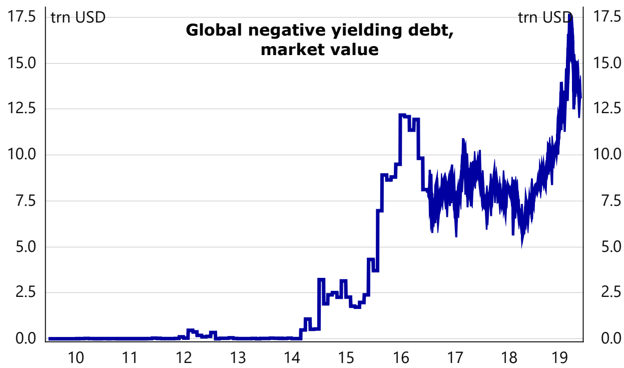
On the other hand, the ECB's most recent action, in September, was a rate cut – so for some the bottom has not yet been reached. As a consequence of the Danish fixed exchange rate regime, this prompted the Danish central bank to lower the deposit rate to a record low of -0.75%, thereby sending a clear signal that negative interest rates have become the new normal. The Swiss National Bank has called negative rates "essential" to its economy. So, have central banks drawn different conclusions from their experiences with negative rates, or is the Swedish canary once again signalling a shift in attitudes to negative rates?

POLICY RATES LOWER THAN EVER



Source: Macrobond and Nordea

NEGATIVE YIELDING UNIVERSE HAS EXPANDED STRONGLY



Source: Barclays Global Aggregate Negative Yielding Debt Index

Conclusions

Winds of change are blowing in the world of central banks, but so far it feels more like a breeze than a storm.

Small but important steps

Inflation targeting as we have known it for the past 25 years is under pressure. We note a transition towards increased flexibility, a less strict focus on inflation, and a reduced propensity to use negative policy rates, however, this is indeed a gradual change. Much suggests that policy rates below zero will remain for some time.

A wake-up call

The sharp drop in interest rates over the summer, when for instance the German ten-year government bond yield dropped to an all-time low of -0.7%, was a wake-up call, as it underlined prospects of very low interest rates for the foreseeable future. The drop has increased concerns about the adverse effects of negative rates and prompted regulators to speed up reforms to adapt the financial system to the "new normal". There are concerns that the regulatory framework is not fully reflecting the risks associated with very low interest rates. Prolonged low interest rates could lead to solvency issues for pension funds and insurance companies and to a greater risk for pro-cyclical behaviour during periods of greater uncertainty in the financial markets.

Increased concerns over adverse effects

We also note increased worries that the low interest rates have led to greater risk-taking. For example, actors are investing more in more illiquid assets such as corporate bonds with lower credit ratings and other alternative investments. The increased risk-taking has contributed to upward pressure on prices of financial assets as well as homes and real estate. Households and companies have in many countries increased their debt. The low rates and flat yield curves are also weighing on bank's profitability.

Moreover, it is increasingly questioned by central bankers and commentators whether the response to sticky below-target inflation should be even lower policy rates or other expansionary monetary policy measures. The general view about monetary policy is no doubt more split and the debate is now more diversified than it was just a couple a years ago.

The outlook differs between regions and countries

The outlook differs between regions and countries. The ECB has recently cut the repo rate deeper into negative territory, and we find it more likely that the policy rate will be lowered rather than raised in the near term. This spills over to Denmark and fixed exchange rates regimes, where policy rates are entirely an instrument to keep exchange rates in check. In Denmark, measures are being taken to prepare for a negative interest rate for an extended period. The same goes for Switzerland, which in order to fight a strengthening exchange rate has mirrored decisions from the ECB. Japan seems to be stuck at the negative level and is designing measures to relieve financial institutions. On the other hand, Fed officials have stated that negative policy rates are not on the US agenda, but the next downturn will likely put this to the test.

The Riksbank plans to lift the repo rate to zero for what seems to be more technical reasons

In Sweden, the Riksbank plans to lift the repo rate to zero for what seems to be more technical reasons rather than being warranted by inflation and growth outlooks. The bank will lift rates despite the fact that transmission mechanisms have largely worked when the repo rate was lowered below zero. The expansionary monetary policy stance has had an impact on the economy, but there are question marks about how much it has boosted core inflation. Perhaps insights regarding the difficulties in controlling inflation contributed to the Riksbank's plans to hike rates. Thus, negative policy rates and an extensive quantitative easing programme were simply not enough to stabilise core inflation at the 2% target.

Instead, concerns over adverse effects of the low interest rates seem to have become more important for the Riksbank. The Riksbank has for long expressed worries about the housing market, but for the first time it is also citing other risks related to negative rates. The bank does not present any details regarding these concerns, though. Additional reasons for the Riksbank's reversal may be risks for the SEK depreciating too much. The Riksbank does not have a tiering system for policy rates, which means that Swedish banks are more exposed to negative rates than other countries. Banks have nevertheless been relatively profitable, so far. The Riksbank's recent signals indicate that negative rates were just a temporary measure, not meant to last for ever.

In Denmark, macro-prudential measures have been implemented to curb the effects of very low rates

In Denmark, the negative policy rate at the central bank is very much an external condition set by the fixed exchange rate regime and solid economic balances. The negative rates are widespread and have caused numerous spillover effects for banks and the housing market, but these effects have have been less straightforward than in Sweden. One reason for this is the fact that macro-prudential measures have been implemented to curb the effects of very low rates and, more importantly, to adapt the economy to the new normal of very low interest rates.

The ECB is increasingly mindful of side effects, and the bar for more cuts is high

In the Euro area, the debate about the side effects of negative rates is growing. For now, the conclusion is still that the monetary policy stance supports economic activity sufficiently to outweigh the costs. Given the recent turnaround in Sweden, however, we see a risk that the assessment of the costs and benefits will give a different outcome after some time, and we believe the bar for further easing is high. The heterogeneity in effects across countries complicates this assessment. The upcoming strategic review of the monetary policy framework against the background of the current environment of low real interest rates and low inflation could provide the ECB with more room to manoeuvre in the future.

The Swedish experience

Sweden was among the first countries to go below zero for deposit rates; now it is starting to backpedal.

Opening up the throttle in 2015-17

Rate cuts to -0.50%

After being on hold at 1.0% for most of 2013, the Riksbank started an easing cycle in December of that year. In February 2015, the Riksbank took a first, small step and cut the repo rate below zero to -0.10%. Three further rate cuts followed. The last easing move came in February 2016, when a split Executive Board reduced the repo rate to -0.50% (one of six board members entered a reservation and advocated for an unchanged policy rate).

The lowering of the repo rate was accompanied by the introduction of a quantitative easing programme. The Riksbank's balance sheet increased by SEK 350bn from 2014 to year-end 2016, or 45% of the government's nominal bonds and 7% of GDP. Thus, it is difficult to isolate the main driver, but interest rates facing households and companies to a large extent followed the repo rate down in 2015, in line with the historical pattern. In more detail, though, it can be noted that the last rate cut by 15bp to -0.50% in February 2016 was somewhat different as 3-month mortgage rates remained stable, raising question marks about transmission mechanisms if interest rates are cut below -0.50%. Moreover, interest rates for household's deposits have remained at zero.

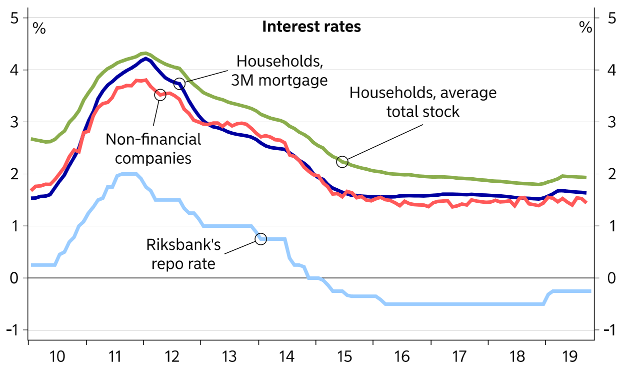
Mortgage rates with longer maturities declined more gradually than shorter maturities. As a consequence, the share of adjustable mortgage rates increased by 20 pp to 70% of the stock, reinforcing the effects of the reduction in the policy rate.

Monetary easing feeding through to the economy

The monetary easing and drop in interest rates had an impact on the economy. Home prices rose by 10% per year 2015-2017 (HOX/Valueguard) and households' credit growth geared up. The net growth in household debt doubled to SEK 20bn per month, or to around 0.4% of GDP per month. Household consumption and housing starts were already on a strong upward trend, which was further fuelled by the accommodative monetary policy stance.

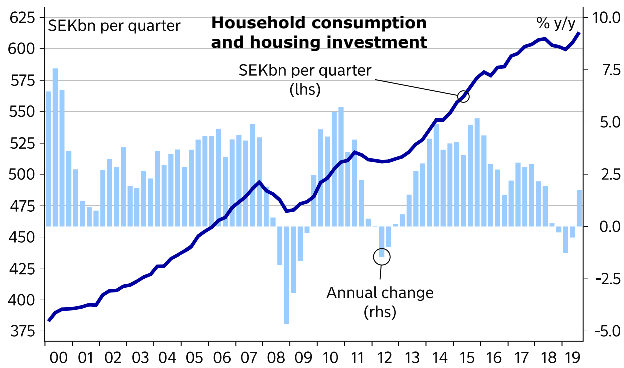
Non-financial companies' credit growth rose too. However, the picture is mixed. While growth for banks' loans to companies geared down, companies' financing in the bond market took off as bonds offer longer maturities and financing risks are more diversified. Fixed investment growth accelerated on the back of healthy global growth and the swift rise in domestic demand, but likely also underpinned by the record low financing costs.

RIKSBANK'S RATE CUTS HAVE LARGELY FED THROUGH



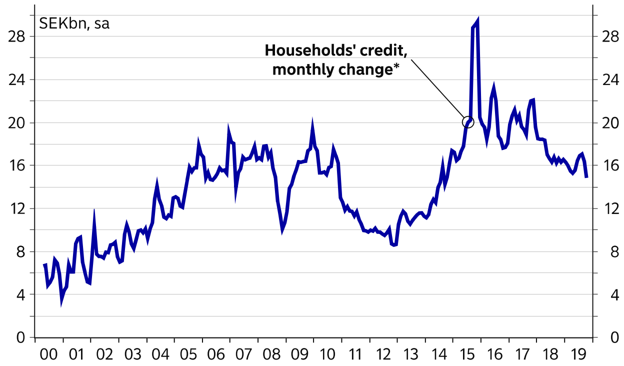
Source: Macrobond and Nordea

CONSUMPTION AND HOUSING ROSE SWIFTLY 2014-17



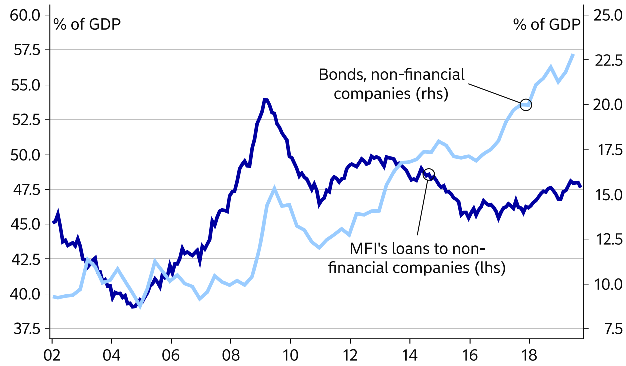
Source: Nordea Markets and Macrobond

HOUSEHOLDS' CREDIT GROWTH TOOK OFF 2014 AND 2015



Source: Nordea Markets and Macrobond

RISING DEBT ALSO IN THE BUSINESS SECTOR



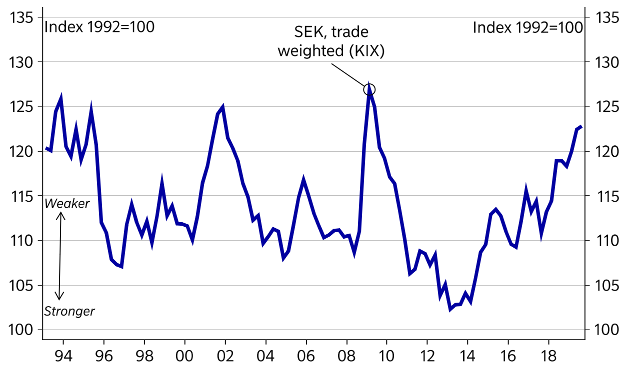
Source: Macrobond and Nordea

The SEK a key to control inflation.

An important effect of the monetary policy easing was the sharp depreciation of the exchange rate. In fact, the SEK, which had appreciated since 2010, was a target for the Riksbank's monetary easing. In March 2015, the Riksbank made an unusual move and cut rates by 0.15 pp to -0.25% and expanded the QE programme between scheduled monetary policy meetings. Taking action between policy meetings is very unusual and has only happened once before since the inflation target was introduced in the mid-1990s, and that was in the midst of the financial crisis in 2008. The QE programme was also introduced in order to balance the ECB's measures and to keep the SEK in check, and not to fix any dysfunctional transmission mechanisms.

During 2015 and up to and including December 2018, the exchange rate continued to be important for the Riksbank. Despite the fact that the exchange rate was on a depreciating trend, the bank repeatedly said that the SEK may not appreciate too rapidly as it may threaten to reduce inflation. elatively strong growth and robust public finances pointed to a stronger SEK, but the trade-weighted exchange rate weakened by 16% from the beginning of 2014 to year-end 2018 mainly due to the Riksbank's expansionary monetary policy.

WEAKER EXCHANGE RATE



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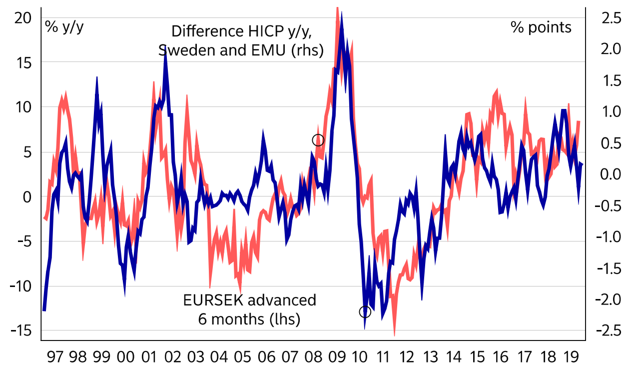
THE SEK EXPLAINS SOME OF THE INFLATION DEVIATIONS



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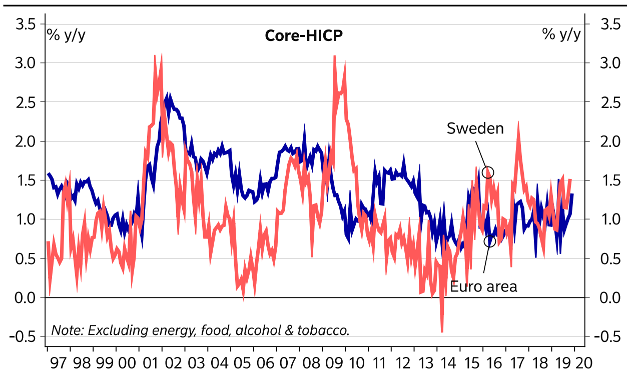
SWEDISH INFLATION ON PAR WITH EURO AREA SINCE 2015



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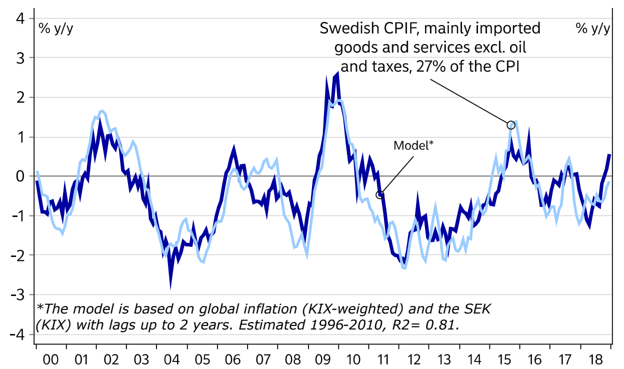
THE WEAKER SEK HAS FED THROUGH TO IMPORT PRICES



Source: Macrobond and Nordea

The SEK is important for the inflation path and the depreciation has indeed boosted consumer prices. The rule of thumb that 10% weaker (or stronger) SEK will lift (or lower) inflation by 1 pp over time has largely worked. Thus, the exchange rate channel has been efficient, although it has mainly resulted in temporary effects on inflation. Historically, core inflation has been lower in Sweden than in the Euro area, but during 2015-18, core inflation was higher or in line with that of the Euro area.

Core inflation has remained muted.

Some domestically set consumer prices have also risen, eg hotel prices, restaurants and car repairs. But these services are only a small part of the CPI basket. The overall picture is that, besides the effects of the exchange rate, core inflation has remained muted. For instance, wage increases have remained remarkably stable at 2.5% over the past seven years. However, energy prices and food prices have risen, which explain why headline CPIF inflation was in line with the 2% target in 2017 and 2018.

Safeguarding the credibility for the inflation target has been a main focus point for the Riksbank. Inflation expectations rose when the Riksbank took action in 2015 and have been anchored around the target since then; although the expectations have edged lower this year.

The end of the ultra-loose monetary policy – a precautionary measure?

The Riksbank hiked rates in December 2018 for the first time in seven years. The repo rate was raised by 25 bp to -0.25%. The Riksbank motivated the rate hike with the explanation that inflation and inflation expectations had stabilised at around 2% and thus “the need for a highly expansionary monetary policy has decreased slightly.”

It is difficult to see growth or inflation being too high in the future if the repo rate is left unchanged

In October of this year, the Riksbank sent clear signals of a second rate hike by 25 bp to 0.0% in December 2019. The purpose of the planned rate hike is less clear, however the Riksbank argued that economic developments warrant a tightening move, but the overall impression is still that the bank sees an intrinsic value in lifting rates to zero. After all, it is difficult to see growth or inflation being too high in the future if the repo rate is left unchanged.

A wish to lift rates to zero is reinforced by the October Monetary Policy Report. It says that “...if negative nominal rates are perceived as a more permanent state, the behaviour of agents may change and negative effects may arise. In light of this, the Executive Board considers it appropriate, in the near term, to keep to the monetary policy plan...”, ie to hike rates in December 2019.

In addition, at the press conference, Governor Ingves said that it would be “odd” to have negative rates for an extended period and that negative rates were “never intended to last forever”. Previously, the Riksbank has played down the significance of rates being below zero.

It is not obvious why the Riksbank changed its view. There has been no specific news in the past year related to the subject and the Riksbank has not published reports or research on the effects of negative rates. The Riksbank has, however, called for more macro-prudential measures to curb rising household debt, but that is mainly the responsibility of the FSA and thus does not explain the Riksbank's turnaround.

Concerns for adverse effects seem to have taken the upper hand for the Riksbank

That said, there are of course reasons to be concerned, including the pension system in Sweden and in other countries being under pressure. Many pension funds are dependent on interest rates and it is a challenge for them to meet their commitments; especially from a longer-time perspective. Add to this an ageing population and longer life expectancy as well as the question marks surrounding how other financial institutions will cope with the low rates. Risks for adverse effects on the economy are also highlighted by the FSA. Thus, these kinds of considerations seem to have taken the upper hand for the Riksbank.

The weak SEK may have played a role too

It cannot be ruled out that the weak SEK has also played a role. The historically weak exchange rate has been frequently debated over the past year. Importers have been squeezed and have had problems passing on higher import prices to consumers. In addition, exporters of commodities have expressed concerns about the exchange rate.

Overall, we see evidence that the Riksbank is moving away from negative rates. The main reason seems to be concerns over adverse effects on the economy of interest rates being negative for a longer time period.

The Danish experience

Denmark was one of the first to reduce its policy rate below zero and it currently has the most negative rate in the world, alongside Switzerland. To counter the risk of negative interest rates causing unwarranted bubbles in the real economy, the authorities have implemented a number of macroprudential measures. With these measures in place, the central bank shows no signs of turning around any time soon.

A pioneer when it comes to negative interest rates

In early July 2012, the Danish central bank cut its deposit rate (CD rate) to -0.20%. This was the first time in the central bank's 200-year history that one of its policy rates was set below zero. Denmark thus became one of the first countries in the world to have monetary policy rates in negative territory. Since then, the Danish central bank's deposit rate has been below zero, except for a short period in 2014. Currently, deposits are charged at -0.75%, which is 0.25 pp below the ECB's deposit rate. This implies that Denmark (alongside Switzerland) currently has the most negative policy rate in the world.

Fixed exchange rate regime leaves little room for independent monetary policy

In Denmark, the CD rate is the central bank's key monetary policy tool to maintain exchange rate stability versus the euro. The reason is that Danish banks and mortgage lenders currently need to deposit vast sums of money with the central bank owing to large excess liquidity in the money market. This means that the CD rate is a peg for short-term money market rates in Denmark – and for the interest rate differential versus the euro area, which is critical for the direction of the EUR/DKK.

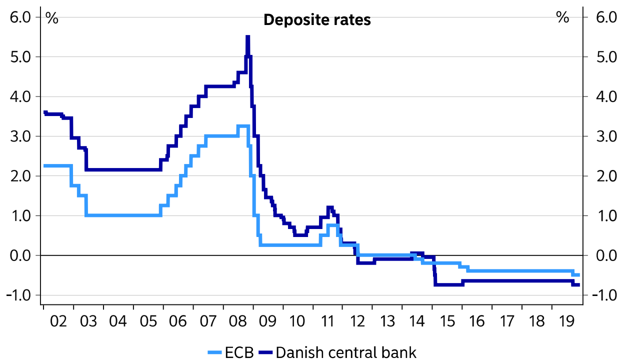
This also implies that for the Danish central bank there is no alternative but to follow the ECB on negative interest rates if the fixed exchange rate regime is to be maintained. And due to strong fundamentals, especially a very large current account surplus (above 8% of GDP), the Danish central bank has, since the beginning of 2015, been forced to set the Danish policy rate below that of the ECB. Therefore, in Denmark the negative policy rate at the central bank is very much an external condition set by the fixed exchange rate regime and solid economic balances.

Negative interest rates are an unintended cost to banks

The negative deposit rates have caused numerous spill-over effects for both banks and the housing market.

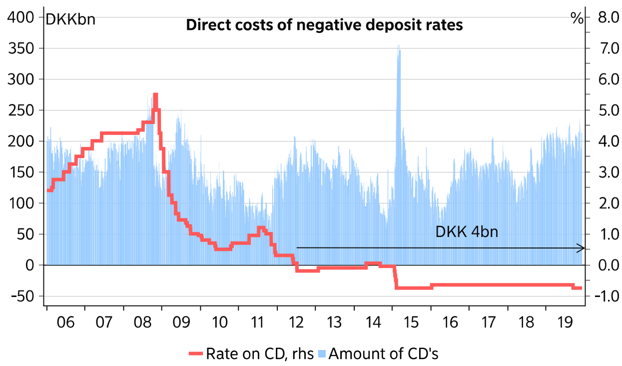
Firstly, the negative deposit rates impose an (unintended) cost on Danish banks and mortgage lenders. Currently, Danish banks and mortgage lenders have around DKK 200bn deposited with the central bank using CDs at -0.75%. The combination of large excess liquidity and a long period with negative deposit rates has generated a total cost of close to DKK 4bn, which is equivalent to around 0.2% of annual GDP.

DANISH POLICY RATE 25 BP BELOW THAT OF THE ECB



Source: Nordea Markets and Macrobond

ACCUMULATED COSTS TO BANKS ARE INCREASING



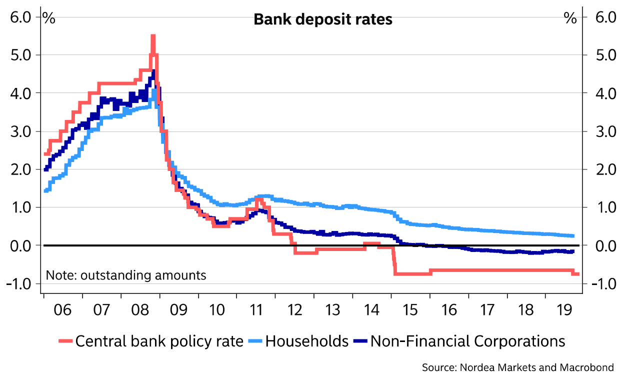
Source: Nordea and Macrobond

Macroprudential tightening

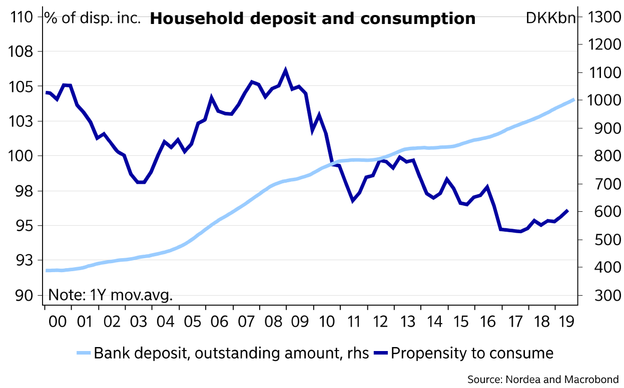
Secondly, to counter the effects of this highly accommodative monetary policy line, the authorities have implemented measures to tighten the financial conditions. The Systemic Risk Council led by the Danish central bank has recommended to the government that the countercyclical capital buffer should be gradually increased. The buffer introduced in 2017 raises the capital requirements of banks to make them more

	resilient to systemic risks. Currently, the countercyclical capital buffer rate in Denmark is 1.5%, but the goal is to increase this to 2.5% over the coming years.
Transmission mechanism has been diluted...	**Thirdly**, traditionally, Danish banks have set the deposit rates for households and non-financial corporations in close correlation with the CD rate at the central bank. However, after the large interest rate cuts by the central bank at the start of 2015 in particular, this transmission mechanism has declined significantly, thereby narrowing the interest rate margin for banks.
...but will probably come back	However, the latest rate cut by the Danish central bank and the shift in interest rate expectations have prompted more banks to change their policy on deposit rates. For non-financial customers, more banks are now charging the same deposit rates as the central bank and several banks have introduced negative deposit rates for household customer deposits that exceed a certain threshold. These new initiatives will most likely cause average bank deposit rates to once again move closer to the policy rate, meaning that more and more households and companies will be exposed to negative deposit rates.
Still a large saving surplus in the household sector	So far, it is hard to find any clear evidence that lower deposit rates have triggered an increase in household consumption or changed the incentive for bank deposits. Households' propensity to consume has been falling since negative interest rates were first introduced in 2012 and the outstanding amount of household deposits in banks has continued to increase despite the more negative real interest rate.

BANK DEPOSIT RATES APPROACHING POLICY RATE

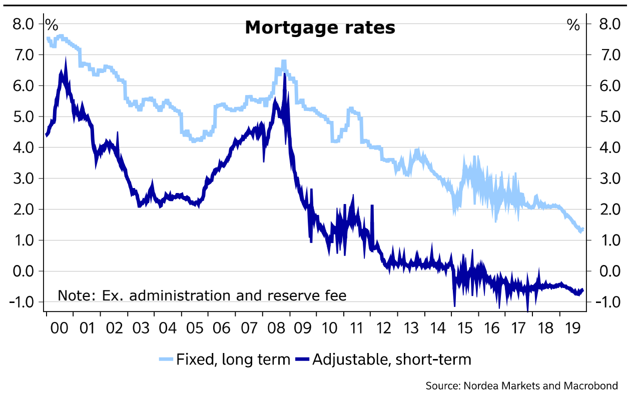


HOUSEHOLD SAVINGS ARE STILL HIGH

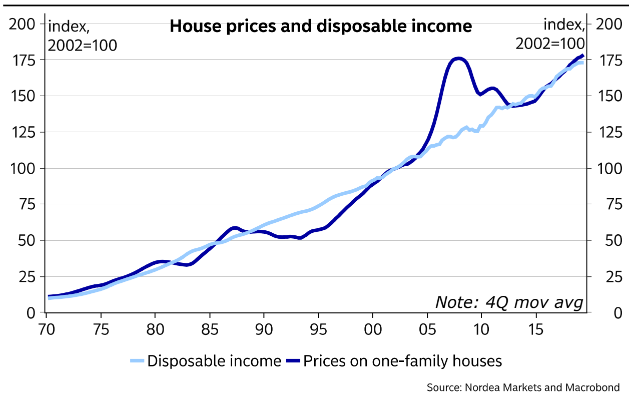


Upward price pressure on the housing market...	On the Danish housing market, the central bank's negative deposit rate has caused the average mortgage rate on adjustable short-term loans to fall below zero since 2015. However, owing to administration and reserve fees, most homeowners must still pay a positive interest rate on their mortgage loan. The sharp fall in mortgage rates has put upward pressure on prices in the Danish housing market. Over the past five years alone, the effective rate of interest on a 30-year fixed-rate mortgage loan has been halved, equating to a drop of 2 pp. As a crude rule of thumb, a permanent interest rate decline of 1 pp will trigger an increase of around 10% in cash home prices over the medium term.

SHARP DROP IN DANISH MORTGAGE RATES



NO NEW HOUSING BUBBLE

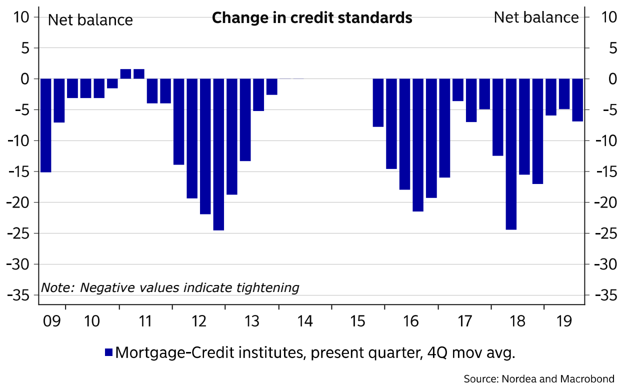


...but no housing bubble thanks to macroprudential tightening

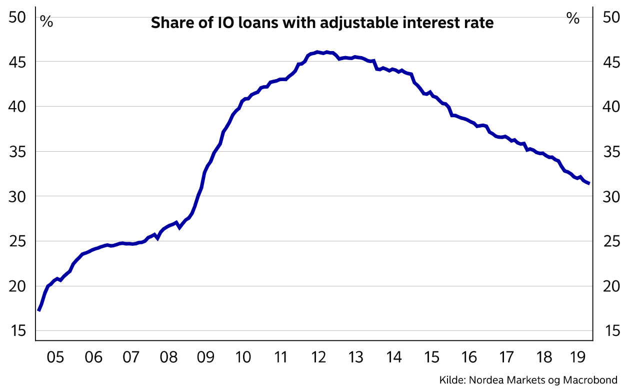
Based on experience from the period preceding the financial crisis, the authorities have on several occasions tightened regulations, especially for the part of the housing market that is the most sensitive to prices, ie the market for owner-occupied flats in major cities. In 2016, the authorities issued guidelines recommending a cautious approach to lending in growth areas, and in early 2018, they restricted the access to loans for homeowners with a high debt rate. These guidelines stipulate that homebuyers' debt cannot exceed four times their annual income unless their existing wealth can withstand a price drop of 10%. If the debt-to-income ratio is above 5x, their existing wealth must be able to withstand a price drop of 25%.

These macroprudential measures have had a clear dampening effect on the rise in house prices, meaning that the current level is close to a long-term fair value – in sharp contrast to the situation in the run up to the 2008 financial crisis. At the same time, it has helped strengthen the long-term robustness of the housing market, as more homeowners have shifted to fixed long-term mortgage loans with amortisation.

TIGHTER CREDIT STANDARDS



SHARE OF RISKY MORTGAGE LOANS IS FALLING



Negative interest rates have become the new normal

To conclude, Denmark has been at the very forefront in terms of gathering experience with negative interest rates. The full effect of this new regime is now flowing through the economy, causing a negative drag on bank profitability and upward price pressure on the housing market. To counter the risk of the negative interest rate causing bubbles, the Danish authorities have implemented a number of macroprudential measures targeting both banks and the housing market. So far, this has helped to neutralise the effect of the negative interest rates, but has also muted an increase in household consumption.

Looking forward, the policy of negative interest rates in Denmark is very likely to remain in place for several years. This outlook has caused more and more banks to reinforce the transmission mechanism on deposits, thereby opening the next frontier in the country whereby negative interest rates have become the new normal.

ECB wades deeper into negative territory

After more than three years with a stable negative policy rate, the ECB has recently cut its rate again. The side effects from this are receiving increasing attention and could eventually stand in the way of more easing.

The latest ECB rate move was a deeper cut into negative territory

In the Euro area, banks have been facing negative rates on their deposits with the ECB since 2014. After keeping the deposit facility rate (DFR) stable at -0.40% for more than three years, the Governing Council decided to cut the DFR by another 10 bp in September, stressing that more cuts could be made if necessary. However, different stakeholders are increasingly questioning whether it is appropriate and effective to stick with negative rates for much longer, most notably banks, Dutch pension funds, prudent German savers, and even prominent former ECB policymakers.

The cut was accompanied by a tiering system to soften the blow to banks

At the same time, the introduction of the two-tiered reserve remuneration system to limit the adverse effects of negative policy rates on banks' profitability opened the door for further rate cuts. Some of banks' excess liquidity is now exempt from the cost of the negative deposit rate at the ECB. The degree of fragmentation in the Euro area's money markets, however, makes it challenging to successfully implement this scheme. On top of that, banks also vary widely across the region. This makes it difficult to effectively lower market rates. This is possibly the reason that markets have priced out additional rate cuts over the last few months.

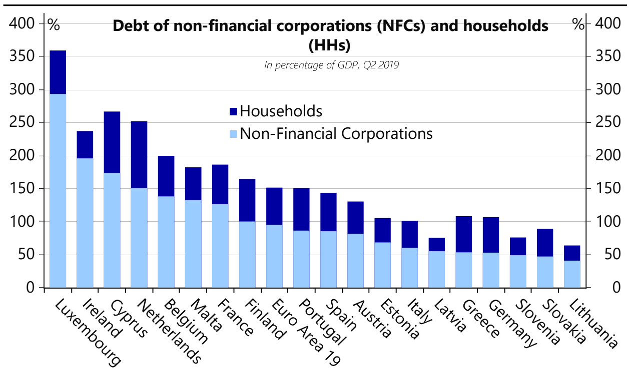
Side effects of negative rates are winning ground in policy considerations

Adverse effects, however, are noticeable in other sectors besides the banking sector. In the ECB's November Financial Stability Review, it was noted that there are side effects from negative rates, but that "while the low interest rate environment supports the overall economy, we also note an increase in risk-taking which warrants continuous and close monitoring". More specifically, financial institutions other than banks have continued to take on more risk and increase their exposure to riskier segments of the corporate and sovereign sectors.

Pensions are at risk of being squeezed due to low returns

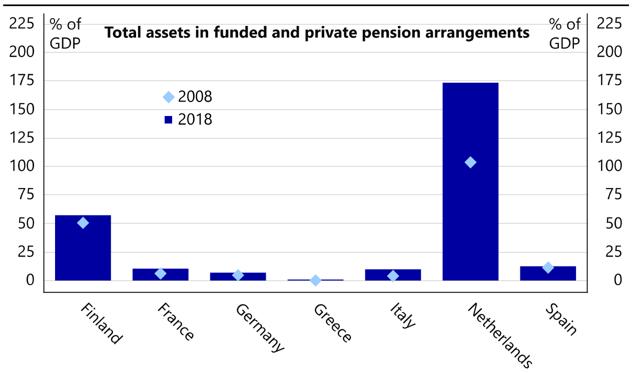
Pension funds, however, are constrained in their risk-taking and are struggling to generate the required returns. The extent of this problem varies throughout the region and has become most prominent in the Netherlands, where pension funds comprise a large share of the economy. Low returns from negative bond yields, however, are not fully attributable to the policy rate – more structural factors are in play.

HETEROGENEITY ACROSS THE EURO AREA



Source: Nordea Markets and Macrobond

VARYING SIZES OF PENSION SYSTEMS

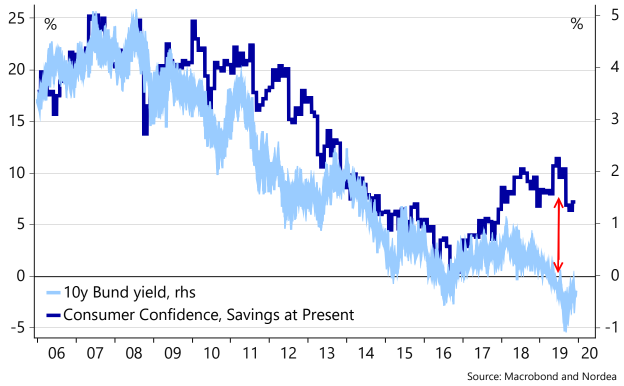


Source: Macrobond, OECD and Nordea

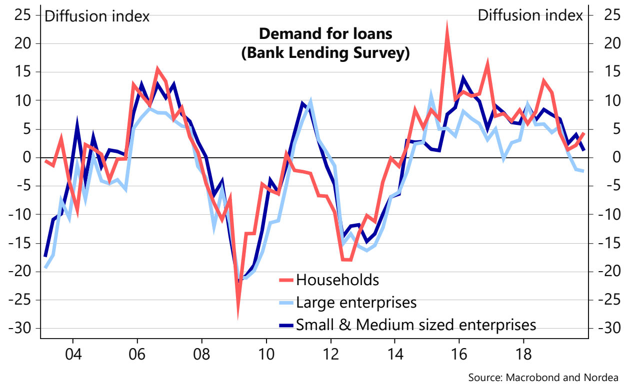
Markedly increased savings would be a sign of counterproductive effects

There are no signs of excessive uptake of loans in the Euro area in response to negative rates by either households or businesses. The flip side of the coin is fears that savings will increase due to perceived uncertainty about the future and pensions, rather than decrease as expected, because of higher incentives to spend. This adverse effect is visible in some survey data but is not reflected in the hard data on the Euro area level. In Germany, though, there are some signs of an increasing trend in savings rates. The question is again whether this can be fully attributed to low policy rates or the uncertain environment in general.

SIGNS OF INCREASED SAVINGS DESPITE LOWER RATES



NO EXCESSIVE UPTAKE OF LOANS



As long as the conclusion is that the monetary policy stance supports economic activity, negative rates in the Euro area will remain. However, given the recent turnaround in Sweden, there is a risk that the assessment of the costs and benefits will give a different outcome after some time. The heterogeneity in effects across countries complicates this assessment. The upcoming strategic review of the monetary policy framework against the background of the current environment of low real interest rates and low inflation could provide the ECB with more room to manoeuvre in the future.

Switzerland and Japan

In these two countries, despite relatively generous tiering systems, the debate around negative rates is lively.

Switzerland

SNB has one of the lowest policy rates around...

Switzerland's policy rate is the lowest of any major economy at -0.75%, the same as Denmark's. As with other central banks, negative rates were initially intended as a crisis measure, but rates have now been in negative territory for almost five years, and are expected to stay there for years to come. SNB governor Thomas Jordan recently said that negative rates are "essential" for the Swiss economy, signalling no plans to exit any time soon given the current outlook.

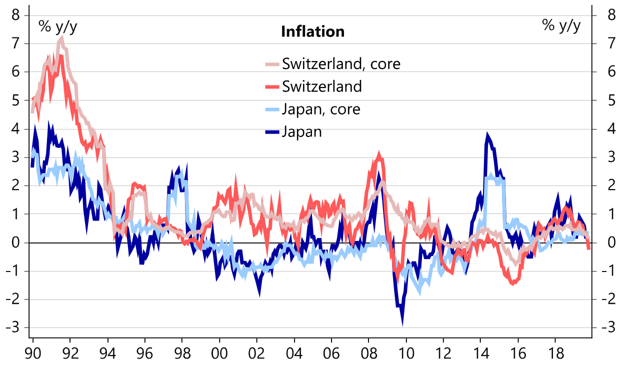
...but does not see the costs outweighing the benefits, in contrast to bankers' calls to reverse course

The SNB is dismissing concerns that the costs of negative rates, particularly for Swiss banks and pension funds, are starting to outweigh the benefits. The tiering system in place is also more generous than in Denmark and the euro area. Nonetheless, the Swiss Bankers Association earlier this year published a white paper with strong conclusions on the negative rate policy, with the telling title "Little impact and structurally problematic". In the paper, the Association calls upon the SNB to initiate an exit from what it calls the crisis mode of negative interest rates. Swiss pension funds are also facing a significant worsening in their financial positions as a result of the policy, as bond yields have collapsed.

The franc plays a large role in the rate setting

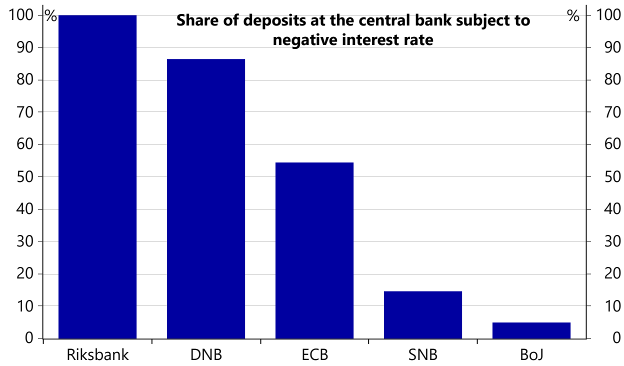
The SNB, however, has little choice but to adjust its policy to the ECB's course, in order to maintain the value of the franc around current levels. A strong appreciation of the currency would weigh too heavily on the Swiss economy. Thus, we believe that pressured banks will increasingly pass negative rates on to their customers.

INFLATION WELL BELOW TARGETS



Source: Macrobond and Nordea

SWISS AND JAPANESE TIERING SYSTEMS MOST GENEROUS



Source: Macrobond and Nordea

Japan

Afflicted by persistently low inflation, the BoJ is keeping its rate negative...

Japan has been facing a very long period of low inflation, marked by bouts of deflation and short spikes upwards. This has led to the anchoring of inflation expectations at low levels as well. After already raising the inflation target to 2%, expanding its asset purchase programme, and strengthening forward guidance, the BoJ cut its policy rate to -0.10% in 2016, where it has remained. However, the measures have failed to lift inflation or inflation expectations. Japan's case is often used as an argument for pre-emptive policy action to stop rates from falling to very low levels in the first place.

...and stands ready to cut more, as it has a generous tiering system

The BoJ has signalled that deepening negative rates will be among the key options for further easing. At the same time, the BoJ is aware that there are costs related to prolonged negative rates, especially in the banking sector. When cutting below zero, the BoJ adopted a three-tiered system under which it charges 0.1% interest on a portion of excess reserves that financial institutions deposit with the central bank. The rest of the reserves are charged zero or plus 0.1%. Overall, only a small portion of total deposits are subject to negative rates. Pension funds and insurance companies are also reporting lower profitability, and the BoJ is making efforts to steepen the yield curve in order to support them. Not everything can be blamed on the negative rates, however; shrinking populations are also squeezing margins for Japanese financial institutions.

Negative rates debated globally

The global debate on negative rates has seen a marked change over the past year, with the emergence of increased scepticism about the benefits of very low policy rates.

Many central banks are reviewing frameworks

For many years, inflation targeting has been the name of the game for most central banks around the world, but this framework has now come under scrutiny. The Riksbank committee's proposal for a new Riksbank law was presented on 29 November, and an adjusted framework for Norges Bank will take effect on 1 January 2020. The Fed and the ECB will publish the results of their reviews during 2020.

The reviews are being conducted in the aftermath of the financial crisis, based on the challenges stemming from the new normal of lower natural rates. The focus is on strategy, tools, and communication, but the overviews seem largely to be adjustments of the current setup for monetary policy rather than any fundamental change in inflation targeting.

"Insignificant" effects of recommendations in Riksbank law proposal

The Riksbank committee’s proposal for the Riksbank law is very much an adjustment to EU regulations. Some proposals may be seen as offering increased flexibility and reducing focus on inflation, such as the legally binding requirements to factor in other aspects of the economy, eg production and employment. The Riksbank says that the bank conducts a flexible monetary policy already today, however, and the Riksbank's committee underlined that the difference between the Riksbank’s current strategy and the proposal is "insignificant". Thus, inflation remains the dominant target, which implies that negative policy rates may be on the agenda again if inflation disappoints.

The new framework for Norges Bank aims for a wider perspective in monetary policy considerations, although we mainly see this as a continuation of what we already consider to be one of the more flexible monetary regimes.

Some researchers argue that more of the "old school" policies are the solution for future problems. For instance, a working paper by the IMF argues that the zero lower bound is not a law of nature but rather a policy choice. Central banks can enable deep negative rates with only administering small changes, according to the IMF paper.

The view on monetary policy is shifting

The view on monetary policy is nevertheless shifting and the debate is more diversified than before. Not least, some Fed officials have declared that negative rates are not an option in the US. A hot topic this year has been "the reversal interest rate", ie when the intended stimulative effects of monetary policy reverse and become contractionary. The ECB's Executive Board was split in its decision on the stimulus package launched in September. Several of the ECB's board members have expressed concerns over cutting rates further, and about the scaling up of the quantitative easing programme. Financial watchdogs, eg in the Euro area and Sweden, have highlighted the risks associated with very low interest rates being perceived as permanent.

Is monetary policy lowering the natural rate?

The Bank for International Settlements (BIS) for a long time has expressed concerns regarding the expansionary monetary policy stance worldwide. In a working paper, Claudio Borio, Head of the Monetary and Economic Department at BIS, even suggests that through intertemporal trade-offs, monetary policy can have a persistent influence on the economy, thus also lowering the natural rate. In his speech in Jackson Hole, the Bank of England's Governor Carney recognised the difficulties in controlling inflation, citing globalisation as one important reason. Another example is Professor Summers, who emphasises that reducing policy rates may be counterproductive in a "secular stagnation" environment. Instead, Summers argues that governments should promote demand through fiscal policy.

What are the alternatives?

The alternatives for unconventional measures that are put forward are as widespread as the views on negative rates. Many call for fiscal policy to take the lead in fighting too low inflation and stabilising the business cycle. Keeping the inflation targets but to a larger extent taking other factors into account is advocated by some commentators. Higher inflation targets have also been mentioned. In our view, the absence of clear-cut alternatives makes it more likely that the central banks will stick to the current setup, with policy rates as an important tool, despite in some cases already being below zero.

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Nordea Bank Abp, Satamaradankatu 5, FI-00020 NORDEA, Finland, domicile Helsinki, Business ID 2858394-9

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