InvestmentUpdate

23 November 2020

UK rate talk is getting a bit too negative

The Bank of England has recently added to its stimulus programme yet again, and it isn't ruling out negative interest rates. But don't believe the hype – it's not yet ruling them *in* either.

In mid-May, Bank of England Governor Andrew Bailey was questioned by the Treasury Select Committee about the possibility that the Bank might cut interest rates below zero. Ever since, the national media has published headlines – and sometimes whole articles – that suggest negative interest rates are just around the corner. But Governor Bailey's initial comments in May were taken out of context. Throughout 2020, he and his colleagues have been very clear – in private and, moreover, in many public speeches – that they are not ruling them out. Indeed, they are now considered part of the 'toolkit' the Bank has at hand for stimulating inflation and maintaining financial stability. However, the Bank is not yet ruling them *in*. As one member of the Bank's Monetary Policy Committee (MPC, the nine-member group who set the policy rates) made clear in October, the Bank is still to determine if negative interest rate policy (NIRP) is feasible, effective, and appropriate.

Is NIRP feasible?

For NIRP to be feasible means the financial system has the operational ability to cope with it. On 12 October the Bank wrote to financial firms asking for information to assess their operational readiness. They were asked to respond by 12 November, with more intimate consultations to follow. The Bank has been clear that they are not yet asking firms to begin taking steps to ensure they are operationally ready for NIRP, they only want to gauge the status quo. Given that the Bank has not cut rates below zero in its 326-year history, it's highly likely that some financial firms are running IT systems that were programmed at a time when no one thought accommodating negative numbers would be necessary. We expect the consultation would take at least a few months.

At the Society of Professional Economists' annual conference in October, MPC member Sir Dave Ramsden also confirmed that the Bank is still preparing its own IT systems.

Previously, the Bank has also expressed reservations about NIRP on the basis that it is difficult to explain to the public. Transparency has become more important to the Bank. We're not convinced this would be a major impediment – after all, how many members of the public understand how quantitative easing works?

Would NIRP be effective?

A look back through many years of the Bank's archive of speeches reveals frequent critical references to the efficacy of negative rates. This year, however, policymakers have been more ambivalent. Still, only one of nine MPC members, LSE professor Silvana Tenreyro, has indicated clearly that she is positive overall about their effectiveness.

The evidence is somewhat mixed. Four – and until recently five – of the 23 central banks we monitor already use negative rates. Just like a rate cut that keeps rates positive, a cut into negative territory could stimulate the economy by lowering borrowing costs, because the price of mortgages, business loans and so on are usually benchmarked to the central bank rate or something heavily influenced by it (such as the overnight lending rate for banks). It also disincentivises the hoarding of cash and, because commercial banks would have to pay to hold reserves at the central bank, they could be incentivised to use some of those reserves for lending or buying financial assets instead.

However, unlike 'regular' rate cuts (that finish with a positive interest rate), there is a risk that NIRP can create problems for commercial banks, inhibiting their ability to pass through the reduction in borrowing costs to households and businesses. In particular, negative deposit rates may not be passed on to retail depositors due to competition, political considerations, or because millions of *small* depositors could conceivably keep their cash elsewhere, in a way that large corporate depositors couldn't possibly. If deposit rates didn't fall but loan rates did, banks' profit margins would fall, particularly among those that are funded predominantly by retail deposits. These banks may therefore either not reduce lending rates or be incentivised to reduce lending.

The academic evidence we've looked at on the efficacy of NIRP is mixed. However, we note that *empirical* studies tend to reach positive conclusions, while papers that argue against NIRP's effectiveness tend to be purely *theoretical* in nature. Four working papers published by the European Central Bank (ECB) over the last 18 months have presented convincing evidence that they have successfully stimulated activity in the Eurozone. We tried to grill the ECB in Frankfurt last year and they wouldn't hear a bad word said about them!

Rathbones
Look forward

Indeed, contrary to the standard concern that lending would decline, the ECB has found that banks most reliant on large amounts of retail deposits extended significantly *more* loans to the private sectors after NIRP began. In other words, the extra costs of negative rates caused commercial banks to try to mitigate them by making more loans and rebalancing their portfolios to earn high returns. Importantly, they did not engage in wayward risk-taking, which would destabilise the financial system (this is harder to do in today's world of stringent regulations anyway).

Another ECB paper (a thumping 329-page report of the last 20 years of policymaking) emphasised that if NIRP were used on its own, the effects could be counterproductive. But combined with other central bank programmes, in particular the offer of cheap long-term financing for banks where the cheapness is linked to how much the commercial bank goes on to lend (Targeted Long-Term Refinancing Operations, or TLTROs, to use the jargon), they have the desired effect. The ECB calls this a 'combined-arms strategy' and we would expect the Bank of England to replicate it if it chose to use NIRP.

Still, this evidence doesn't necessarily mean that NIRP is as effective as a regular rate cut. Or that there aren't better policy options. A working paper published by the Federal Reserve Bank of San Francisco (noteworthy because it roots its estimates in the observed behaviour of 5,405 banks in 19 countries which lived through rate cuts near to or below zero) suggested a cut into negative rate territory is still effective but perhaps as much as 40% less effective than a regular rate cut. The San Francisco Fed's analysis also suggested that the efficacy of the policy may fade over time as banks run out of ways to offset tighter profit margins. They conclude that NIRP may become counterproductive after five years.

Injecting a lot of grit into the NIRP oyster, the official account from the Riksbank, the Swedish central bank, released in various speeches and research papers over the last year, has been rather damning. They consider it a mistake and stopped the policy in December 2019 because the negative effects on the profitability of commercial banks compromised their ability to pass on the rate cuts to their customers - lending rates stopped falling after the introduction of NIRP. It should be noted, however, that the Riksbank didn't employ the 'combined-arms strategy' of the ECB.

All this said, banking sectors are not homogenous across countries. As the Bank of England's August Monetary Policy Report stressed, just because NIRP did or didn't work well in one country, doesn't mean it would have the same effect in the UK.

It's possible that the issue of bank profitability may be less acute in the UK. With over 90% of mortgages now on fixed rates (compared to c.40% before the financial crisis), ongoing interest payments are fairly insensitive to the policy rate, for example. Nevertheless, the transmission of policy via new lending or refinancing could still be an issue, especially if fixed-term mortgages are short. Indeed, the latest rate cut to 0.1% hasn't been passed through into new mortgage rates, although the counterfactual could be that they would have risen *considerably* given the broader tightening of financial conditions as a result of the extraordinary economic disruption.

There's also a risk to the UK's balance of payments (the balance of all trade in goods and services and capital flows in and out of the country) which is not present in other economies that have used negative rates. Other NIRP economies have generally had current account surpluses (positive net balances of trade and investment income) and strong associated net investment positions. The UK has neither, so further lowering the rate of return on UK assets with NIRP could cause capital outflows. This may lower the pound and stimulate competitiveness, but it could also be destabilising at a time when the UK is already losing out on global investment.

Is NIRP appropriate?

For NIRP to be appropriate would mean the economy actually requires more stimulus.

Unfortunately, there is a long list of reasons why the UK may lag other major economies as the world emerges from the COVID recession, and therefore why additional stimulus may be appropriate. Indeed, the UK is on track to have one of the worst outcomes out of the 42 developed and developing countries that we monitor. Its GDP in the third quarter of this year was 10% below what it was in the final quarter of 2019. France and Italy's were just 4% smaller, and even Spain's was 9%.

Some of the disparity is due to the different way that the UK's Office for National Statistics computes public education and health services, which meant they 'fell' by more. But that's far from the only reason.

Part of it is because the UK has suffered the 6th worst health outcome, when measured by deaths per million citizens (3rd among advanced economies only behind Belgium and Spain). That raises the relative risk of more stringent restrictions even beyond the latest four-week lockdown.

Another reason why the UK may emerge an economic laggard is that the UK has a larger consumer services sector than most other countries, and therefore is more sensitive to COVID restrictions. Similarly, it ranks third out of 22 advanced economies for the proportion of its GDP produced in its cities. Key sectors were already ailing before the pandemic, and there's some evidence to suggest the UK may have had a greater share of so-called "zombie" companies. The private sector is more indebted than many countries too, which increases fragility.

International surveys of firms' employment intentions are notably weaker than average in the UK. This is likely to be in some part due to uncertainty around Brexit. A European survey of consumers' unemployment expectations also identifies the UK consumer as being more fearful, which correlates with a lower propensity to spend. While surveys of businesses' investment intentions in other countries improved in the third quarter of the year, in the UK they remain stuck near the lowest level they have been since the UK survey began in 1997, even substantially worse than during the financial crisis.

Of course, much of this disparity would be reversed if a vaccine were rolled out in a timely manner. In that regard, the Pfizer-BioNtech and Moderna trial data is hugely encouraging. And the Oxford-AstraZeneca vaccine, though of a lower average efficacy, was found to be as much as 90% effective with different dosages, as well as being more easily stored and distributed. But as Governor Bailey has said, "there's still quite a way to go in trialling [a vaccine], in production and distribution."

Interestingly, Sir Dave Ramsden recently stated that he does not believe NIRP should be tried during a period of unprecedented crisis and the myriad uncertainties caused by COVID-19. Introducing it for the first time when commercial banks are unclear about how their balance sheets will look in six months' time could be counterproductive.

The Bank has already expanded its quantitative easing (bond buying) programme in response to the current four-week lockdown, agreeing to purchase another £150 billion of government bonds. Although there are more question marks over the efficacy of QE when interest rates are already so low at longer maturities, we expect the Bank to continue to increase asset purchases and expand other schemes (such as the TLTROs discussed above) if the economy needs more stimulus, using NIRP as a last resort. We do not expect to see NIRP used until the second quarter of 2021 at the earliest, and after the surge in gilt issuance starts to abate.

When gilt issuance increased earlier in the year, Governor Bailey stated that the Bank was focusing on three objectives: helping the UK handle the cost of the pandemic by spreading it over time, keeping markets stable in the face of the surge in issuance, and helping to fund the primary fiscal response to the crisis. These three attributes – smoothing costs over time, stabilising markets, and facilitating the fiscal response – make additional QE a better tool than negative rates, which can't directly influence longer-term interest rates at which governments – especially the British government – tend to borrow.

The impact on financial markets

If or when the Bank of England does cut into negative territory, we do not expect it to have much impact on sterling. That's because the pound has had no statistically significant relationship with interest rate differentials for the last four years. Even if we use a so-called "shadow" policy rate, which attempts to account for the effects of QE, still there has been no relationship with the exchange rate. Extra QE is unlikely to move sterling in the next few months either. Remember where currencies are concerned, it's all relative. The ECB is highly likely to increase its QE programme as well, while the American Federal Reserve has already expanded its balance sheet by a much greater degree than the Bank of England, with little discernible impact on the exchange rate. As we have written many times before, exchange rates do not have a relationship with factors such as interest rate differentials that is consistent enough to make much more than specious short-term currency forecasts.

For now, the direction of the pound is likely to be driven by global risk appetite and Brexit. Ordinarily, the pound is a highly cyclical currency versus the dollar or the euro – it falls when global investors are nervous and gains when they are more optimistic (mainly because the dollar accounts for c.60% of reserve assets, the euro c.22.5% and the pound just 5% - it's not a major safe haven, therefore, and it is also tied to a lot of pro-cyclical financial activity). During such a tremendous risk-off period as the one we went through in spring, you might have expected sterling to have fallen by far more than it did. Just an 11% peak-to-trough fall, compared to 35% during the financial crisis. We believe that pessimism over Brexit had already driven the pound close to its floor.

With gilt yields already so low, we expect meagre returns from UK government bonds that are held to maturity. For bond prices to rise over the shorter term would require either a greater risk of deflation or the instigation of NIRP (or both).

Lower 'risk-free' rates of return would raise the relative attractiveness of riskier assets such as equities and corporate bonds, as well as mechanically raising their valuations because future cashflows are discounted into today's prices at a lower rate. Whether the risk-free rate is positive or negative makes no difference to this mechanism. Holding all else equal, this would benefit the valuation of so-called growth stocks whose cashflows are projected to be much larger in the future.

Growth-oriented portfolios also tend to have less exposure to financial companies, such as banks and insurers, whose profit margins and business models may be hampered by even lower rates. As we have discussed, the Bank of England wouldn't pursue the policy if it was clear that financial companies would be significantly hurt. But the very best analysis is still fallible, and the risk of an adverse outcome would remain. Growth portfolios also tend to have larger exposures to consumer discretionary goods and services, which tend to respond positively to cheaper borrowing costs.

We'll write to you again if and when the Bank clarifies its position.

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