Comment on Gerhard Illing: The limits of a negative interest rate policy (NIRP)

Prof. Dr. Heike Joebges
HTW Berlin, university of applied sciences

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Limits of negative interest rate policy
Comment on Gerhard Illing*

- Great paper! I fully agree,
- ... especially with the summary of the presentation:
- “**Monetary dominance requires** adequate fiscal response ... Fiscal spending to prevent stagnation”
- Belief: **Expansionary monetary** confronted with (rather) restrictive fiscal policy **cannot be successful**
- Theoretical justification: standard DSGE models overstate the stabilizing effects of monetary policy, understate the ones of fiscal policy
- (**afternoon session**)

*The limits of a negative interest rate policy (NIRP), prelimary version, Sept. 2016

Yet, regarding publications on the ECB‘s success and the reasons for negative rates:

Why are Germans so critical about the ECB (besides business cycle arguments)**?**

- [Money illusion: higher in low inflation countries?]
- **Distributional consequences?**
- **Asset price bubbles?**
- **Effects on the banking system**
- **Effects on life insurance companies**
- **Conclusions**

Distributional consequences of unconventional monetary policy on wealth inequality

	Positive effect for:	Effect on net wealth Inequality*
Negative rates …	lenders (favored over savers)	Not clear (higly discussed in a country of savers…)
Equity prices* increase by 10%	wealthy households	↑ Highest 5% quintile benefits
Bond prices* increase by 10%		no effect
House prices* increase by 10%	households where housing wealth is relatively important	↓ Middle quintiles (20-95 %) benefit

*Adam/Tzamourani (2016): Distributional Consequences of Asset Price Inflation in the Euro Area, May, working paper; here: average results for the euro area

Distributional consequences: other effects

- Total effect of unconventional monetary policy not clear
- ⬄ **positive employment and income effects** (Bundesbank 2016, monthly bulletin, Sep.)
- Discussed in Germany: **distributional effects of asset and bond purchase programs** of the ECB, see Illing:

  > "So large scale asset purchase are bound to remain controversial…. Decisions about which assets to purchase have political impact, running the risk to threaten central bank independence. " (Illing 2016:7)

Asset price bubbles?
Equity

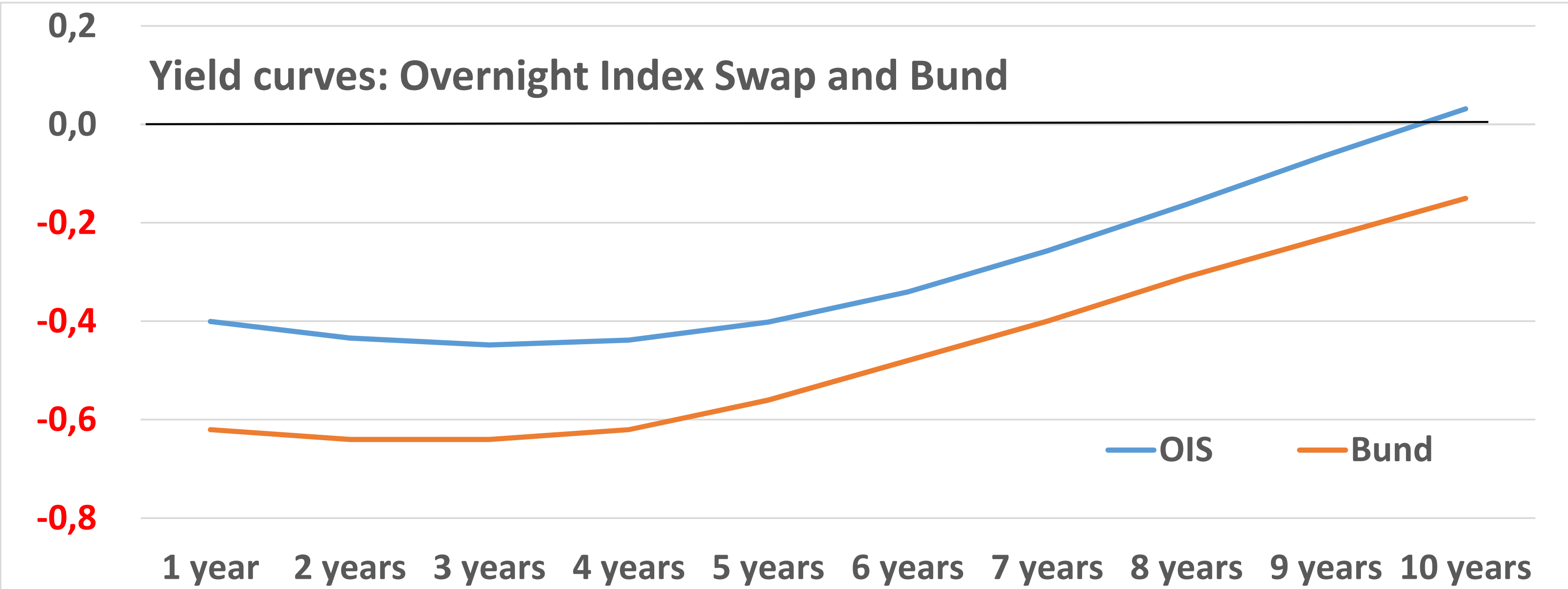
- Increases in equity prices
- But price increases of equity and bonds are wanted effects for the transmission of monetary policy
- Price bubbles remain a risk, but
  - real effects seem to be less severe than from housing bubbles,
  - financial regulation could reduce risks

Asset price bubbles?
Housing

- Relevant house price increases especially in cities
- But: lower interest rates imply higher fundamental prices ⇔ no bubble
- And: Housing bubble prevention is possible:
  - Sensible regulation more important than interest rate levels (Dullien/Joebges/Márquez 2015)
  - Germany: regulation has already reacted (since March, banks have to factor in repayment ability after a future rate increase for potential borrowers)

Effects on the banking system: endangering profitability

- Empirically: The lower the policy rate, the lower are margins for banks 💣
- The steeper the yield curve, the higher potential gains from term transformation ⇔ almost flat yield curve 💣



Effects on the banking system: endangering profitability

- Banks cannot easily pass on negative rates to private households
  - **"ELB"** (Illing): cash holdings are an option
  - **Legal barriers**, Germany: § 488 BGB* (1)

    "Der Darlehensnehmer ist verpflichtet, einen geschuldeten Zins zu zahlen und bei Fälligkeit das zur Verfügung gestellte Darlehen zurückzuzahlen."

    German Civil Code: interest rates have to be non-negative

    Bank's reaction: increase account maintenance fee

Effects on the banking system
Technical issues

- If the ECB buys government bonds, it creates deposits at commercial banks that imply a negative rate for the deposit facility (-0.4 since March 2016), at least for not required reserves
- Deposits at commercial banks increase costs in the national system, if banks
  - do not pass on negative rates to depositors
  - do not use the deposits for credits to foreigners

Effects on life insurance companies: endangering profitability

- Life insurance companies are heavily regulated regarding asset holdings
- Low risk weighted (government) bonds play an important role in the portfolio
- Negative rates cannot be passed on to retirement provisions, due to a guaranteed (minimum) interest rate in most contracts
- Guaranteed (minimum) interest rate have been reduced since 2000, to 0.9% in 2007, but only for new life insurance/ pension contracts

Conclusions

Critic against low/negative rates in Germany:

- Harmful for savers and harming the banking system
- Harming the profitability of life insurance companies, thereby increasing the problem of old age poverty due to too small pensions
- Fear of asset bubbles, especially in housing, even though this could and has been addressed by regulators
- (Plus: fear of indirect financing of crisis countries' governments)
- Negative side effects should be kept small

Hochschule für Technik
und Wirtschaft Berlin

University of Applied Sciences

Prof. Dr. Heike Joebges
HTW Berlin
E-Mail: Heike.Joebges@HTW-Berlin.de