Central banks confront unintended consequences

Nick Beams
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Three of the world's major central banks are to meet this week in the wake of last week's decision by the European Central Bank to push the interest rate it charges on deposits further into negative territory and expand its supply of ultra-cheap money to banks and financial institutions from €60 billion to €80 billion a month.

The Bank of Japan (BoJ) meets today, followed by the US Federal Reserve on Wednesday and the Bank of England on Thursday. No major policy decision is expected to result from any of the discussions. But financial authorities will have plenty on their agenda amid growing concerns that the entire financial system is moving out of their control.

Since the Japanese bank's decision to introduce negative rates on new deposits from February 16, central banks have been confronted with a series of problems and unforeseen consequences.

When BoJ governor Haruhiko Kuroda announced the new interest rate regime, it was intended to put downward pressure on the Japanese yen and boost the stock market. A lower yen would improve the competitive position of Japanese companies in global markets and lift their bottom line.

Moreover, Kuroda's announcement was an admission that the policy of massive purchases of Japanese government bonds, initiated in 2013, had failed to lift the rate of inflation. The stated objective was to reach an inflation rate of 2 percent in two years. Three years on, inflation is still close to zero and the target date has been shifted to the middle of next year. No one seriously believes it will be met.

The policy has also failed to promote growth. In the fourth quarter of 2015, the Japanese economy contracted at an annual rate of 1.1 percent and further negative growth is expected in the first quarter of this year. This would mark the third technical recession—defined as two consecutive quarters of negative growth—in four years.

In a 5-4 vote on the BoJ's governing council, Kuroda and his supporters decided to introduce negative rates with the stated purpose of lifting prices and boosting the economy and the unstated objective of lowering the value of the yen.

Given public pronouncements from the G-20 that there should be no resort to 1930s-style beggar-thy-neighbour policies, no central banker will admit to targeting the exchange rate, lest they be accused of engaging in currency wars. But the various forms of monetary easing are all carried out with that aim.

The move to negative interest rates has backfired badly, however. Instead of falling, the yen has actually risen in recent weeks, while the stock market has declined. This is because the BoJ decision had unintended consequences. First, it was seen as making less likely a decision by the US Fed to further increase interest rates, following the 0.25 percentage point increase in December. This had the effect of slowing the appreciation of the dollar relative to the yen and other currencies.

Second, the Japanese decision added to the growing perception in financial markets and more broadly that the world's central bankers have no clear idea of where their policies are heading. Instead, they seem to be stumbling in the dark and reacting in an ad hoc manner to each development.

The increase in uncertainty, combined with fear that negative rates would have an adverse impact on the business models and profits of banks, made investors more wary and resulted in a shift to so-called safe havens. As Japan is regarded as one of these, the yen rose, rather than declined as might otherwise have been expected.

The introduction of negative rates also has had significant consequences internally in Japan. One of the aims of so-called Abenomics is to increase consumer confidence and spending in order to counter deflation. The new interest rate regime has had the opposite effect. Consumers have rightly concluded that if the BoJ has to introduce negative rates then the economic situation must be worsening, rather than improving, and so have cut back on spending.

A source cited by the *Wall Street Journal* as "close" to the BoJ commented: "There is a perception that we are set to further lower the negative rates, and it seems to be stoking a sense of uneasiness among the public." The article noted that opinion polls regarded the negative rate policy as ineffective and consumer sentiment last month fell at its sharpest rate for two years.

The European Central Bank (ECB) program, based on the pledge by its president Mario Draghi in 2012 to do "whatever it takes," has proven no more successful than that of its Japanese counterpart. The measures the ECB introduced last Thursday had an air of desperation. Draghi warned of "disastrous deflation" had nothing been done over the past four years.

However, as with the BoJ decision, the latest ECB measures seemed to have the opposite effect from what was intended. The further lowering of interest rates into negative territory could have been expected to lower the value of the euro. After an initial fall, the euro rose, swinging through a range of 4 percent in a single day, because Draghi appeared to indicate that interest rates would not be reduced further.

Two reasons have been suggested for Draghi's comments: open opposition to further rate cuts from Germany, where the Bundesbank has expressed hostility to the entire easy money policy; and concerns that the negative interest rate regime was calling into question the business models of the major banks.

The US Federal Reserve meeting on Wednesday is not a policy event. However the comments of chairwoman Janet Yellen will be followed closely as to what they indicate about the possibility of a further interest rate increase when the Fed meets in June.

When the Fed increased its base rate by 0.25 percentage points in December, the general consensus was the first rate increase in a decade had proceeded smoothly. But the apparent calm was short-lived. Since the start of the year, markets have experienced a series of gyrations, to which the central banks are responding with ever-more desperate measures, giving rise to unanticipated consequences that are contributing to further instability.