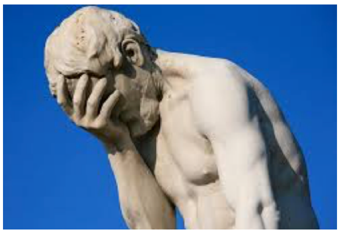
"Positive anything is better than negative nothing."

Elbert Hubbard

Global WRAP

11th March 2016



An EU zone depositor after he has checked his interest return...

This week: How negative are negative interest rate policies? And mattress banking the new cheap way to bank and protect your money.

Please note this will be the last CheckRisk Global WRAP for two weeks. The weekend of 18th March there will be no WRAP due to the St.Patrick's Day holiday and the weekend of 25th March is the Easter weekend. We will be keeping a watchful eye on markets as usual and are available if you have any questions.

How negative is N.I.R.P.?

This week's quote, "Positive anything is better than negative nothing" seems particularly apropos as the ECB cut their main deposit rate to -0.4% yesterday, extended and expanded the QE program, and introduced advantages to banks that start lending. In this weekend's CheckRisk Global WRAP we will look at how negative, a negative interest rate policy (N.I.R.P.) is, and why this may be the beginning of the end game. We also examine the impact N.I.R.P has on CheckRisk's core risk schematic B.U.M.P.

Technically negative interest rates should not exist.

Negative interest rates should not happen. Cash, if you consider, carries an implicit interest rate of 0%. Whatever one thinks about N.I.R.P one should not be under any illusion; this is new and dangerous territory. Negative interest rates are not a typical policy response and, as a result, there may be unintended consequences. There are some positives that can be found, and CheckRisk will look at these too and see if they are what they purport to be.

This is new and dangerous territory

It is important to understand what negative interest rates are and what they are not. Having negative real rates of return is possible. So for example, where an interest rate may be greater than zero but below the level of inflation; this is not, however, a negative interest rate in the sense we are referring to. For the purpose of this discussion, we are talking about nominal interest rates with a value less than zero irrespective of inflation or deflation value.

What is unconventional monetary policy trying to achieve?

What is the aim of QE and unconventional monetary policy? In simplified terms, there are four reasons for unconventional monetary policy. First, to stimulate inflation, secondly to stimulate the economy and increase GDP, third to stabilize the banking system, and fourth to buy time; even ardent monetarists would agree with this list. It is legitimate to ask, now having the list of its goals, whether QE has worked? Global GDP is pretty anaemic at about 3% with risks to the downside. The USA is growing close to 1.4%; neither rates are sufficient to offset the massive increase in global debt, $59 trillion, since 2008. Inflation is a problem too, most central banks around the globe are well below their stated targets. One can easily say that the first two principal objectives of QE have not yet worked, despite the biggest monetary experiment in history. Is that a monetarist's scream we hear? "But what about saving the financial world in 2008?" The truth is, we will never know. The base case of no bailouts and allowing creative destruction to occur was never tested, and likely never will be unless there is a major catastrophe.

QE has failed on the important goals of the program.

The third test of QE is the purpose of stabilizing the banking system. Here it is fair to say that QE has worked, at least partially. The problem, however, is stabilizing is different to revitalizing. The banking sector in many parts of the world is dysfunctional, hence the need for extraordinary policies like N.I.R.P. A zombie banking system is what Japan ended up with following the meltdown in 1989. Some 27 years later Japan is still suffering the effects. One of CheckRisk's biggest fears is that the global economy opts for the Japanification route. The fourth test of QE is, did it buy time? Here the answer has to be "yes" but perhaps more important is for what purpose? The global economy has bought time, however, instead of structural reform we get booming equity and commodity markets. The measure of success is in financial assets and not in the grassroots economy. This is a policy of the path of least resistance. There is little work involved, no political risk (for the moment at least), and covering up the cracks appears to be good enough. The opportunity to reform to make real change has been missed. This matters a lot because without reform the next crisis will be much harder to escape. Investors will just no longer believe that central banks can make a difference.

Japanification.

The longer N.I.R.P lasts the more dysfunctional the system.

The ECB and the BOJ are the biggest central banks to have taken rates negative. The Swiss, Danish and Swedish central banks have too. But there are serious doubts as to whether negative rates can ever work. The BOJ halted the Yen's rise for a few days at best. The ECB's latest move saw stock markets rise initially and then reverse course to end negatively, the first time a "shock and awe" move by a central bank has been responded to by investors selling. Is it possible that investors are beginning to question the central banks ability to manage risk and the economy? If so N.I.R.P.s days are numbered. There are, admittedly positives and negatives to N.I.R.P, which should be considered.

The negatives of N.I.R.P

1) N.I.R.P may directly impact the banking sector. (The ECB has tried to consider this in its latest plan for the banks) Commercial banks make money on what is called the Net Interest Margin. The net interest margin is basically the difference in the rate at which banks can lend at compared to the amount they have to pay to depositors. If the rate at which they can lend is being squeezed lower because of central bank policy, but they are unable to pass that cost onto the customer by lowering deposit interest rates then the net interest margin is reduced. Commercial banks find it very hard to go negative on deposit rates for fear of losing depositors money to other banks or that clients just withdraw their cash and switch to "mattress banking." As a result, bank net interest margin is compressed, and that is bad for bank profits and bank lending. A second negative impact is that while banks may be afraid to maintain margins via deposit accounts, in other words, they will drop them close to zero, but not negative initially, they will not be as fearful of charging higher rates of interest on mortgages and other commercial loans. This has the impact of tightening credit, entirely the reverse of what is intended. The BIS has specifically warned, "If negative policy rates do not feed into lending rates for households and firms, they largely lose their rationale."

2) Another N.I.R.P. negative is that it smacks of currency war politics. By reducing the interest rate below 0%, it is hoped that the currency will fall to boost exports. Another bonus of a N.I.R.P. is that as well as promoting exports it imports inflation to the host country because a weaker currency means imports are more expensive and inflationary. The problem is that currency wars are a zero sum game. Currency wars are the modern day equivalent of the Smoot-Hawley Act introduced in 1933 that introduced a host of protectionist tariffs on foreign goods imported into the USA. Smoot-Hawley is cited as being one of the main reasons for the drop back into economic recession at that time.

The Emperor has no clothes

3) Another problem of N.I.R.P is that it is a continuation of an existing policy, only more desperate. There is a real concern that N.I.R.P is a result of Unconventional Monetary Policy simply failing to work. So far Central Bankers have not admitted that to be the case, but N.I.R.P is a strong indication that this kind of loose monetary policy simply does not work and that perhaps the Emperor has no clothes. The reaction to the ECB's announcement was worrying in this context the markets rose and then reversed when looking at the detail.

4) Following on from a perceived lack of confidence in central bank policy another problem with N.I.R.P is that investors know that on average central banks must lower interest rates some 300bps to 500bps in a recession to offset the negative economic growth. With rates below zero, this is no longer possible; central banks would have to find another way.

Running out of ammo.

The end game is possibly signalled by the fact that Central Banks have decided to use negative interest rates. Central banks and governments have been loathe to admit, but they may end up having to bypass the banking system altogether and inject funds directly into the economy. CheckRisk believes that at some stage it will be inevitable that Central Banks will have to commence investing in infrastructure to reignite global GDP. It will be a big bet; it has to be, or it will not work. When the bet is taken, markets will have an extremely volatile period. Perhaps a market crash will precipitate the need for the direct infrastructure experiment or DIE for short, which is ironic as it will, indeed, be the last roll of the DIE. As we have been saying for some time, the period of maximum risk appears to be between 2017-2020 when the global economy is due a normal economic cycle slowdown at a time when central bank policy is aimed at trying to speed it up. At some point, investors will turn around and throw in the towel. T

There are some positives to N.I.R.P.

The positives to N.I.R.P.

1) N.I.R.P does not have to apply to all bank deposits. Banks are disincentivised to hold money at the central bank, so they find other means.

2) N.I.R.P. is supposed to be good for the economy and to that extent should help the banks rebuild their balance sheets.

3) N.I.R.P should theoretically reduce the cost of capital thus encouraging loan growth and capital spending.

4) Another positive is that the experience of N.I.R.P in economies like Sweden, Switzerland, and Denmark have not been disastrous for their banking system or economies. However, we would caution that because N.I.R.P is ultimately akin to currency wars it is a zero sum game. Those that start first may win initially but will eventually lose as the bigger plays join in.

Which view is likely to be more right? For that we turn to the view of the Bank of International Settlements. (BIS)

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The BIS is worried about N.I.R.P.

The Bank for International Settlements BIS warned of the impending credit crisis in 2007. The BIS is making similar noises today. The central bank of central bankers is clear that the unintended consequences of N.I.R.P may be far reaching. Today the BIS says:

"On the other hand, if negative policy rates are transmitted to lending rates for firms and households, then there will be knock-on effects on bank profitability unless negative rates are also imposed on deposits, raising questions as to the stability of the retail deposit base."

further,

Banking under the current model just may not work.

"The viability of banks' business model as financial intermediaries may be brought into question," the research also stated.

These are not small irrelevant comments. The BIS is saying that the banking system itself may be brought into question at the core of their business. Negative interest rates are a sign of inflexibility at the Central Bank, perhaps in Draghi's case, this was unavoidable. Nobody dares speak of direct investment for fear of being accused of running a central economy. It may turn out that infrastructure spending is the only viable alternative. The problem will be who will fund such a program and will it signal the fact that QE has failed?

The last roll of the die...infrastructure spending.

As we have mentioned above CheckRisk believes that eventually governments will have to resort to direct investment because it will be seen as the only way to drive the economy. That is good news for building firms, engineering companies, engineering and steel companies, and the commodity miners, as well as infrastructure funds. For direct investment to happen though central bankers will have to cross the Rubicon, dragged and kicked no doubt. Ironically it may be more likely for a left wing, or socialist government to embrace such a policy, the result of which could be a far-reaching change in the world of finance.

The other alternative is "mattress banking" ... We are planning on opening a branch soon.

Have a good weekend the Team at CheckRisk

CheckRisk considers new banking concept....

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