How Ultralow Interest Rates Could Backfire

When the Fed raises interest rates, the stock market usually takes it badly, but banks are praying for tighter monetary policy.

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Updated May 3, 2017 5:59 p.m. ET

When the Federal Reserve raises interest rates, the stock market usually takes it badly. These days, though, one big sector is praying for tighter monetary policy: banks.

Lenders’ stocks have been on a tear, rising 24% since the November election, and not just on hopes the Trump administration will reduce regulation. After all, banks have rallied almost as much in Europe.

Rather, it reflects two Federal Reserve rate increases, expectations of more, and confidence the European Central Bank won’t push rates further into negative territory or expand bond buying.
That is the opposite of the usual relationship. Rising rates typically hurt banks by raising their cost of funds and dampening demand for loans.

The inversion of this historic relationship is ominous. It suggests that central banks’ use of interest rates near or below zero to revive stagnant economies can backfire by undermining bank profits and capital and, thus, their ability to lend. Two Princeton University economists, Markus Brunnermeier and Yann Koby, have coined the term the “reversal rate” for the rate at which easy-monetary policy switches from stimulative to contractionary.

The idea is controversial. Fed officials have disputed the link, and in Europe, banks report that while low rates have hurt profits, they have also helped lending. Nor is the U.S. now near such a reversal rate. The economy is growing solidly and the Fed has signaled it hopes to raise short-term rates this year by another half percentage point from the current target of between 0.75% and 1%.

But the reversal rate, if it does exist, casts a large shadow over the future. Structural forces, such as weak productivity growth and a glut of global savings, likely mean central banks will have to push rates close to zero more often than in the past. There may be circumstances when this does more harm than good.

Standard economics says that as interest rates drop, they increase the demand for credit and investment, raise stock prices and thus wealth, and weaken the currency exchange rate, which is good for exports.

In theory, interest rates shouldn’t lose their potency as they fall below zero. Yet a study presented at the International Monetary Fund last fall found some evidence that they do.

Precisely why is unclear, but the likeliest culprit is the impact on commercial banks. They profit from the margin between what they charge on loans and what they pay depositors for the funds they lend out. When central banks push their policy rates below zero, commercial banks are reluctant to impose that on their depositors by charging them a negative rate on their accounts.

For example, between early 2015 and mid-2016 Sweden’s Riksbank pushed its policy rate from zero to minus 0.5%. Loan rates by commercial banks also dropped, but not as much, and their deposit rates, which were already at zero, barely fell at all.

This also affects bank profits. A study by two Chicago Fed
economists found that lower interest rates tend to depress banks’ returns on assets.

That study did find that this effect was more than offset by stronger loan growth, more fee income and lower loan-loss provisions. Moreover, the value of banks’ bond holdings rises as rates drop.

But those offsets may diminish over time. Research by the Swiss-based Bank for International Settlements found that in 2009 and 2010, falling interest rates bolstered bank profits, but from 2011 to 2014 they had the opposite effect. The BIS also looked at 108 global banks and found that as interest rates drop, lending rises—until rates reach very low levels, when lending starts to shrink.

When interest rates dropped to zero, central banks turn to another tool for stimulating demand: buying bonds, which reduces long-term rates. This compresses the spread between long-term and short-term interest rates, i.e. the yield curve. Because loans are linked to long-term rates and deposits to short-term ones, a flatter yield curve also erodes profits, a finding confirmed by both the Chicago Fed and BIS studies.

The BIS authors caution that it is difficult to disentangle any negative effects of low interest rates and a flatter yield curve on banks from the overall weak economic environment, which both keeps rates low and hurts the demand for credit.

Moreover, the effect may not be constant. Mr. Brunnermeier and Mr. Koby says regulation can change the effect. For example, a long period of low rates makes it harder for banks to retain enough earnings to both meet heightened regulatory requirements for shareholder capital, and also expand lending.

With economic growth now picking up around the world, central banks don’t have to worry as much about the health of commercial banks. Nonetheless, they may need to keep the unusual dynamics that occur at low rates in mind.

The longer the ECB keeps rates negative, the harder it will be for commercial banks to recover.

For its part, the Fed, which is debating when to start shrinking its balance sheet, may want to consider the effect on banks. Selling some of its $4 trillion in bonds should push up long-term rates, which would restrain growth, but in the other direction it would steepen the yield curve and bolster banks’ incentives to lend.

That should provide some comfort as the Fed slowly returns monetary policy to normal.

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