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EUROPE ECONOMY

ECB's Draghi Hints at Drawbacks of Negative Rates

Comments mark significant shift from previous ECB statements on negative rates

Comments by ECB President Mario Draghi, pictured in Frankfurt, Germany, on Wednesday, represent a significant shift from previous ECB statements that negative rates are on balance positive for bank profits because they stimulate the region's economy. PHOTO: ANDREAS ARNOLD/BLOOMBERG NEWS

By Tom Fairless and Brian Blackstone

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FRANKFURT—European Central Bank President Mario Draghi signaled Wednesday that the bank is starting to worry about the adverse effects of negative interest rates, a controversial policy tool it introduced almost five years ago to encourage European banks to lend.

The ECB's change of tone comes after its latest bout of monetary stimulus, announced this month to shore up Europe's sagging economy, led to fresh falls in eurozone bond yields, piling extra pressure on the region's weak banks.

Expectations of easier monetary policy in Europe and elsewhere have pushed government bond yields in places like Germany below zero, meaning some governments effectively get paid to issue debt. While a boon for public finances and interest-rate sensitive sectors like housing, this may wreak havoc in other parts of the financial markets.

Negative interest rates force commercial banks to pay to park funds at the central bank. By reducing borrowing costs, they should make it more attractive for companies and households to borrow, spend and invest. The policy also typically weakens an economy's exchange rate, boosting exports.

But negative interest rates, which are also being deployed by central banks in Sweden, Switzerland and Denmark, come at a cost to commercial banks and weaken interest income from loans and holding safe assets. The policy has also raised the risks of housing bubbles in parts of Europe, by propping up interest-rate sensitive sectors such as real estate.

Speaking at a conference in Frankfurt, Mr. Draghi said the ECB would, if necessary, look for ways to maintain the positive impact of negative rates for the economy "while mitigating the side effects, if any."

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The ECB would continue to monitor how banks can "maintain healthy earning conditions while net interest margins are compressed."

European bank stocks jumped after the comments were published, with Italy's UniCredit SpA and Deutsche Bank AG both up around 4%.

Mr. Draghi's comments represent a significant shift from previous ECB statements that negative rates are on balance positive for bank profits because they stimulate the region's economy.

They suggest the ECB could consider action to mitigate the impact of negative rates on banks, a step already taken by some of its peers including the Bank of Japan, which attempts to control the yield on 10-year bonds. The Swiss central bank exempts a certain amount of deposits from its negative deposit rate. One option for the ECB is to introduce a tiered deposit rate, which would shield a part of banks' deposits from the charges.

Bank executives have complained for years that negative rates curb their profits because they can't fully be passed on to customers.

Casting doubt on negative rates could be risky for the ECB if investors interpret it as a sign that the central bank doubts its own strategy.

Earlier this month, the ECB responded to Europe's recent economic slowdown by signaling it won't raise its key eurozone interest rate, currently set at minus 0.4%, before next year.

With ECB rates expected to stay where there are for many months at least, central banks outside the eurozone, like Switzerland and Denmark, are expected by economists to delay any rate increases, leaving open the prospect of negative interest rates for years to come.

One argument supporting the policy is that it gives central banks more room to respond to ultralow inflation or deflation. Policy makers can stimulate the economy by setting interest rates below the inflation rate. Zero had long been seen as a floor on policy rates, but by moving below zero in recent years, central banks shattered that taboo.

Although the Federal Reserve took interest rates close to zero in the aftermath of the financial crisis, it didn't cut rates to below zero. It did embark on large-scale bond purchases which, like negative rates, reduce long-term borrowing costs. In recent years, the Fed has slowly increased interest rates, though it has signaled it will pause, with the fed-funds rate at a range of 2.25% to 2.5%.

European bank stocks have fallen since the ECB's decision three weeks ago, and are down around 30% since the start of 2018. U.S. banks have fared better in recent years.

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That could ease the way for fresh ECB interest-rate cuts if the economy doesn't improve. "We are not short of instruments to deliver on our mandate," Mr. Draghi said. The ECB targets annual inflation of just under 2%. It is currently 1.5%.

Still, some officials consider European banks themselves are largely to blame for their poor performance, and that the ECB's negative bank-deposit rate isn't a game changer for bank profits. They point to Danish banks, which are doing well despite negative rates.

Mr. Draghi insisted Wednesday that "low bank profitability is not an inevitable consequence of negative rates."

Rather, successful banks have been able to reduce costs and invest in information technology while diversifying their businesses, he said.

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