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Fed unlikely to follow others in adopting negative rates

- **Although a number of other central banks have now adopted negative policy rates, the chances of the Fed following suit are pretty small. Even if US economic conditions deteriorated, we suspect that the obstacles to setting the fed funds rate below zero in the US would persuade the Fed to try other unconventional tools first.**
- Fed Chair Janet Yellen noted in her testimony last week that she is "not aware of anything that would prevent us from doing it", that is setting a negative fed funds rate. But the wording of the Federal Reserve Act only gives the Fed the power for interest "to be paid" on reserves held by commercial banks. Whether it can also legally *charge* interest is another matter that would presumably need to be settled in court.
- Even if the Fed can legally charge commercial banks for holding reserves under the existing Act, some non-bank institutions that hold reserves but currently don't qualify to be paid interest would also presumably be exempt from negative rates. That would open up an arbitrage opportunity for Fannie Mae, Freddie Mac and the Federal Home Loan Banks, who could profit by charging banks a small penalty rate to borrow their reserves. Just as the effective fed funds rate currently trades below the interest rate on excess reserves (IOER), it would remain less negative that the IOER if the latter were ever set below zero.
- The lack of reform of money market mutual funds since the financial crisis is an even more substantive obstacle preventing negative rates in the US. Those funds, which hold $2.6trn of high-quality short-term assets, would presumably suffer big outflows from both institutional and retail clients if negative rates pushed the net asset value below a dollar a share. Redemptions from those funds could trigger serious liquidity problems in the repo and commercial paper markets.
- Finally, perhaps the biggest obstacle, particularly in a Presidential election year, is that the Fed would come under unprecedented political pressure if commercial banks began to charge their own retail customers a negative rate on deposits. It won't matter that the policy was designed to boost overall economic activity and reduce unemployment. Given how unpopular the Fed is now, politicians would exploit such a policy to the hilt. At the very least, the politiclal fallout could be big enough for an "audit the Fed" type bill to pass Congress.
- There is a more general concern that a flat yield curve could hit bank profitability, particularly if banks are reluctant to charge negative rates on the deposits they hold. But we don't see that as an insurmountable obstacle. Banks could simply increase fees on account holders, boosting non-interest revenues, and increase the spread on the rates they charge on loans relative to risk-free Treasury yields.
- **Setting a negative nominal policy rate is not the only option that central banks have to reduce *real* interest rates. Under the circumstances, the Fed might opt to raise its inflation target instead, either temporarily or permanently. The resulting jump in inflation expectations would push real interest rates further below zero. The Fed could also take measures to reduce long-term interest rates, either by using forward guidance and/or by beginning another round of large-scale asset purchases**.
- Asset purchases designed to reduce yields actually makes more sense in the US because banks are a relatively smaller part of the financial system, with bank assets accouting for slightly less than 70% of GDP. That compares with more than 300% of GDP in France and the UK and nearly 250% of GDP in Germany. In Switzerland and Sweden, the two countries with the most negative interest rates, bank assets account for more than 400% of GDP and more than 350% of GDP respectively. Negative policy rates makes more sense in bank-orientated financial systems. **But in the US, where the bond markets are much more developed and banks play a smaller role in credit intermediation, there is a case to be made that additional asset purchases would provide the biggest boost to economic activity**.

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