

“Rewardless Risk”

Faramir: Then farewell! But if I should return, think better of me.

Denethor: That depends on the manner of your return.

-- J.R.R. Tolkien “The Lord of the Rings” (1954)



I'm going full-nerd with the "Lord of the Rings" introduction to today's Epsilon Theory note, but I think this scene -- where Denethor, the mad Steward of Gondor, orders his son Faramir to take on a suicide mission against Sauron's overwhelming forces -- is the perfect way to describe what the Bank of Japan did last Thursday with their announcement of negative interest rates. The BOJ (and the ECB, and ... trust me ... the Fed soon enough) is the insane Denethor. The banks are Faramir. The suicide mission is making loans into a corporate sector levered to global trade [as the forces of global deflation rage uncontrollably](#).

Negative rates are an intentional effort to weaken your own country's banks. Negative rates are a punitive command: go out there and make more bad loans where risk is entirely uncompensated, or we will, in effect, fine you. The more bad loans you don't make, the bigger the fine. Negative rates are only a bit worrying in today's sputtering economies of Europe, Japan, and the US because the credit cycle has yet to completely roll over. But it is rolling over (read anything by Jeff Gundlach if you don't believe me), it is rolling over everywhere, and when it really starts rolling over, any country with negative rates will find it to be significantly destabilizing for their banking sector.

There's a reason that the Fed kept paying interest on bank reserves even in the darkest, most deflationary days of the Great Recession. Yes, it's the Fed's job to support full employment. Yes it's the Fed's job to maintain price stability. But the Fed's job #1 -- the reason the Federal Reserve was created in the first place -- is to maintain the stability of the banking system. Go ask a US moneycenter bank how things would have turned out in 2008 if the positive interest coming in on their reserves had been flipped to negative interest going out on their reserves. Go ask a US regional bank how things would have turned out if they had made even *more* rewardless risk loans in 2006 and 2007 under the pressure of negative rates.

Look, I get the "theory". I understand that weakening the yen is an existential domestic political issue for Kuroda and Abe, just as weakening the euro is an existential domestic political issue for Draghi and Merkel, just as [weakening the yuan is an existential domestic political issue for Zhou and Xi](#). And I understand that policy-addicted markets will respond exuberantly to anything that can be described as central bank support for financial asset price inflation. Hey, I'm an addict, too.

But what I'm concerned about is not the theory but the practice. **What I'm concerned about is the intentional destabilization of the global financial system for domestic political purposes.** What I'm concerned about is the Fed's inevitable adoption of negative rates, something Alan Blinder pushed for in 2008 and [Ben Bernanke is pushing for now](#).

When the ECB instituted negative rates, that was just a point. The BOJ's move last Thursday makes a line. Now we have a pattern. Now we have a market that expects MOAR! Now we have a Fed that will undoubtedly implement negative rates when things get squirrely again, even if there are some in the Fed who I'm sure are shaking their heads at all this.

I've come to expect every elected politician or politician wannabe to rail against "the bankers" and the terrible mess they've made of the world with their "predatory lending" and "easy credit", even though this is *exactly* what every politician in the world desires. But I didn't expect central bankers to betray their own charges. I didn't expect central bankers to throw their own domestic banks into a battle they can't win.

You know what negative rates are? They are the final stripping away of the illusion that central bankers somehow exist above and separately from domestic politics, that they are wise and able stewards of financial stability. Nope. They're Denethors.

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