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Where Banks Pay Borrowers to Borrow Money

By KEN BELSON

TOKYO, Feb. 4 — People often think of zero interest the way physicists do the speed of light, as an absolute limit. After all, who would agree to lend money at negative interest and be certain of a loss, when it could simply be left in a safe and remain whole?

But head-scratching things have been known to happen in Japan, where political immobility in the face of deflation and economic stagnation has obliged the central bank to keep interest rates very nearly zero for years. Now, the once-rare phenomenon of loans at negative interest, first seen here in the late 1990's, is back.

On closer inspection, these odd deals do have a financial logic, given Japan's peculiar economic malaise. Still, their reappearance highlights anew the weakness of the nation's banks, which foreign financial institutions are increasingly holding at arm's length.

The Bank of Japan used what some economists called the last arrow in its quiver when it cut its benchmark short-term rate effectively to zero in 1999. The bank hoped to stimulate borrowing, investment and growth, but the easy-money policy has largely failed to do so.

Instead, it has all but wiped out trading in Japan's money markets. When short-term rates were above zero, investors could profit by trading bonds and other debt securities of varying yields, and financial institutions regularly parked money in the market overnight. But such money earns only 0.001 percent these days, too little even to cover the cost of trades.

Yet the banks must still transact business. So under certain circumstances, they are finding themselves having to pay borrowers to borrow from them, a practice analysts say will continue until faith in the banking system improves. With inflation nowhere in sight and the banks struggling with mounds of bad debts, that day may not come for years.

Though most banks will not confirm the specifics of their trades, traders say the most common example is a Japanese bank that needs dollars, say to finance an import or export transaction for a client. The usual method is to swap yen for dollars with a foreign bank, and then agree to reverse the trade at a future date. These forward contracts, as they are called, expose the two banks to the risk that exchange rates will move adversely, but each bank can put the money to other uses in the meantime.

Foreign banks that provided dollars this way would often put the yen they got in return into the money market, or buy Japanese bonds with it. Yields were not high, but that was acceptable as long as the overall swap deal was profitable and the yen were invested safely.

Safety became an issue, though, when global credit agencies began downgrading their ratings of Japan's banks. To compensate for greater risk, the foreign banks began demanding more attractive terms on the yen half of the swap transaction.

"The Japan premium is starting to return," said Masaharu Usuki, an economist at the NLI Research Institute, referring to the banks' higher cost of funds. "This is really a reflection of their weakened state."

As a result, to get dollars now, Japanese banks are reportedly having to pay foreign banks 0.08 percent to take their yen.

"It's counterintuitive to pay someone to hold your money for you," said Michael Wilkins, a market strategist at Société Générale Securities North Pacific. "But interest rates were already at one basis point, so it only took a bump to get there." Noting that the overall swap deal could still be profitable if the dollars earned more for the bank than the yen loan cost it, Mr. Wilkins said, "Minus interest rates are now part of the vocabulary."

Japanese banks are not the only ones with more yen than they can put to profitable use, and many foreign banks are required by rule or law to invest excess cash in risk-free assets rather than leave it idle. The number of ways to do that with yen are shrinking, reportedly obliging one European bank to lend yen for a day at minus 0.01 percent, an offer that found willing takers because of the bank's strong credit rating. Still, the European bank made a profit, because it had borrowed the yen from a Japanese bank at minus 0.08 percent.

Japan's nationwide experiment with ultralow rates is spreading. On Monday, the government sold all of a 350 billion yen ($2.9 billion) issue of new 10-year bonds meant for retail investors. The bonds have a face value of 10,000 yen ($83.17), which is guaranteed, and their yield was set at 0.09 percent. It will be adjusted twice a year and could rise if inflation appears; to reassure skittish investors, the yield cannot fall below 0.05 percent.

"The fact that the bonds sold out so quickly shows that people need these kinds of guaranteed investments," one Finance Ministry official said.

Such razor-thin yields — the bonds sold on Monday may pay just 9 cents a year — are easier to accept in a country where consumer prices are falling by nearly 1 percent a year.

"We laugh at 0.09 percent yields, but it's a sensible investment in real terms," said Graeme Knowd of UBS Warburg (Japan) Ltd. "Deflation is not leaving us for a long time."