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NEGATIVE INTEREST RATES EXPLAINED

CONTRIBUTOR
John Heilner
Chief Investment Officer

WEALTHMANAGEMENT
WHITE PAPER

Key Takeaways

- Negative interest rates are a recently-developed and unconventional monetary policy tool.
- Negative interest rates are a drastic measure revealing that policymakers fear a risk of a deflationary spiral.

Negative Interest Rates in Theory

If you watch CNBC or read the Wall Street Journal it would be nearly impossible to not hear something about negative interest rates.

In the simplest sense, negative interest rates mean banks would pay money each month to park their money at the central bank – a reversal of how banking typically works. Usually deposits are rewarded rather than penalized. Banks are left with two options: 1) pass negative interest costs to customers by charging for deposits,[1] which is a tough sell to the consumer market or 2) put their money to work through loans and investments, which is what the central bank is aiming for.

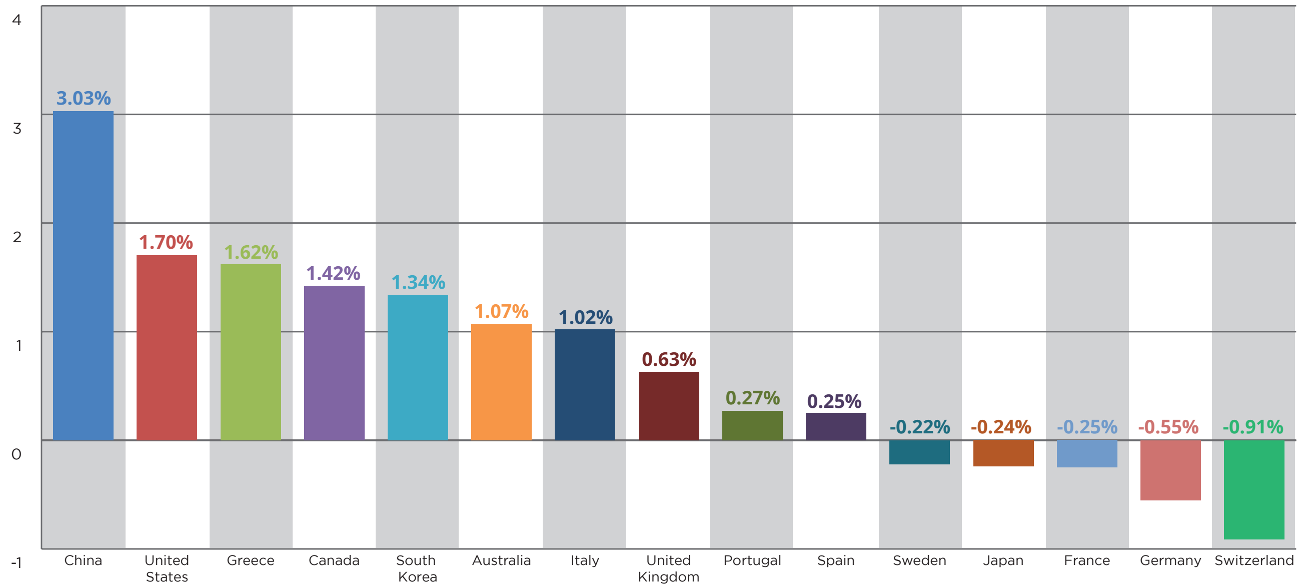
Let's look at the math. An annualized 2% interest rate on a $100 deposit means that the saver receives $2 after one full year for a new deposit total of $102. We're all familiar with this result. On the other hand, a -2% interest rate means the saver pays the bank $2 after a year of having the $100 deposited at that financial institution. As a result, the saver would have $98 after the first full year, which is highly counterintuitive and unusual.

While seemingly inconceivable, there may be times when central banks run out of policy options to stimulate the economy and turn to the desperate measure of negative interest rates like we have witnessed in Europe and Japan.

Negative Interest Rates in Practice

Negative interest rates are an unconventional monetary policy tool. They were first deployed by Sweden's central bank in July 2009 when the bank cut its overnight deposit rate to -0.25%. The European Central Bank (ECB) followed in June 2014 when it lowered its deposit rate to -0.1%. Since then, other developed countries like Denmark, Germany and Japan have chosen to implement negative interest rates, resulting in $15 trillion worth of government debt carrying negative yields in 2019, according to Deutsche Bank. [2]

Select Countries' 10-Year Yields
(intraday as of 9/10/2019)



Source: Bloomberg Finance, L.P.

Most economists agree that negative interest rates are a drastic measure that indicates a country is at risk of falling into a deflationary spiral. What is deflation and why would what appears to be a good thing (lower prices) actually be a bad thing? In uncertain economic times, people and businesses tend to hold on to their cash while they wait for the economy to improve. However, this behavior can weaken the economy further, as a lack of spending causes decreased GDP, lower corporate profits, subsequent job losses, which reinforces people's fears, giving them even more incentive to hoard cash and reduce spending. As spending slows, prices drop (deflation) creating further incentive for people to wait on purchases as prices steadily fall. This is precisely the deflationary spiral that European policymakers are trying to avoid with negative interest rate stimulus. The effect that an artificially low interest rate has on an economy could be emotionally harmful to its people. People are smart, they will ask "are things really this bad" and curtail their spending.

By charging European banks to hold reserves at the European Central Bank, policymakers hope to encourage banks to lend more. In "theory", negative interest rates should help to stimulate economic activity and stave off deflation as banks should prefer to lend money to borrowers and earn at least some interest as opposed to being charged to hold their money at a central bank.

Negative rates charged by a central bank could theoretically carry over to deposit accounts and be passed on to consumers. However, there is also nothing to stop typical savers/depositors from withdrawing their money and stuffing the physical cash in mattresses. At least that way they wouldn't be losing money. While the initial threat could be a potential run on banks, the resulting drain of cash from the banking system could lead to a rise in interest rates—the exact opposite of what negative interest rates are supposed to achieve for the economy. [3]

The Bottom Line

While negative interest rates may seem like a "Hail Mary", this has not prevented a number of the world's central banks from adopting them. We can only ask ourselves what could be next.

Globally, interest rates are at low levels never imagined a few years ago. And negative interest rates are uncharted ground. Most of the research we have reviewed predicts that negative rates "could" result in income inequality growth and social instability could follow. Excessively low interest rates support bloated asset valuation levels, favor the rich over the poor, favor the renter over the investor, encourage leverage and stock buybacks over capital expenditure and business investment.

We do not believe negative rates will lead to increased economic activity. They have a poor track record so far. Instead European and other countries should look at why growth is stagnant and what can be done to spur economic activity organically and not mechanically.

SOURCES

[1] *www.investopedia.com/terms/n/negative-interest-rate.asp*

[2] *www.cnbc.com/2019/08/07/bizarro-bonds-negative-yielding-debt-in-the-world-balloons-to-15-trillion.html*

[3] *www.thebalance.com/understanding-bank-runs-315793*

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