MACROECONOMICS
ED LANE

NEGATIVE INTEREST RATES

NEGATIVE RATES

What, exactly, are negative rates?

- Negative rates falls into three categories
  - Rates that are set by the monetary authorities (a negative interest rate policy or NIRP) – today's focus
  - Rates that become negative through market action
  - Inflation-adjusted rates ("real rates")

- The purpose of negative rates is to stimulate the economy by:
  - Encouraging greater bank lending
  - Encouraging greater investment and spending
  - Stimulating exports by lowering the local currency exchange rate
  - Stimulating inflation (maintain inflation target; avoid deflation)
  - Lowering longer term interest rates

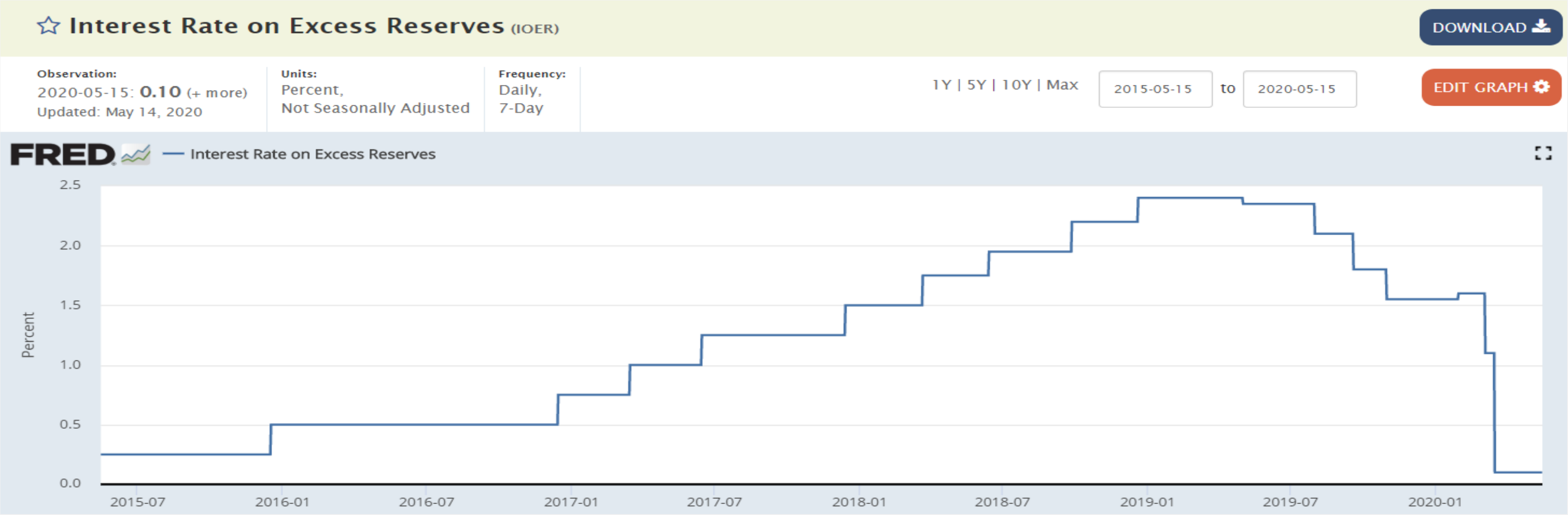
- Usually accompanied by other "unconventional" monetary stimulus programs, such as QE

- The practice has been followed by central banks in Sweden, Denmark, Switzerland, the EU and Japan

NEGATIVE RATES

Rates that are set by the monetary authorities

- Interest on overnight excess reserves (IOER)
  - Member banks store reserves in excess of their required reserves (temporarily suspended) at the Fed to earn interest (now 0.10% but was as high as 2.5% in April 2019)
  - The European Central Bank (ECB) was the first to adopt the practice of charging member banks to hold reserves in 2014 (started at -0.1% and now is -0.5%)
  - The loss of member bank income from loss of interest on reserves held at the central bank gets passed on to certain depositors in the form of negative bank deposit rates with tiering so that corporate and large retail depositors are targeted

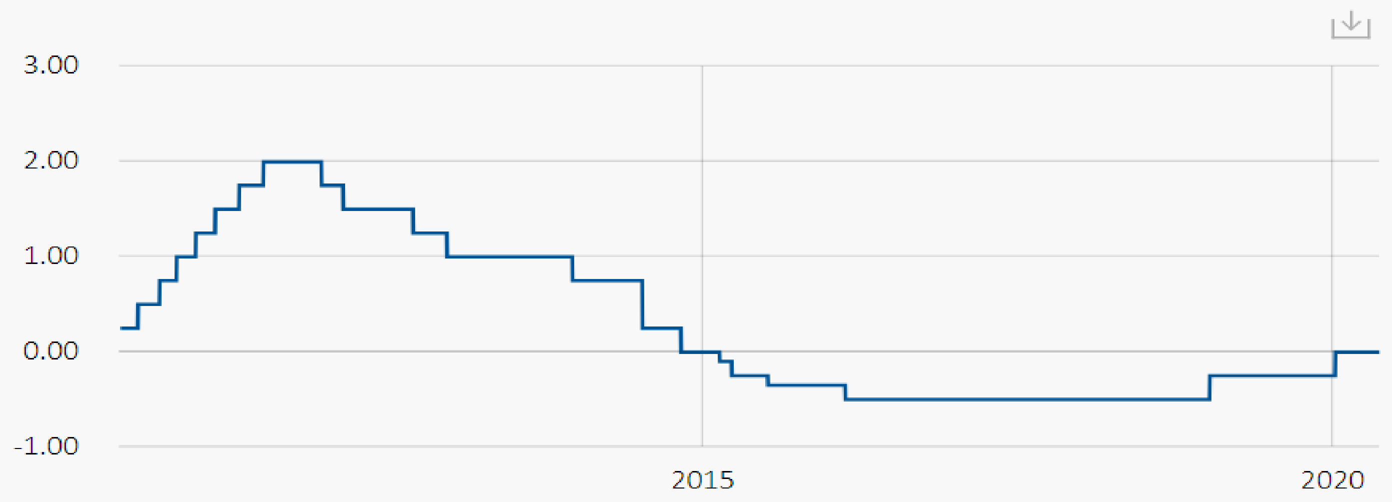


NEGATIVE RATES

Rates that are set by the monetary authorities

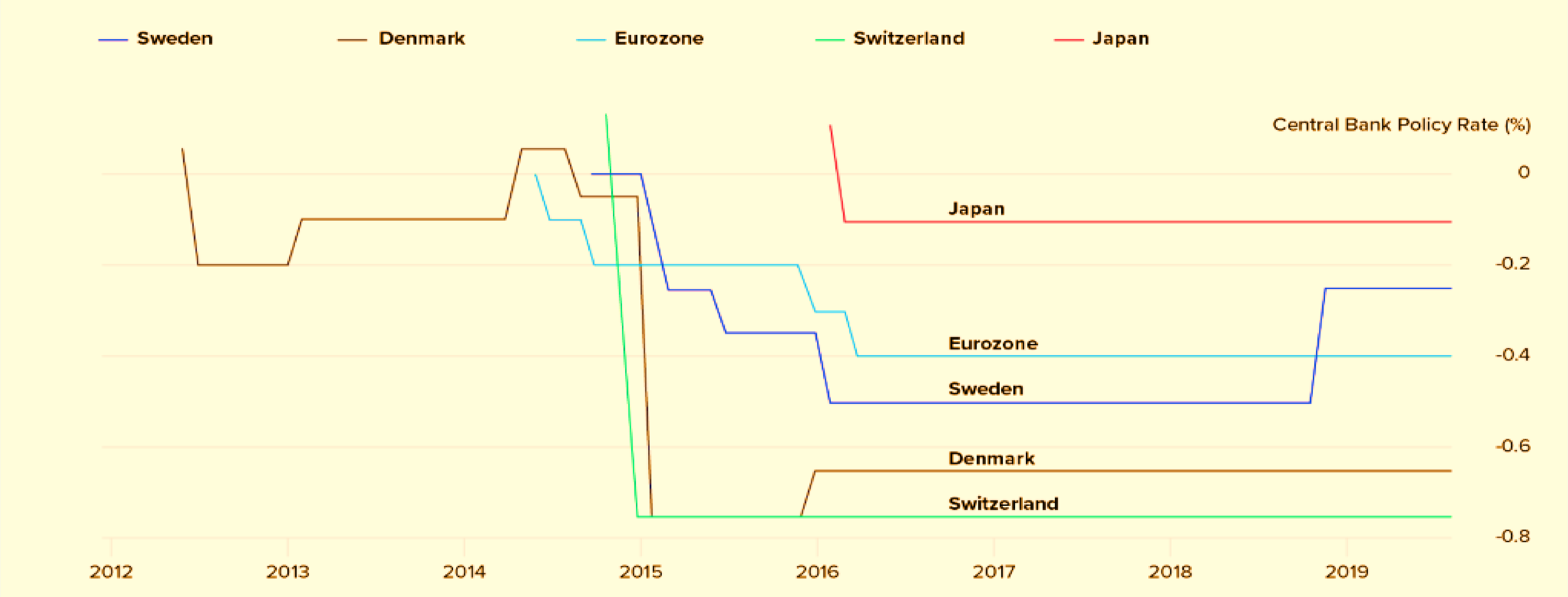
- Lowering the central bank target rate (Fed funds rate in the U.S.; the repo or refinancing rate elsewhere)
  - Concerned about a weakening economy and a lack of inflation pressures, Sweden's Riksbank, the world's oldest central bank, was the first to lower its repo in 2015 starting at -0.1% and eventually reaching -0.5% in 2016 (now back to 0.2% as of March 2020)
    - Riksbank repo rate is for bank deposits up to 7 days
  - Even before that, in 2014, Riksbank lowered its "deposit rate"
    - This is the overnight rate provided to banks for deposits at the central bank – similar to the U.S. Fed's IOER

Repo rate -- Riksbank



NEGATIVE RATES

European central banks implemented negative rates more or less together in order to limit the potential for arbitrage between the banks.



NEGATIVE RATES

Implications:

- Reduction in interest rates across the yield curve
  - Increases demand for longer-dated assets

- Potentially negatively affects bank profitability
  - Commercial banks loss of interest on reserves held at the central bank incentivize greater lending
  - "Negative rate mortgages" offset by fees
  - Lending is not affected by increased reserve holdings by banks per se (banks don't lend reserves)

- According to the ECB (not an unbiased assessment), negative rates, in conjunction with other policy measures, have supported economic activity and contributed to price stability
  - Estimates of up to 0.7% loan growth attributed to NIRP
  - With other measures, believed to have added up to 3 percentage points to growth

- Inflated asset prices

NEGATIVE RATES

Implications:

- Not transmitted to retail depositors

- May have serious negative implications for forward currency pricing and contracts

- Negative impact to savers and institutions with long term liabilities like insurance companies and pension funds

- Unknown long term consequences
    - Unwinding NIRP could be very hard to do in the current recessionary environment
    - Promotes risk-taking with unknown consequences
    - Boost to asset (equity) prices may be a set-up for a future correction

- Negative rates may be asked to solve problems that are not strictly economic in nature, such as aging demographics or a declining workforce

NEGATIVE RATES

Are negative rates coming to America?

- Fed Chair Jay Powell has repeated said that negative rates are not under consideration
  - The need may not really be there as inflation is close to target
  - Points to mixed results in Europe
  - Reliance on other tools preferred (QE, forward guidance)
  - Various support for credit markets under C-19 programs
  - Prefers greater fiscal policy intervention but the door is left open

- Investors betting some likelihood
  - Bank hedging contributes to the outlook
  - COVID fears raise specter of deflation

- Sweden's Riksbank pulled out of negative rates in December 2019 with concerns about the long term effect

- Inflation-adjusted real rates remain negative

NEGATIVE RATES

Are negative rates coming to America?

- Economists views mixed
  - JP Morgan analyst supportive for short-term NIRP
  - Ken Rogoff, Harvard, recommends NIRP and programs to prevent large scale cash hoarding and sees a benefit for emerging economies with high dollar-denominated debts
  - Former president of Minneapolis Fed is a "big fan" of negative rates – when the time is "right"
  - Mohamed El-Erian, chief economic adviser at Allianz, formerly co-CEO at PIMCO, says negative rates would be a disaster in the U.S. as systems are not set up for it and institutions would be severely hurt
  - MMTers say lower rates do not incent lending (backed by BoJ experience, yet, ECB experience suggests it does)
    - In fact, negative rates may have a depressing effect on the economy as savers and those dependent on interest income have less to spend
    - While a ZIRP may be beneficial in the long term, it is not because it is a stimulus to the economy
    - There is some evidence that low rates remove more demand from the economy than is added (though I question whether this is true of the incremental impact)
      - According to one analysis, QE removed $90 billion from the economy in 2012
    - There are much better ways to stimulate the economy through fiscal policy

NEGATIVE RATES

Are negative rates coming to America?

My take:

- Technically, this could be very disruptive to money market funds
  - But that's a problem the Fed can fix

- The key motivators for negative rates in the U.S. are:
  - Deflation – This was the primary incentive in Sweden and is the economy's worst enemy
  - Inadequate action by Congress – Chair Powell has not taken negative rates off the table. He has said it is up to Congress (fiscal policy) to carry the ball from here. If it does not and unemployment runs high for long, Powell may be forced to pull the trigger. Trump would like nothing more and may stall on future legislation in order to pressure the Fed.