Negative Interest Rates

Less Than Zero

By Jana Randow & Simon Kennedy | Updated June 6, 2016 9:08 AM UTC

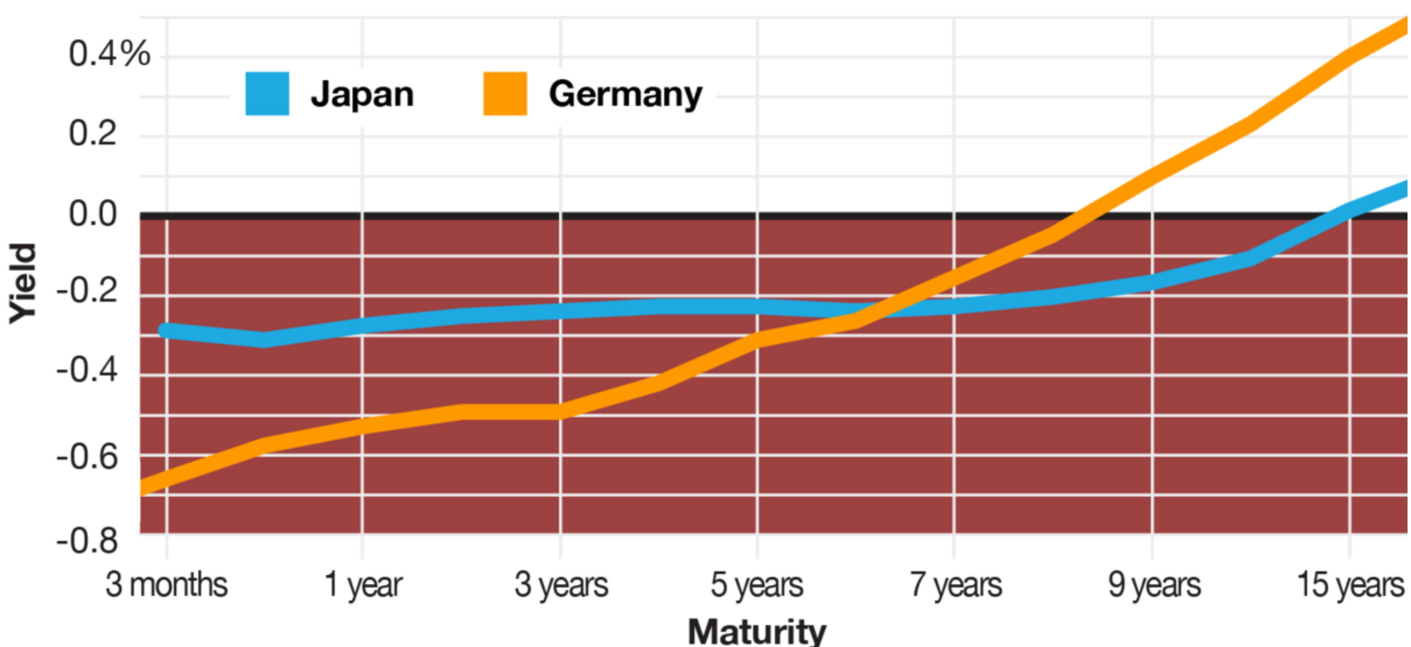
Imagine a bank that pays negative interest. In this upside-down world, borrowers get paid and savers penalized. Crazy as it sounds, several of Europe's central banks cut key interest rates below zero in 2014, and now Japan has followed. By mid-2016, some 500 million people in a quarter of the world economy were living with rates in the red. Unthinkable before the 2008 financial crisis, the idea is to jolt lending, spur inflation and reinvigorate the economy after other options have been exhausted. It's an unorthodox move that has distorted financial markets and triggered complaints that the strategy is backfiring. Negative rates will either mark the start of a new era for the world's central banks, or finally expose the limit of their powers.

The Situation

More policy makers have warmed to the experiment, even though sub-zero rates can crimp the ability of banks to make money or lead them to take additional risks in search of profit. The Bank of Japan rattled global markets by adopting negative rates in early 2016, more than 18 months after the European Central Bank became the first major monetary institution to venture below zero. The ECB cut again in March, charging banks 0.4 percent to hold their cash overnight. Sweden, Switzerland and Denmark have also adopted negative rates, weakening their currencies by encouraging investors to seek higher returns elsewhere. Even Janet Yellen, the U.S. Federal Reserve chair, said in 2015 that a change in circumstances could put negative rates "on the table" in the U.S. Since central banks provide a benchmark for all borrowing costs, negative rates spread to a range of fixed-income securities. By the end of April, about $8 trillion of government bonds worldwide offered yields below zero. That means investors holding to maturity won't get all their money back. While most banks have been reluctant to pass on negative rates for fear of losing customers, a few began to charge large depositors.

Paying to Save

Government bonds in Japan and Germany pay a negative yield, so investors holding to maturity won't get all their money back

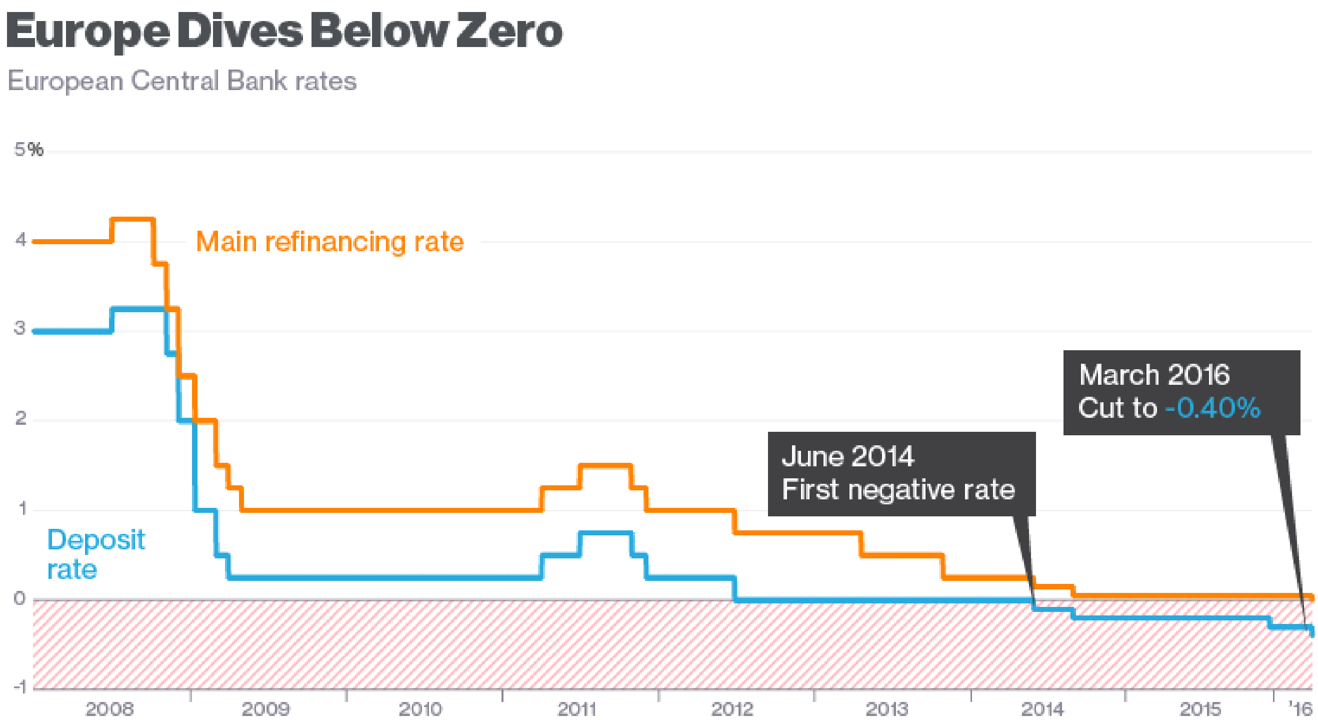


Data as of April 29, 2016

SOURCE: BLOOMBERG

The Background

Negative interest rates are an act of desperation, a signal that traditional policy options have proved ineffective and new limits need to be explored. They punish banks that hoard cash instead of extending loans. Europe's central bank chose to experiment with negative rates before turning to a bond-buying program like those used in the U.S. and Japan. Policy makers in both Europe and Japan are trying to prevent a slide back into deflation, or a spiral of falling prices that could derail the economic recovery. ECB President Mario Draghi said in January 2016 that there are "no limits" on what he will do to meet his mandate. The euro zone is grappling with a shortage of credit and unemployment that is only slowly receding from its highest level since the currency bloc was formed in 1999.



SOURCE: EUROPEAN CENTRAL BANK

The Argument

In theory, interest rates below zero should reduce borrowing costs for companies and households, driving demand for loans. In practice, there's a risk that the policy might do more harm than good. If banks make more customers pay to hold their money, cash may go under the mattress or into a safe instead, robbing lenders of a crucial source of funding and perhaps even triggering a bank run. Even if that doesn't happen, there's mounting concern that when banks absorb the cost of negative rates themselves, it squeezes the profit margin between their lending and deposit rates, and might make them *even less* willing to lend. Two years into the experiment, it was still too early to tell if negative interest rates will work, but central bankers say that so far the costs have been manageable. If more and more central banks use negative rates as a stimulus tool, the policy might ultimately lead to a currency war of competitive devaluations. The Bank for International Settlements warned in a March 2016 report of "great uncertainty" if rates stay negative for a prolonged period. However, the fact that such tools have now been tested means they're likely here to stay.

The Reference Shelf

- A Bloomberg comic explains how negative interest rates aim to put money to work.
- The Bank for International Settlements published a March 2016 report on negative rates.
- An analysis of the impact of negative rates in 2015 from Sweden's central bank.
- Blog posts from Francesco Papadia, a former director general for market operations at the ECB, on whether the central bank should have negative rates, and a discussion about where rates could go.
- A speech by Benoit Coeure, a member of the ECB Executive Board, on monetary policy and the challenges of the zero lower bound.
- A Bloomberg News article outlining the pros and cons of a deposit rate of zero or below and a QuickTake on the ECB's debate over quantitative easing.
- An ECB research paper on non-standard monetary policy and a Bank of England study of negative rates.

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FIRST PUBLISHED DEC. 4, 2013

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