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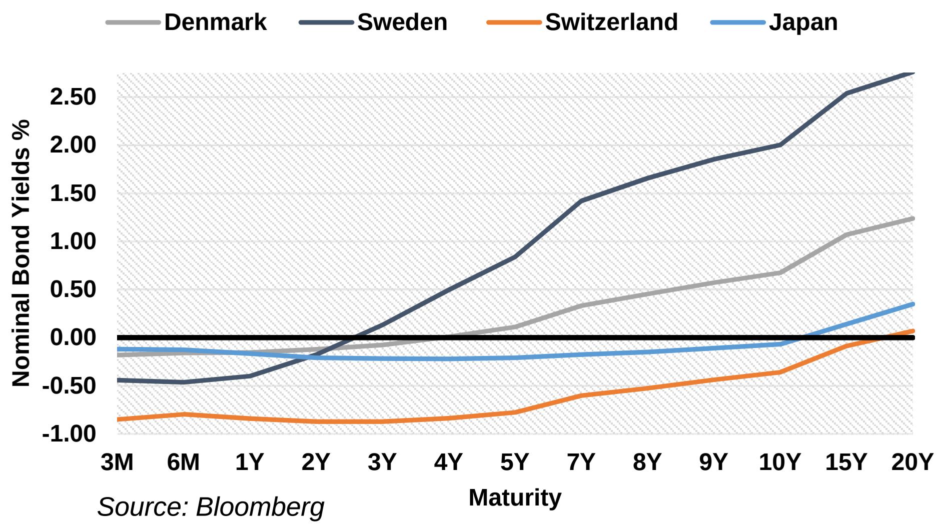
Negative Interest Rates: Acceleration or Desperation?

The financial crisis and its lingering effects have prompted central banks to take unprecedented steps to support their economies. Asset purchase programs such as the Troubled Asset Relief Program (TARP) and near zero interest rates were viewed as unconventional tools after the financial crisis. However, governments are now considering negative interest rates to further stimulate economic growth.

Paying To Save



Source: Bloomberg

Negative Rates in Theory vs. Practice

Monetary policy is a tool used by central banks to influence both economic growth and inflation by controlling the money supply. Central banks can either inject capital into the system to achieve a more accommodative stance, or pull capital from the system in order to restrict inflation. Savers have an advantage in periods of higher rates since they can earn more on their savings. However, this can also negatively contribute to economic growth if savings are by definition not being spent in the economy. Lower rates have the opposite effect and presumably incentivize consumption today, which can stimulate aggregate demand in the shorter-term. Negative interest rates provide even more incentive in theory with a quasi-tax on savers and even lower borrowing costs to support corporate growth initiatives.

Despite the implementation of negative rates being fairly new, Denmark, Sweden, Switzerland and now Japan have all embraced negative interest rate policies (see chart above). While some view such actions positively with respect to continued stimulation, some have expressed concern that such extreme actions undermine the credibility of central banks and ultimately signal desperation, which can have a negative effect on investor sentiment and ultimately economic growth.

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In an extreme scenario, it is conceivable that as the magnitude of negative rates were to increase, savers could eventually remove their capital from the financial system altogether since earning 0% on their savings would be an improvement over being penalized for saving. This has the potential to deprive banks of their key funding source with which to lend, which has the potential to undermine a major source of economic growth through a lower velocity of money.

The Impact

Despite the academic theory that the risk-free asset will provide assurance of return of capital plus some marginal return, negative interest rates have the potential to undermine this generally accepted theoretical premise. Even if the loss proves to be de minimis, a small loss is hardly riskless by any definition. The idea of losing the risk-free asset could redefine the opportunity cost of what risk means for investors. While not a call for the demise of Treasuries, the possibility of negative rates warrants that investors be mindful of their bond exposures and how they define risk in their portfolios.

In addition, currency prices have the potential to be heavily influenced since exchange rates fluctuate based on global risk-free rates. Capital tends to flow to countries with higher real risk-free rates which can provide support of the price of a particular currency. The recent strength of the U.S. dollar is an easy example of this since investors have continued to favor dollar-denominated assets at the expense of assets denominated in other currencies that continue to print in order to stimulate their economies. Europe and Japan are clearly in this mode and the impact on returns in global portfolios has been undeniable.

Investors in various economies have recently been willing to accept a negative return for peace of mind that their money is “safe.” To some degree, U.S. investors continue to hold Treasuries for this same reason, but negative interest rates have the potential to push those investors to their limits.

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