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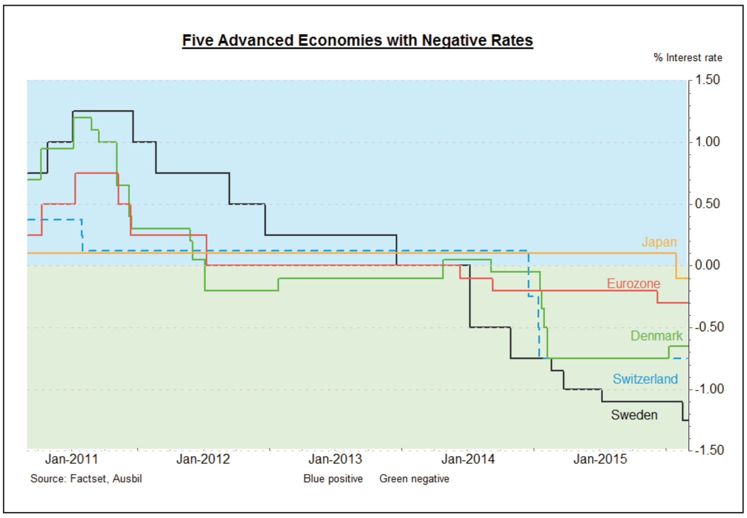
Negative interest rates

Central Banks in Europe and Japan have lowered their key interest rates to less than zero in a bid to stimulate activity and boost inflation in their economies. A negative interest rate occurs whereby instead of receiving money on deposits, depositors must pay regularly to keep their money in the bank.

Effectively, negative rates are intended to force banks to lend even when there is a lack of end-user demand for money and to inspire the private sector to consume more.

Japan is the latest nation to join the ranks of the European Central Bank, Switzerland, Sweden and Denmark offering negative interest rates. These advanced economies are running sizeable current account surpluses while also displaying core inflation rates consistently below their targeted levels (typically 2%).



The rationale for acting is the risk that core inflation will continue undershooting the 2% target, especially given the significant decline in energy prices in the past year.

What has happened to see a major turning point in Central Bank thinking on the tools for implementing monetary policy?

Excessive private credit growth in the advanced economies prior to the 2008 global financial crisis lead to unsustainable levels of over-leverage. To offset the debt adjustment against the backdrop of fiscal constraints the nominal cash rate was lowered in most cases to the lower zero bound. But this has had only a marginal impact in reviving global investment. Aggregate nominal demand has been sluggish and the traditional V-shaped recovery has morphed into an elongated U-shape.

Developments since 2014 have seen the “theoretical and the unthinkable” in terms of policy action become more the “new way” to navigate the worst financial crisis since the 1930’s. The enforced negative interest rates act like a tax on the banking system. The transmission channel to the real economy aims to work through two areas, namely credit supply and depreciation of the foreign exchange rate.

Funds will most likely flow to the credit sensitive sectors including housing, motor vehicles and business investment, resulting in multiplier effects on the broader economy. Banks will also be investing their excess reserves in government bonds, therefore driving yields lower with a spill-over into investment and non-investment grade credits. In addition there will be a reduced interest charge burden for debt obligations priced off the cash and yield curve. Overall there will be a wealth effect via rising asset valuations.

Depreciation in the exchange rate will have an impact on inflation via higher imported prices, however, a lower currency may be matched by other nations to protect their export market shares. So in effect, at a global level, currency depreciation may amount to a pointless zero sum game.

Ironically, the new policy tool operates on private credit growth which is the key variable that caused the Global Financial Crisis in the first place. Implementing negative rates requires re-leveraging which will compound the risks of financial instability. Lack of fiscal stimulus means more central bank liquidity going into financial markets and inflating the bubble further for assets. More importantly, there is a policy mismatch as negative rates are a supply side response to the demand side problem of persistently sluggish aggregate demand, against the macroeconomic backdrop of fiscal constraints with the emphasis on balance sheet repairs.

At Ausbil, we believe this policy will cause distortions in the allocation of capital. Adopting negative rates actually amounts to market failure where risk is not taken by private agents and the bank's lending practices also act as a constraint. To encourage risk taking for the longer term and to help drive investments into productivity enhancing models this should be conducted through the government's arm of traditional fiscal policy, namely infrastructure investment. We have long advocated the need for active Fiscal policy in providing a necessary circuit breaker for anaemic business investment and to help drive productive growth.