Negative Interest Rates. Not Much To Be Positive About.

Global economic growth has been slow and inflation has been stubbornly low despite efforts by central banks to raise them. The first round of unconventional policy involved central banks buying bonds and other assets and increasing their balance sheets. The strategy has only been moderately successful and is probably at the point of diminishing marginal returns. Therefore, an alternative unconventional policy had to be implemented: negative interest rates.

It is hoped that negative interest rates would encourage more credit creation to spur growth and inflation. What central banks would prefer markets to focus on less is the expected impact on currencies lest they are accused of waging currency trade war. Negative rates might also encourage investors further up the risk spectrum to taking more risk and reducing borrowing costs across a wider swathe of the economy.

There are a number of problems, however, with negative interest rates. First of all, it assumes that the problem stems from weak supply of credit. Low equilibrium interest rates are indicative of poor demand for credit, not deficient supply. Lowering the cost of credit is of limited impact in raising the demand for credit which depends more on the available unlevered returns in asset markets today, which looks quite meagre, as well as the prospects of paying down debt in the future. If economic prospects are poor, increasing the supply and lowering the cost of credit is unlikely to spur lending.

Negative rates are also confounded by banking regulation. Central banks and regulators have two conflicting missions for banks, make more loans and take less risk. Banking regulation highlights the fact that banks lend not out of liquidity but out of capital, and therefore the calculus for increasing the supply of credit is not entirely the cost of the bank’s credit but the cost of its capital as well. Cutting rates into negative territory helps with one part of the equation but is nullified by the other. Negative rates pay banks to borrow from central banks and to lend cheaply to borrowers. However, the type of borrowers central banks would like banks to lend to are small, medium enterprises, businesses too small to access bond markets. Unfortunately, loans to these types of borrowers consumer more capital under Basel III regulation. Banks have to apportion more capital against these loans which makes the cost

of capital more relevant to the bank than cost of liquidity, which carries the negative interest rates. Cost of capital is a more comprehensive measure of how much it costs to make a loan and this is not directly addressed by simply cutting interest rates below zero.

Meanwhile, negative interest rates have some less desirable side effects. For one, it encourages cash hoarding. While individuals might be expected to engage in cash hoarding it was instructive to see Munich Re, one of Europe’s largest reinsurance companies engaging in storing physical cash in vaults. Negative interest rates could, perversely, result in a shrinking of the money supply.

Negative interest rates are damaging to the savings industry, in particular insurance and pensions. Insurance companies have long term liabilities which have to be funded. With ultra low interest rates and low asset returns, assets maturing face a lower expected return. Most insurance liabilities, however, are not benchmarked to interest rates and many have a guaranteed floor on returns. Negative rates threaten the long term solvency of the insurance industry. The same calculus applies to pensions, especially defined benefit schemes which guarantee a certain level of payouts unrelated to the returns generated by their assets.

A more insidious way that negative interest rates undermines the economy is that interest rates represent a hurdle for investments as well as a tide for the economy to swim against. A certain level of interest rates is also useful in eroding excess capacity and euthanizing unviable businesses. Human enterprise thrives on hardship to innovate and evolve. Nothing destabilizes like a tide from the rear. It is the life support that keeps inefficient businesses alive, maintains excess capacity and ultimately weakens the economy as a whole.