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Negative Interest Rates – A Brave??? New World

As far back as our memories can recall, when we took out a mortgage or borrowed money from a bank or other lender, we always expected to pay back more than we borrowed—the difference being interest. Or, if we deposited cash in savings or money market accounts, we would expect to receive interest. Well, the times they are a changing. In the new upside-down world, borrowers get paid and savers get penalized.

So, what are negative interest rates? They are effectively the opposite of interest rates. Typically, if you borrow $100 at a 1% interest rate, you'll have to pay back $101. With negative interest rates, it's reversed—you'll have to pay back only $99. You, as the borrower have been advantaged. The lender, on the other hand has been disadvantaged.

Why such a radical change?

Economic growth throughout the developed world has been moribund for many years.

In Europe, after racking up massive debt, the region continues to be burdened by a stagnant economy even as the job market and some other areas have improved.

Japan's economic problems largely stem from demographics. The previous booming population has turned into an old one and immigration and births are not enough to counteract this socio-economic trend. Some estimates suggest that Japan has a deficit of about one million employees costing up to 2% of GDP growth.

Over the past year, Europe has pursued a bond buying program a.k.a. "quantitative easing." Japan has overhauled parts of its economy. Neither approach has produced encouraging results. It's time to pull out all the stops—negative interest rates.

Central Banks

Central Banks are the driving force behind negative interest rates. They alone have such power. While their gradual reduction in interest/borrowing rates in the past has produced no significant upturn in GDP growth or economic activity, central bankers continue on this path.

Central Banks believe that attaching a cost to holding cash will incentivize those sitting on such huge hoards to consider other options. More specifically, they believe that negative rates will cause banks to lend, businesses to invest and savers to spend. Were this to happen, the forecast would be for very positive economic growth.

Critics of negative rates are plenty primarily because they are so new as a tool, there is no proof of their effectiveness. Many believe that negative rates will either mark the start of a new era of world Central Banks, or finally expose the limits of their powers.

Winners and losers

Certainly, Central Banks have their raison d'être and reputations on the line. However, they will also be the beneficiaries of a stream of new revenue. Banks and many other institutions park their cash with Central Banks for safety and to earn interest.

In the negative rate environment, Central Banks will actually earn money by paying these depositors less than they deposited. With trillions of Dollars/Euros/Yen involved, Central Banks and their government sponsors should realize a sizable windfall.

Commercial banks will require changes. They will now lose money on those deposits with Central Banks. To compensate, they will have to increase their volume of lending, increase the interest rate on such lending and/or increase bank fees.

Those issuing bonds (governments, corporations, municipalities) will benefit. The interest rates on these bonds will be lower thus reducing their costs of doing business.

Insurance companies and pension funds, major holders of bonds, will see their earnings from interest decline.

Retirees and others living on income from investments will eventually realize a reduction in their income streams.

In summary, negative rates must be considered a work-in-progress. History offers no clear evidence of their effectiveness.

One thing is for sure—they're not going away quickly. In January, ECB President Mario Draghi said that there are "no limits" on what he will do to meet his mandates. Even Janet Yellin, the U.S. Federal Reserve chair, said that a change in circumstances could put negative rates "on the table" in the U.S.

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Our Two ¢

On the argument that tariffs are needed to support vital domestic industries: "these political favors will inevitably go not to the deserving but to the strong and the unscrupulous."

Henry George
American economist 1886

Quarterly Trivia:

Following the depression from January 1920 to July 1921, the economy came roaring back–the "roaring twenties." Which government programs were responsible for this strong recovery?

- *a. fiscal stimulus (spending)*
- *b. lowering interest rates*
- *c. bailouts*
- *d. quantitative easing*

None of the above. The government essentially took no action. See: The Forgotten Depression by James Grant