What is Negative Interest Rate Policy Anyway?

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Several central banks, notably Japan and the European Central Bank, have instituted Negative Interest Rate Policy (NIRP) in a radical move to spur economic growth. NIRP refers to a policy whereby banks are charged to keep money with the central bank and charges are potentially passed on to savers. The general goal of NIRP is to encourage consumer spending, reduce borrowing costs and increase liquidity to help fight deflation. It's a relatively new policy and many economists are concerned about the long-term consequences.

By February 2016, more than $7 trillion of government bonds worldwide offered yields below zero which represents over a quarter of the world's government bonds (Bloomberg/Business Insider). That means investors buying bonds and holding to maturity won't get all their money back! The Bank for International Settlements, a financial institution for central banks, warned of "great uncertainty" if rates stay negative for a prolonged period. If more central banks use negative rates as a stimulus tool, a currency war could result. This is an event where countries devalue their currencies in hopes that exports will increase and they can gain a trade advantage over other countries. The hope is that a weaker currency will encourage more domestic production, which raises employment and GDP.

Although many of the potential outcomes of NIRP seem beneficial, financial institutions have been adversely affected. For example in Europe where NIRP has taken hold, the iShares MSCI Europe Financials ETF (EUFN) was down 11.94% in the first quarter. Banks need higher interest rates in order to grow their most important source of earnings, net interest income. Negative rates will severely hurt bank earnings as it makes it harder for lending to be profitable. Policy makers hope that the cost to the banks of holding money pushes them to lend more at low rates to help grow the economy. Other non-bank financial companies such as insurance firms or pension funds may also struggle to meet their long-term liabilities if their investment policies dictate that they must hold some assets in "safe" government bonds.

While the U.S. is still in the midst of a tightening cycle, Janet Yellen testified that the Fed may consider NIRP if we see slowing economic growth, deflationary pressure or higher unemployment. While we don't anticipate this in the U.S. in the near term, the scenario exists where the Fed would follow other central banks and implement NIRP to fight sluggish growth and disinflation. The investments that should benefit from a negative interest rate environment include currency, precious metals, dividend paying stocks, leveraged investments such as real estate and government bonds as rates decline.

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