P I M C O

VIEWPOINT

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Negative Interest Rate Policies May Be Part of the Problem

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Central banks around the world are developing a newfound fondness for experimenting with negative interest rate policy (NIRP) despite unknown consequences and what appears to be a chilling effect on financial markets.

After initially rejecting the idea given the uncertainties and potential for collateral damage, the European Central Bank in 2014 and the Bank of Japan last month joined the central banks of Denmark, Sweden and Switzerland in negative territory. Now it seems the Fed may be warming to the idea, having gone beyond supportive innuendo to subtle preparation for potentially engaging in NIRP. (One example: The Fed's 2016 scenarios for bank stress tests, released in late January, included as part of the "severely adverse scenario" the potential for short-term Treasury rates to fall to negative 50 basis points.)

While there is no longer any doubt about the ability or willingness of many central banks to manufacture negative interest rates, their efficacy on growth or inflation is far from certain. In fact, policymakers may have significantly underestimated the economic risks.

THE NEW ABNORMAL

Central bank advocates of NIRP increasingly seem to portray it as nothing more than a natural extension of conventional monetary policy. In a "normal" interest rate cycle, central banks cut interest rates to reduce nominal and real (inflation-adjusted) interest rates; the goal is to ease the burden on debtors and lower hurdle rates for investment. The belief is that lower rates (even negative ones) are always stimulative, while higher rates are always restrictive. However, risks may increase exponentially the lower rates go and the longer they stay there.

Although it is difficult to know the counterfactual because this is such an unprecedented situation, it appears that NIRP has not been especially impactful in lifting growth or inflation, or in lifting expectations about future growth or inflation. Instead, it seems that financial markets increasingly view these experimental moves as desperate and consequently damaging to financial and economic stability.

What are the potential negative externalities that could be upsetting financial markets?

MARKETS

At a minimum, NIRP is a contributing factor to the financial market volatility of the past few months. And contrary to current central bank dogma, NIRP is possibly one of the major catalysts behind the tightening in global financial conditions. While NIRP undoubtedly helps lower government bond yields, which in isolation represents a loosening of financial conditions, it may be causing the opposite effect on overall financial conditions: widening of credit and equity risk premiums, increased volatility and reduced credit availability from a more stressed bank system.

Moreover, NIRP may act to reduce inflation expectations embedded in financial assets rather than encourage anticipation of a return to targeted inflation. Nominal government bond yields can be decomposed into two yield components: a component that represents the expected "real" inflation-adjusted return, and a component that compensates for expected inflation. The exact decomposition is not scientifically determined; individual investors will make their own decisions. But policymakers hope that all of the downward adjustment in yield reflects a lowering of the real yield component and not the nominal yield piece that reflects inflation expectations.

This seems unrealistic. When interest rates are negative, some of the resulting lower nominal yield will tend to spill over from the real yield component into the inflation expectations component. Central banks cannot control this; the process is imprecise by nature. The result, however, is that NIRP and the lowering of nominal yields can suppress medium- and long-term inflation expectations. This is directly at odds with the central bank policy objective of returning inflation and inflation expectations to target.

In addition, negative interest rates may act to increase risk aversion and uncertainties across the financial system through portfolio decisions. As rates fall into zero or negative territory, the "safest" financial assets – government and other high quality bonds – actually become riskier! As yields are pushed into negative territory, holding these bonds represents a guaranteed loss of purchasing power if held to maturity. In essence, perceived risk-free and other high quality assets are being removed from the financial system and replaced with riskier, negative-expected-return assets. While that may encourage some investors to take more risk to compensate for loss of income, others will certainly be forced to reduce risk in response.

MACRO EFFECTS

Negative interest rates represent another escalation of the so-called currency wars – these policies seem to have outsized influence on currency levels and volatilities. A beggar-thy-neighbor currency policy designed to suppress a currency's value for competitive gain can hasten a return to protectionism and nationalistic polices, which are negatives for global growth.

Also, negative rates affect the financial system in other adverse ways. Bank interest margins are reduced and their cost of capital is increased as spreads on debt and equity expand to compensate for reduced profitability. Banks attempt to pass on these costs to consumers and businesses; they also constrain credit and raise lending rates, weighing on growth. Insurance companies and pension funds may also come under stress as potentially reduced future portfolio returns make it harder to deliver on their commitments to policyholders and pensioners.

Finally, negative interest rates also act as a tax on savers and investors who must plan on lower rates of return into the future. This, in turn, may cause an increase in savings rates, further hampering near-term growth.

NIRP ALTERNATIVES

In summary, negative interest rates may be a central bank tool that is increasingly ineffective at boosting growth and inflation, and may pose more risk to the financial system than commonly understood. It could very well be that a return to more normal monetary policy rates would beget a return to more normal economies with normal inflation expectations.

Even if that were not to be the case, monetary policies more focused on easing financial conditions by lowering credit and equity risk premiums directly (for example, asset purchase policies directed at credit and equity, or raising the inflation target) may prove far more effective than negative interest rate policies that have many unknown costs and risks and, to date, have done more harm than good.

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