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What Are Negative Interest Rates & Why Do They Occur?

Negative interest rates are a monetary policy tool aimed at stimulating economic activity and inflation by setting the nominal target interest rate to a negative value. There are two types of interest rates, nominal interest rate which is the stated rates that borrowers pay on a loan, and the real interest rate, which is the nominal rate minus the rate of inflation. The real interest rate can be negative if inflation exceeds the nominal interest rate, but the nominal interest rate is historically set at the zero-lower bound (ZLB). To be clear, in this white paper, we are referencing negative nominal interest rates.

Under a negative interest rate policy (NIRP), savers pay banks to hold their money and lenders pay borrowers to borrow funds. If extended to central banks, NIRP would mean banks are charged a fee for holding excess reserves at the central bank, thus encouraging banks to substitute out of reserves and into lending. Negative interest rate policies are most likely to occur during deflationary periods when people and businesses are hoarding money instead of spending and investing. Such activity can cause a significant fall in demand, which leads to prices falling even further, a severe reduction in production and output, and an increase in unemployment.

Which Countries Have Negative Interest Rates?

Despite ZLB theory, several central banks including the European Central Bank, and the central banks of Switzerland, Denmark, Sweden, and Japan have implemented negative interest rates. The Swiss National Bank has the lowest interest rate at -0.75% and Denmark is not far behind with a -0.60% interest rate. Japan has a -0.10% interest rate while Sweden and Spain reported 0% interest rates. Negative rates in Japan have not stimulated the economy.

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The Japanese government has a considerable amount of debt and faces restrictions in its ability to invest in structural economic reforms because of its increasing obligations to an aging population. Similar to Japan, there is no real evidence that negative rates have had a positive effect in the Eurozone. The negative interest rates at the ECB were intended to help banks, but they have actually created a spiral of declining profit margins. Denmark has not experienced inflation above 1% since 2012 even though rates have been in negative territory since 2015. While Denmark has experienced an asset price boom, the nation also experienced widening inequality that can be linked to a negative interest rate. On the other hand, Sweden's use of negative rates to create export growth, has contributed to the country's robust economic growth.

Who is Hurt By Negative Interest Rates? How?

To put it simply, negative interest rates would hurt savers and lenders. Consider that banks earn profits on the difference between the interest rates they charge on loans and the rates they pay on deposits. So, a bank would pay borrowers to take out a loan, while individuals would have to pay the bank to hold their money for them. Therefore, negative interest rates would compress the profit margin of banks, leaving them worse off. Individuals with large savings accounts, companies with large cash balances, and those who rely on interest income, like some retirees, could be hurt by NIRP. In reality it would be nearly impossible for banks to lower interest rates below zero on deposit accounts without leading cash withdrawals.

However, it might be possible for them to successfully impose negative interest rates on large corporate accounts. Given that companies and individuals would have to pay the banks to hold their money, it creates an incentive for them to invest those funds to stimulating economic growth or retire debt.

Who Benefits From Negative Interest Rates?

If NIRP works, it could stimulate economic activity. The beneficiaries include companies and individuals with large amounts of debt, current bond holders, and stock investors. Companies and individuals with large amounts of debt would essentially be getting paid to borrow money. Current bond holders would benefit because currently existing bonds rise in value when interest rates decline. As spending increases, companies facing increased demand will likely see an appreciation in their stock prices. The lower the interest rate, the fewer fixed income options investors have, which leads more money flowing into stocks driving share prices higher. Like other countries, in times of economic uncertainty, which negative rates tend to imply, purchasing tangible assets, such as real estate with low cost financing becomes more attractive.

What Are the Short- And Long-Term Affects of Negative Interest Rates?

COVID-19 has led to increased consideration of unconventional monetary policies in the U.S. but it is challenging to determine the short- and long-term effects of such policies. In theory in the short-term, negative interest rates would stimulate economic activity by increasing lending which would lead to rising investment and spending levels. Negative rates have only been around for eight years, making long-term effects difficult to determine. But, the long-term impact of depleting savings rates and increased household debt brought about by negative interest rates will likely impact future generations of savers and retirees.