focus

Are negative interest rates on the way?

The concept of “negative interest rates” is one many of us will struggle to comprehend. Will I have to pay the bank to hold my cash? Will the bank pay me to have a mortgage? These two common questions almost seem surreal, however the reality is that not much is likely to change. Negative retail interest rates for both depositors and borrowers are still very uncommon in countries that have negative central bank interest rates.

Why are we discussing such a topic?

The Reserve Bank of New Zealand (RBNZ) stated recently that lowering the Official Cash Rate (OCR) into negative territory was still an option (albeit not until March 2021), as part of its quantitative-easing programme to battle the economic impacts of COVID-19.

Central banks around the world are responding to the unprecedented economic conditions caused by COVID-19. One of their key policy tools is to lower their benchmark interest rates, (the OCR in New Zealand's case), which then filters through to lower retail borrowing costs for businesses and households.

The RBNZ is committed to the current 0.25% OCR at least until March 2021. This is because the banks' systems are not yet able to operate with negative interest rates. Whether the OCR heads into negative territory will depend on present and forecast economic conditions.

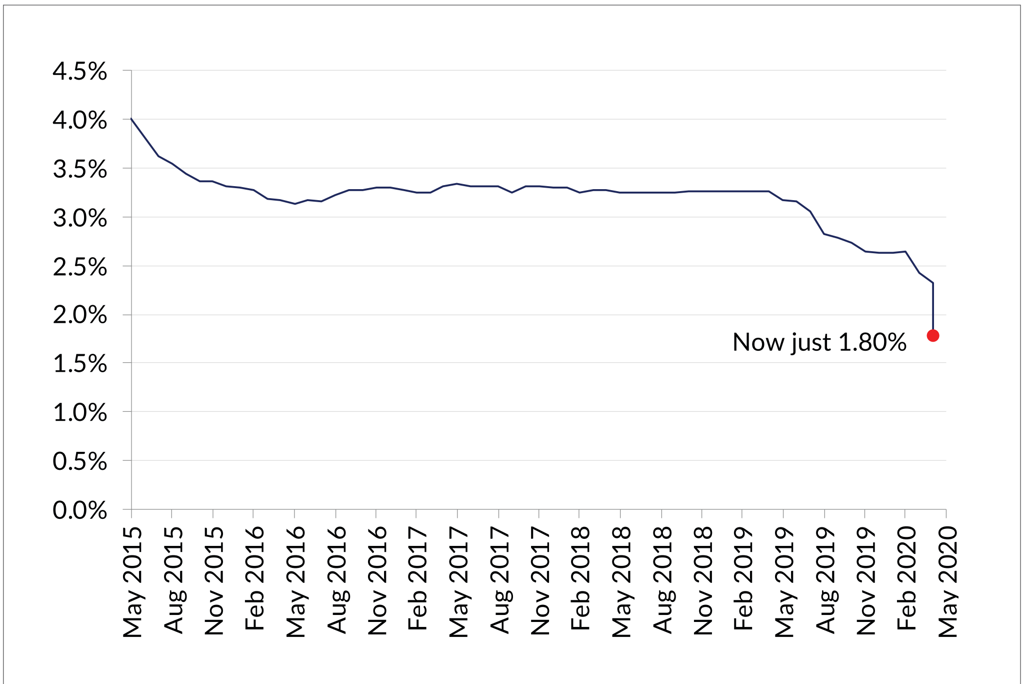
How do negative interest rates work?

The theory is that if the OCR is negative, banks will decide against 'parking' so much cash with the RBNZ, as it will actually cost them to do so. Instead they will lend to consumers (businesses and households), thereby keeping credit flowing through the economy.

However, the success of negative interest rates is mixed, with many economists now believing that negative interest rates have actually had negative effects on economies. Some of the downsides are thought to include the following:

- Depositors choose to spend less because they are not earning as much interest (or perhaps negligible interest) and they are reluctant to withdraw capital to fund any spending
- Negative interest rate policies assume that consumers and businesses have the capacity to borrow more, and that they have the confidence to spend and invest. But:
    - Borrowers cannot take on unlimited debt
    - Negative interest rates signal that the economy is in trouble and that prices are set to fall, which hurts the confidence of businesses and consumers — limiting demand for loans even at low rates

6 Month Term Deposit Rates (New Zealand)

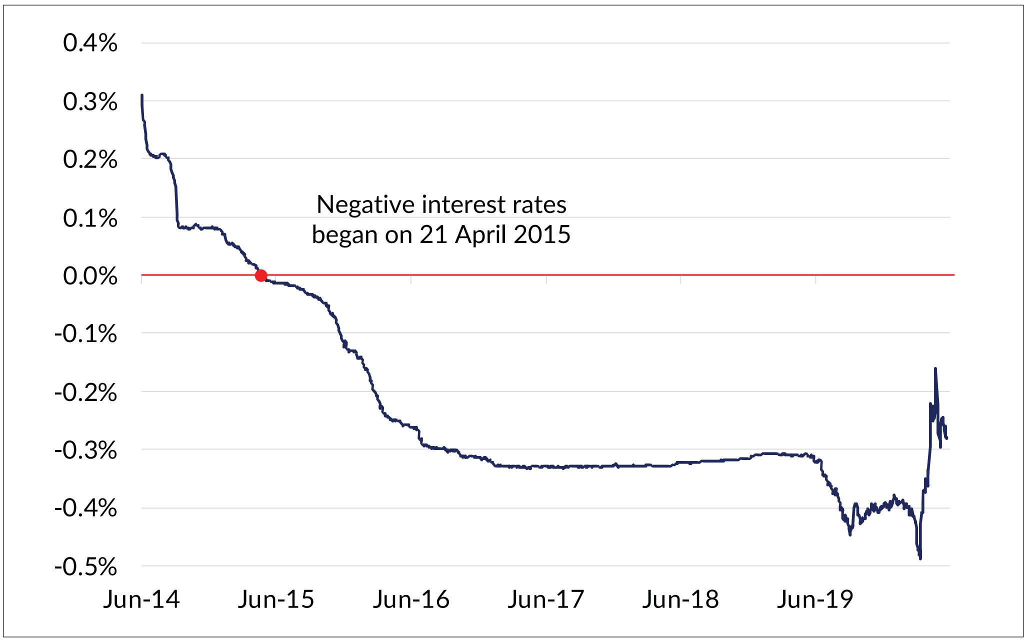


Source: Bloomberg

- Negative interest rates fuel asset price increases
- Negative interest rates prop-up inefficient businesses, which reduces the growth potential of an economy
- Negative interest rates could hurt fragile perceptions of the political independence and credibility of central banks

Negative interest rates are not new, with the Bank of Japan (BoJ), the European Central Bank (ECB), the Swiss National Bank and Sweden's Riksbank all implementing negative interest rate policies over the last decade. Retail depositors may eventually see 0.01% deposit rates, but negative retail interest rates for both depositors and borrowers are still very uncommon in countries that have negative central bank interest rates.

European 3 Month Bank Bills



Source: Bloomberg

Both mortgage and deposit rates in New Zealand have been heading lower as the RBNZ's and Government's monetary and fiscal response to COVID-19 begins to impact financial markets. It would appear that the economic recovery may take some considerable time, with the likelihood of very low interest rates being present for both lenders and borrowers in the years to come. However the scenario that retail depositors will have to pay the bank to hold their cash, is highly unlikely in our view.

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