The Gower Initiative for Modern Money Studies

What are Negative Interest Rates?

The Bank Rate[1] is the rate of interest that the Bank of England pays commercial banks on any money (reserves) they hold with the Bank. If the Bank of England decides to set the Bank Rate below zero[2] it has adopted a Negative Interest Rate Policy (NIRP). This means the Bank has decided to charge commercial banks a rate of interest on money they hold with the Bank rather than pay them.

Reducing interest rates is the usual method of monetary policy. It sets a single interest rate in the belief that will help the economy hit an inflation target of 2%.

Reducing interest rates is supposed to help the economy in two ways[3]:

1. Reduce the cost of borrowing so that firms are more likely to borrow money to invest.
2. Reduce the interest paid on savings so that holders of credit balances are encouraged to spend them.

When the Bank Rate is above zero, it is expected that the policy will encourage borrowing more than reducing savings. When the Bank Rate drops below zero the policy looks to reduce saving more than encourage borrowing.

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[1] Interest rates and Bank Rate
[2] Information request: Operational readiness for a zero or negative Bank Rate
[3] An understanding of MMT contradicts this view. Given the current high public debt to GDP ratios, the reduction of risk-free interest income following interest rate falls is likely to exceed any expansionary effects arising from these two effects. Thus interest rate reductions are contractionary, not expansionary (Mosler and Armstrong 2019) https://gimms.org.uk/2019/02/24/central-bank-operations-interest-rate-policy/

The Negative Interest Rate Process

As a whole, banks cannot get rid of the money (reserves) they hold with the Bank of England. All they can do is move it between themselves. Overall, the banks will be charged by the Bank of England and they cannot avoid it. Negative Interest Rates are a tax on banks, and the banks will look to pass that charge onto their customers. The more QE that has taken place in an economy, the more central bank money the banks hold and the bigger the overall tax charge.

Banks are unlikely to pass on the cost to individuals with deposits. The value of deposits is usually relatively low and can easily be exchanged for cash. Cash is expensive for banks to process and they would want to avoid a switch into it for both practical and marketing reasons.

It is difficult for banks to pass on the cost on the loan side too[4]. In a negative rate environment, loans start acting more like deposits normally do. Competition drives the interest rates to cluster around the Bank Rate.

That leaves corporate deposits and wholesale deposits where banks can pass on the cost in full - charging them for storing money[5]. It is far more difficult for corporates to move to cash, and their relationship with the bank is often deep and more difficult to change. It is this ability of the banks to charge firms to store money that the Bank of England is relying on for negative interest rates to work.

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[4] Negative interest rates, excess liquidity and retail deposits: Banks' reaction to unconventional monetary policy in the euro area

[5] Is There a Zero Lower Bound? The Effects of Negative Policy Rates on Banks and Firms

What Negative Interest Rates Changes

A negative interest rate policy (NIRP) is aimed at firms holding a lot of money on deposit. By forcing banks to charge them, the intent is that firms will start investing and buying assets (hopefully, productive assets). The belief is that this will cause increased activity in the wider economy.

In this sense, NIRP acts like any other duty or levy: encouraging the desired behaviour and discouraging unwanted behaviour.

The problem is that this tax does not reduce automatically as corporations change their behaviour. It just gets moved somewhere else in the economy. Where it ultimately ends up is unpredictable, but it is clear that *somebody's* deposit somewhere has to be reduced to pay the tax!

Pretty quickly, firms will have enough machinery to make the few extra things people are buying. Then what? Firms start shedding cash by paying out dividends, buying up their shares, buying up other firms or moving their liquid assets to other currency zones. This puts downward pressure on the exchange rate.

NIRP will drive up the price of gilts, which causes pension funds a problem as they price the pensions they have to pay out based upon the price of gilts and the income that can be received from them.

Very many pension funds in the UK are company pensions, where the company is legally obliged to top up the fund when the fund determines it hasn't enough money to pay pensioners. Rather than going into productive assets, a company may be required to hand its cash over to its pension fund to cover the shortfall caused by NIRP.

However here in the UK, given the evidence from Denmark[6] and Sweden[7], the likely effect will be the usual one: a rise in the price of property. If we ever get to the point where people are being paid to borrow money, then a property price bubble is near certain.

This is where negative rates start to become unstuck. Will the negative rates be enough to dislodge company savings into productive investments, or will they simply be cycled round the property and share markets driving up prices until the central bank finally taxes them all away with ever more negative rates?

Eventually, we have to conclude that monetary policy doesn't work in the way its advocates[8] insist. It should be relegated to the back seat and replaced with the superior stabilisation capabilities of a Job Guarantee[9].

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[6] Danish house prices reach highest ever level, beating 11-year record
[7] The Swedish experience with negative central bank rates
[8] The Case for Implementing Effective Negative Interest Rate Policy
[9] The Job Guarantee: A Superior Buffer Stock Option for Government Price Stabilisation

Why are Negative Rates different from Positive Rates?

This is perhaps best explained by analogy.

If you have a decent capital sum in a bank account - say £50,000 - and the interest rate drops from 2% to 0.5% how do you feel about that? It's a bit annoying you've lost income, but really it is an opportunity cost and probably isn't going to get you to spend the £50K. Probably not even when you know that inflation is 1.5% because people tend to think in cash terms, not inflation-adjusted terms.

Now let's drop the interest rate below zero to -0.5%. At this point, your nest egg is shrinking by £250 per year. Suddenly the threat has changed quality from a loss of income to a tax. Now it might be time to get that last new car or upgrade the bathroom.

The hope is that firms will feel the same way and stop deferring their investments in an uncertain environment, and that extra spending from firms will kickstart the economy.

How Effective are Negative Interest Rates from the MMT View

- *It is curious to impose a new public tax on the private sector when the objective is to achieve a higher inflation rate … Banks would have a greater incentive to economise on their holdings of reserves, but this does not mean that banks have an increased incentive to create credit*[10]

- *QE [Quantitative Easing] built bank reserves, allegedly to encourage the banks to lend more. Now negative interest rates are being used in the hope of reducing bank reserves, in the hope that banks will lend more.*

  If you think we are entering the land of absurdity, you wouldn't be far wrong.[11]

[10] Macroeconomics; Mitchell, Wray and Watts; §23.6; pp367
[11] The folly of negative interest rates on bank reserves