There has been a great deal of talk in the press over the last few months concerning negative interest rates, with specific focus on the implications for global markets. The concept of paying a bank to hold your money sounds bonkers (you can after all stash your cash under a mattress for free!) so why have they attracted any attention at all, let alone billons of Euros worth of bank deposits?

What is it?

What is the definition of a negative interest rate? This is when an individual or institution pays for the privilege of depositing their cash with a bank, rather than a bank 'rewarding' the depositor with a rate of return (interest). The policy has been initiated by central banks in order to discourage institutions from keeping vast sums of cash on deposit and thus forcing them to extend more loans to customers, thereby boosting growth and inflation in an otherwise stagnant economy. The idea was first implemented by Sweden's Riksbank in July 2009 and has seen increasing take-up throughout 2014 and 2015 so far, predominantly across the flagging Eurozone economy. However as we will explore, this appears to be a desperate act after other means of stimulus have failed, yet there is no guarantee that negative rates will actually have the desired effect.

Source: www.hedgeye.com

Why are they initiated?

When an economy shows signs of low growth and falling inflation, there are several actions at the disposal of a central bank to try to stimulate that economy. One of these options is to lower interest rates, as most major economies did during the credit crunch in 2007/8. As demonstrated subsequently, such action helps to prevent a slide into deflation and helps to kick-start economic growth. But what happens when you've cut interest rates to such low levels that they fall to 0%? There's no more wiggle room left to boost growth further and that's when negative interest rates come into play. Having slashed rates to close to 0% (0.05% to be precise), the European Central Bank is currently experimenting with negative rates as a last resort. At the same time, the ECB has also embarked on its own bond buying program of €60bn per month, similar to the stimulus packages in the United States and Japan.

Another intention of lowering interest rates into negative territory is to bring about a devaluation of the Euro, which coupled with Quantitative Easing (QE) in the region, has pushed the Euro further down against major foreign currencies, notably the US Dollar and Sterling . Switzerland successfully implemented the same strategy in December last year when, after the Swiss Franc rose in value as investors bought into the perceived 'safer' currency, the central bank lowered rates to reduce rising export costs by devaluing the Swiss Franc. The Swiss government then also became the first country to auction its ten-year bond at a negative yield of -0.055% (as an aside, none of this stopped the Swiss Franc from rising dramatically against the Euro specifically when they unexpectedly abolished the Euro's CHF1.20 cap on the 15th January 2015).

But why on earth would anyone want to own an investment that pays a negative rate of interest?

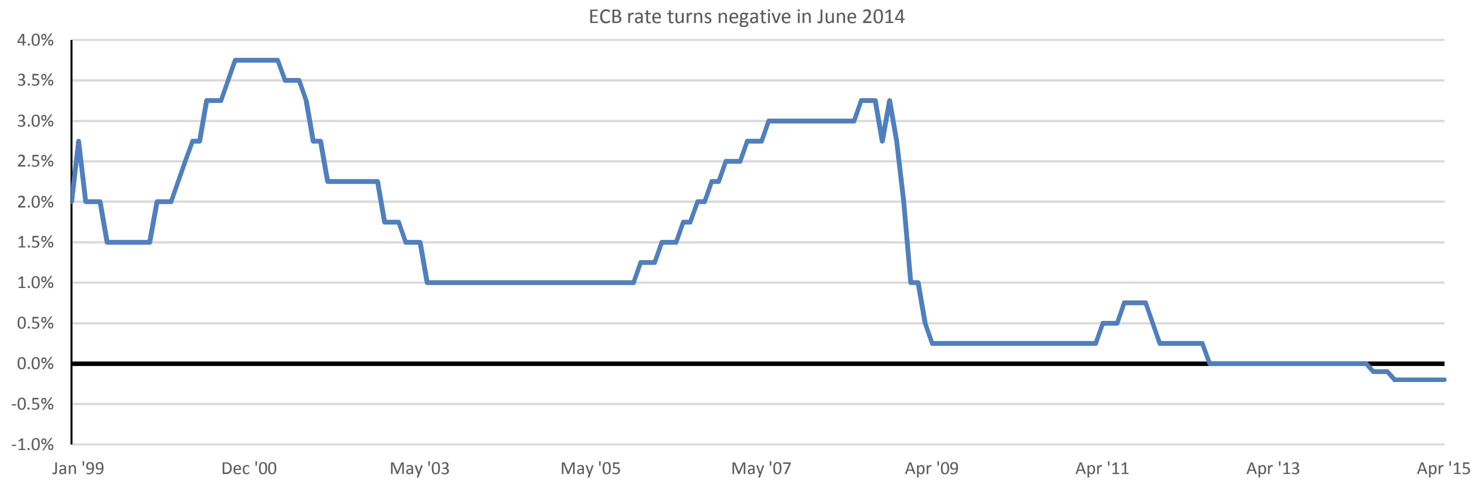
Well, some pension funds and major investment funds are forced by their investment policies to buy assets of the highest quality or lowest risk and therefore by default are forced into placing deposits with these banks regardless of how low (or indeed how negative) the returns are.

Also other banks are forced to hold a certain % of capital with other institutions as security. Finally some are concerned that negative rates may fall even lower and that therefore locking-in a 'good' negative rate now might save them some money in the future (!). It all sounds crazy but in reality many entities are forced to buy into this concept as a result of either regulatory pressure or their documented investment principles.

How are negative rates implemented?

Mario Draghi initiated negative interest rates for institutional deposits across the Eurozone in 2014. This was one of a handful of stimulus packages put in place to raise inflation across the economy from its dismal position of between 0.3% and 0.5% to just below the target of 2.0% over the medium term. There are three interest rates they use to steer borrowing costs in the region. Firstly the refinancing rate, which determines how much banks pay for ECB loans. Secondly, the marginal lending rate, which governs overnight lending rates to banks, pension funds and other financial institutions. Finally there is the deposit rate, which determines the interest received by financial institutions that hold deposits with the ECB (the same financial institutions who offer deposit rates to retail clients). All three have been lowered throughout 2014 but the most significant being the deposit rate. As is shown in the graph overleaf, deposit rates have entered and remained in negative territory since 11th June last year.

The number of institutions depositing cash with the ECB at the end of each trading day has also reduced but not as much as you might expect, due to the fact that financial institutions are still required to hold a certain amount of regulatory capital on deposit as a percentage of their risk-based assets. Forcing banks to hold a proportion of their assets with the ECB therefore forces these institutions to accept a negative interest rate, which has consequences that we will address below.



Do negatives interest rates work?

There appear to be strong views on either side. On the one hand, lowering rates into negative territory encourages those who have excess cash reserves to release funds as loans. On a sovereign level, countries flush with cash (e.g. Germany) are encouraged to lend money to those dependant on funding from the ECB (e.g. peripheries in Europe). This policy has been further underlined in Europe by Mario Draghi's 'whatever it takes' stance on securing a Eurozone recovery, adding further reassurance to lenders.

However those who are sceptical about lowering rates highlight the immediate and longer term impact on the economies concerned. First and foremost, foreign investment is likely to be withdrawn and reallocated to those that offer better-than-negative returns on their capital. Negative rates can also act as a catalyst for currency wars between countries as investors look to move capital to locations where it earns more. With QE likely to supress yields in the Eurozone we could see a growing flood of assets out of the region. Having struggled through their own Quantitative Easing programs, and now with their economies now in a recovery phase, the US and UK are in a much stronger position than the Eurozone and as a result both currencies have strengthened against the Euro. The rise of the US Dollar and Sterling vs the Euro has encouraged institutions within the Eurozone to stop adding to domestic currency investments, preferring instead to look outside of the region, while the threat of US operations in Europe scaling back their Euro-earning channels grows in tandem. That said a stronger currency inevitably leads to more expensive exports and this will have an impact on both US and UK corporate profitability (US corporate reporting season starts on the 8th April).

Perhaps the most pertinent objection to negative rates raised by many is the fact that it may result in profit margins being squeezed across major banks. As we know from recent experience during the credit crisis and the market turbulence that followed, when banks see their profit margins squeezed they are less keen to lend. If banks lend less capital to businesses and individuals then any economic recovery may suffer.

Does this affect me?

In short, no, at least not yet. Negative interest rates are very much targeting institutional assets held by banks, pension funds and insurance companies who hold billions of Euros on their balance sheets. There is a direct impact on these businesses, who must reassess their deposit strategy in light of changes in rates implemented by central banks and as a result multi-national enterprises may look to review their business exposure to economies offering negative interest rates.

Whatever the view on growth prospects for Europe, the launch of Quantitative Easing in the region has led to government bond prices rising, meaning that many short-dated bonds have started to trade with negative yields. Investors who have been holding these investments to generate income will now have to search elsewhere. We have not held exposure to these assets for some time and see no reason to start investing in them during the current climate. Mario Draghi and his team at the ECB have not made any commitments to keeping rates at current levels for years to come. However in the meantime a prolonged period of negative rates could give consumers the opportunity to capitalise on lower borrowing costs, so we may yet see a benefit to individuals in these economies.

What does this mean for markets in future?

This is the billion Euro question. It could have very little impact on economic growth, as is currently the case in Europe, or it could have a much greater impact in the longer term, as we saw in Switzerland at the end of 2014. The result will be determined by a combination of other factors, including realised (or otherwise) inflation targets, government deficits growing or reducing and realised GDP growth in Eurozone economies over the quarters ahead. Forcing rates into negative territory in Europe along with long-awaited Quantitative Easing were both combined to stimulate growth in a flagging Eurozone economy. However we have yet to see whether or not QE in the Eurozone will really work and charging investors to hold cash on deposit has yet to be proven as a measureable success. We sincerely hope that both strategies combine to boost Eurozone growth, instead of adding to further concern that the region requires further economic life-support.