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# Negative Rates: Negative View

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We believe that negative policy rates could do more harm than good to economies and markets, due to their impact on banks, insurance companies and pension funds, and also a possible adverse effect on consumption. Below, we discuss potential implications for investors.

## SUMMARY

The unintended consequences of negative interest rate policy are already evident. We believe that negative rate policy does not have much further room to run.

Persistently low or negative interest rates, alongside expanding central bank balance sheets, are likely to continue to support risk assets for some time, as investors are forced to "reach for yield." However, such a policy may be damaging in the medium or long term.

## NEGATIVE RATES: A TWO-SIDED COIN

Why are negative nominal interest rates so troubling? Economic theory favors real rates, which have already been negative in most developed countries for some time. In theory, lowering the nominal policy rate into negative territory should produce many of the same expansionary effects as cutting the policy rate in a positive rate environment: to make individuals and companies save less and spend and invest more. Lower real rates should also lead to a depreciating currency, which improves a country's external competitiveness, and supports asset prices, boosting the wealth of the private sector.

In practice, though, negative interest rates come with three key drawbacks:

1. **They impair the banking system.** As the policy rate turns more negative, banks start earning less return on their assets, while the interest they pay on deposits generally stays above zero – due to relatively high competition for deposits, legal challenges, political resistance and the potential for cash withdrawals. As profits decline, banks may issue fewer loans to businesses and households, or raise the interest rate they charge for those loans. Lower bank equity prices risk exacerbating these effects.[1]

1 For more detail, see "**The reversal interest rate**," a recent paper describing this rate as the theoretical limit below which monetary policy interest rate cuts become contractionary.

2. **They create significant challenges for other parts of the financial system.** This includes the pension and insurance sectors, which offer nominal return and minimum income guarantees in the future, but that are hard to deliver when interest rates are negative, as they don't generate enough yield.

3. **Negative nominal rates may lead to more, not less, savings.** Economists refer to this concept as "money illusion," as what should matter – at least if people were completely rational – are not nominal but rather real, or inflation-adjusted, variables. While "money illusion" may hold for rate cuts in a positive rate environment too, the effects are likely magnified under the zero line.

## WHAT'S THE EVIDENCE SO FAR?

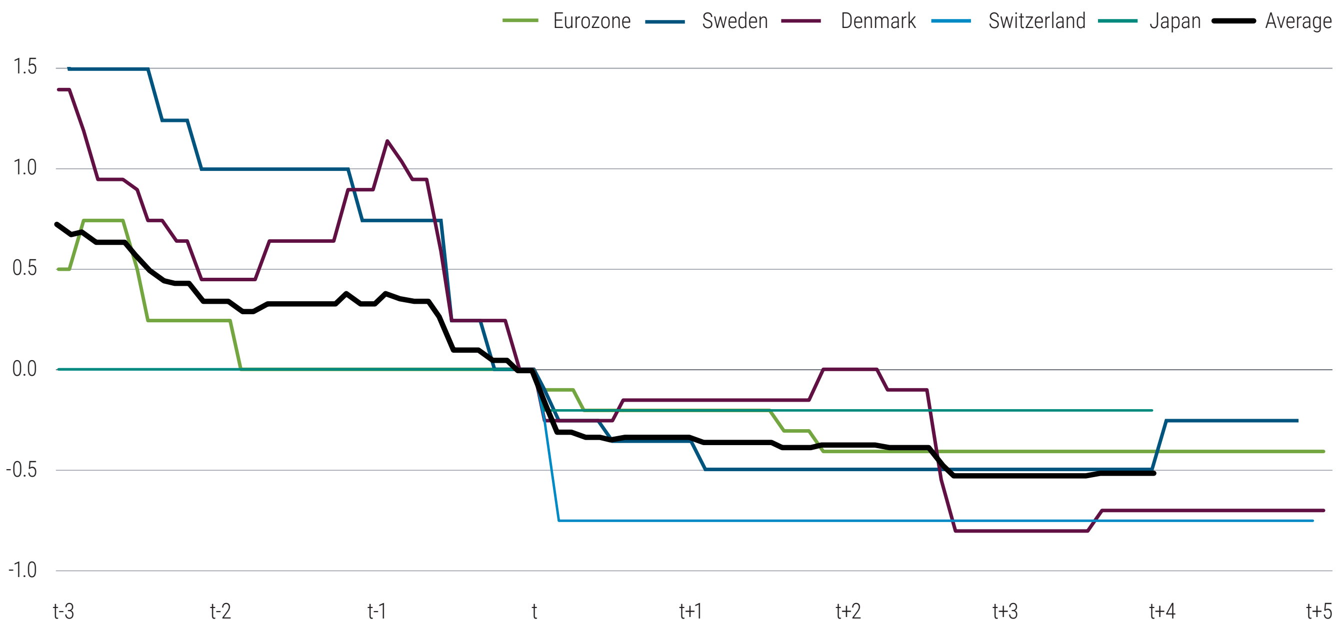
We studied the effect of negative rates in five different countries, drawing some conclusions on their effect on financial markets, bank deposits, lending rates and volumes, and macro variables, such as growth and inflation. Our universe includes: Denmark (which first brought the policy rate into negative territory in July 2012), Eurozone (June 2014), Switzerland (December 2014), Sweden (February 2015) and Japan (January 2016). We found that:

- **The policy has been successful in easing financial market conditions so far.** Negative policy rates (figure 1) have led to a fall in both short-term and long-term market rates, with 2-year and 10-year government bond yields on average declining roughly as much as policy rates (figure 2). However, the policy looks to have had mixed impact on countries' currencies: while the euro and Swedish krona underperformed, the yen and the Swiss franc appreciated (figure 3). The policy also had a positive impact on risk assets, with stock prices on average rising, although this result is skewed by a significant rise in Denmark. Importantly, bank equity prices have suffered in the negative rate environment, challenging the sustainability of any improvements in financial conditions.

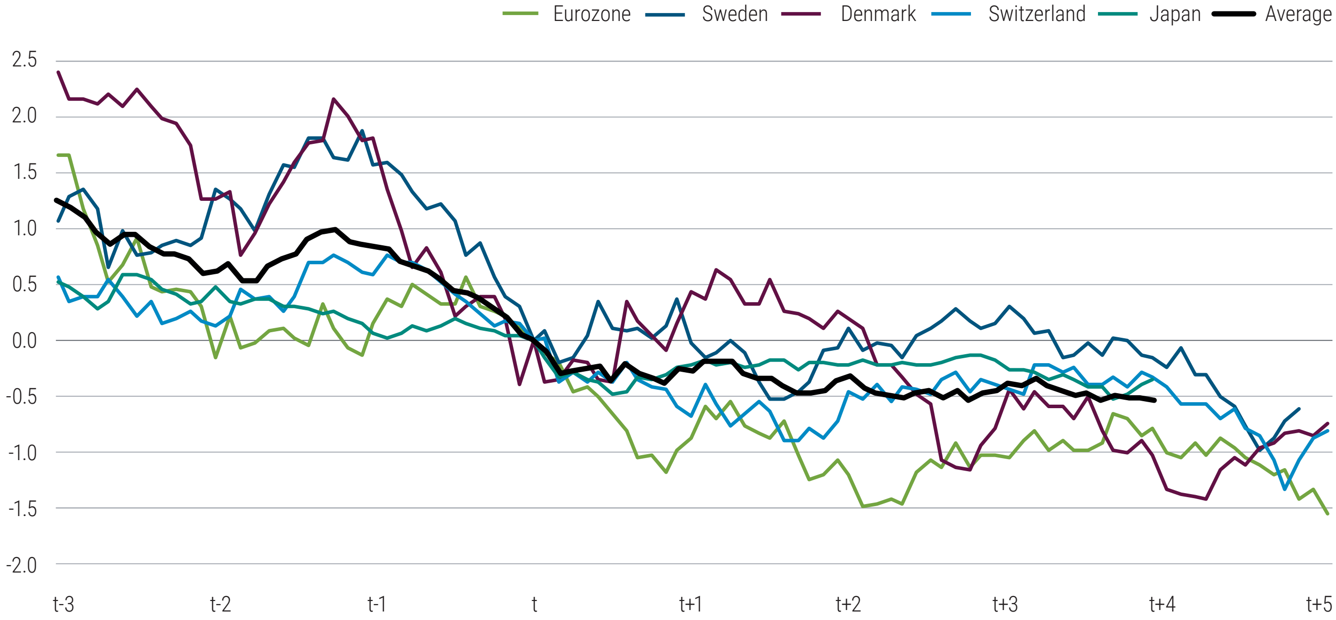
- **The impact on bank lending conditions appears to have been positive.** On balance, banks have lowered household and corporate deposit rates, though by less than the policy rate, while lowering lending rates roughly as much as the policy rate. On average, financial institutions have increased the pace of loan creation (figure 4), especially in the Eurozone, albeit from a low starting level.

- **The macro impact seems to have been positive, but modest.** While the policy has been associated with stronger growth (figure 5), the dispersion of outcomes has been high. On the other hand, the policy appears to have been unsuccessful in lifting inflation (figure 6) and inflation expectations. In this regard, we note the European Central Bank's (ECB) analysis that negative rate policy has had the least impact on growth and inflation relative to the other easing measures it has implemented recently.

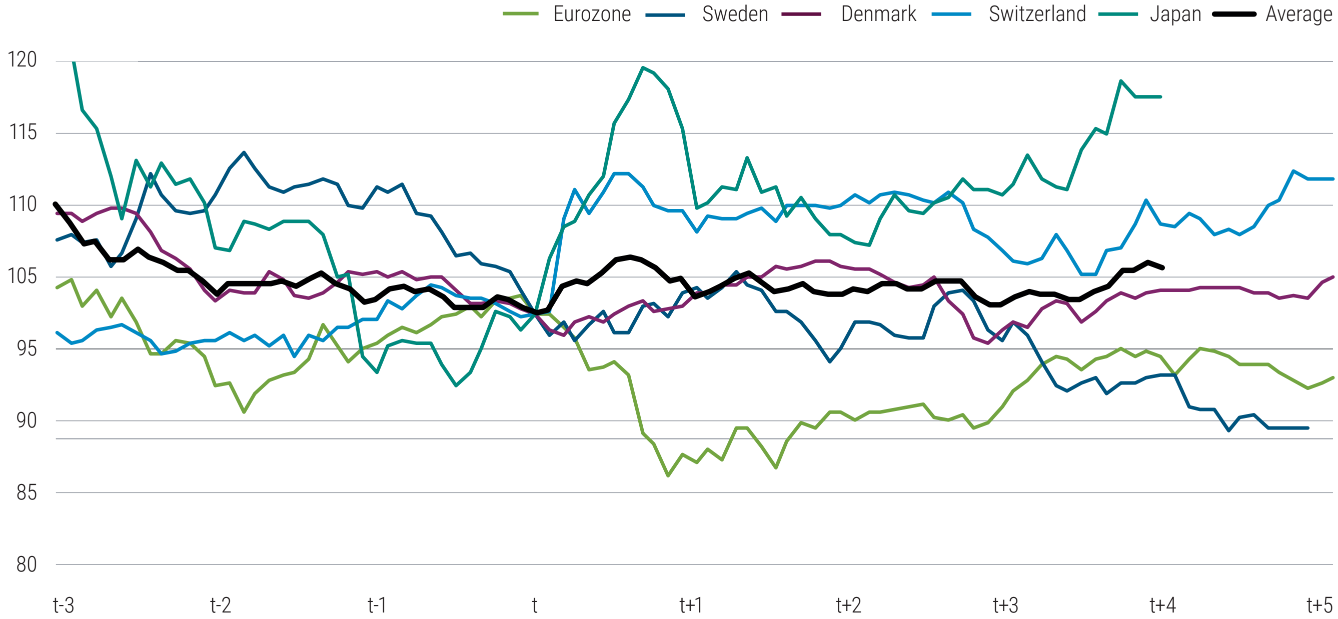
## Figure 1: Policy Rates, %



## Figure 2: 10 year sovereign bond rates, %

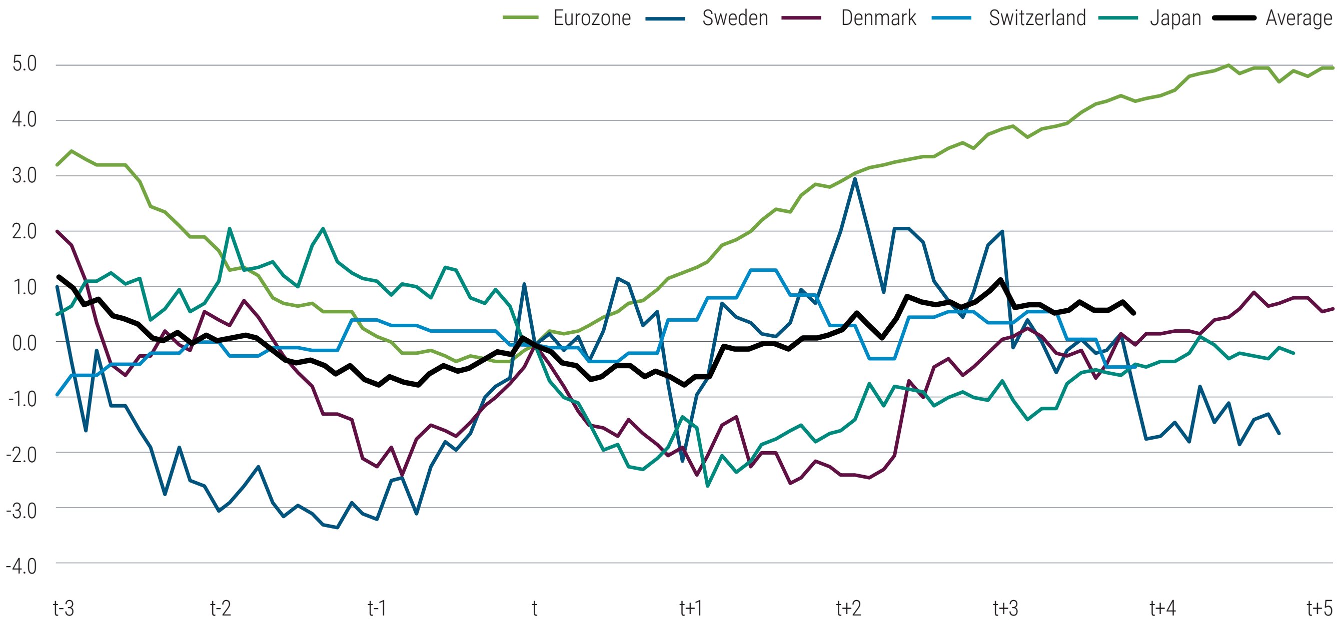



## Figure 3: Nominal effective exchange rates (NEER) index

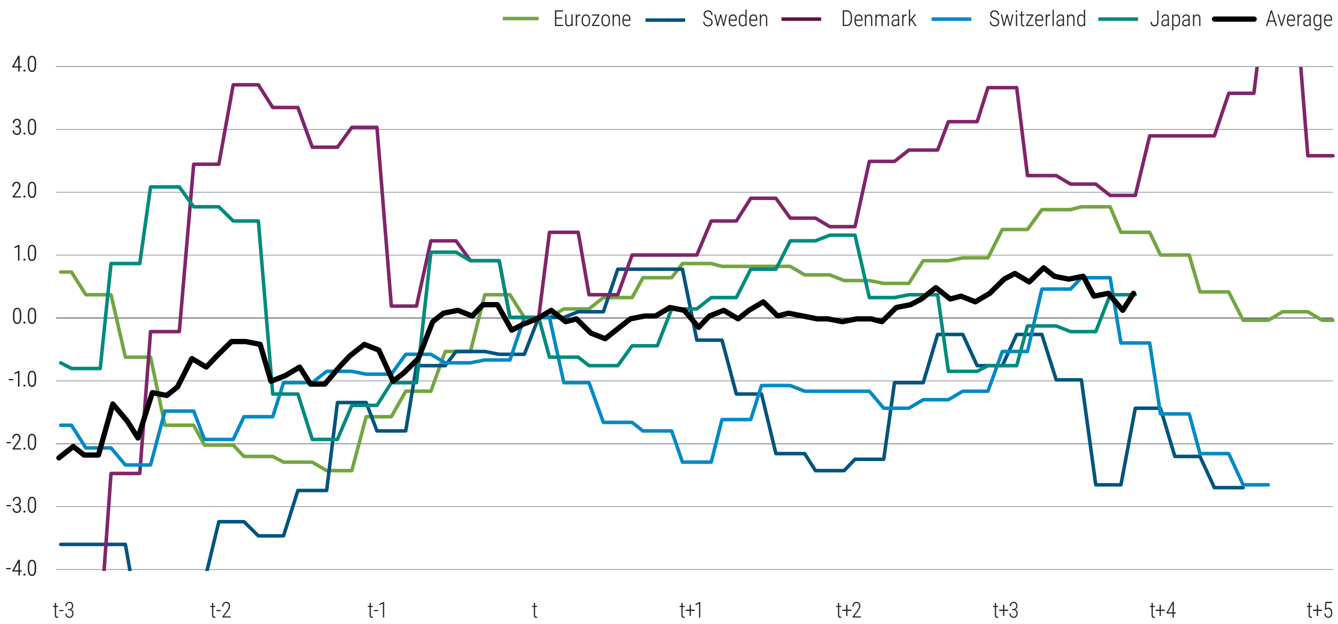



Sources: PIMCO, Statistics offices and central banks of the various jurisdictions. As of November 2019. The charts depict the changes in the variables from their level at the time when negative rates were first introduced (time "t", with t-1, t-2, t+1, t+2 etc. representing the number of years before and after that date). The bold black line in each chart represents the average change in each variable across the various jurisdictions since time "t". NFC is non-financial corporation; HH is household; GDP is gross domestic product; yoy is year-on-year.

## Figure 4: Loans to Non-Financial Corporations and Households, % yoy




## Figure 5: Real GDP, % yoy




Sources: PIMCO, Statistics offices and central banks of the various jurisdictions. As of November 2019. The charts depict the changes in the variables from their level at the time when negative rates were first introduced (time "t", with t-1, t-2, t+1, t+2 etc. representing the number of years before and after that date). The bold black line in each chart represents the average change in each variable across the various jurisdictions since time "t". NFC is non-financial corporation; HH is household; GDP is gross domestic product; yoy is year-on-year.

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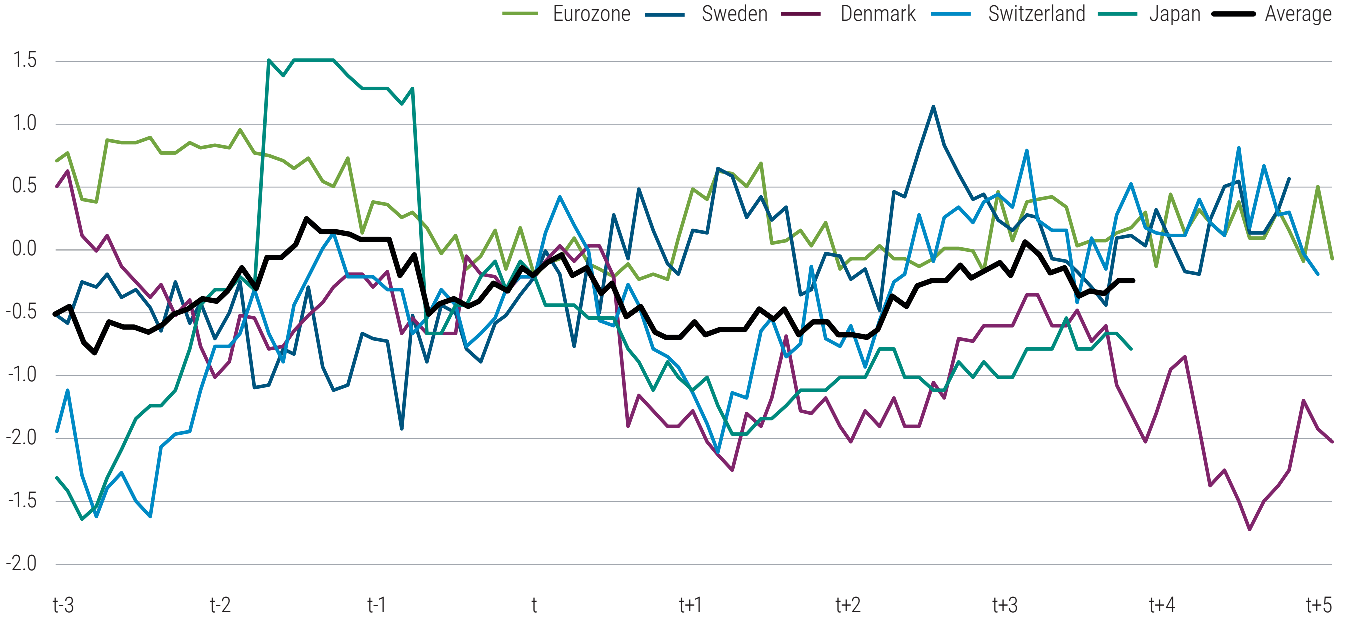
## Figure 6: Core inflation, % yoy




Sources: PIMCO, Statistics offices and central banks of the various jurisdictions. As of November 2019. The charts depict the changes in the variables from their level at the time when negative rates were first introduced (time "t", with t-1, t-2, t+1, t+2 etc. representing the number of years before and after that date). The bold black line in each chart represents the average change in each variable across the various jurisdictions since time "t". NFC is non-financial corporation; HH is household; GDP is gross domestic product; yoy is year-on-year.

To be clear, there are some important caveats to our analysis. First, it does not show causality; i.e. we do not know how these variables would have moved in a rising rate environment, or how much of the changes happened because of other measures introduced by central banks, including Quantitative Easing (QE) and forward guidance. Also, there is some evidence of adverse effects on confidence from negative rates, as seen in falling bank equity prices and persistently low inflation expectations.

## NEGATIVE RATES: TROUBLE BREWING ON THE HORIZON

With financial market and bank lending conditions loosening, and a slightly improving macro environment, is this the "all-clear" for negative rate policy?

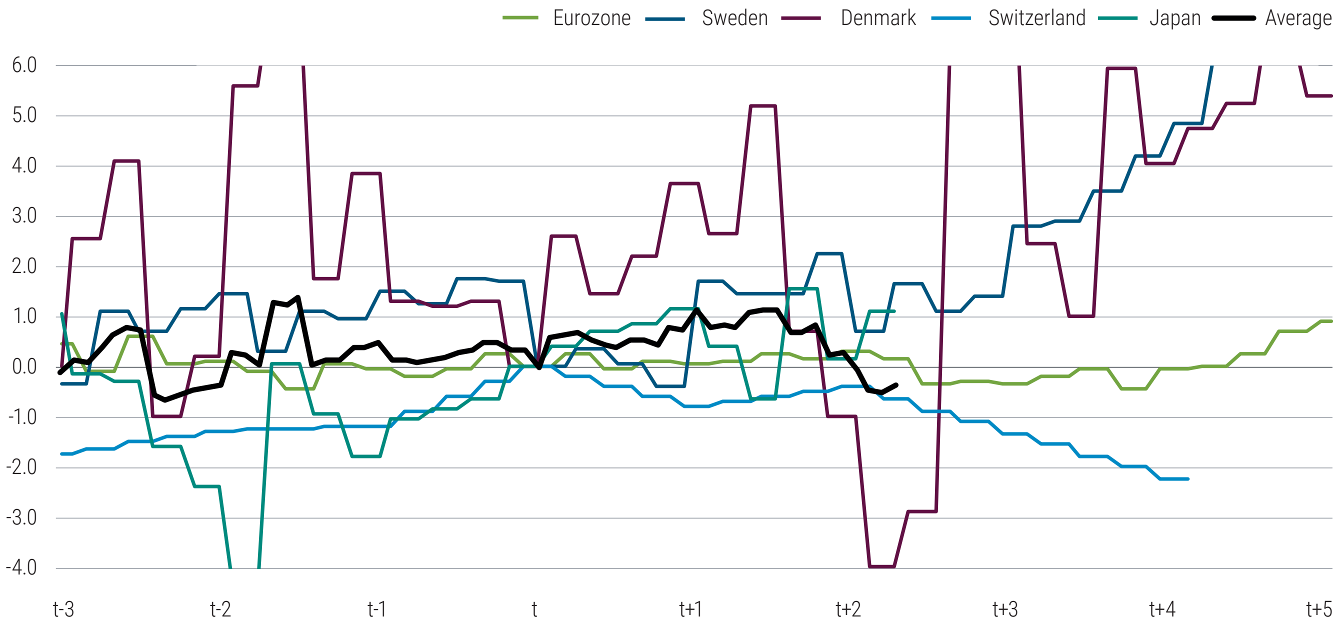
We don't think so. Significant trouble is brewing under the surface, especially on the banking front: bank lending rates are declining more rapidly than deposit rates, putting downward pressure on banks' profit margins. In response, and following the implementation of negative policy rates in some countries, some banks have started to charge negative rates on some deposit accounts (some of the German cooperative banks, for example, now charge negative rates on deposits larger than €100,000), although they remain the exception rather than the rule.

This squeeze in bank margins across Europe means that their contribution to return on assets (ROA) has diminished. In aggregate, Eurozone bank ROA has held up so far, thanks to capital gains and improved credit quality – which have benefitted from negative rates and other unconventional monetary policy measures. However, these are not sustainable sources of profitability, and can only temporarily mitigate the structural downtrend in profits coming from lower profit margins. As we have seen in Japan, structural declines in bank profitability are usually associated with depressed equity valuations. The combination of lower profitability and lower equity prices could be a source of financial instability over time, especially if European growth were to slow down meaningfully once again.

Banks are not the only institutions that are suffering from negative rates. Insurance companies and pension funds have committed to paying nominal returns and minimum income guarantees that are hard to finance at the current levels of interest rates. To make matters worse, these institutions may not have hedged their liabilities in full to absorb any interest rate changes, jeopardizing their ability to meet future payouts. Persistent low rates could lead to instability in these sectors and potentially call for capital injections into corporate pension plans and insurance companies over time.

Finally, while evidence of the "money illusion" phenomenon is inconclusive, there are some signs that household saving rates have risen in some countries following the introduction of negative interest rates, especially in Sweden and Denmark (Figure 7).

## Figure 7: Household saving rate, % gross disposable income




Sources: PIMCO, Statistics offices and central banks of the various jurisdictions. As of November 2019.

### OUTLOOK FOR NEGATIVE RATE POLICY

The unintended consequences of negative interest rate policy are already evident. Mitigating measures like tiering[2] can help some banks, but as the European experience shows, these tools have limitations and side effects, which diminish the effectiveness of the policy.

On balance, this leads us to conclude that negative rate policy does not have much further room to run, and that its persistence will end up damaging markets and the macro outlook. Looking ahead, it is possible that the ECB will lower rates a little further, but market expectations of another 5 basis points are close to the maximum we expect. Notably, the Riksbank, the central bank in Sweden, seems set to lift its policy rate out of negative territory in December, in the face of ongoing economic slowdown, as it appears concerned about the consequences of negative interest rates.

In the U.S. and the U.K., negative rates seem unlikely, given policymakers' doubts on its effectiveness and political resistance to the concept. If policy rates in the U.S. and the U.K. ever go to zero, and more accommodation is needed, these central banks would most likely focus on QE and other measures other than negative rates. In Japan, it is possible the central bank will cut its policy rate further, but only by a small margin - Japanese banks are heavily dependent on deposits to access funding, making them vulnerable to a squeeze in margins from negative rates (wholesale funding accounts for less than 10% of Japanese banks' total financing, compared to around 60% in Sweden and 40% in Italy and Spain).

2 A tiering system means that a central bank, with a negative rate policy, reduces the amount of banks' excess liquidity subject to the negative interest rate.

Finally, at a global level, extending a negative rate policy might exacerbate political accusations of currency manipulation, not a welcome move in the midst of ongoing trade tensions.

## INVESTMENT IMPLICATIONS

While negative rate policy may have reached its limits, we expect global rates to remain anchored. This is due to the need to maintain stimulative policies, and to the limited efficacy of monetary policy to steepen yield curves in the absence of more fiscal activism (see also Is Fiscal the New Monetary). Generally, we favour U.S. duration over Europe's and Japan's, as higher U.S. rates have more room to fall.

Persistently low or negative interest rates, alongside expanding central bank balance sheets, are likely to continue to support risk assets for some time, as investors are forced to "reach for yield" – even if such a move may be damaging in the medium or long term. However, already inflated risk valuations suggest that it is important to be selective, leading us to take a cautious stance overall (see our September Cyclical Outlook, Window of Weakness).

Crucially, low or negative rates will continue to weigh on bank profits. While this is likely to hurt bank equity valuations, it should not meaningfully affect bank bond valuations for now, given the sector's generally healthier capital cushions and better regulation following the 2007-08 financial crisis. We continue to favor bank bond holdings in our portfolios.

On currencies, we have a positive view on the yen, partly because high bank reliance on retail deposit funding makes it particularly challenging to lower the policy rate further into negative territory.

Don't miss PIMCO's 2020 Outlook, to be released in January, following our next Cyclical Forum.

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