

However, things get somewhat messy when you think about the practicalities. So far, negative interest rates are only charged on balances of commercial banks with the central banks. Commercial banks have been reluctant to pass this cost on to their clients, so most of the private sector, including practically all individual savings accounts, is not charged. This, in turn, means two things. First, households are shielded, so lower interest rates will not have an impact on household behavior (encouraging current consumption, say, by discouraging saving, or prompting households to purchase riskier assets). Second, bank profitability will suffer.

2. What's the evidence so far on the impact on banks?

In Sweden, Denmark and Switzerland banks have coped reasonably well with negative interest rates, in part because their domestic banking markets are quite concentrated.¹⁰ This allowed the top two or three key players to make up for the shortfall by pushing up profits on other products. For example, Swedish banks have been able to protect their net interest margin by increasing mortgage loan rates to offset charges on deposit. The problem is that, first, this means that the NIRP results in tighter, rather than looser financial conditions. Second, it would not work in other, less concentrated markets. And third, and perhaps most troubling for the ECB, it means NIRP will have a differential impact in different Eurozone countries, depending on the degree of concentration in the local banking market.

3. How low can central banks go?

Therein lies another problem. After all, there was a reason why most economists were doubtful of attempts to push interest rates below zero. Reduce the interest rates too much, and the private sector might simply withdraw their bank deposits and hold the money in cash. Of course, there are some costs to storing cash, with some estimates at 20 basis points (bps), and some a bit higher. However, the ECB is already in the lower range of such estimates. Moreover, comparisons with credit-card charges of several hundred bps are somewhat flawed: a large chunk of cash deposits are probably held as a store of value, rather than with any immediately looming payments in mind. To implement negative deposit rates anywhere near that level, you would probably have to introduce a time-varying fee of some sort on (physical) cash of the sort initially proposed by the German merchant Silvio Gesell 100 years ago. No country has since tried to implement 'Gesell money' and political obstacles look sizeable.

The evidence so far suggests that when they work, the effect from NIRP is mainly from driving down exchange rates rather than by stimulating lending. For small open economies, this might even be part of a "foolproof way" to escape the liquidity trap and deflation. The idea was for the central banks to give a commitment to higher future price levels, concrete action, such as a currency's sharp depreciation, to demonstrate that commitment, and an exit strategy of when and how to get back to normal.¹⁰

In a small open economy, such as Sweden, a currency devaluation can go a long way in rekindling inflation. Unfortunately, using devaluation is a lot harder to manage in large economies, such as Japan and the Eurozone.

¹⁰ Svensson, Lars E.O. "Escaping from a Liquidity Trap and Deflation: The Foolproof Way and Others." *Journal of Economic Perspectives*, Fall 2003, 17(4), pp. 145-66

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