Negative rate policy

What is the issue?

- Negative rate policy is becoming a more attractive option for some countries' central banks.
- This policy would counter unwelcome rises in the currencies of these countries.

Why have some central banks adopted negative rates?

- To battle the global financial crisis triggered by the collapse of Lehman Brothers in 2008, many central banks cut interest rates near zero.
- A decade later, interest rates remain low in most countries due to subdued economic growth.
- With little room to cut rates further, some central banks have resorted to unconventional policy measures, including a negative rate policy.
- The euro area, Switzerland, Denmark, Sweden and Japan have allowed rates to fall slightly below zero.

How does it work?

- Under a negative rate policy, financial institutions are required to **pay interest for parking excess reserves** with the central bank.
- That way, **central banks penalise financial institutions** for holding on to cash in hope of prompting them to boost lending.
- **The European Central Bank (ECB)** introduced negative rates in June 2014, lowering its deposit rate to -0.1% to stimulate the economy.
- Given rising economic risks, markets expect the ECB to cut the deposit rate, now at -0.4%, in September.
- **The Bank of Japan (BOJ)** adopted negative rates in January 2016, mostly to fend off an unwelcome yen spike from hurting an export-reliant economy.
- It charges 0.1% interest on a portion of excess reserves financial institutions park with the BOJ.

What are the pros, cons?

- Aside from lowering borrowing costs, negative rates **weaken a country's currency rate** by making it a less attractive investment than that of other currencies.

- A weaker currency gives a **country’s export a competitive advantage** and **boosts inflation** by pushing up import costs.
- But negative rates put **downward pressure on the entire yield curve** and narrow the margin financial institutions earn from lending.
- If prolonged ultra-low rates **hurt the financial institutions’ health** too much, they could hold off on lending and damage the economy.
- There are also limits to how deep central banks can push rates into negative territory – depositors can avoid being charged negative rates on their bank deposits by choosing to hold physical cash instead.

What are central banks doing to mitigate the side-effects?

- **The BOJ adopts a tiered system** under which it charges 0.1% interest only to a small portion of excess reserves financial institutions deposit with the central bank.
- It applies a zero or +0.1% interest rate to the rest of the reserves.
- **The ECB is expected to take “mitigating measures”**, such as a partial exemption from the charge in the form of tiered deposits rates, if it were to deepen negative rates from the current -0.4%.
- But designing such a scheme won’t be easy in a bloc where cash is distributed unevenly among countries.
- It could even backfire by pushing rates up in certain countries, rather than down.

Source: The Indian Express

Quick Facts

Lehman Brothers crisis/Subprime Mortgage Crisis/Financial crisis 2008

- On September 15, 2008, Lehman Brothers filed for bankruptcy.
- With $639 billion in assets and $619 billion in debt, Lehman's bankruptcy filing was the largest in history.
- Its assets far surpassed those of previous bankrupt giants such as WorldCom and Enron.
- Lehman was the fourth-largest U.S. investment bank at the time of its collapse, with 25,000 employees worldwide.