



## Super low interest rates come with side effects

Ultra-loose monetary policy could even be counterproductive for economies.

**Sitting on the desk of Reserve Bank of Australia Governor Philip Lowe most days when he arrives at work are letters from the public. Many are from retirees who have one complaint in this world of low interest rates. "It's not uncommon for people to say to me they've worked hard all their lives, they've saved, they're frugal, they don't spend very much, they rely on interest income and they're having to cut back their spending," Lowe told a parliamentary committee last year.[1]**

The RBA governor earlier that session said that for every dollar the household sector received in interest income, it paid more than two dollars in interest payments. So overall, lower interest rates help the economy because they enable more consumer spending. To extend such conventional analysis, lower interest rates promote business investment, reduce borrowing costs for governments, which frees up more spending, help exports by lowering a currency and create a 'wealth effect' that encourages household spending by boosting asset prices.

Such thinking has motivated central banks to reduce interest rates to rev economies such that low rates have been a mainstay since the global financial crisis of 2008. An obvious problem with interest rates as a macro tool is they lose their stimulus fizz when they are close to zero or even mildly negative, as are some policy rates in Denmark, the eurozone, Hungary, Japan, Sweden and Switzerland.

UK economist John Maynard Keynes in 1936 spoke of the 'liquidity trap' when describing the limits of low interest rates as an effective policy tool. In *The general theory of employment, interest and money* of that year, Keynes described situations when uncertainty is so great that even low interest rates would fail to generate enough demand to ensure full employment.[2]

But Keynes was indicating that low interest rates could be ineffective as a macro tool. The worry after 12 years of low and negative rates is that these settings produce side effects that make them counterproductive. Ten side effects stand out.

A core concern is that Keynes's liquidity-trap concept seems to underestimate the dampening effect of emergency measures. Low rates seem to dent consumer spending and business investment because they signal that authorities are gloomy, even panicked. Swedes found negative interest rates "strange", said the Swedish central bank last year when abandoning its second experiment of the negative policy rates it invented in 2009 (though it still has a negative deposit rate).[3]

A second side effect is that low interest rates have encouraged so much borrowing that consumer, corporate and government debt have reached an unprecedented level of GDP in many countries. In the US, for example, total debt is at least 250% of output, according to the Federal Reserve Bank of St Louis.[4] This could prove a systemic risk. Even without such mishaps, future repayments are likely to reduce consumption and investment.

Another side effect is that low and negative rates can lift asset prices. Lower interest rates push investors into riskier assets and argue for higher prices on property and shares, asset gains that tend to boost inequality. More tellingly, negative policy rates helped push bond prices so high that yields went negative. And widely so. A record US\$17 trillion worth of government bonds in August 2019 had negative yields[5] (compared with about US\$15 trillion now).[6] The concern is that, if low and negative rates help the economy as intended, interest rates will move higher and puncture asset prices.

A fourth problem is that low and negative rates trouble the business models of insurers and pension funds that typically use the safety and positive returns of government bonds to help meet long-term liabilities (that, in Europe especially, are often income guarantees). A fifth spillover is that low and negative rates squeeze bank margins, perhaps to the point of threatening financial stability, even if asset values on balance sheets rise and bad debts are generally lower. Any crimping in bank margins brings a sixth problem; that at some level, low rates could backfire by forcing banks to restrict lending – a level known as the 'reversal rate'.[7]

A seventh handicap is that central banks have faced political pressure for hurting savers and rescuing reckless borrowers, as letters to the RBA's Lowe[8] and Germans fuming at the European Central Bank attest.[9] An eighth side effect is low and (especially) negative rates can, perversely again, force people to save more to attain a targeted level of savings.



A ninth drawback is that low rates can encourage unproductive investment. If money has no 'time value' – the concept that money is worth more now than in the future – there is no hurdle for investment. Negative interest rates, in fact, send this concept haywire. A tenth criticism is that low rates help embed economies in the 'debt trap'. This term describes how indebted economies need more debt to overcome the problems left by past debt. But at some indeterminant point this strategy must miscarry.

These risks might explain why low rates have often failed to spark sustainable economic growth.[10] The question arises as to whether such risks are worth taking to fight mild deflation which, in economic effects, is not much different from negligible, or zero, inflation. No matter these doubts, low and negative interest rates appear entrenched for the foreseeable future. In such a world, policymakers will need to rely less on monetary stimulus and be mindful of, and perhaps take steps to mitigate, the side effects they are creating.

It must be noted that real interest rates are more critical economically than nominal ones. Low nominal rates have essentially failed to charge economies because they haven't approached the negative real rates that stimulated economies over much of the 1940s to the 1970s. That said, low nominal rates have helped stoke some economic growth. For all their side effects, low interest rates are yet to trigger an upheaval – a jump in inflation would undermine bond prices whatever level they were at. But even with these qualifications, central bankers appear concerned about the side effects that low and negative rates are provoking. They are among the most vocal in calling for instruments other than monetary policy to lead the world back to prosperity.

## RECORD LOWS

In the US during the Great Depression, prices plunged 25% from 1929 to 1932, an annual drop of 6.7%.[11] This is perhaps recent history's most famous case of malicious deflation. Such a poisonous tumble in prices saps economic growth by increasing real interest rates. It prompts consumers to postpone purchases due to a view that things will soon cost less. Businesses respond to falling demand by cutting prices, which reduces their profits and investment. Unemployment climbs. As prices fall, real debt burdens climb.

But in recent times the world has experienced only mild declines in consumer prices in some regions. IMF data (used to smooth comparisons) shows the eurozone has only suffered deflation in one calendar year since 2007; prices fell 0.2% in 2014. Japan and Switzerland have experienced only four years of mild deflation over those 13 years – Japan's deflation peaked at minus 2.0% while the Swiss top was minus 1.3% in 2015. Sweden and the US have not experienced deflation in recent times (over a calendar year.) Sweden's inflation fell as low as 0.3% in 2013 while the US's bottom was 0.5% in 2014.[12]

For all the angst about inflation, it's possible to overstate the harm a tiny decline in prices can mean for household behaviour, profits and debt burdens. A small positive or negative inflation rate usually falls within the estimate provided by most consumer-price indices and does not change economic behaviour much.

[13] No central bank has turned to low interest rates to prevent a 1930s-style form of deflation from taking hold. They know that monetary and fiscal stimulus and rigid labour markets prevent such plunges in consumer prices today.

Yet without such low or negative policy rates it's doubtful that bond prices would have climbed to the extent that so much government debt would offer a record low or negative yield (when the price paid for a bond exceeds the amount to be repaid by future coupon payments and the face value of the bond.) Historically, negative interest rates have been rare. In the US, some Treasury bill yields briefly turned negative in the 1930s and again in 2008-2009. Swiss deposits held by foreigners faced negative returns (of up to 40%) in the 1970s to stop the rise of the Swiss franc,[14] while some Japanese government bonds fleetingly offered negative yields during the slump of the late 1990s.[15]

Today, however, bond yields are around record lows and negative yields are prevalent across European and Japanese bond markets. On September 21, yields on German bunds were negative out to 30 years and French, Netherlands and Swiss government yields were negative out to 10 years while yields on Japanese and UK sovereigns were negative out to five years. Bloomberg calculates that more than 265 billion euros worth of euro-denominated corporate bonds offer negative yields. US Treasury yields are positive because investors think the Fed is unlikely to make the US cash rate negative. As a 2010 Fed memo shows, the US central bank doubts the legality of such a move and its research shows such rates might prompt lenders to flee US money markets.[16]

Negative yields, first, reflect low and negative key rates and a view that inflation will stay low or turn negative. (The shorter-dated a bond the more it is influenced by the cash rate rather than inflation expectations.)

The other reason for low and negative bond yields is that central banks are conducting asset-buying programs to keep longer-term rates low to help their economies. The fact that the Fed has conducted asset purchases since 2009 and US government yields have stayed positive over that time, even with a cash rate close to zero, would tend to show benchmark rates and inflation expectations hold more sway than asset buying when it comes to turning bond yields negative. UK gilt yields are negative out to five years even though the Bank of England has never reduced its policy rate (now at 0.1%) below zero due to speculation it could be the next central bank to do so.

How low could yields go? Bond investors know the lower a negative yield, the bigger the risk of capital loss. Another barrier to yields going too negative is that investors and households can hold cash instead, even allowing for the inconvenience, storage costs involved and risk of theft.

Central bankers know there are limits as to how low they can drive bond yields and as to how long they can hold them there. The complaints from retirees watching their income disappear are just one of the many reminders of these limits.

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- [1] Official Committee Hansard. House of Representatives Standing Committee on Economics. Reserve Bank of Australia annual report 2018. 9 August 2019. Page 6. [https://parlinfo.aph.gov.au/parlInfo/download/committees/commrep/eea5d0b8-72e9-4b5e-acf8-52ed46888ced/toc\\_pdf/Standing](https://parlinfo.aph.gov.au/parlInfo/download/committees/commrep/eea5d0b8-72e9-4b5e-acf8-52ed46888ced/toc_pdf/Standing)
- [2] Keynes said the liquidity trap occurs when interest rates are so low that people prefer cash to holding a debt and in such cases "the monetary authority would have lost effective control over the rate of interest". See Paul Krugman's explanation of the liquidity trap. "Nobody understands the liquidity trap (wonkish)." 14 July 2010. [krugman.blogs.nytimes.com/2010/07/14/nobody-understands-the-liquidity-trap-wonkish/](http://krugman.blogs.nytimes.com/2010/07/14/nobody-understands-the-liquidity-trap-wonkish/)
- [3] Financial Times. 'Why Sweden ditched its negative rate experiment.' 20 February 2020. [ft.com/content/478fe908-5168-11ea-8841-482eed0038b1](https://www.ft.com/content/478fe908-5168-11ea-8841-482eed0038b1).
- [4] Federal Reserve Bank of St Louis. Government debt is about 135% of GDP ([fred.stlouisfed.org/series/GFDEGDQ188S](https://fred.stlouisfed.org/series/GFDEGDQ188S)), corporate debt about 50% ([fred.stlouisfed.org/tags/series?t=corporate%3Bdebt](https://fred.stlouisfed.org/tags/series?t=corporate%3Bdebt)) and [fred.stlouisfed.org/on-the-economy/2019/august/corporate-debt-great-recession](https://fred.stlouisfed.org/on-the-economy/2019/august/corporate-debt-great-recession)) and consumer debt about 75% of GDP ([fred.stlouisfed.org/series/HDTGPDUSQ163N](https://fred.stlouisfed.org/series/HDTGPDUSQ163N)).
- [5] Bloomberg News. 'Bond world backing away from all that negativity as 2019 ends.' 23 December 2019. [bloomberg.com/graphics/negative-yield-bonds/?sref=ORbm2mFs](https://www.bloomberg.com/graphics/negative-yield-bonds/?sref=ORbm2mFs)
- [6] Bloomberg News. 'World's rising stock of sub-zero debt has investors adding risk.' 27 July 2020 [bloomberg.com/news/articles/2020-07-27/world-s-stock-of-negative-yield-debt-climbs-toward-2019-s-record](https://www.bloomberg.com/news/articles/2020-07-27/world-s-stock-of-negative-yield-debt-climbs-toward-2019-s-record)
- [7] Markus Brunnermeier and Yann Koby of Princeton University released a study in 2016 that warned that at some point accommodative monetary policy might backfire if banks reduce lending due to concerns about meeting capital regulations. See 'The 'reversal interest rate': an effective lower bound on monetary policy.' 3 May 2017 version. [scholar.princeton.edu/sites/default/files/markus/files/16f\\_reversalrate.pdf](https://scholar.princeton.edu/sites/default/files/markus/files/16f_reversalrate.pdf)
- [8] In the words of the RBA's Lowe about his correspondence from retirees: "Some of these letters go on to say that there are other people in the community who've borrowed a lot of money and they feel like they're being bailed out and the savers are having to pay for that." Hansard. Op cit.

- [9] See Bloomberg News. 'ECB cast as villain for Germany in TV debate of smaller parties.' 5 September 2017. [bloomberg.com/news/articles/2017-09-05/ecb-cast-as-villain-for-germany-in-tv-debate-of-smaller-parties](https://www.bloomberg.com/news/articles/2017-09-05/ecb-cast-as-villain-for-germany-in-tv-debate-of-smaller-parties)
- [10] The Riksbank, for example, only lowered its benchmark rate as much as minus 0.5% in 2016 and only reduced its deposit rate to a low of minus 1.25% from 2016 to 2019.
- [11] Stephen G. Cecchetti. National Bureau of Economic Research. NBER working paper series. Working paper No. 3174. "Prices during the Great Depression: Was the deflation of 1930-32 really unanticipated?" November 1989. [nber.org/papers/w3174.pdf](https://www.nber.org/papers/w3174.pdf)
- [12] IMF World Economic Database. 'End of period consumer prices, percent change' for the eurozone, Japan, Switzerland and the US. [imf.org/external/pubs/ft/weo/2020/01/weodata/index.aspx](https://www.imf.org/external/pubs/ft/weo/2020/01/weodata/index.aspx)
- [13] Australia's consumer price index, for example, is based on a select basket of goods bought by a sample of households in the eight capital cities. For all its credibility, associated sampling errors combined with non-sampling errors (such as overlooking improvements in the quality of goods) means the index falls short of being a true measure of how price changes are being felt across the nation. Viewing the CPI in this way explains why consumers' inflationary expectations are holding up once you allow for the drop in oil prices.
- [14] See J.P.Morgan. 'Reflections on negative interest rates in Switzerland.' 14 May 2020. [snb.ch/ftp-content/uploads/2012/10/JP-Morgan-on-Negative-Interests.pdf](https://www.snb.ch/ftp-content/uploads/2012/10/JP-Morgan-on-Negative-Interests.pdf)
- [15] World Bank. Policy research working paper 7791. Carlos Arteta et al. 'Negative interest rate policies. Sources and implications.' August 2016. [documents1.worldbank.org/curated/en/235551470834953672/pdf/WPS7791.pdf](https://documents1.worldbank.org/curated/en/235551470834953672/pdf/WPS7791.pdf)
- [16] Federal Reserve memo. 'Options for further monetary policy stimulus.' Written 5 August 2010. Published 29 January 2016. [federalreserve.gov/monetarypolicy/files/FOMC-20100805memo04.pdf](https://www.federalreserve.gov/monetarypolicy/files/FOMC-20100805memo04.pdf)

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