

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.

