Written by **Walter McLaughlin** on April 27, 2016

Negative Interest Rate Policies Create Ironic Trap for Central Banks

Irony is just honesty with the volume cranked up. — George Saunders

Within the toolbox of stimulus programs utilized by central banks around the world, the usage of negative interest rates — whereby depositors are *charged* to deposit their funds — is an overt act of desperation. Based upon a recent poll of reserve managers from 77 countries around the world, the unintended consequences of these actions now include damaging the very same central banks foisting said programs upon their economies.

Before we discuss why this is so, it's important to understand exactly how negative interest rates work.

Negative Interest Rates

Investopedia.com defines negative interest rates as follows:

> A negative interest rate policy (NIRP) is an unconventional monetary policy tool whereby nominal target interest rates are set with a negative value, below the theoretical lower bound of zero percent.

It then goes on to discuss the reasons behind their usage:

> During deflationary periods, people and businesses hoard money instead of spending and investing. The result is a collapse in aggregate which leads to prices falling even farther, a slowdown or halt in real production and output, and an increase in unemployment. A loose or expansionary monetary policy is usually employed to deal with such economic stagnation. However, if deflationary forces are strong enough, simply cutting the central bank's interest rate to zero may not be sufficient to stimulate borrowing and lending.

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The argument for the deployment of negative interest rates is that by creating a disincentive for banks, consumers, and businesses to sit on cash, more money will be spent in ways that eventually boost the economy, raising GDP growth and stemming deflationary pressures.

Countries With Negative Interest Rates

Negative interest rates are a strong indication of a struggling economy.

As of this past February, the list of countries seeing the tactic implemented by their central banks includes Switzerland (-.75 percent), Sweden (-0.5 percent), Ireland (-0.3 percent), France (-0.3 percent), Italy (-0.3 percent), Finland (-0.3 percent), Latvia (-0.3 percent), Portugal (-0.3 percent), Lithuania (-0.3 percent), and Japan (-0.1 percent). If another global recession were to strike, a number of other countries would be in danger of dropping below zero percent as well — including the United States.

Negative interest rates are highly correlated with slow growth, deflation, or both. Switzerland, for example, experienced GDP growth of just 0.9 percent in 2015, while industrial production and retail sales declined. Ireland has suffered from recent bouts of deflation, as has France. Until 2015, Finland's economy was in recession for three straight years, with producer prices plummeting. Japan's GDP growth and inflation rate bumped along at below one percent last year.

The evidence is clear: Negative interest rates are spreading throughout the Western world. Even worse, with forecasts of continued subnormal growth and weak overall economic conditions in the Eurozone and Japan, their usage is poised to fail spectacularly.

Among the cadre of casualties in the rampant overzealous monetary policy seen around the world: the central banks themselves.

Central Banks Are Speculating

According to a March 2016 poll of 77 reserve managers jointly conducted by the trade journal *Central Bank Publications* and HSBC (Hongkong and Shanghai Banking Corporation), negative interest rates are prompting the majority to adjust their portfolio management strategies. In many cases, the steps being taken included purchasing riskier assets.

"Central banks need to preserve capital, so investing in securities that force them to lose money is counterintuitive," explained Christian Déséglise, head of central banks, sovereign wealth, and public funds at HSBC. "They are needing to act more aggressively to generate yield and in some cases take more risk."

Traditionally, central banks invest in safe, liquid assets such as government bonds. Given that many countries are seeing these and other investment-grade assets trading at negative yields, many are shifting resources into pools of loans repackaged as asset-backed securities, as well as equities.

The United States' central bank is the Federal Reserve, whose website lists its primary responsibilities in four bullet points. Note the one italicized for emphasis:

• Conducting the nation's monetary policy by influencing money and credit conditions in the economy in pursuit of full employment and stable prices.

• Supervising and regulating banks and other important financial institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers.

• *Maintaining the stability of the financial system and containing systemic risk that may arise in financial markets.*

• Providing certain financial services to the U.S. government, U.S. financial institutions, and foreign official institutions, and playing a major role in operating and overseeing the nation's payments systems.

Central banks such as the Federal Reserve not only set and deploy monetary policy, but represent one of the largest classes of investors around the world. Per the International Monetary Fund, total managed reserves by central banks were $10.9 trillion at the end of 2015.

The Irony of Negative Interest Rates

The practice of taking on more and more risk by an entity charged with *containing* systemic risk is rich in irony. After driving interest rates into the negative, the governmental entities created to reduce systemic risk are actively acquiring risk in order to improve portfolio yields, an approach that is counter to longstanding generally accepted investment strategies that place emphasis on liquidity and safety. With central banks doing so even after creating the toxic environment, it's small wonder that investors worldwide are speculating in risk as well.

As Mitchell Zuckoff wrote, "We've suffered a 'Ponzification' of the economy in recent years, as bubbles have built up and then burst, and each time we act as though it's the first time."

Here comes the next bubble.