NEGATIVE INTEREST RATES AS A POLICY TOOL IN THE U.S. AND CANADA: PROS AND CONS

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1. Summary

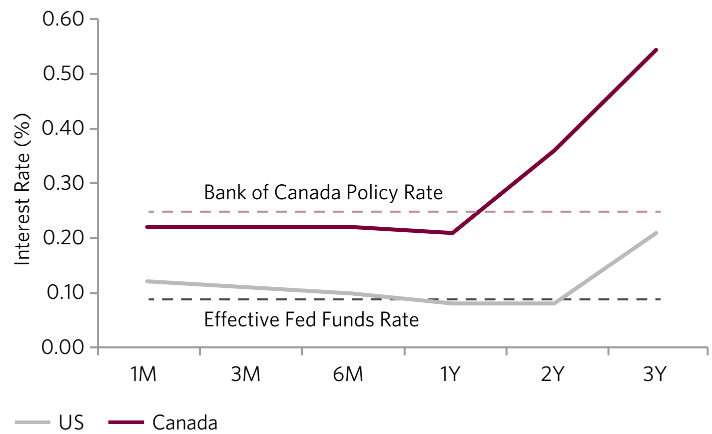
- Discussion of whether negative interest rates should form part of the monetary policy response to the current economic downturn has intensified.
- We do not currently assign a significant probability of negative policy interest rates being adopted in Canada or the U.S..
- The main catalyst that would cause us to adjust our view is evidence of persistent, significant structural damage to the Canadian and U.S. economies that results from the economic shutdowns implemented in response to COVID-19. Such evidence would be contrary to our current base case forecast.

2. Introduction

Central banks have deployed unprecedented policy tools and support to alleviate the liquidity consequences of the current recession, and to minimize the risk of persistent adverse systemic effects. Will negative interest rates be the next tool? Japan and several European countries began using this policy measure long before the current crisis, to mixed results. More recently, European Central Bank (ECB) adjustments to its various lending support programs have caused a sharp rise in the amount of funding requested by Euro system banks, an encouraging sign for proponents of negative rates.

Policy rates were low in Canada and the U.S. by historical standards coming into the current recession. Market expectations for policy rates are close to zero in both countries for an extended period.[2] But concluding from this observation that the likelihood of negative policy rates is high is premature.

Figure 1 – Market expectations are pricing policy interest rates close to zero for an extended period in the U.S. and Canada



Source: The information was prepared by CIBC Asset Management Inc. using the following third party service providers' data: Bloomberg Finance L.P.. As at September 30, 2020.

Proponents of negative rates argue that aggressive interest rate cuts may nonetheless be required to spur a sustained recovery in investment and consumption spending, which in turn would boost employment and GDP growth.

Critics of negative rates argue that adopting this policy tool would harm banking sector profitability, and provoke a negative signaling effect for market participants that would actually lead to less, rather than more, spending and a weaker outlook for growth. For those on this side of the argument, central banks have many other more effective policy options at their disposal before any need to resort to negative interest rates.

In the following sections, we expand on both sides of the debate, and discuss our own views and conclusions.

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[2] As at June 30, 2020.

2.1. The case for negative policy rates

The level and pace of job losses, increase in corporate and government debt, and the number of projected bankruptcies due to the Q1 2020 economic lockdown and subsequent recession are immense. Although the threshold for another full-scale economic shutdown is high, the continued prevalence of COVID infections across much of the world suggests at least some adverse impact on the pace of the economic recovery in the near term.

Against this backdrop, proponents argue negative rates could exert a strong stimulative impact on economic activity, through a number of transmission channels. The most direct is the same as for an interest rate cut when rates are above zero—incomes, equity prices, and financial wealth rise, leading to an increase in consumer and investment spending, and aggregate demand. Lower interest rates also reduce debt service burdens. This acts to lower bankruptcy risk, and free up cash for more productive, growth-supportive uses in the economy.

Adopting negative interest rates may also depreciate the value of a country's currency. A weaker currency makes that country's exports cheaper to foreign buyers, boosting external demand and GDP. Central banks will of course not admit currency devaluation is a target of a negative interest rate policy, or monetary policy more broadly, for fear of retaliatory action by key competitors. But it is an important means to the end objective of stronger growth, and achievement of inflation targets.

To ensure a negative interest rate policy is effective, regulatory and tax adjustments would likely be required to prevent cash hoarding by banks, insurance companies, and pension funds. A common criticism of central banks that have embraced negative interest rates is that accompanying structural changes were not implemented, muting the effective transmission of this policy tool into the broader economy. For example, the first few iterations of the ECB's Targeted Longer-Term Refinancing Operation (TLTRO) program stimulated little net new lending by European banks, and pressured bank profitability.

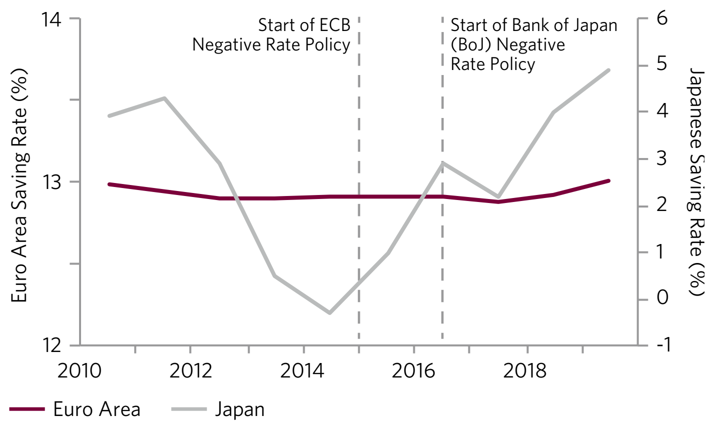
The ECB has subsequently learnt from experience. In March 2020, it introduced a number of changes to its TLTRO program, including lowering the favorable borrowing interest rate it makes available to banks who on-lend borrowed funds to the real economy, to -1%. In effect, banks are now paid to lend. The ECB also eased conditions associated with access to the favorable rate, including the amount of funds individual banks can borrow, and collateral requirements.

In effect, the ECB has transformed negative interest rates from a net tax on the banking sector into a net subsidy (Gavekal, 2020). European bank profitability will benefit, and an improvement in bank lending is expected, underpinning the nascent economic recovery.

2.2. The case against negative policy rates

Proponents of negative rates argue that they discourage saving and promote increased consumption. In reality, a number of countries that have adopted negative rates (for instance, Japan and the Euro Area) have actually seen household saving rates increase (Figure 2).

Figure 2 – Euro Area and Japanese household saving rates are at a 10-year high



Source: The information was prepared by CIBC Asset Management Inc. using the following third party service providers' data: Eurostat. and Japanese Cabinet Office. As at December 31, 2019.

There are a number of possible explanations. First, to counter the loss of wealth caused by a reduced rate of interest on the stock of savings held in the form of bank deposits, or near-cash substitutes. Related, many developed economies face challenging demographic trends. Retirees living on fixed incomes are adversely affected by lower, and negative, interest rates.

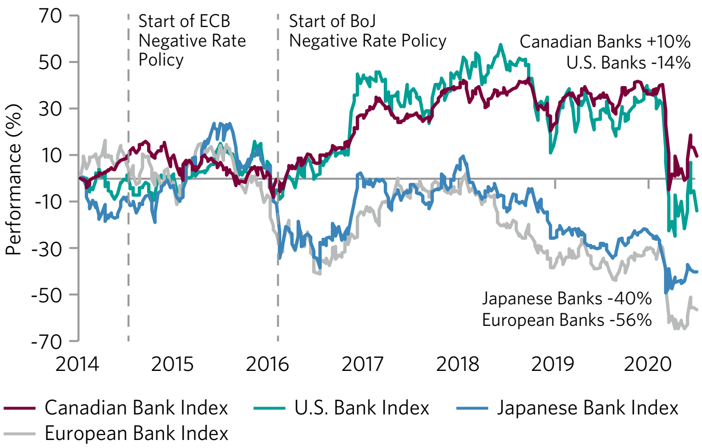
Second, adoption of a negative interest rate policy may implicitly act as a signal from central banks to consumers and investors that the economic outlook is worse than expected, including a greater risk of deflation than previously priced. A rising probability of deflation encourages investors and consumers to postpone spending, for instance by extending the lifecycle of durable goods; why buy today, when you expect to have an opportunity to buy for less tomorrow?

Third, negative interest rates also reduce bank interest margins, as banks are reluctant to levy negative interest rates on depositors, even in a falling rate environment. This negatively impacts bank profitability, which in turn inhibits their ability to lend to the real economy. As previously noted, the ECB appears to have designed an effective solution for this concern in Europe.

Fourth, relative to many other economies, Canadian and U.S. consumers do not maintain large deposit bank balances. Banks rely instead on money market funding from foreign investors. If interest rates fall below zero, foreign-derived funding may be strained, tightening financial conditions.

Negative interest rates were introduced in the Euro Area in June 2014, and in Japan in January 2016. Since then, Canadian and U.S. bank stock performance has been stronger than European and Japanese counterparts, despite the recent oil-related underperformance.

Figure 3 – Global bank stock indices



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U.S. Bank Index = Keefe, Bruyette and Woods (KBW) Nasdaq bank index is a stock index of the banking sector, European Bank Index = Banks Price Index EUR, a European capitalization -weighted bank index, Japanese Bank Index = TOPIX Banks Index, capitalization-weighted Japanese bank stock index, Canadian Bank Index = S&P TSX Banks Index, Composite of bank stocks listed on the S&P TSX.

3. The Fed and BoC view

The U.S. Federal Reserve (Fed) Federal Open Market Committee (FOMC) has so far been unanimous in its opposition to negative rates. Unanimity within the FOMC is rare. This creates an important signaling effect that makes it difficult for the committee to reverse course.

The BoC has, through time, been more equivocal on the validity of a negative interest rate policy. But in recent pronouncements, reference to an effective lower bound policy interest rate of 0.25% has remained prominent (Poloz, 2020; Macklem, 2020). Arguments against a negative interest rate policy have been framed in terms of the potential damage it could inflict on the financial sector, impairing its ability to support recovery in the real economy.

The Fed and BoC have several, complementary rather than competing, policy alternatives yet to deploy, ahead of negative rates:

1. **Change the policy target:** In September, the Fed announced a change to its policy framework, altering the inflation target, from 2% to an average of 2%. This change will allow it to run policy looser for longer, to compensate for earlier periods when inflation has undershot the target.
2. **Forward guidance:** Both central banks can explicitly commit to keep policy interest rates low for a long period of time, emboldening consumers and investors to commit to big-ticket spending with the confidence that associated financing costs will remain low for a prolonged period. To bolster credibility, guidance could be made conditional on realization of a particular inflation outcome, or a combination of inflation and unemployment outcomes, or could be calendar-based (a commitment not to raise the policy interest rate for a minimum time period).[3]
3. **Expand quantitative easing:** The Fed and BoC can further increase the size of already large asset purchase programs, and expand the range of eligible assets encompassed by existing programs.
4. **Expand lending and credit programs:** The Fed and BoC have introduced a number of programs to facilitate lending to individuals, small and medium-sized businesses, and large corporations. These programs can be enhanced and further expanded as needed to ensure credit flows effectively through to the real economy, or Main Street.
5. **Yield Curve Control (YCC):** Instead of focusing on the level of the policy interest rate, both central banks could commit to purchase longer-dated bonds, with an objective of targeting a specific bond yield at a specific maturity, again to encourage household and corporate spending. If the policy commitment is credible, there will be little need to make significant purchases.

The BoJ adopted YCC in September 2016, with a target for 10-year government bond yields of around 0%. The Reserve Bank of Australia (RBA) introduced YCC in March 2020, targeting a yield of 0.25% for 3-year government bonds.

The time horizon embedded in the RBA variant seems a more likely target for any future Fed or BoC policy, for instance based on comments by FOMC member Brainard (2020).

Targeting the level of yields over a relatively short time period would allow the Fed or BoC to directly link this commitment to another of the policy options discussed above, conditional forward guidance. The two would be explicitly mutually reinforcing. The June 2020 FOMC meeting minutes served to temper building market expectations of imminent YCC. But it remains more likely than negative rates given its effectiveness in Japan and Australia to date.

[3]On July 15, 2020, the BoC adopted a version of forward guidance indicating rates will not be raised until slack in the economy is absorbed and inflation is running persistently at 2%, which their base case doesn't see happening until after 2022.

4. Our view

The Fed and BoC are unlikely to adopt negative interest rate policies. Unprecedented fiscal and monetary policy actions have averted a liquidity crisis, re-established normal market function, and minimized the risk of long-lasting structural damage due to the Q1 economic shutdown. Economic leading indicators suggest a cyclical recovery that began in spring is continuing, albeit from very low activity levels and despite some moderation in recent months.

Policy support will continue to nurture this recovery, which we expect to persist through the second half of 2020 and 2021. Support will come via existing tools, with the potential addition of others we have outlined in this paper, including conditional forward guidance. It is unlikely to come through negative interest rates.

5. What would change our view?

- A broad-based and persistent weakening in economic data, likely associated with a substantial roll-back of economic re-opening, that undermines our current relatively constructive cyclical growth outlook.
- Related, in the U.S. no resolution of the fiscal cliff inherent within the Coronavirus Aid, Relief, and Economic Security (CARES) Act enacted to provide income support to workers temporarily unemployed due to the economic shutdown. Millions of U.S. households will suffer significant income loss if benefits in this program are not extended past the current July 31 expiry date.
- Significant longer-term economic scars due to COVID-19 and responsive economic shutdowns. Some scarring is certainly likely, for instance due to behavioural changes that impact spending patterns in particular economic sectors, including discretionary consumer, or encourage a continued gradual move away from globalization. But scars would have to be particularly deep to encourage adoption of a negative interest rate policy.

6. Conclusion

Unprecedented fiscal and monetary policy support has encouraged a nascent global economic recovery. Support will remain in place, and even grow further, over coming quarters. As a result, we expect economic activity to continue to gain momentum for the remainder of the year and into 2021.

The Fed, particularly, and BoC have been definitive in ruling out negative rates. Both still have a number of policy options at their disposal with which to continue supporting and stimulating economic activity without resorting to negative interest rates. Unless these more favoured options fail to nurture recovery over the next 1-2 years, we do not consider a proactive policy decision to introduce negative interest rates to be likely in either country.

7. References

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Let’s Connect

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