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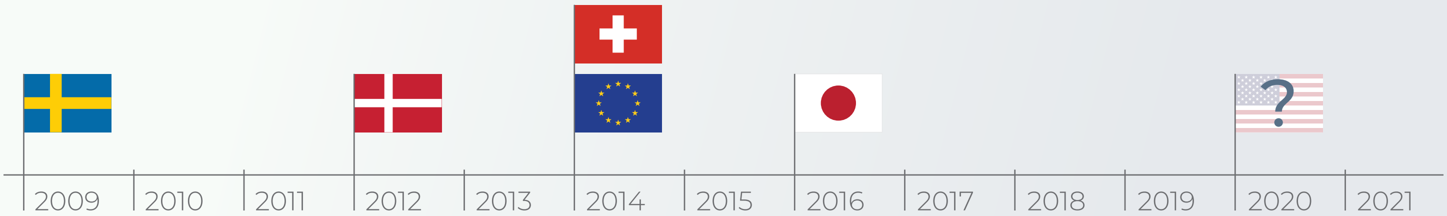
INVESTMENT MANAGEMENT

Negative Interest Rates

The COVID-19 pandemic is impacting our daily lives in a variety of ways. Recent news headlines and tremendous market volatility are making communication more critical than ever as the pandemic continues to restrict commerce around the world. The surge in jobless claims and loss of economic productivity due to the impact of the virus is unlike anything the modern global economy has seen. In the U.S., the Federal Reserve is being extremely aggressive in their attempt to provide economic relief by implementing measures to increase the money supply in the economy.

Their preferred method of impacting monetary policy is adjusting the level of short-term interest rates. The Fed utilized this approach and cut the overnight lending rate between banks by a total of 1%, to a target range of 0–0.25% and stated that the committee would keep rates at that level until the economy weathered the effects of the COVID-19 virus. The Fed stated a normal level would be determined by using figures that showed the U.S. had reached maximum employment and maintained their goal of price stability. To further help, Congress passed more than a $2 trillion spending package aimed at flooding the economy with liquidity. After all this stimulus, one question remains.



WHAT IF IT IS NOT ENOUGH?

What if all the measures that the Federal Reserve has taken does not get the U.S. to attain full employment? What if all the unprecedented levels of cash that flooded the economy are not enough to maintain a modest level of inflation? Many investors fear that the only arrow that the Fed has left in their quiver, is to introduce negative interest rates. As shocking as this sounds to many, some fear that it is inevitable.

WHAT ARE NEGATIVE RATES?

The concept is just as it sounds. It is thought provoking but is relatively simple in its execution. The goal is to spur inflation by encouraging substantial levels of borrowing and spending. To help illustrate this concept, consider the following example.

If a borrower takes a 1-year loan of $100,000 from a bank with an interest rate of –3%, at the end of that term the investor will only be required to pay back $97,000 of the original principal. This makes it extremely attractive for those that are borrowing money, but not those lending.

There are several unintended consequences of negative interest rates that could occur.

- Banks and other lenders are disincentivized to lend money. Every loan they make would be at a financial loss. For the same reason, it would also likely cause banks to not keep their excess reserves with the Fed, but instead house their cash on-site in their vault.
- Investors that need to generate income from fixed income investments income would suffer greatly. Each year, they would be guaranteed to lose a portion of their principal. The main reason someone might still choose to a bank to deposit their money would be to pay for the safety of FDIC insurance.
- Negative rates could also cause a run on the banking system if people chose to withdraw their money over a short period of time. If we assume that the physical safety of cash is not an issue, in this scenario, putting money under a mattress is guaranteed to be a better investment than leaving it in a bank. It would also make it much more difficult for the Fed to determine how much physical currency remains in circulation.

There are only a handful of central banks in countries around the world that have implemented negative interest rates. In 2009, Sweden was the first to implement negative interest rates. In 2012 Denmark followed, along with Switzerland and the European Union in 2014. Most recently, Japan dropped their interest rates below zero in 2016. Unfortunately, the economic impact of negative interest rates in these countries remains very unclear. While the Federal Reserve has repeatedly stated that they have no intention of implementing the policy in the U.S. to stimulate the economy, only time will tell if they will be forced to use this financial experiment as a last resort.

If you have questions or would like to talk about your individual situation, please reach out to the professionals at Meeder by calling 866.633.3371, or visit us online at meederinvestment.com.