Investment Insights

Will Negative Interest Rates Come to the U.S.?

David Rossmiller
Head of Fixed Income

BESSEMER TRUST

Highlights

- As Europe and Japan have adopted negative-interest-rate policies, many investors worry that the U.S. will follow suit
- While negative-rate policies may have some positive goals — such as encouraging greater investment — there are many potential risks, including stress on financial institutions critical to the Fed's own policy implementation
- In our view, a better balance of fiscal, structural, and monetary policies is needed to boost economic growth
- The Fed is continuing to study the effects of negative rates; we believe a push below zero would only be considered as a last resort and is not our base case

With the advent of negative-interest-rate policies in major economies — the euro area (starting in June 2015) and Japan (in January 2016) — many people are wondering whether the U.S. Federal Reserve may also adopt a negative-rate policy. Fully $6.4 trillion worth of (non-U.S.) government bonds' yields as of this writing have dipped below zero, and investors in many countries are finding it difficult to find a positive yield in high-quality, low-risk bonds (see Exhibit 1, page 2).

What are negative rates and why do they exist?

Usually, a lender receives interest payments from a borrower. Under negative interest rates, a lender actually pays the borrower to take his or her money. When cash and even short-term bond yields are negative, this creates strong motivation to invest in equities, high-yield debt, long-duration debt, and others assets that can potentially provide a positive return. The problem for investors is that this entails taking more risk.

A central bank's goal, in setting its policy rate below zero, is to make cash so unattractive that both institutions and individuals will invest their capital in riskier assets. For an institution, these riskier assets could include capital spending projects; loans to small businesses (which are riskier and pay higher returns than, say, AAA-rated Exxon Mobil bonds); loans for mortgages; or stock buy-backs. In theory, all these activities tend to promote a wealth effect and encourage economic growth.

Currency devaluation is another potential effect of negative interest rates. If Country A's cash yield declines faster than that in Country B, Country A's currency will tend to decline in value. This improves Country A's terms of trade, making its goods cost less to other countries. A negative-interest-rate policy is an effective way to devalue a currency, with the goal of improving terms of trade and, as a result, boosting economic growth.

Encouraging greater investment, providing a wealth effect, and improving terms of trade are worthy goals, and on the surface, the concept of negative interest rates seems intuitively appealing. Even so, this policy approach is in its early stages, and much will be learned of its rewards and risks over time.

Exhibit 1: Negative Yields in Major Government Bond Markets

Country	CB*	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-0.75	-1.07	-0.02	-0.97	-0.88	-0.80	-0.71	-0.61	-0.51	-0.41	-0.32	-0.12	0.08	0.27
Japan	-0.10	-0.15	-0.19	-0.17	-0.18	-0.20	-0.19	-0.18	-0.15	-0.11	-0.08	0.18	0.43	0.65
Germany	-0.40	-0.50	-0.46	-0.45	-0.37	-0.26	-0.22	-0.17	-0.01	0.15	0.28	0.51	0.74	1.01
Netherlands	-0.40	-0.47	-0.47	-0.42	-0.35	-0.28	-0.17	-0.06	0.09	0.23	0.37	0.65	0.94	1.13
Finland	-0.40	-0.42	-0.38	-0.32	-0.20	-0.14	-0.01	0.12	0.27	0.42	0.58	0.82	1.06	1.21
Austria	-0.40	-0.40	-0.41	-0.33	-0.30	-0.25	-0.11	0.04	0.19	0.34	0.49	0.84	1.20	1.43
Belgium	-0.40	-0.42	-0.41	-0.37	-0.29	-0.22	-0.10	0.03	0.24	0.45	0.66	0.94	1.22	1.68
France	-0.40	-0.42	-0.41	-0.34	-0.26	-0.15	0.00	0.14	0.30	0.46	0.62	0.92	1.23	1.55
Sweden	-1.25	-0.64	-0.63	-0.50	-0.37	-0.03	0.11	0.25	0.37	0.49	0.61	1.02	1.42	1.42
Denmark	-0.65	-0.43	-0.30	-0.19	-0.09	0.02	0.11	0.19	0.32	0.44	0.57	0.71	0.85	1.13
Ireland	-0.40	-0.35	-0.35	-0.25	-0.10	0.02	0.20	0.37	0.53	0.69	0.86	1.16	1.46	1.83
Italy	-0.40	-0.07	-0.02	0.04	0.15	0.32	0.53	0.74	0.93	1.12	1.32	1.71	2.10	2.51
Spain	-0.40	-0.06	0.04	0.14	0.22	0.40	0.69	0.97	1.14	1.31	1.48	1.97	2.46	2.70
United States	0.38	0.71	1.01	1.20	1.36	1.53	1.59	1.81	1.87	1.92	1.98	2.16	2.34	2.71

Source: Bloomberg.
* Central Bank Policy Rate. As of March 16, 2016

Is effectiveness dependent on a country's size?

In 2014, Switzerland — which is not a member of the euro zone — was struggling to maintain a reasonable exchange rate of its Swiss franc against the euro. Switzerland's central bank had been selling vast quantities of francs (and buying euros) in amounts that were unsustainable in the long run, in an effort to keep the exchange rate stable. Letting the franc appreciate would have had disastrous effects on Swiss competitiveness and could have severely undermined Switzerland's economic growth. Investors, though, were more interested in safety, deeming the franc safer than the euro, and kept pouring money into francs.

Finally, in December 2014, the Swiss central bank implemented negative interest rates. When investors were faced with a significant cost of selling euros to buy "safer" francs, the transactional flows slowed, and the franc-euro exchange rate stabilized. In the case of tiny Switzerland, a negative-interest-rate policy worked reasonably well, without serious adverse consequences.

In a larger economy, such as the euro zone, Japan, or the U.S., the dynamics are different. First, when a large economy uses negative rates to spur growth or devalue its currency, other countries are forced to react, and as a result, the entire global economy is affected. This can cause a beggar-thy-neighbor spiral of competitive currency devaluation across countries. Second, when rates go below zero, a number of things can happen in large, well developed markets that aren't as disruptive in smaller countries.

What are the pros and cons in a large economy (like the U.S.)?

The positive results of negative interest rates can include 1) encouragement to invest in riskier, higher-return assets and projects, 2) better terms of trade through currency weakness, and 3) a boost of economic growth through a wealth effect.

The negative side of below-zero rates is less clear-cut and may not even become significant if 1) interest rates are only slightly negative, 2) individual (non-institutional) bank savings-deposit rates aren't affected, and 3) bank profitability isn't crippled through deposit flight.

Even so, it is worth exploring the darker consequences in the event negative rates are implemented broadly over an extended period.

In the U.S., the large money-market-fund industry would be hurt badly. Negative rates would cause funds to "break the buck," with shares falling below their $1.00-per-share pegs, and many funds would likely be forced to close. Money-market funds act as an important cog in the U.S. financial-system machinery. They are a significant transmission vehicle of Fed policy, and if the money-fund industry were crippled by negative rates, the Fed would lose an important means of control over the money markets.

If interest rates were to remain significantly negative for a long time, banks, insurance, and pension-fund viability would suffer. If these institutions' financial health were to decline, a credit contraction and ensuing economic slowdown could result, offsetting the goal of a negative-rate policy. The banking system in particular is an important transmitter of the Fed's influence over the financial system, and without Fed control, confidence in the financial system could sag, and the U.S. economy could become unstable. The Fed could control this effect to some extent by tiering its policy rates, for example, by leaving bank-deposit rates (for individual checking and savings accounts) at zero. That said, tiering takes away some of the benefits of a negative-rate policy.

Other potential negatives are 1) cash hoarding, which would hurt the banking sector, 2) the tendency of investors to take too much risk in avoidance of safe cash, likely causing higher market volatility, 3) the lack of incentive for politicians to implement economy-friendly fiscal policies when the Fed's monetary policy is at center stage, and 4) the potential for bank runs if investors don't want to pay institutions to hold their liquid assets.

All these adverse consequences are difficult to quantify or predict. They are even more difficult to manage in the event they were to lurch out of control. There are also potential political ramifications of negative rates (especially if the policy included individual savings accounts) that would almost certainly require the support of key political leaders if the Fed's policy implementation were to be effective. As a result, we feel the Fed will be extremely diligent in studying the potential effects of negative interest rates — positive and harmful — before possibly moving forward with such a policy.

What's actually needed? Fiscal, structural, monetary policy balance

In recent years, weak economic growth in all the major economies has been exacerbated by government efforts to reduce fiscal spending, and monetary policy has provided the only major functional economic stimulus. Better policy balance is needed in order to improve economic-growth prospects in the major countries, and an infusion of fiscal spending combined with structural reform providing, for example, infrastructure spending, tax cuts and simplification, education spending, and other stimulative programs would be helpful, especially in Europe and Japan. Monetary policy alone — even a negative-interest-rate policy — isn't enough. Higher fiscal spending could help Europe and Japan exit sooner from their negative-rate policies and move toward better economic balance.

Of course, many policymakers today are reluctant to use fiscal policy — either because deficits and debt overhangs are already large (Japan), because of cultural and long-held political biases (Germany), or because of charged political environments (U.S. and parts of the euro zone). Better balance in policy does not seem likely, in our view, to come easily.

Will the Fed adopt negative rates?

The Fed has no need to adopt negative interest rates at the moment. U.S. economic growth is reasonably solid and seems to be improving. Job growth is very good, and inflation indicators are ticking up a bit. In this context, we expect the Fed will likely raise its policy rates as early as its June FOMC meeting. That said, if the U.S. economy were to plunge into a recession (which we do not expect this year), and the Fed reacted by easing its policy rates back down to zero, a discussion of negative interest rates would likely occur around Chair Yellen's conference table. The Fed has already studied, and is continuing to study, the effects of negative rates, and we feel pushing below zero would only be considered as a last resort. The risks are significant to a large, complex economy such as the U.S., and the Fed would not proceed quickly or without thorough reflection. By the time the U.S. enters its next recession, negative rates may become a possibility, but by then, the Fed may have invented other approaches to monetary policy that are potentially safer and more effective. Either way, the possibility of negative rates in the U.S. is a worry we don't have to endure for now.

Our Recent Insights

A Briefing on Brexit — Evaluating the Risks of the U.K. Leaving the EU — A Closer Look (March 2016)

Thinking About Corrections — Investment Insights (February 2016, **Video Also Available**)

Navigating Underfunded Pensions — Investment Insights (February 2016)

Addressing Recent Market Weakness — Investment Insights (January 2016, Video Available)

Inflation Checkpoint — Investment Insights (January 2016)

Managed Volatility Equities — Q&A — Investment Insights (January 2016)

Happy New Year? — Investment Insights (January 2016)

At Long Last — Fed Liftoff — Investment Insights (December 2015, **Video Also Available**)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 100 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.