



## EconoMag

The show that demystifies economics

### Negative Interest Rates: What's the Deal? ©

by Pierre Vercueil

Hi there and welcome back to a brand new episode of Economag. Today we'll have a look at a topic in the economic world making headlines: negative interest rates. On 29 January, the Bank of Japan surprised markets by adopting a negative interest-rate strategy, more than 1,5 years after the European Central Bank became the first major central bank to venture below zero. Sweden's Riksbank also currently has negative rates, Denmark uses them intermittently to protect its currency's peg to the euro and Switzerland recently moved its deposit rate below zero for the first time since the 1970s. But before we dive into the story, let's take a quick look at some basic economic theory to help us understand what's going on:

When you lend somebody money, he or she normally pays you for the privilege in the form of an interest rate – this has been a bedrock assumption across centuries of financial history. The banking system works no differently; when we deposit our hard-earned savings into our accounts, our bank pays us interest in return for being able to keep our money safe (don't be fooled into thinking that that sounds like a raw deal for banks, they make plenty of money from our savings!) Now imagine a bank that pays negative interest – that means depositors are actually charged to keep their money in an account.

How and why would a country's central bank turn its economy's interest rates negative? Let's start with the how. The first thing you need to know is that commercial banks, such as BNP Paribas or Société Générale, regularly need to deposit money in the central bank, which would be the European Central Bank (ECB), on an overnight basis. The central bank decides what we call a "base rate", essentially the interest rate for commercial banks to deposit money overnight, which they then pass onto their customers who deposit with them. The base rate can be either negative or positive, so crudely speaking if the central bank sets a negative base rate, commercial banks are going to set a negative interest rate for their customers.

Let's move on to the why. Negative interest rates are a sign of desperation, a signal that everything the central bank has tried to steer the economy in a certain direction has

indeed proven ineffective. What direction might that be? Up, of course, in the form of economic growth! Many commercial banks took a beating during the 2008 Financial Crisis due to bad loans, leading to what is now a risk-averse banking sector. Central banks the world over have desperately been trying to unclog the banking system—in other words, get banks to give out loans, the very thing they're designed to do. Loans imply increased spending, and thus economic growth. With negative interest rates, banks will now be punished if they continue to hoard cash instead of extending loans to businesses.

Will negative interest rates work? It's hard say with any certainty. At a minimum it will lower the value of any currency whose economy's rates are below zero, meaning exporters will benefit. In the same breath, it's less clear if it can help create sustained economic growth. Perhaps more worryingly, if people start preferring to place their money under their mattresses rather than in their bank accounts, it would spell trouble for the banking and financial system as we know it. Nonetheless, negative interest rates are poised to continue making headlines in the near future as the central banks of Israel, Norway, Canada and the United Kingdom keep edging their base rates ever closer to zero.

Stay tuned for the next Economag here on EnglishWaves when we'll have a look at another topic making news in the world economy.