

# Will you "pay to save"? What negative interest rates mean for investors

With negative interest rate policy (NIRP) imposed in Japan and across much of Europe, we explain what it means and look at its effects.

04/08/2016

**David Brett**  
Investment Writer



**30 Minutes**  
Unstructured  
Learning Time

**What are negative interest rates?**

Negative interest rates mean that banks have to pay – rather than receive – interest on the reserves they hold with their central bank. In turn, the banks are then faced with the choice of whether they pass on that cost by charging savers to hold deposits with them.

## **Why are negative interest rates being used?**

Following the 2008/09 financial crisis, the economic gears of the global economy have struggled to grind into action.

Despite central banks trying to lubricate the cogs using unprecedented monetary policy, such as quantitative easing, economic growth has been weak. The World Bank says global growth has been around 2.5% for the past three years compared with 3.8% to 4.5% in the four years before the credit crisis.

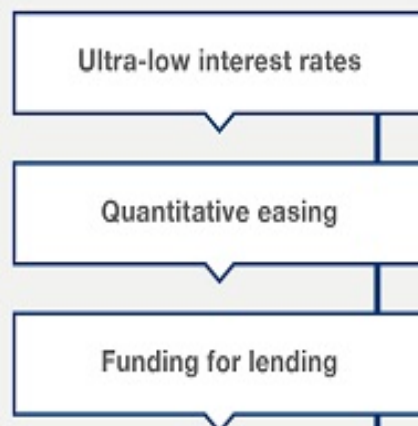
Growth is urgently needed to help prevent a global recession and not least to ease the debt burden weighing on economies.

NIRP is one of the last remaining options available to central banks to stimulate growth.

## Negative interest rates: opening Pandora's box?

Years after the end of the global financial crisis, mediocre growth and low inflation still haunt many advanced economies

This has led many central banks to resort to extreme policies



### Negative Real Interest Rate Policy (NIRP)

**What?**

An unconventional monetary policy tool where nominal target rates are set with a negative value

**Why?**

- Heralded as the solution to secular stagnation
- Proposed as a solution for weak growth

**How?**

NIRP puts a charge on deposits encouraging financial institutions to lend, leading to investment and consumption

**Where?**

Switzerland, Denmark and Sweden employ NIRP to maintain currency competitiveness and discourage excessive capital from overseas

The Bank of Japan and European Central Bank have also employed NIRP to boost activity and lending, but both have seen their currencies appreciate

**However, NIRP is not cost free:**



Encourages households to withdraw cash



Hurts the banking system, reducing lending and competition in the long-term



Strong potential for the market to overreact



We believe central banks should clearly stipulate the limitations of negative rates before markets get ahead of themselves

Source: Schroders, as at May 2016.

For information purposes only. This material is not intended to provide advice of any kind. Information herein is believed to be reliable but Schroders does not warrant its completeness or accuracy.

## What do negative interest rates mean for investors?

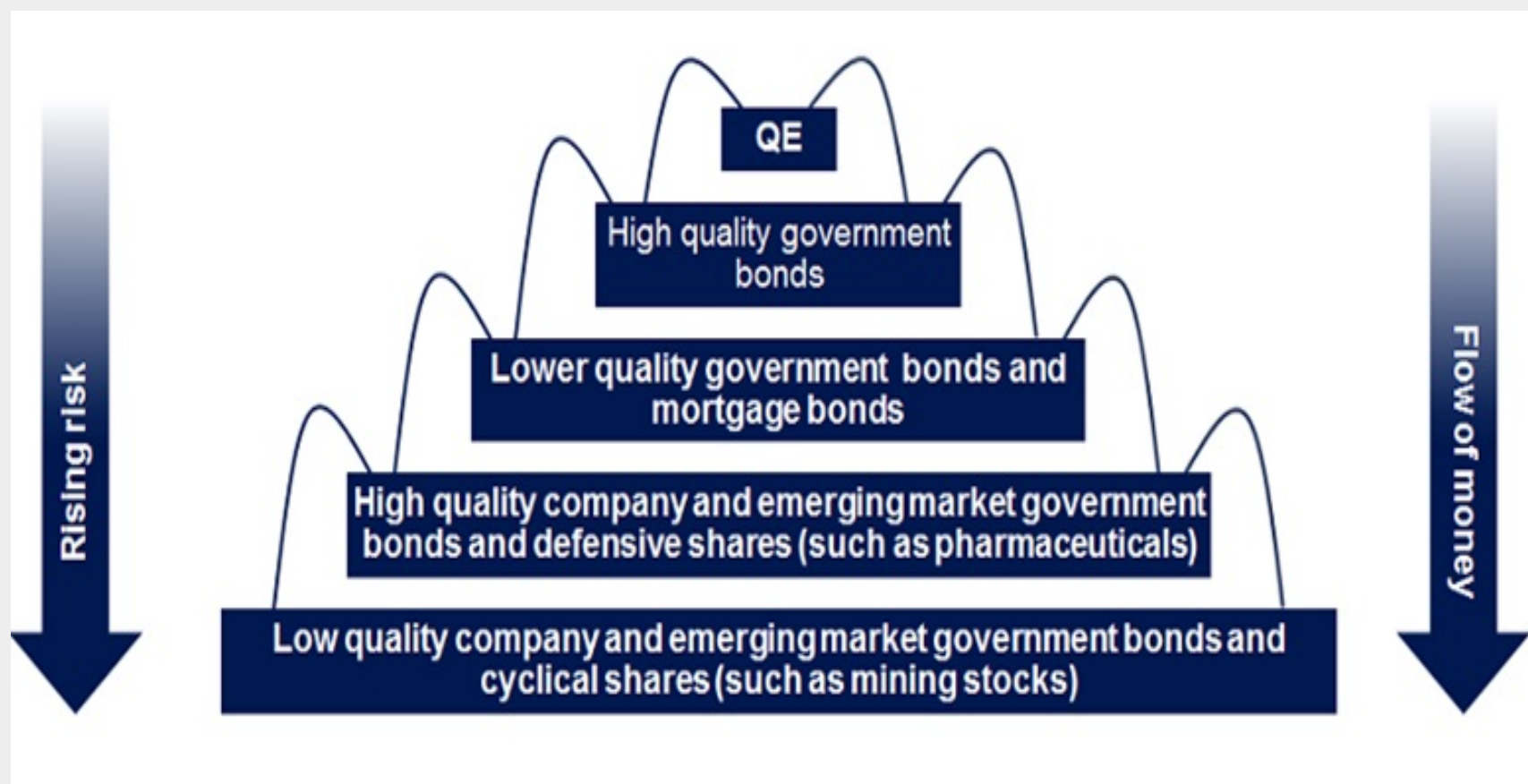
Negative interest rates mean that investors, potentially, face greater uncertainty. NIRP seems logical: make saving expensive so people go out and spend. But we live in an illogical post credit crisis era.

Central banks have already been using unprecedented monetary policy, such as quantitative easing and low interest rates, for the best part of a decade, yet robust growth remains illusive.

Investors seem reluctant to spend despite central banks' best efforts; there are no guarantees that NIRP is working where it's already deployed or that it might be the right option for the UK.



Additionally, QE and ultra low interest rates have already suppressed income yields in “safer” asset classes, such as government bonds, potentially creating asset bubbles. It forces investors to look elsewhere for income and consider higher risk investments, such as equities. The chart (below) shows how QE has trickled through the financial system, pushing up the prices of different assets.



Source: Schroders

NIRP could force investors further down that route.

The outlook for investors, in particular those with large savings and/or those heading towards retirement, is confused.

## Why are retirees so affected?

In short, pensioners and those approaching retirement will face more of the same issues that they have endured for the past seven years – falling savings rates, falling annuity rates and increasingly finding it difficult to find low-risk income elsewhere.

Once retired, savers could rely on their nest egg to pay an income or they buy an annuity, which would pay regular income for life. Often it is a bit of both.

But it has been harder to find income on investments, and most notably on savings accounts due to all of the central bank measures mentioned above. With negative rates, savers may even have to pay banks to hold their deposits.

There is a further complication for those heading towards retirement.

Usually, investors who are approaching the retirement age would begin to shift their investments away from more risky assets such as equities, and into lower risk assets, such as government bonds, which provide more guaranteed long-term (albeit lower) returns.

Those government bonds are now expensive and their yields are at or close to zero. In some cases, they are already negative.

So, facing a potential shortfall in retirement, investors might be forced to take on more risk than they might otherwise have wanted. This potentially builds up bubbles in the future which, if they pop, can cause longer-term damage.

## **Timeline for central banks' NIRP**

### **Denmark's Nationalbank – July 2012**

- cut its deposit rate to -0.20%

### **European Central Bank (ECB) – June 2014**

- cut its deposit rate to -0.10%

### **Swiss National Bank (SNB) – December 2014**

- cut its deposit rate to -0.25%

### **Swedish Riksbank – February 2015**

- cut its repurchase rate to -0.10%

### **Bank of Japan (BoJ) – January 2016**

- Applied a rate of negative 0.1% to excess reserves that financial institutions place at the bank.

### **National Bank of Hungary – March 2016**

- cut its deposit rate to -0.05%

It is worth noting that so far, few banks have imposed negative rates on savers, or asked them to pay to save.

Some banks in Switzerland tried this and then backtracked. At least one bank in the UK – NatWest – has told business customers it may need to pass the costs on should the Bank of England (BoE) adopt NIRP. However, it is widely seen as potentially unpopular and difficult policy to enact.

A more likely scenario is that banks might trim generous benefits that they offer elsewhere to attract new customers.

For instance, most of the biggest banks offer generous income on current accounts, sometimes up to 5%. These could be trimmed to avoid “pay to save” stipulations for existing customers.

## **Has NIRP worked?**

Whether NIRP has worked in the countries that have adopted it is a difficult question to answer.

If the aim is to get people spending and accelerate economic growth then even the most ardent supporter of NIRP would say this has so far failed, given the extremity of the measures taken.

The problem is that countries such as Switzerland, Japan and Sweden have adopted NIRP primarily to weaken their currencies.

However, with central banks around the globe competing with similar policies the potential effect is being cancelled out. For instance, Japan’s currency has actually strengthened following the cut in rates.

The answer is not straightforward. Would it be better to ask where the global economy might be if these types of policy, including quantitative easing, were not to have been adopted?

## **What is the solution?**

Central banks are running out of options. Despite measures that have been adopted by central banks, consumers and businesses have so far not been coaxed out of their shells.

Possibly stung by credit crisis and fearful of future fallouts occurring, investors are stuck in a crisis mindset.

Investors are saving and hoarding as they lack faith in the financial system, despite little return on their investments.

Those that are spending and investing are being cascaded into ever riskier investments. The BoE appears acutely aware of this. Mark Carney, the bank's Governor, expressed reservations about the [effectiveness of negative rates](http://www.bankofengland.co.uk/publications/Pages/speeches/2016/885.aspx) (<http://www.bankofengland.co.uk/publications/Pages/speeches/2016/885.aspx>) in a speech in February, recognising that such a policy would also put further pressure on bank business models.

While it is expected the BoE's monetary policy committee may vote to cut rates to zero by the end of 2016, the market is not anticipating interest rates to go negative in the UK.

One thing seems certain, once a central bank has opted for negative rates, its already limited options for sparking sustained economic recovery shrink further.

---

Issued by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA. Registered No: 1893220 England.

Authorised and regulated by the Financial Conduct Authority

For more information on Schrodgers' products and services visit [Schrodgers' global website](http://www.schrodgers.com/global/home).  
(<http://www.schrodgers.com/global/home>)