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Getting ready for Negative Interest Rates in the UK

- Negative Interest Rate Policy ("NIRP") is a "last resort" policy tool
- The UK is getting ready for "NIRP"
- The hunt for yield and alternatives to cash

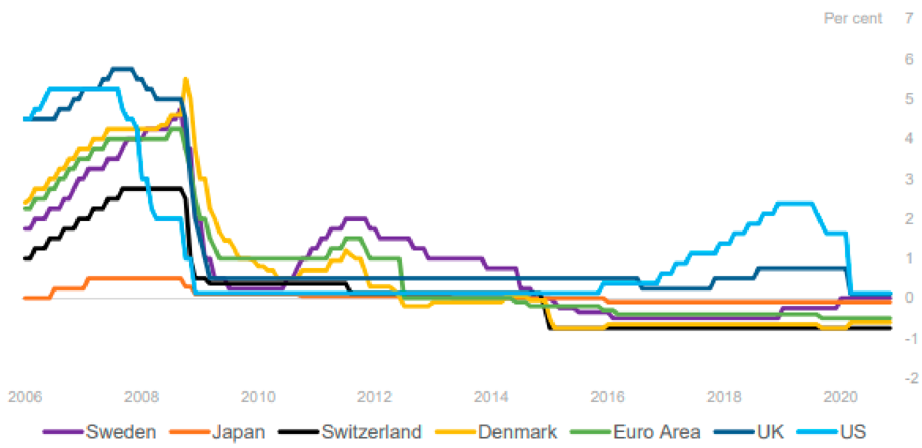
A "last resort" policy tool

Zero & Negative Interest Rate Policy are Non-Traditional forms of Monetary Policy is a way of Central banks creating a disincentive for banks to hoard capital and get money flowing.

Zero Interest Rate Policy (ZIRP) is when Central Banks set their "policy rate" (a target short-term interest rate such as the Fed Funds rate of the Bank of England Base Rate) at, or close to, zero. ZIRP was initiated by Japan in 1999 to combat deflation and stimulate economic recovery after two decades of weak economic growth.

Negative Interest Rate Policy (NIRP) is when Central Banks set their policy rate below zero. Japan, Euro Area, Denmark, Sweden are currently using a NIRP. US & UK are currently using a ZIRP, and are considering a NIRP.

Fig.1. Advanced economy policy rates



Source: BIS, ECB and Bank calculations
Notes. Sweden: repo rate. Japan: target for uncollateralised overnight rate until December 2015; rate on Complementary Deposit Facility thereafter. Switzerland: average of SNB target range until June 2019, SNB policy rate thereafter. Denmark: certificate of deposit rate. Euro Area: rate on main refinancing operations until May 2012, deposit facility rate thereafter. UK: Bank Rate.US: average of range for Fed funds rate.

Whilst bond prices may imply negative real yield, or negative nominal yields, a NIRP impacts the rates at which the Central Bank interact with the wholesale banking system and is intended to stimulate economic activity by disincentivising banks to hold cash and get money moving. A NIRP could translate to negative wholesale rates between banks, and negative interest rates on large cash deposits, but not necessarily retail lending rates (e.g. mortgages).

Ready, steady, NIRP

Negative Interest Rates were used in the 1970s by Switzerland as an intervention to dampen currency appreciation. . It was the subject of academic studies and was seen as a last resort Non-Traditional Monetary policy during the Financial Crisis of 2008 and during the COVID crisis of 2020. Sweden adopted NIRP in 2009, Denmark in 2012, and Japan & Eurozone in 2014. The Fed started looking closely at NIRP in 2016.

According Bank of England MPC minutes of 3rd March 2021, wholesale markets are generally prepared for negative interest rates as have already been operating in a negative yield environment. By contrast, retail banks may need more time to prepare for negative interest rates to consider aspect such as variable mortgage rates.

There are arguments for and against NIRP. The main argument for is that NIRP is stimulatory. The main argument against is that NIRP failed to address stagnation and deflation in Japan and can create a "liquidity trap" where corporates hoard capital rather than spend and invest.

The hunt for yield

With negative interest rates, there will be an even greater hunt for yield. We look at the some of the options that advisers might be invited to consider.

- Foreign Exchange: This is what drove many Japanese retail investors to open savings accounts in foreign currencies that – despite the exchange rate risk – paid a greater interest rate.
- Structured Retail Products may offer high headline yields, these typically involve a complex return pay-off or conditionality linked to an index level such as the FTSE 100. Return and risk cannot be created or destroyed. Structured Products simply re-distribute the pay-offs between issuer and investor and – in aggregate – represent market returns less product costs and commissions. We do not consider these as appropriate alternatives to Cash in a NIRP environment, or at all.
- Mini-Bonds that offer too-good-to-be-true interest rates that lure investors in to speculative investment schemes have, thankfully, been banned for promotion to retail investors.
- Up-risking: Alternative yield options necessarily require a modest "up-risking" relative to the zero-volatility and guaranteed (if paltry) return on cash deposits. This up-risking could include money market funds (which will also come under interest rate pressure), longer dated bonds, and ultimately equities.

Getting the balance right between additional non-negative income yield and additional downside risk will be key for investors and their advisers when preparing for and reacting to a NIRP environment.

Find out more

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