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Negative Nominal Interest Rates

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Summary

Negative interest rates are but the latest monetary virus, sown by central banks in the early 2010s. Commercial banks were the first to be hit by the bug, and have remained the primary carriers of this contagion ever since. The virus's gradual spread has meant it has been slow to reveal its full destructive potential. That said, its transmission accelerated in 2019, and the disorder has been impacting an ever-growing number of savers. Negative ***nominal*** *interest rates make no economic sense – why would anyone consent in advance to losing some of their own money? **Cash, unaffected by negative interest rates,** is the final line of defence against this scourge. This is why it is crucial to keep as many people as possible immune by keeping our own cash in our own hands. This does not, however, mean we should promote only banknotes and roll back the recent advances made by the banking system. On the contrary: there's no reason not to use the whole range of innovative payment technologies. The underlying issue, though, is that no alternative asset can come close to cash for liquidity and security. Not even central banks' digital currencies (CBDCs) offer a substitute. Put simply, digital assets **do not guarantee nominal stability** as not even the central banks themselves are certain that CBDCs are **a complement to physical banknotes.** If banknotes are not used by a majority of people, they will inevitably disappear due to the negative network effect. Their departure would eliminate the final bulwark against central bankers' unrestrained technocratic absolutism and destructive negative interest rates, which deprive our money, incomes, and assets of their nominal value.*

Key words: *negative nominal interest rates, monetary policy without constraint, cashless society.*

Why negative rates

Negative interest rates are the latest monetary virus sown by the central banks of Switzerland and Sweden, and the European Central Bank (ECB), in the first half of the 2010s. The bug first hit commercial banks and they have remained its primary carriers to date. The virus's gradual spread has meant it is yet to reveal its full destructive potential. That said, transmission accelerated in 2019, and the disorder is now impacting an ever-growing number of savers, people with money in banks. Their deposits have been dwindling in proportion to the negative rates, which now mainly range from 0.5 to 1 percent, meaning that, for instance, 10,000 euros in someone's bank account will fall to 9,900 euros one year later. On top of that, the banks also already charge account management fees. **Cash, unaffected by negative interest rates,** is the final line of defence against

this scourge. This is why it is crucial to keep as many people as possible immune *by keeping one's own cash in one's own hands.*

Monetary experts defend exposing the general population to this interest rate virus by claiming that *banks can no longer hold your money 'for free'.* There should, obviously, be no doubt as to how serious these experts are, nor how ready banks may be to act purely out of the goodness of their own hearts. Doing away with 'free' deposits means that the future may hold something hitherto unimaginable – ***negative interest rates*** on YOUR OWN money in the bank: in other words, you may catch the bug as well. These *penalty* interest rates are already paid by many deposit holders in Switzerland, Germany, Denmark, and elsewhere in the EU. Fewer than one-half of all banks have introduced such negative rates, but the number is growing. The first to be affected were the largest, multi-million deposits in some Swiss banks, followed by accounts with more than 100,000 euros in other European countries. In 2019, the contagion spread to all deposits, even the tiniest ones, including those in co-operative banks.

This unconventional idea is currently applied only to *current accounts* or *demand deposits*, meaning accounts we use for day-to-day transactions, and not to time deposits, savings, or other bank accounts. To better understand the effects of *negative interest rates*, we ought to first look at how these accounts work.

How current accounts work

Banks keep our money 'for free' in 'current accounts' or as 'demand deposits'. It is universally acknowledged this is our non-cash money that we use for day-to-day payments, which is why these accounts are often termed 'transaction accounts'. Don't be confused: all of these names, including 'sight deposits' and 'overnight deposits', mean the same type of account. These are the accounts our salaries and other income – such as interest, rents, dividends, and the like – get paid into. For practical reasons we keep much more money in these accounts than in our wallets: it's easy to use them to pay by card or mobile phone, without having to write cheques (even though we're still able to).

Maintaining a current account was never completely free, with most banks charging fees, usually as fixed monthly sums. Fees for individual transactions are based on banks' policies, and can be fixed, percentage-based, or a combination of both; these payments can also be free of charge. If you thought banks didn't make much money from these charges, you'd be wrong: payment services are the greatest non-interest source of revenue for most banks.

Just as we have our current accounts in banks, so banks have their own transactional accounts with the central bank. These are called 'reserve deposits', or just *reserves*, and banks use them to settle our transactions with clients of other banks and to make all other payments. There is, evidently, a logical connection between our and banks' current accounts, or reserves. This link is the key for explaining why negative interest rates are charged on our money.

Negative or penalty interest rates

The interest rate is every central bank's primary monetary policy instrument. Central banks set these interest rates independently and apply them in their day-to-day operations intended to supply money to the economy by either lending to banks or buying securities in the open market. This is how central banks influence the market price of money, which also extends to the cost of our own borrowing. Specific interest rates also apply to banks' reserves, and these have slid to below zero ('into negative territory', in economic parlance) in a number of developed countries. Since these are nominal rates, we can assume they constitute some sort of penalty or disincentivising interest.

Monetary history up until the 2010s has never known *negative **nominal** interest rates*, because these make no economic sense – why would anyone consent in advance to losing some of their own money? That being said, *negative **real** interest rates* have appeared in times of inflation, when all prices have risen. This was not caused by nominally negative interest rates but, rather, by the fact that contractual nominal interest rates were lower than the rate of inflation. Put simply, if your contract with the bank stipulated, for instance, a 2% annual rate on your deposit, and the inflation rate reached 4% in that year, you'd have incurred a real loss of some 2% (2% - 4% = -2%). This phenomenon has been known since the late 1890s, when it was explained by the brilliant American economist Irving Fisher, who termed the lack of differentiation between nominal and real interest rates the 'money illusion'.

You're probably going to ask why commercial banks would even keep money with a central bank at negative interest. This is due to central banks' monopoly on bank reserves, so banks have no choice. The one thing they can do, though, is reduce their reserves, but doing so exposes them to liquidity risk (meaning they may be unable to meet their financial demands). Banks, however, have no way to avoid negative interest rate losses outright, because they cannot operate without reserves, or money. A look at what motivates central banks will help shed light on this 'illusionist' interest rate policy.

Central banks' motives

Commercial banks use reserve deposits, their current accounts with the central bank, to keep money for day-to-day payments, including our own transactions. In addition to using our own money, we can also pay in money we've borrowed from the bank. Lending to individuals and firms is the most extensive banking operation and provides key support to every nation's economy. History teaches us that economic prosperity is generally connected with credit growth, whereas contractions (recessions) are associated with downturns in lending. Hence, central banks tend to discourage bank lending when the economy overheats, and, conversely, stimulate it when the economy is cooling down.

Following the 2007 global financial crisis and the attendant recession, the most severe economic downturn since the Great Depression of the 1930s, central banks endeavoured to use monetary

policies to restart economic recovery. It quickly became apparent that traditional economic policy was not going to do the trick, so central bankers resorted to so-called unconventional measures. Two of these were key: a drastic cut in interest rates, and the provision of unlimited liquidity to banks in the form of an extreme money supply. However, the explosion of money, which multiplied in aggregate relative to pre-crisis levels, failed to jump-start credit growth, which meant there was no expected positive impact of lending on economic activity and employment. The extended economic contraction was then renamed as the Great Recession.

Unhappy with this turn of events, central banks concluded that commercial bankers were not as quick in approving loans as they could be, and that they were holding too much money in their reserves. The final expedient remaining to the central banks was to make interest rates negative and so force commercial banks to lend more. Not even this irrational idea, however, yielded the expected results, as the banks responded only by buying more government bonds and similar safe securities. In the face of a lack of bankable borrowers, even at low nominal rates, the desired credit growth never took off.

What ensued was a true illusionist sleight of hand with our current accounts. Commercial banks were encouraged to do to their clients what central banks, the 'banks of banks', had done to them. This is where we return to the warning cited at the top of this article, that ***banks can no longer hold your money 'for free'.*** A separate article on fractional banking on this web site has more information about how banks hold our money and to what extent they do so. Promoters of the non-free bank account theory are mainly drawn from academia, with fewer coming from central banks and the fewest from the commercial banking sector. They seem to believe the notion of *stable money* must be sacrificed on the altar of economic recovery. Of course, nobody expects private banks to ever lend at negative interest rates, yet this would be an intriguing concept: borrow 100,000 euros and, in a year's time, repay, say, 98,500, at an interest rate of negative 1.5%. And how about a multi-year loan at cumulative compound interest – just imagine the debt disappearing as if by alchemical transmutation.[1] No, the proponents of this idea only expect that negative interest rates on current accounts will **force** us to spend more of our hard-earned cash on goods and services, which is the textbook formula of economic recovery. They seem to believe banks' clients are not sufficiently sophisticated or knowledgeable to invest in other assets and so safeguard the nominal value of their money.

If commercial banks continue to hold off from using negative interest rates – and they have not shown much enthusiasm to date – we can expect to see the invention of even less conventional measures. These policies would aim at 'incentivising' most commercial banks to charge negative rates on their clients' accounts.

Commercial banks' reactions

Commercial bankers are not as naïve in their expectations, as it is abundantly clear that their clients have ***two immediate options: either to change banks or physically take cash out of their***

accounts, with ruinous effects. Visualise the slogan: 'put your money in our bank because our ***negative*** interest rates are the most attractive'. Bankers are aware that this policy would be tantamount to commercial suicide and will avoid it for as long as they're able to, in other words until pressure from the central bank and other government agencies becomes too much to bear.

If banks are compelled by some means to apply negative rates, one other readily available option for their clients is to hoard banknotes. The nominal value of banknotes cannot change, which is why they're critical for maintaining money stability. Inventive academic economists have a solution for this obstacle, too: *phase out cash or abolish banknotes*. Books have already been written declaring a 'war on cash', which has grown from an academic conflict into a hot war after it was taken up by central banks and other government bodies. The scrapping of large-denomination banknotes is in fact their first victory, but the final outcome is highly uncertain. It seems obvious that central bankers, these unelected technocratic rulers, are attempting to gradually change the monetary landscape enshrined in the Constitution. Due to its monumental importance, the issue of doing away with banknotes is discussed in a separate article on this web site.

The alternatives

In an Orwellian world without banknotes, the only way money can exist is as a non-cash means of payment, available only via commercial banks and non-bank money providers. In such a world, negative interest rates would continuously erode the general measure of value, in accordance with central bankers' technocratic decisions. Nevertheless, there remain a number of other options open to money holders wishing to preserve the nominal value of their money, at least to some extent. These alternatives are showcased on a wide variety of investment recommendation sites.

The primary problem is that no alternative comes close to cash for liquidity, security, or protection from negative interest rates. Not even central banks' digital currencies (CBDCs) offer a substitute. Put simply, digital assets **do not guarantee nominal stability.** In a recent paper on these innovative instruments, part of its *Future of Money* series, the Bank of England takes pains to assure its readers that '£10 of CBDC would always be worth the same as a £10 banknote'.[2] However, the only guarantee of nominal value **always** remaining the same are banknotes, the same as personal identity papers are proof of 'nominal' identity for each one of us. Without banknotes, negative interest rates could easily turn £10 into £9.99.

It becomes apparent that any attempt to **preserve your wealth** requires preserving your money, or, rather, its nominal value. An absence of this stable measure of value jeopardises not only your wealth, but also your salary and all other income, which, in turn, creates uncertainty for your prospects for the future, such as your savings and retirement income.

The solution

The only possible solution to deflect the threat posed by negative interest rates would be to **retain banknotes as the guarantee of nominal value of our money.** This does not, however, mean we

should promote only banknotes and roll back the recent advances made by the banking system. Quite the contrary: there's no reason not to use the whole range of innovative payment technologies. For instance, the most advanced payment method – contactless smartphone payments – is the most widely spread in several developing countries, Kenya in particular. Even Sweden, the leader in cashless payments, lags behind these nations.

If you feel the danger of negative interest rates has been blown out of proportion, I invite you to look at what one of their greatest proponents, Willem Buiter, recently wrote in his article, 'The New Normal Should be Cashless': '**Negative** nominal interest rates will become the **new normal**, and that the "inflation illusion" or "nominal interest rate illusion" will become a thing of **the past**. There is no reason to assume that such **cognitive distortions** will last forever. ... The rest of us could prepare to welcome **-5%** policy rates during the next deep recession."[3] Don't doubt Mr Buiter's competence and influence,[4] nor those of the other advocates of negative interest rates. And, by all means, do consider your own *cognitive distortions* and a rate of -5% on your money, incomes and assets.

A true solution can be glimpsed in the Bank of England's paper cited above, where CBDC is referred to **'as a complement to physical banknotes?'**. Yet the question mark at the end of this sentence in the paper's foreword comes from the Bank's outgoing governor Mark Carney, whose last legacy at the Bank was *a platform model of CBDC*. 'In this model, CBDC would serve as a payment platform on which the private sector could innovate.' There is no need to explain that such a model would provide no safeguards against negative interest rates.[5]

The central banks' inherent inertia in creating their own electronic money, an area where they have only recently begun to do research (only Sweden's Riksbank and the Central Bank of Uruguay have moved to the pilot stage), and their divergent views of its features, from the method of issuing it to channels for distributing it to the general public, gives us little reason to be optimistic. **The fate and ultimate design of CBDCs are highly uncertain,** as borne out by the view promoted by Professor Buiter, he of the cognitive distortions: 'But I would prefer the third option: **abolish the currency and replace it with a central-bank digital currency.'**

This arrangement would remove the sole *monetary policy constraint* – 'the practical inability of central banks, such as the Fed, to implement negative interest rates'.[6] The idea of those who promote *monetary policy without constraint* is to use negative rates to fight recession in the cashless society of the future. The futility of such designs is amply borne out by the on-going recession due to the Covid-19 pandemic.

The above discussion shows how important it is for the majority of the world's population to directly support the preservation of physical banknotes by holding at least smaller denominations and using them occasionally for retail purchases. In addition, we should oppose any further reduction in banknote denominations to only the lowest amounts (the 5 and 20 monetary units), as this is in effect a covert way to push cash out of the payment system. Billions of dollars, euros,

pounds, and other currencies did not arrive in tax havens in the form of banknotes: they got there by wire transfers between banks. Banknotes in the Virgin Islands and other island nations are out of global use, which may prevent petty crime and small-time tax evasion, but promotes large-scale criminal activity and helps major tax evaders.

Unless most people support banknotes, they will inevitably disappear due to the negative network effect. This trend is at its most visible in Sweden but can also be seen in many other developed and developing economies. Perhaps this is why the Riksbank gave up on its negative interest rate policy earlier this year, after five years of failure.

Keeping banknotes means more than just giving them a stay of execution as a means to guarantee access to cash until vulnerable groups and retail businesses have adjusted. No: this **issue** is about preserving the nominal stability of our money: so that £10 is always worth £10, $10 stays $10, €10 remains €10… Banknotes are the last bulwark against *monetary policy without constraint* and destructive negative interest rates. Ultimately, paper money is the sole remaining ballot paper we can use to rein in the central bankers and other policymakers. This is why your vote is decisive.

PROTECT YOURSELF FROM THE NEGATIVE INTEREST RATE EPIDEMIC

KEEP YOUR MONEY IN YOUR HANDS

[1] Actual preparations for this arrangement were reported in November 2019, but so far only for refinancing a loan with a government bank. The *Financial Times* covered the story on 18 November 2019 in an article titled 'Most German banks are imposing negative rates on corporate clients', noting that 'State-owned German development bank KfW is preparing to pass on negative interest rate to its borrowers – paying them to borrow money. KfW is legally obliged to pass on its own funding terms to clients and it can already refinance itself at negative rates.'

[2] Bank of England (2020), Central Bank Digital Currency: Opportunities, challenges and design, Discussion Paper, March 2020.

[3] *Project Syndicate*, 25 February 2020.

[4] In the course of his respectable career, Willem Buiter has taught at prestigious universities (Cambridge, London, Princeton, Columbia) and occupied senior positions at the EBRD (Chief Economist), Bank of England (External Member of the MPC), Goldman Sachs (International Advisor), Citigroup (Chief Economist), and elsewhere.

[5] *See:* Vlastimir Vuković (2020), CBDC: Currency or Platform? CBM *Research*, Paper 6, April 2020.

[6] 'Another benefit (from a macroeconomic perspective) of a cashless society cited by economists would be the potential elimination of the practical inability of central banks, such as the Fed, to implement negative interest rates.' David Perkins (2019), Long Live Cash: The Potential Decline of Cash Usage and Related Implications, *CRS Report R45716*, Congressional Research Service, Washington, May 10, 2019.