Negative interest rate policies are backfiring: new research

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Negative interest rate policies—where nominal rates are set below zero percent—have been introduced in Europe and Japan to stimulate flagging economies but research from the University of Bath shows the unconventional monetary strategy may be doing more harm than good.

Recently, several major European banks announced plans to pass on negative interest rates to corporations and wealthy individuals. Since 2012 Japan and six European economies—the Eurozone, Denmark, Hungary, Norway, Sweden and Switzerland—introduced negative interest rates, making it costly for commercial banks to hold their excess reserves with central banks.

Negative interest rates are supposed to stimulate the domestic economy by facilitating an increase in the demand for bank loans. In theory this could increase new capital investment by firms and domestic consumption, via credit creation.

But the research showed bank margins were being squeezed, curbing loan growth and damaging banking profits.

"This is a good example of unintended consequences. Our study shows negative interest rate policy has backfired, particularly in an environment where banks are already struggling with profitability, slow economic recovery, historically high levels of non-performing loans, and a post banking-crisis deleveraging phase," said Dr. Ru Xie of the university's School of Management.

"If bank margins are compressed due to low long term yields, and if there is limited loan growth, then bank profits will fall accordingly. The decline in profits can erode bank capital bases and hitherto further limit credit growth, thus stifling any positive impact on domestic demand from negative interest rate policy monetary transmission effects," Xie said.

Xie, working with researchers from Bangor Business School, the U.S. Department of the Treasury and the University of Sharjah in United

Arab Emirates, identified new evidence that bank margins and profitability fared worse in countries where negative interest rates were adopted than in countries that did not pursue this policy.

The results also suggested that following the introduction of negative interest rates, bank lending was weaker than in countries that did not adopt the policy. This was largely driven by the compressed net interest margin from a long term low yield.

Xie said negative interest rates also appear to have cancelled out the stimulus impact of other forms of unconventional monetary policy such as quantitative easing.

More information: Philip Molyneux et al, Bank margins and profits in a world of negative rates, *Journal of Banking & Finance* (2019). DOI: 10.1016/j.jbankfin.2019.105613

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