Negative Interest Rate Policy (NIRP)

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The U.S. Federal Reserve recently implemented massive stimulus programs to combat the economic fallout from COVID-19. In response, numerous interest rate market participants have come to ask: will the Fed be compelled to adopt a Negative Interest Rate Policy (NIRP) as a 'last resort'? In this month's bulletin, we shed light on the NIRP concept, its macroeconomic consequences for adopting countries, and how such policy can impact corporate hedging programs.

Negative Interest Rate Policy is when a central bank reduces its policy rate below 0%, attempting to discourage financial institutions from allocating excess reserves (funds that a financial institution keeps back beyond what is required by regulation) with the central bank. For the U.S., the Fed reduced reserve requirement ratios to zero starting from 26 March 2020, meaning that institutions were not required to allocate reserve balances. Should the Fed adopt NIRP, institutions will actually be required to pay interest on any excess reserves. The Fed's holdings of institutions' excess reserves as of 17 June 2020 amounted to $3.13 trillion – that is $1.13 trillion more than the largest ever U.S. stimulus deal, signed by President Donald Trump on 27 March 2020.

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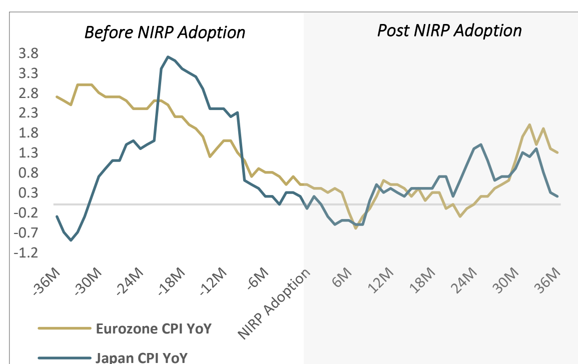
MACROECONOMIC CONSEQUENCES

The Swiss National Bank (SNB) pioneered the NIRP practice in the 1970s. Decades later, Sweden's Riksbank was the first central bank in the modern history to implement NIRP; they did this in 2009, aiming to counter the Global Financial Crises (aka 'the GFC'). Other central banks such as Danmarks Nationalbank (DNB), the European Central Bank (ECB), and the Bank of Japan (BoJ) have also embraced NIRP since then. The SNB and DNB's motive for adopting NIRP was to protect their respective currencies from abnormal appreciation amid capital inflow. However, the other cases share the same incentive as the U.S. – to revive economic growth and sustain healthy inflation levels.

Some argue that NIRP revives economic activity over the short term. The chart on the right shows the Eurozone and Japan inflation rates 36 months before and after NIRP adoption. The Japanese government's attempt to revive stubbornly low inflation succeeded in lifting the YoY Consumer Price Index "CPI" above the zero level shortly after NIRP adoption, although it continued to fall short of the BoJ's target thereafter.



Source: Bloomberg

A counterargument is that NIRP puts downward pressure on bank profitability, consequently reducing banks' lending appetite and shattering the likelihood of NIRP being passed to borrowers. Despite the BoJ adopting a three-tier system that considers protecting financial institutions' functions as intermediaries, Japanese banks nonetheless, rapidly increased commission fees from their clients and expanded their international operations. European banks were hit harder because the ECB's NIRP was deeper – applicable to nearly 55% of the liquidity deposited at the ECB compared with just 5% of the BoJ's reserves – and partially due to the fact that Japan's capital ratio requirements were relatively lenient compared with ECB's.

WILL THE U.S. FEDERAL RESERVE ADOPT NIRP?

The Fed has consistently pushed back the concept of NIRP, indicating that it will remain a 'last resort' monetary policy tool. Chair Jerome Powell ensured that the Federal Open Market Committee (FOMC) considers NIRP neither an appropriate nor useful policy for the U.S. economy. He added that although NIRP does support economic activity on net, it introduces distortions into the financial system. The latest Fed dot plot (a chart denoting the FOMC projections for interest rate path) showed that none of the seventeen FOMC members expects rates to dip below zero. Nevertheless, the Fed has proven that it is dynamically monitoring the U.S. economy and continuously seeking its economic targets of a longer-run normal unemployment rate of 4.4% and an inflation rate of 2%. For example, in 2019, the Fed introduced three rate cuts, none of which was projected by its dot plot chart a few months earlier. So we wouldn't put NIRP out of the picture.

Post the GFC in 2008, the Fed relied on both conventional (like policy rate) and unconventional monetary policy tools (like forward guidance and quantitative easing) to stimulate economic activity. The Fed is expected to take a similar approach in fighting the COVID-19 pandemic. "Since March 3rd, we have deployed our entire toolkit to provide critical support to the economy during this challenging time", says Fed Vice Chair Richard Clarida. Although the Fed's adoption of NIRP seems unlikely, it will remain highly dependent on how much is left in their toolkit, how generous the U.S. fiscal policy will be, and how fast the U.S. economy recovers.

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KEY HEDGING CONSIDRATIONS

To layout some of the hedging consideration for corporates with USD exposure, we currently suggest revisiting the likes of both, market risk quantification and hedge implementation. Before you quantify your risks, ensure your market risk models account for all market possibilities, including those predicting negative interest rates. For hedge implementation, ensure your live market data feed and internal pricing models, especially those impacted by volatility, capture negative interest rate paths. Moreover, consider hedge provider's market risk limit computations when contemplating products that would require credit lines.

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