

Negative interest rate, how they work, and what's the effect?

Negative interest rates, a policy that has been a controversial topic for economists for more than a decade. Beginning in the 1970s, Switzerland is the first country to impose negative interest rate. The country imposed a negative interest rate to help stabilize the economy and to prevent the foreign currency from flowing in too much, making swiss currency to appreciate and weaken the currency purchasing power. Interest rates which most of the time defined as the price of the money, by common sense we know that if we borrow money, we have to pay the price for it. But, with negative interest rates, does it mean that we get paid for borrowing money. If so, does it even make sense, and how it actually works?

To understand the idea, you have to know about how commercial banks and central bank works and the difference between the policy interest rate and commercial bank interest rates. The policy interest rate is a part of monetary policy which is one of the tools that the central bank of each country used to control the money market and economy respectively. The policy interest rate is which is the rate that the central bank charges commercial banks for borrowing money which surely influences the commercial bank's interest rate. For instance, the central bank purposed policy rates of 3% meaning that when the commercial banks borrow money from the central bank and give out loans, it will charge the debtor with the initial 3% plus risks charges.

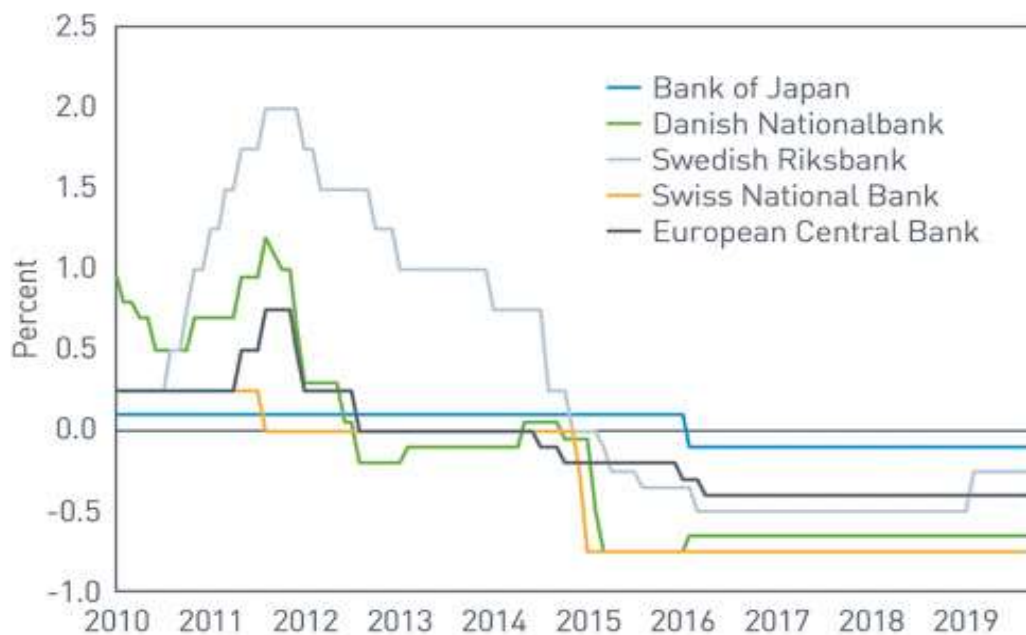
As we know that the interest rate is the price to borrow money when the central bank lowers the policy rate it means that it cost less for commercial banks to borrow money from the central bank to give out loans, so the commercial banks will borrow more money and give out loans which will result in more investment and consumption and that's how the central banks

use the interest rate to stimulate the economy. As the policy interest rate gets lower and lower passes the point where it is zero and becomes negative, meaning that commercial banks get charge for deposits despite the fact that the loaner is taking the risk of giving loans to the debtor.

It actually the result when the economy grows under the desired rate and too much money being saved instead of flowing in the market. The central bank purpose the negative interest rate(charge for deposit) so that the commercial banks are forced to withdraw their money from the central bank since they better withdraw that money out and maybe give out cheap loans or put them somewhere else than lose their money paying negative interest rates. And these cheap loans giving out will hopefully increase investment and consumption to stimulate the economy.

Even we still don't know everything about it, here are some negative effects that can already be seen. The safe-haven for commercial banks with negative interest rates is the government bonds--the safest assets with low returns. This excess demand for bonds drives up the price of bonds to the point that bond yields went negative. This adversely affects pension funds especially in a country with the highest old age people like Japan. Each and every economy has its own capacity. When the economy is stimulated to the maximum through the lowering of interest rate, it will be cheaper for people to get credit money which also implies people borrowing their own future income to use in the present. With the rise in current income, the demand for consumption raised. However, the supply has been raised to the maximum there is no room to expand anymore. As the result, the supplier might raise the price equivalent to the excess demand. Resulting in a rise in inflation, which will have a significant effect on people in debt. With inflation, it will be harder for people to pay back their loans.

As implied above, negative interest is still a controversial topic since we still don't have all the data for it, no one actually knows how it would end or what is the actual result in the long runs so now what we can do is only to observe. From the data that has been collected from the countries involved with the negative interest policy such as Japan and Sweden, the real benefits of the policy are vague, we still cannot conclude anything due to other related factors. What we know now is once the interest rate goes below zero, it will be hard to get back up due to price shock. The current risk for investment is high. In the near future, when we gather enough studies of the policy, we will be able to know and hopefully predict whether it is effective or is it worth imposing a negative interest rate.



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