NEGATIVE INTEREST RATES
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CAN THIS REALLY HAPPEN?

Evidence of a slowdown in the NZ economy continues to show itself. Household spending is sluggish with no growth at all this calendar year. Even our use of "magic plastic" has eased with credit card spending falling in July for the first time since the Global Financial Crisis (GFC). Even New Zealand's favourite asset (property) has stalled. Annual house price inflation has fallen to 0.90% nationwide. June was the first quarter of falling house prices since December 2010. The signs are there and the Reserve Bank is taking action to reverse this trend.

Recently the Reserve Bank lowered the Official Cash Rate (OCR) to 1.00%. Most pundits are predicting this already record low rate to go even lower. But how much lower – and why?

The battle to turn around the NZ economy, and business confidence, has just begun. There are a number of weapons the Reserve Bank could choose to employ if the latest 0.50% fall in the OCR doesn't work. The first cab off the rank is likely to be negative interest rates. In a recent interview, the Reserve Bank Governor Adrian Orr expressed a strong preference for the use of negative interest rates over other weapons in his armoury. The Governor is convinced that the interest rate lever is as "effective as ever" despite interest rates being almost zero.

Other weapons in the Reserve Bank armoury are large scale purchases of Bonds known as quantitative easing. This effectively exchanges long term debt liabilities for cash therefore lubricating the financial system. The bank could also create new reserves by "printing money". Another weapon in the armoury is injecting cash into the financial system. This option, sometimes called "Helicopter Money" has been around since the late 60's and is based on the concept of throwing money out of a helicopter for folk to pick up and spend, thereby stimulating the economy and firing up inflation.

So what is the Reserve Bank trying to achieve?

- Firstly, they want New Zealanders to do something with their money, other than leaving it in cash in a bank. They want you to spend it or invest it into other assets which will provide a growth stimulus.

- Secondly, they want to see some inflation return. The banks greatest fear is stagnant, or even worse, negative, inflation. The Reserve Bank wants you to not delay the decision and to buy now. This will create inflation, especially in the property market. If the equity in our homes is increasing, we are more likely to go out and spend on a dinner out, or buy a new car, or invest into new plant and machinery.

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How can you have negative interest rates?

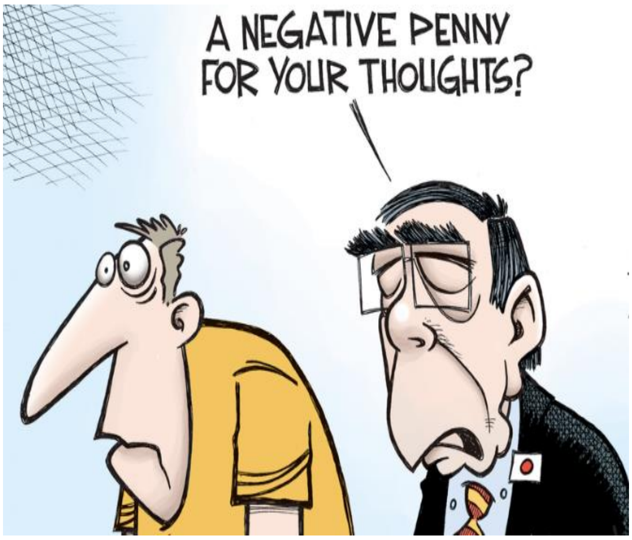
Interest rates for you and me will not be negative, they will be low but still positive. The negative rate will apply to wholesale money and the cash deposits that banks must hold to meet their legal and credit obligations. If the Reserve Bank decided to charge banks a fee on these deposits instead of paying interest, it would incentivise the banks to lend more money. To lend more money they would have to lower the lending rates. If not enough money was being lent, they would have to lower the rates further, even below their cost of money. The concept being that a loss on the lending will be less than the fee they have to pay to the Reserve Bank if they don't lend.

The Reserve Bank could also tax cash in the bank. Again, this is not a new idea. The IRD will put their hand out requesting tax on a nominal return even if the return was zero. The Reserve Bank is relying on the idea that we all hate paying tax on profits, but we will hate paying tax on losses even more.

Will this work?

Evidence suggests it will. There is no doubt that the property market will eventually turn around the lower mortgage rates go. There appears to be a strong link between property price rises and consumer spending. Perhaps we can "eat our letter box" after all.

The high price of safety



If you find mortgage repayments a burden, consider moving to Denmark, where Jyske Bank recently announced a 10-year fixed rate mortgage with an interest rate of minus 0.5%. Copenhagen is lovely this time of year. A million-dollar house that can be paid off in a decade for just A$995,000 might get you through the long winters. And if a 10-year mortgage is a little too short, try Nordea Bank's 20-year mortgage at 0%. These are strange times, and not just in Scandinavia. There are about $15 trillion in government bonds trading at negative yields around the world. Safety has become so highly prized that two years ago Austria successfully launched a 100-year bond with a coupon of just 2.1%. In June, it repeated the trick, this time with a yield of 1.2%. *(Source: apngroup.com.au)*

Did you know?

Rats ate $2.1 billion of Pablo Escobar's loose change. Infamous drug lord Pablo Escobar had so much extra cash lying around that he lost an astounding $2.1 billion dollars to rats. Since he couldn't keep his illegal earnings safe in a bank, he stored them in a warehouse, where rats (with expensive taste!) feasted on 10% of his savings every year. The moral of this story is "don't let the rats get your hard-earned money". Seek advice before you venture out into this very strange market we are in now.

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