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Are You Ready For Negative Interest Rates?

Brian Chang

While most Canadians today are unlikely to be familiar with the concept of negative interest rates, it is a policy that is likely to gain widespread adoption in countries such as Canada during the next significant global economic downturn. Indeed, the Bank of Canada has quietly added an explicit plan of negative interest rates to its Unconventional Monetary Policy (UMP) framework in preparation for a future economic crisis similar in scale to the Great Financial Crisis of 2008-2009.[1] Given the breadth and duration of the recent unprecedented advance in the Canadian residential housing market driven by a sea of global liquidity, the possibility that a subsequent contraction in global credit will serve as the primary catalyst for a severe and widespread economic crisis in Canada remains a distinct possibility.

It is important to note that in times of economic turmoil, the primary means by which the Bank of Canada attempts to "fight" the recession is through a lowering of its trend-setting overnight rate, which is the interest rate that influences the cost of loans offered by banks to customers. The lowering of the interest rate is designed to spur bank lending and increase debt-based consumption and business investment in various productivity-enhancing endeavors. It is this process which mainstream economists often refer to as increasing "aggregate demand", with the subsequent increase in consumption and spending leading to higher business revenues, increased profitability, and eventually filtering through to higher employee wages.

The conundrum currently faced by the Bank of Canada, as well as most other central banks around the world, is that because economic growth in the aftermath of the Great Financial Crisis has required continual monetary policy support, interest rates today are only slightly above their historic lows of 2008-2009. As a consequence, the conventional policy response of slashing interest rates to zero will almost certainly prove ineffective at stemming the negative economic repercussions resulting from a renewed and severe future financial panic. During the previous financial crisis of 2008, interest rates in Canada were slashed from 4.5% to 0.25%, while today's current overnight rate of 1.75% is already so low that it offers extremely limited potential for the Bank of Canada to ease financial conditions through the further reduction of interest rates.

When a central bank slashes interest rates to zero, it has effectively reached what policymakers refer to as the "zero-bound", which is widely assumed to be the outer bounds of conventional monetary policy. When this point is reached, central bankers turn to what they refer to as "Unconventional Monetary Policy" (UMP), which is an emergency framework that the Bank of Canada and other central banks have been quietly developing behind the scenes ever since the chaotic ad-hoc implementation of UMP policies hurriedly thrown together during the Great Financial Crisis of 2008. The most alarming of these policies, which has since been heavily endorsed by central bankers as part of their UMP toolkit, is a framework for driving down interest rates into negative territory once the zero-bound has effectively been reached. In other words, the zero-bound would no longer serve as an absolute floor on the trend-setting overnight rate, allowing the Bank of Canada to effectively slash interest rates without limit in an attempt to stimulate economic growth and avert a wide-scale financial crisis.

But if positive interest rates are meant to transfer interest payments from the borrower to the lender, then a negative interest rate represents the opposite, leading to a perverse situation where depositors must in fact provide payment to the bank for the privilege of "safe-guarding" their funds and savings. In the theoretical world where central bankers live, a reduction of the interest rate into negative territory will serve to stimulate the economy by incentivizing society to further reduce savings and increase both borrowing and consumption. As the theory goes, a depositor will be less willing to save if they know that their account balance will contain fewer dollars a year from now than it does today, and instead move to spend these funds through the purchase of various goods and services which will further serve to increase business revenue and incomes throughout the general economy.

Most studies which have been conducted by policymakers on negative interest rates, however, including those carried out by the Bank of Canada itself, have found one fatal flaw in the ability of central bankers to engage in Negative Interest Rate Policy (NIRP) on a broad and continuing basis. Namely, a depositor will not sit idly by while their savings are being gradually eroded through NIRP and will instead move to zero-yielding physical cash to escape this punitive and repressive policy. Because NIRP serves as a form of tax on bank deposits, a period of significant and prolonged negative rates causes society to subsequently respond by fleeing bank deposits and by extension the banking system itself. But the point of NIRP is to incentivize the population to borrow and spend, not to hoard physical cash under the mattress, in safety deposit boxes, or in non-bank private storage facilities. It is precisely this ability of depositors to stockpile physical currency which serves as the primary obstacle to the Bank of Canada's eventual plan for instituting negative rates once the zero-bound has at last been reached.

And yet it turns out that there are still significant benefits to be gained by those members of the general public who maintain deposits within the banking system in a NIRP environment, even if those deposits continue to lose money on a continuing basis due to negative rates. Because of the convenience that modern banking has on facilitating economic transactions as well as the fact that large amounts of cash must still be stored and insured through other means at a non-trivial cost, people are not generally quick to shift into physical cash even when nominal interest rates are less than zero. The Bank of Canada has concluded that nominal interest rates could therefore theoretically be reduced below their previous 2008 lows of 0.25% to a new lower bound, which they currently estimate in their studies to be approximately -0.75%, roughly equaling the average cost of insurance and storage for large quantities of physical cash.[2] This punitive rate would serve as a sort of "fee" on depositors, effectively charging them for the convenience of maintaining insured account balances that can be easily accessed and used to transact electronically within the Canadian financial payment system.

It should be noted that the current Canadian framework for potential NIRP is far from a purely theoretical construct, as slightly negative policy interest rates have already been tested in countries like Switzerland, Sweden, Denmark, and the Euro Area following the events of 2008. While a negative rate of -0.75% is today the lower limit of NIRP currently being considered publicly by the Bank of Canada, other institutions such as the International Monetary Fund (IMF) are presently engaged in additional policy analysis as they explore ways to further extend the limits of negative interest rates. In order to implement a truly limitless NIRP, academics have taken to studying ways to penalize holders of cash to remove incentives for depositors to withdraw bank deposits for the safety of physical currency.

Recent IMF studies, for example, have proposed a two-tiered system by which deposit money held in banks would constitute a different "type" of money than that of physical money.[3] In order to switch between actual physical cash and bank deposit money, an exchange rate would exist that would devalue physical cash at a rate roughly equal to the negative interest rate. For example, if a negative interest rate of -5% per year were targeted by policymakers, then an exchange rate would exist by which someone attempting to deposit $100 of physical cash into their bank account a year from now would receive only $95 of new bank deposit money following the transaction. Similarly, businesses would be made to offer goods and services priced in both deposit money and physical money, similar to how many businesses throughout the world today offer goods priced in both local currency and foreign currency. In this manner, there would be no incentive to holding cash outside the banking system in actual physical form, allowing policymakers to reduce interest rates at will without risking a general and widespread flight to paper currency.

The above IMF study, of course, is only one potential method available to policymakers as they grapple with a new framework for implementing a pervasive policy of negative interest rates. What they fail to realize, however, is that contrary to their hopelessly misguided models, negative interest rates will not cause society to suddenly cease saving and instead begin spending all their accumulated funds recklessly on consumer goods and services. Rather, it will have the unintended consequence of driving depositors into alternative forms of savings such as foreign currencies and precious metals, forcing the hand of policymakers into placing additional restrictions on the public's accumulation of these safe-haven assets as well.

Given that NIRP is now an official part of the Bank of Canada's recession-fighting toolkit, it should be expected that some variation of these policies will at some point be enacted by the Bank of Canada during a future large-scale economic crisis. NIRP should be expected to be embraced by central bankers in Canada where conventional monetary policy no longer proves sufficient to adequately offset the deflationary forces of an expected full-blown collapse in the Canadian residential real estate market. Given the magnitude of the economic contraction approaching and the limited capacity of the Bank of Canada to respond using conventional monetary policy in the current low-interest rate environment, the reader should soon expect negative interest rates to become an enduring fixture of the Canadian financial landscape.

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1 https://www.bankofcanada.ca/wp-content/uploads/2015/12/framework-conducting-monetary-policy.pdf

2 https://www.bankofcanada.ca/wp-content/uploads/2015/12/san2015-2.pdf

3 https://www.imf.org/en/Publications/WP/Issues/2018/08/27/Monetary-Policy-with-Negative-Interest-Rates-Decoupling-Cash-from-Electronic-Money-46076

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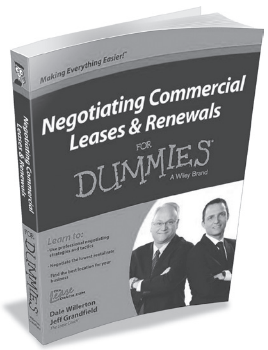

Differentiating Between Good and Bad Leases

– For Commercial Tenants

Jeff Grandfield and Dale Willerton – The Lease Coach

As we explain in our book, *Negotiating Commercial Leases & Renewals FOR DUMMIES*, a bad lease agreement may hold you back from making a good profit or even result in the closure of your business. Great businesses in poor or mediocre locations will never reach the full potential that a better location may offer. On the other hand, perhaps you've picked a great location, but leased too many (or too few) square feet; this can prove to be a problem as well.

Combine a poor location with a high rental rate and you have a recipe for disaster. Your business will never succeed, let alone sell for a profit. Too many entrepreneurs are shopping for cheap space, but for the most part, get what they pay for location-wise. This isn't to downplay the need for skillful negotiation; you don't want to pay too much for a good location – it's all relative. In many of the larger plazas and enclosed malls, the property may be recognized as an excellent location, but getting stuck in a quiet area of the property may make your business less visible than you would like.

Another factor can be a lack of adequate parking for your customers. One tenant The Lease Coach worked with for a midterm rent reduction came to the unfortunate realization that their newest location was parking starved. Just when people wanted to visit, the parking lot was already full of vehicles. Customers parked briefly outside the front door, came in to complain that they couldn't find a parking space even close by, returned to their cars and drove away. Brevity in a lease agreement is the enemy of most commercial tenants. A good lease agreement is longer, not shorter. Never assume that what the lease doesn't say will play out to your benefit later – it won't. As the tenant, you want everything that could