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Negative Rates

Negative interest rate theory and the impact it has on the economy. The thought behind this move was rather simple. If banks are charged interest to hold assets at the central bank then they will be forced to find better alternatives elsewhere. This would lead to the bank's lending more money out or investing their reserves elsewhere, US Treasury's for example. If the bank lends the money out it will drive inflation and growth in the economy through monies being invested in different projects throughout the country. On the other hand if banks invested in foreign assets such as US Treasury's this would lead to capital outflows from the country driving down their currencies value and make them more competitive through exports and in turn improving growth and spurring inflation. Japan has recently implemented this policy, but they were not the first. We do not have many examples, but I will outline what has happened in the Eurozone since the ECB implemented their negative interest policy to try and give an example of the impact.

The ECB implemented a negative interest rate policy in June of 2014. We will use Germany as our example of the impact on the economy. When the policy was adopted the German economy did not see a rise in direct investment, which would have been from an increase in lending. However, they did see dramatic capital outflows into foreign investments such as US Treasury's. This did exactly what the ECB wanted, which was to drive the currency lower. In Germany this lead to a trade surplus and at the same time they had other Eurozone banks investing their reserves in German Bunds as well as US Treasury's because of their safe haven status. The huge move into German Bunds drove their interest rates into negative territory, which meant investors were paying the German government to hold their cash. This added to the surplus that we mentioned before. Yet instead of using this effectively free money to invest, the German government has decided to run a budget surplus. This is telling us that Germany sees no projects to invest in that will earn a return greater than zero. As we know from economics running government surpluses is restrictive and running government deficits is easing. So theory of money flows worked but it has not lead to an increase in growth or inflation, due to the lack of profitable projects in the Eurozone and also the massive burden of debt that these European countries hold.

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