Negative Interest Rates as an Exchange Rate Targeting Tool

Work in Progress

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Abstract

This paper aims to analyze the effects of negative interest rates on exchange rates and the economy as a whole in a theoretical framework. I build a model with two currencies and therefore two central banks in which agents can choose the currency used as means of payment. Agents face different liquidity preferences and can adjust their liquidity holdings by borrowing or lending money in the money market. The central banks implement monetary policy by operating each two standing facilities at which agents can also borrow or deposit money. Therefore, they provide an outside option to the money market. Agents can decide which currency they want to use as means of payment to purchase goods. Monetary policy directly affects the marginal cost of borrowing money and the marginal cost of holding money and therefore affects the demand for a currency and hence the exchange rate. By lowering the interest rate for depositing money into the negative territory, the central bank can make their currency less attractive. In equilibrium, the demand for a currency depends on the ratio of the marginal cost of borrowing money and the marginal benefit of holding money as well as the level of interest rates. Moreover, introducing negative interest rates decreases welfare, because they introduce a cost of holding money, that cannot be avoided.

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