ECONOMIC VIEWPOINT

Five Years of Negative Rates in Europe and It's Far from Being Over!

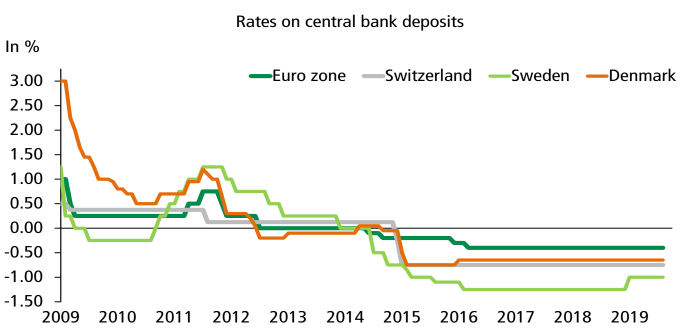
Faced with increased risk on global economic growth, several central banks started easing their monetary policies over the summer, or are thinking of doing so soon. The European Central Bank (ECB) is one of them, having opened the door to restart its asset purchases and to further interest rate decreases. However, interest rates are already particularly low in Europe, with several of them in negative territory since 2014. Even though it is aimed at supporting economic growth and bringing inflation closer to target, there are major issues about the potential negative effects of keeping interest rates too low for too long. This could lead to imbalances that could harm the economy or reduce the effectiveness of monetary policy.

Negative Rates since 2014

Four central European banks switched to negative interest rates in 2014: the ECB in June, the Bank of Sweden in July, the National Bank of Denmark in September and the Swiss National Bank in December. In the euro zone, the ECB's deposit rate ended up dipping to -0.40% in 2016 (graph 1).

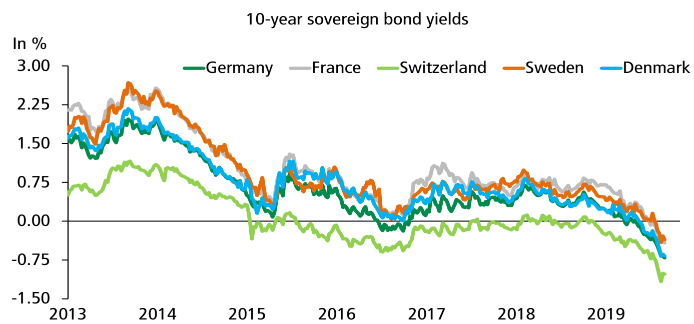
As those key rates dropped, several European bond yields also crossed into negative territory. Negative rates for long-term bonds were rarer until very recently, but renewed anxiety about economic growth and expectations that the central banks would step in have been game-changers. New lows have been reached, with several 10-year European sovereign bonds now trading below 0% (graph 2).

GRAPH 1
Negative interest rates in Europe for more than five years



Sources: Datastream and Desjardins, Economic Studies

GRAPH 2
Several bond yields hit a new low recently



Sources: Datastream and Desjardins, Economic Studies

Very few financial institutions are granting negative rates on client deposits or mortgage loans. According to official figures, businesses and large depositors are mainly the ones having to pay interest on their deposits. This has been the case for some time in the euro zone countries of Germany, the Netherlands, Latvia and Luxembourg. The lowest rates are in Switzerland and Denmark (graph 3 on page 2). Denmark was in the news recently when a bank started offering 10-year mortgages at -0.5%.[1] This

[1] Joshua BOTE, *Bank will pay customers to take out mortgages by offering negative interest rates in Denmark*, *USA Today*, Money, Updated Monday August 12, 2019 at 10:42 a.m. (Consulted on September 9, 2019).

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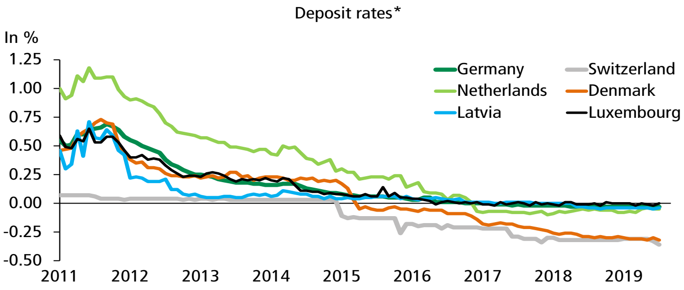
GRAPH 3
Some depositors have to pay interest in Europe



* 3-month term deposits of over 100,000 francs for Switzerland; business demand deposits for other countries.
Sources: Datastream, European Central Bank and Desjardins, Economic Studies

could become more common in the near future, as financial institutions adapt to recent drops in bond market yields and other likely key rate cuts from central banks.

The Limit May Be Reached Soon

Negative rates on mortgages or other loans is bound to make households and businesses happy. It's a dream come true! However, in order for those loans to be profitable, financial institutions need to have access to funds with even lower rates on either the bond market or client deposits. But it is harder to convince households and businesses to keep paying higher interest on their deposits. A limit may be reached when a critical number of households and businesses decide that cash is more advantageous than negative-rate deposits.

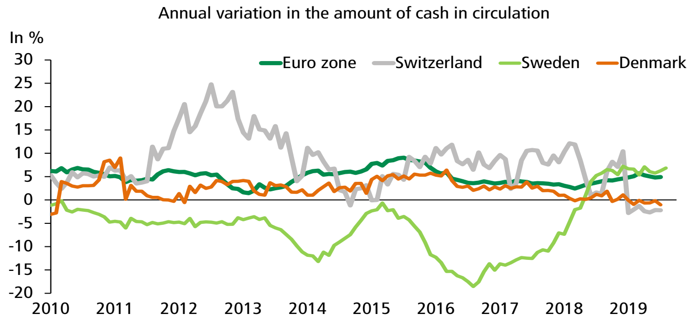
Nevertheless, there are several deterrents to a massive conversion to cash. People may decide it is less efficient, especially when large amounts are involved. There are also security issues that could lead to extra costs for things like safes and insurance policies. Cash is subject to deterioration and is vulnerable to bad weather and accidents, not to mention the dangers of counterfeiting. Thus, interest rates must be low enough to create more of a drawback to holding large quantities of cash.

The amount of cash circulating in Europe has not increased radically since 2014, but there are some indications that warrant a second look. More cash is now circulating in several European countries, despite the counter pressure exerted by new payment technologies. The situation in Sweden is particularly interesting. Demonetization was accelerating in that country, but the trend reversed in 2018 (graph 4).

The Effectiveness of Monetary Policy Could Be in Jeopardy

A significant defection toward cash would make it very hard for the financial system to find the funds it needs to finance credit and investments. The economy would be penalized and central banks would lose influence over credit. Any further dip in interest rates would become counter-productive in terms of supporting the economy.

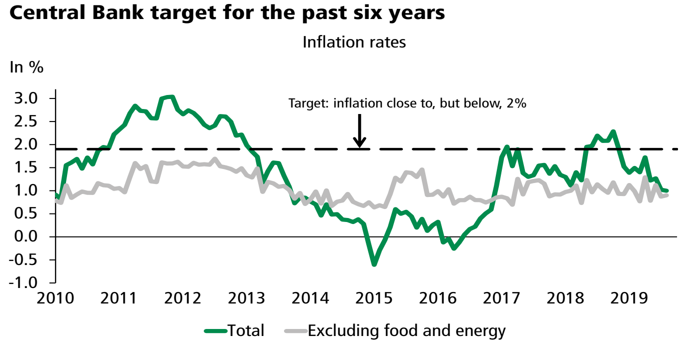
GRAPH 4
The use of cash has accelerated in the euro zone and Sweden



Sources: Datastream and Desjardins, Economic Studies

That is not the only extreme scenario in which monetary policy could become counter-productive, however. The ECB has not managed to generate enough inflation to get back on target in recent years, suggesting that its monetary policy has lost steam (graph 5). Some would say that that is merely the result of a not enough eased monetary policy. But it may also be due to a liquidity trap where households and businesses do not want to borrow substantially more, despite new monetary easing measures.

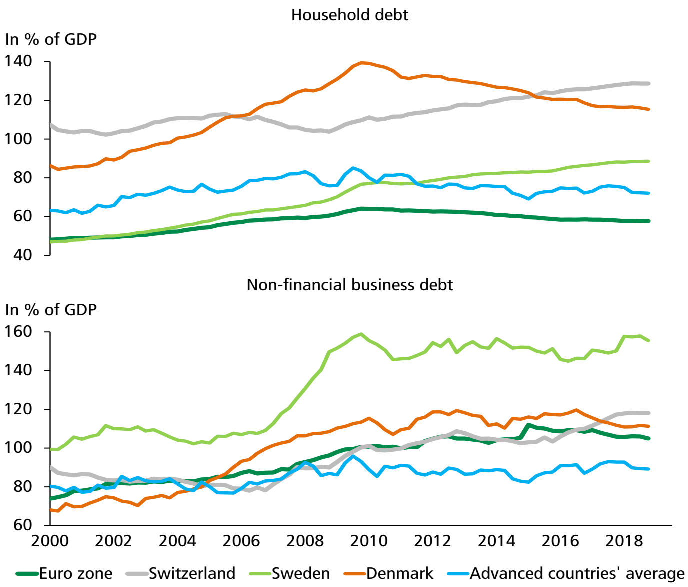
GRAPH 5
Euro zone inflation has generally stayed below the European Central Bank target for the past six years



Sources: Datastream and Desjardins, Economic Studies

Household and business debt has not gone up much in the euro zone in recent years. Debt-to-GDP ratios are even down slightly (graph 6 on page 3). Monetary easing seems to have greater traction on credit in Switzerland and Sweden, where the debt load continues to increase rapidly. However, the high debt load in those countries may increase the risk of financial and economic instability.

GRAPH 6
Credit has not gone up much in the euro zone



Sources: Bank for International Settlements and Desjardins, Economic Studies

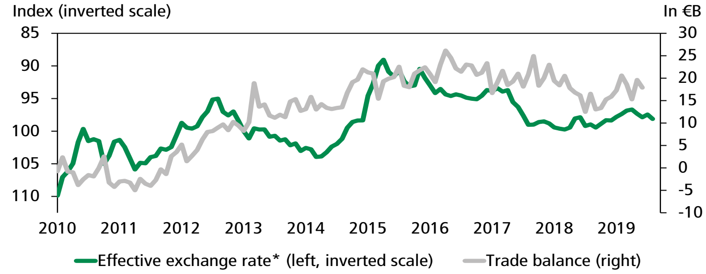
The extent of the debt may discourage credit growth, but that is not the only factor. It is hard to determine a precise debt threshold at which monetary policy becomes less effective. However, the higher the debt, the more sensitive households and businesses become to a possible interest rate trend reversal. Confidence about the future economic situation also has a great influence over decisions to borrow, as does the state of the banking sector, which may have difficulty easing credit conditions for borrowers.

Can Exchange Rates Do the Job?

Exchange rates are another way to convey monetary policy, and they are not constrained by liquidity traps or excessive debt. As a general rule, when central banks cut key interest rates or purchase assets, their currencies depreciate and the economy gets a boost from increased exports. There is also an added inflationary effect due to the increase in prices of imported goods and services.

The euro lost a lot of value when interest rates crossed into negative territory and the ECB made massive asset purchases in 2014. That pushed the trade balance up further (graph 7). But it looks like the next few quarters will tell a different story, with several other central banks around the world easing off and most likely limiting the euro's depreciation. Moreover, even if the currency were to plummet, this would not necessarily make euro zone exports rise sharply. This would require global demand to be on board, something that is highly unlikely given the escalating trade tensions and economic slowdown in several countries.

GRAPH 7
The euro's devaluation seems to have helped improve the trade balance between 2014 and 2016



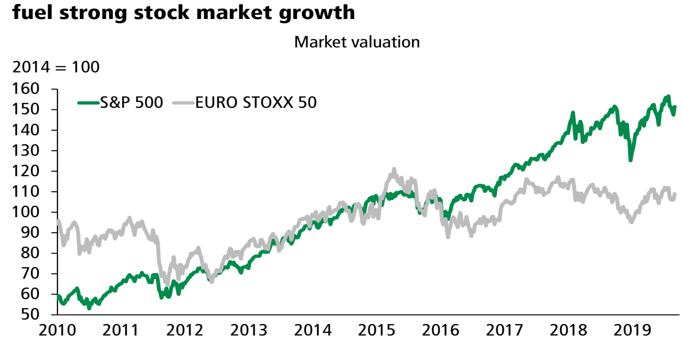
* Weighted exchange rate based on main trading partners.
Sources: Datastream, European Central Bank and Desjardins, Economic Studies

What about the Wealth Effect?

There is one more significant channel for monetary policy and that is the wealth effect, which is linked to central banks' influence over asset values. In principle, monetary easing measures boost asset values, whether those assets are financial or real estate. Businesses and households holding such assets get to see their wealth increase—an incentive to spending more.

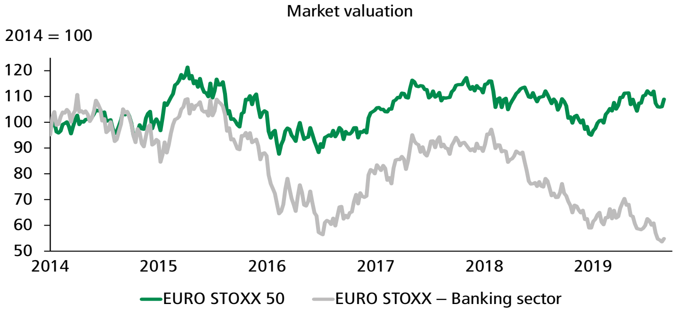
The wealth effect channel does not seem to be very effective in Europe though, judging by the slow growth of the European stock markets in recent years (graph 8). The U.S. markets did a lot better, even though the Federal Reserve (Fed) raised its key rates gradually. Many other factors can influence stock markets. Some industries may be penalized by very low interest rates, such as the banking sector, which has clearly underperformed compared to the European economy average (graph 9 on page 4).

GRAPH 8
The ECB's accommodating monetary policy was not enough to fuel strong stock market growth



ECB: European Central Bank
Sources: Datastream and Desjardins, Economic Studies

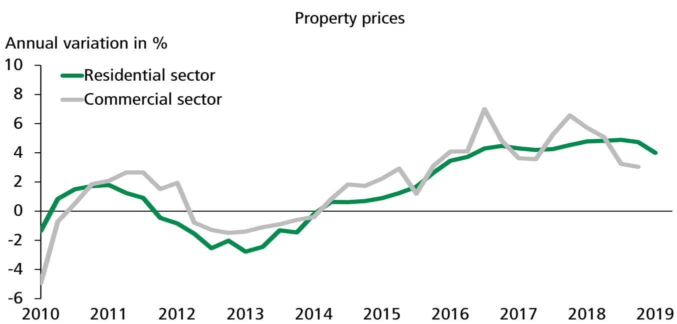
GRAPH 9
The banking sector is lagging behind the European stock markets



Sources: Datastream and Desjardins, Economic Studies

Prices for residential and commercial real estate have risen steadily in the euro zone since 2014 (graph 10). This means that interest rate cuts can still generate wealth effects. Nevertheless, this monetary policy channel may have side effects if it is overused. It could lead to overheating in the real estate market and increased risk of a correction, which could in turn destabilize the economy. We note that the official figures had also shown greater growth in residential real estate prices in Sweden and Denmark, but the trend has calmed down.

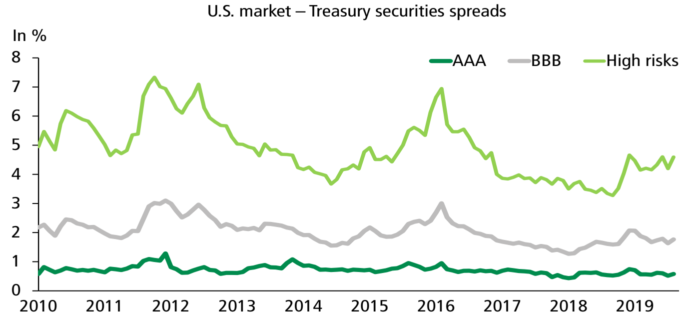
GRAPH 10
Euro zone residential and commercial real estate prices have gone up considerably since 2014



Sources: Bank for International Settlements and Desjardins, Economic Studies

Other assets could also be overvalued. Even the bond market could be subject to a major correction, particularly in terms of risk premiums, which are still fairly low despite increasing anxiety about the global economy (graph 11). Looking for returns, many investors have turned to less secure investments, thereby compressing the risk premiums. This also explains the growing number of negative-yield corporate bonds, even in the riskier categories.

GRAPH 11
Risk premiums are still low for corporate bonds



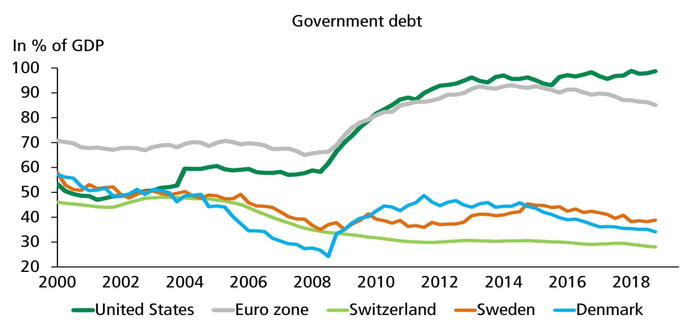
Sources: Datastream and Desjardins, Economic Studies

Governments Could Pick Up the Slack

The constraints caused by the use of monetary policies in Europe could mean that the governments will be called upon to intervene more quickly if there is a serious economic slowdown (or even a recession) in the coming quarters. An expansionist budget or tax cuts could have a greater impact on aggregate demand and inflation. Moreover, governments could finance economic stimulus programs more cheaply against the backdrop of negative interest rates.

However, this raises questions about how much leeway governments actually have. In recent years, lower interest rates have facilitated the cleanup of public finances and the debt burden has generally gone down (graph 12). All that contrasts with the U.S. situation. That being said, public debt is still relatively high in the euro zone compared to what it was before the 2008–2009 crisis. That crisis was followed by great financial turbulence in Europe, fuelled by fears for the sustainability of sovereign debt, especially in Greece, Ireland, Spain, Portugal and Italy.

GRAPH 12
Negative rates have helped to reduce public debt in Europe



Sources: Bank for International Settlements and Desjardins, Economic Studies

If the European countries start sliding into debt again, we cannot rule out a return of financial tensions. Clearly, not all countries could easily put in place major stimulus plans. Fortunately, Germany can still play a significant role. Also, the real problems would arise only when interest rates have return to higher levels into positive territory, which could only happen in several years.

Things Would Be Easier Had Central Banks Managed to Normalize Their Monetary Policies

The coming quarters may test the limits of the monetary policy's ability to support the European economy and generate inflation there, especially if the international situation keeps deteriorating. Five years after negative interest rates came in, new lows have been reached and the downtrend shows no signs of stopping. That may end up doing more harm than good, especially if it triggers a massive switch from deposits to cash. Even if that extreme scenario does not happen, serious difficulties could result from liquidity traps or asset bubbles. The intervention margin is therefore low for several central banks in Europe.

The United States is not in the same position, because the Fed has been able to partly normalize its monetary policy in recent years, leaving it with substantial leeway now. Budget and tax policies could compensate for Europe's lesser leeway on monetary policies. Negative interest rates would make it easier to introduce economic stimulus plans. That said, the markets may well be skittish about the idea of rapid renewed public indebtedness in Europe.

All things considered, we may see central banks adopting new tools or changing the framework of their monetary policy. The idea of intervening more directly in the economy could keep growing. We are not likely to see helicopters spewing out banknotes, but there could be something akin to that. To be continued...

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