NEGATIVE RATES: DO THEY REALLY WORK?

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HAVE NEGATIVE SHORT TERM INTEREST RATES SET BY SOME CENTRAL BANKS BEEN BENEFICIAL TO THEIR ECONOMIES ?

AND, PARTICULARLY IN EUROPE, WILL THEY YIELD THE EXPECTED RESULTS?

As the new ECB Chairwoman, Mme Christine Lagarde, prepares to comprehensively review the monetary policy position, no one expects any normalization process to begin any time soon, but the ECB is seemingly well aware of the side effects negative rates have on the economy. And not only the pressure they apply on banks....

Switzerland is a close-by and instructive example. The Swiss lowered the rates into negative territory, down to -0,75%, in response to the ECB easing in early 2015 – they never changed them in the meantime, and in a recent interview, the SNB (the Swiss Central Bank) affirmed it would have no problem moving them even lower!

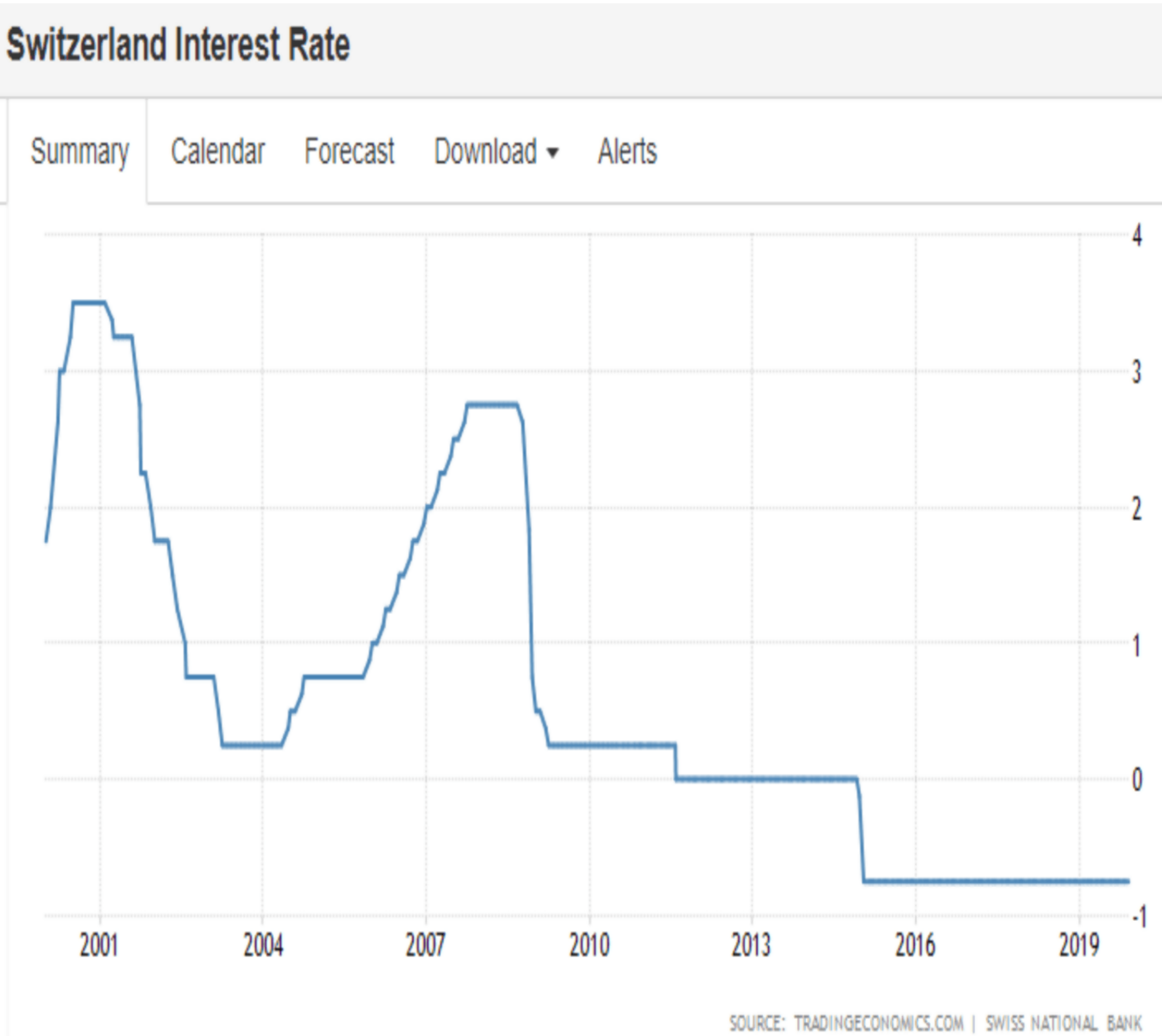


Chart 1 :source : TRADINGECONOMICS.COM & SWISS NATIONAL BANK

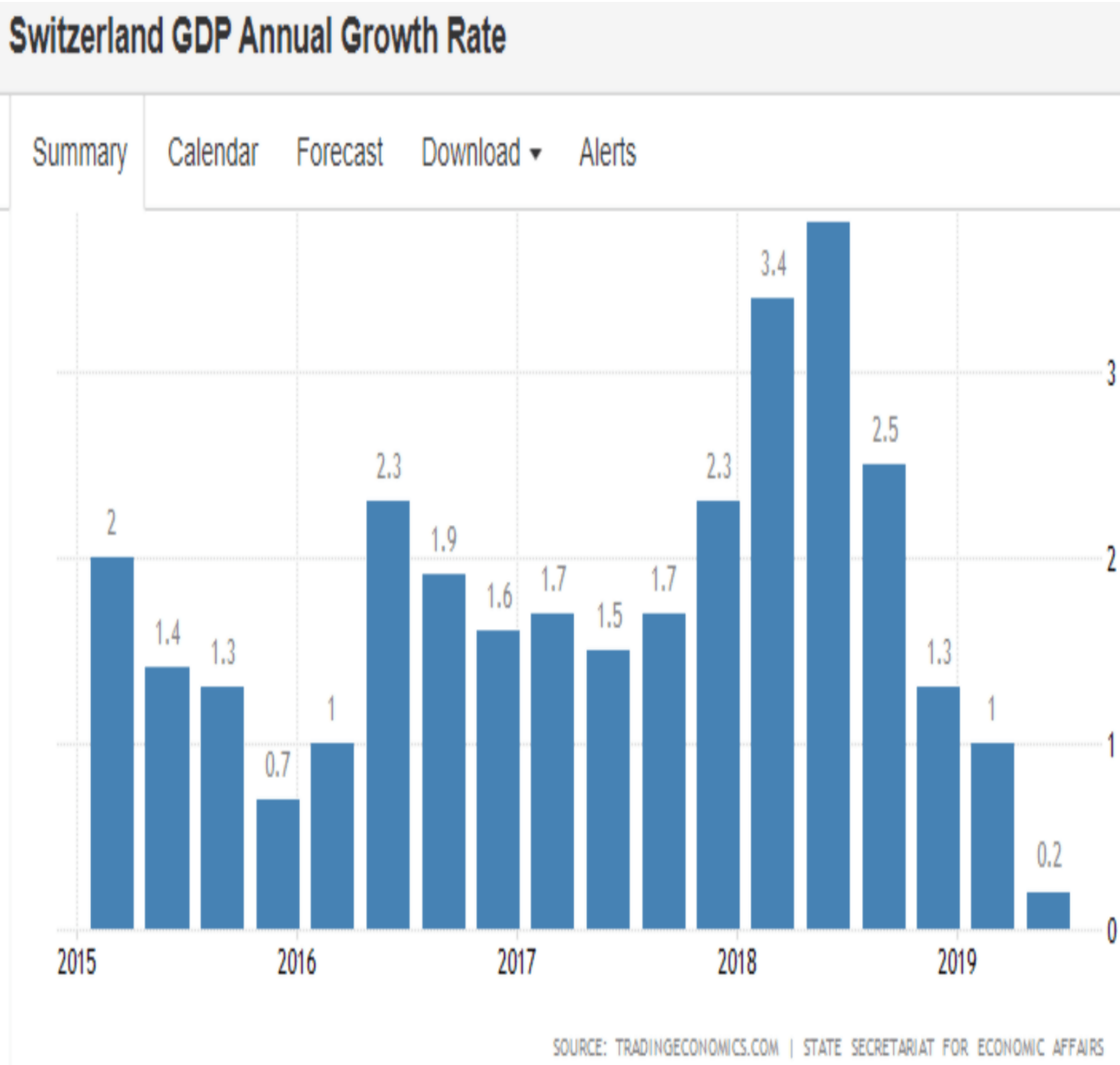
These negative rates were supposed to weaken the currency, especially against the Euro, stimulate the economy and lead to higher inflation.

How did it go?

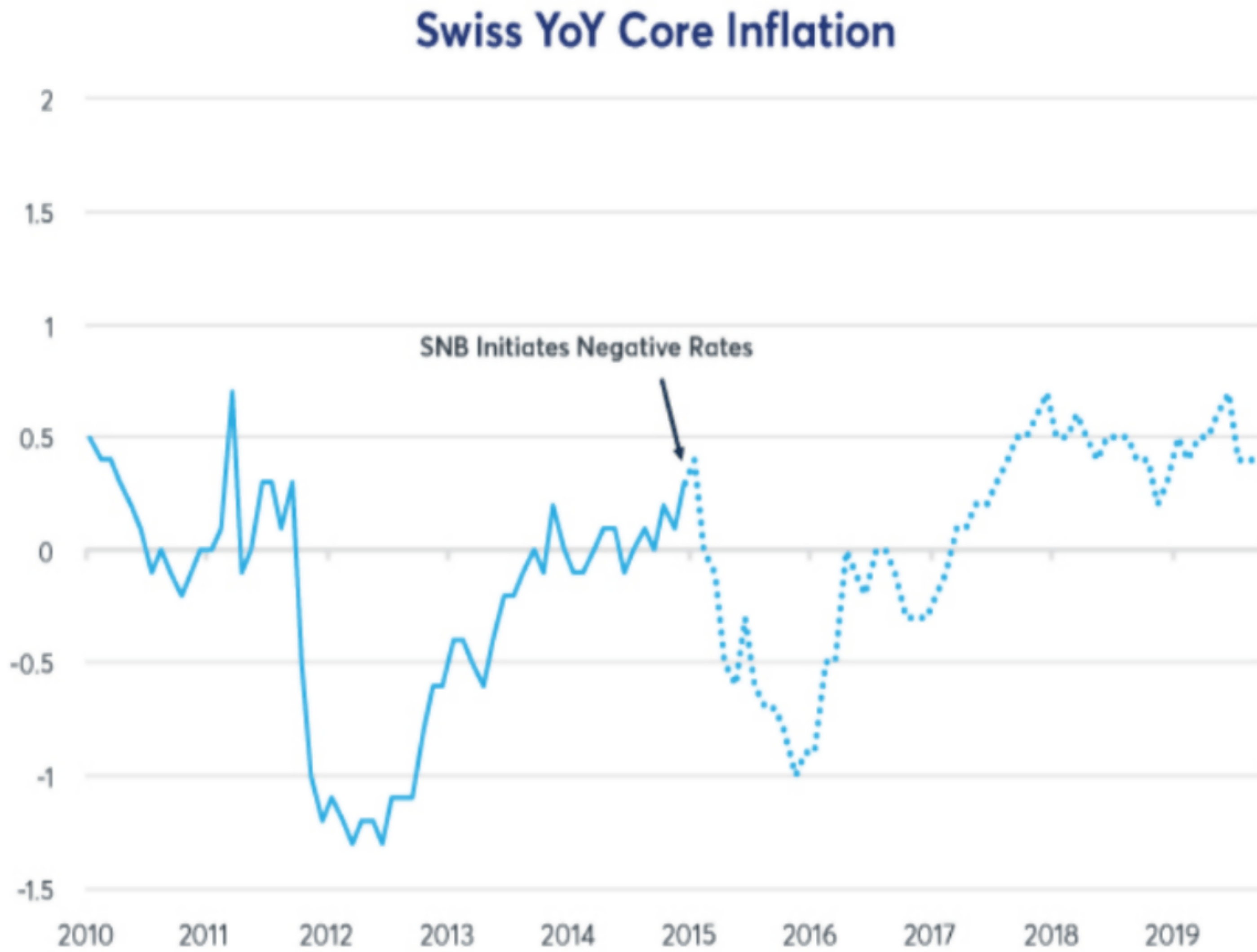
On the currency front, they actually did quite well. Following the unannounced and well hidden abandon of the 1,20 peg at the beginning of 2015, see chart below, setting short term rates at -0,75% managed to actually weaken the currency almost all the way back to 1,20 vs € at the beginning of 2018. And although the Swiss Franc has strengthened a bit since, it’s still around 1,10 and you have to remember that in September this year the ECB lowered its Refi Rate by another 10 bps to -0,5%. So overall this was NOT a failure.

Chart 2: Source: Bloomberg. Yellow: EURCHF Cross White: EuroSwiss 3M

But unfortunately, for both the economy as a whole and the GDP, and for the inflation rate, these negative rates failed to do the trick... As the two charts underneath will show you.



Charts 3: TRADING ECONOMICS;COM, State secretariat for Economic affairs



ource: Bloomberg Professional (SZEXIYOY)

Chart 4: Source: BLOOMBERG PRO

The chart 3 shows you that with negative rates set at -0,75% the average GDP growth over 18 quarters was just short of 1,75%! Although always positive, it's barely a massive success! Especially given the Eurozone economic performances in 2017 and early 2018, which was very good as well.

As you can see on the chart 4 above, it took 3 years for the core inflation rate to get back to its 2015 level and it has been fairly rangebound since, never approaching the 1% mark! So on this front at least, it's a clear failure.

So clearly setting short term rates deep in negative territory is NOT a PANACEA! It might be an efficient weapon in a currency war, but when you consider that after years of negative rates, the Eurozone inflation measures all appear to be very depressed and the growth rate is decelarating, just like everywhere else; it's clearly not a miracle remedy.

On a slightly different front, more and more people like Charles Gave for instance start to worry about what could be a killing confusion: the fact that abnormally low interest rates are the cause of secular stagnation—not its cure!

Green = real rates positive; Pink = real rates negative; Grey = US recessions

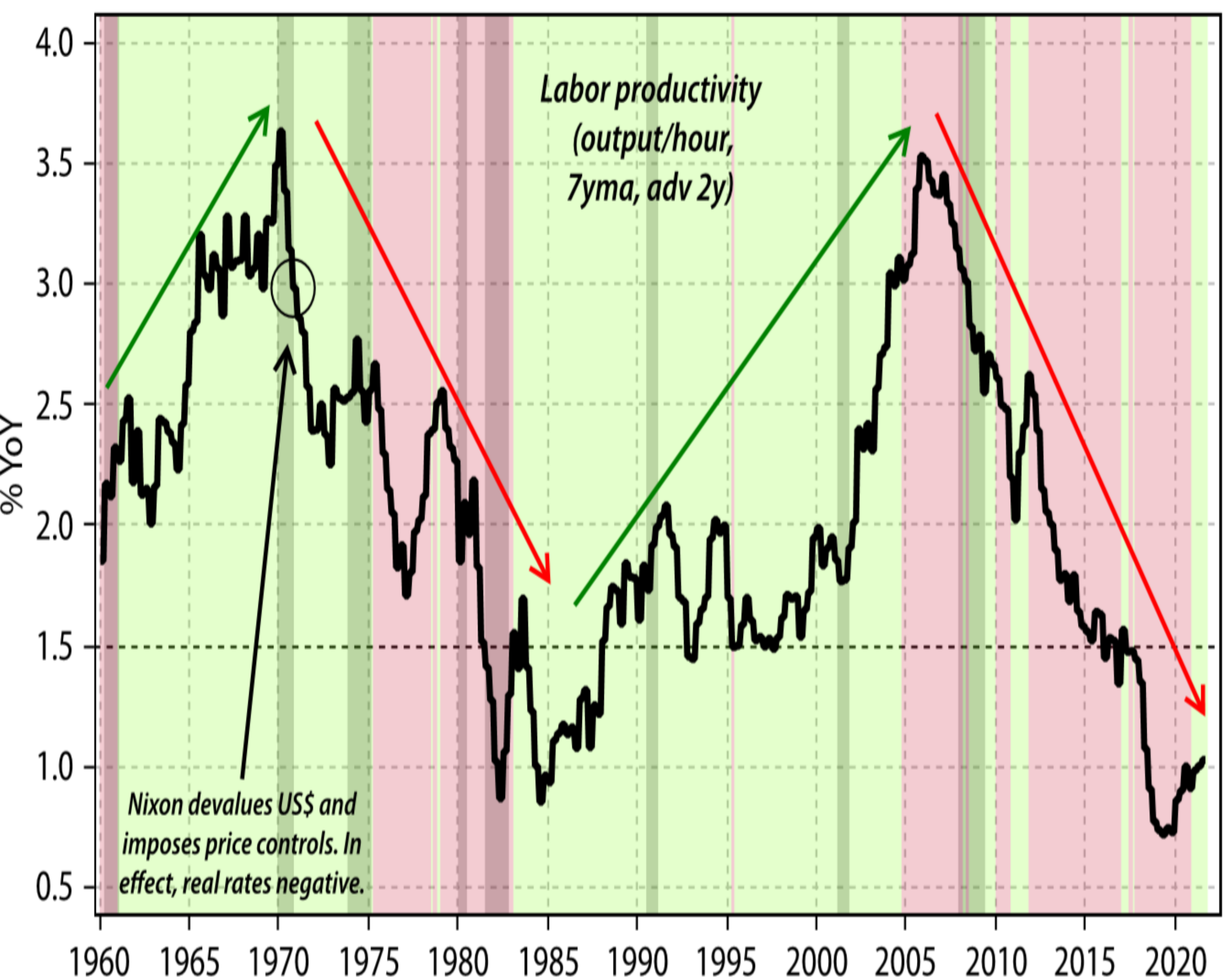


Chart 5: Source : GavekalData/Macrobond

And in a very interesting article, The Daily issued on November the 22nd, Charles Gave after having demonstrated how excessively low interest rates encourage debt-fueled financial engineering binges, writes the following:

« It just takes a couple of years for the damage to become visible. This point has been proved repeatedly, first by Japan (advised by Ben Bernanke, who went on to repeat his mistakes in the US), and then by Europe, with Mario Draghi's "whatever it takes" policy.

Yet strangely, nowhere where zero or negative rates have been attempted have they led to a booming economy. On the contrary, everywhere they have been tried has remained mired in economic stagnation.

When are central bankers going to look at reality, and not at their models which have never worked and never will? "

Indeed, if negative interest rates effectively contribute to a fall in labor productivity as shown in chart 5 above, they will always be a drag on the GDP growth…;

SO WHY WOULD NEGATIVE RATES HAVE A DIFFERENT EFFECT IN THE EUROZONE?

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29/11/2019