NEGATIVE INTEREST RATE: THE SYMPTOM OF A DRAMATIC ECONOMIC POLICY FAILURE

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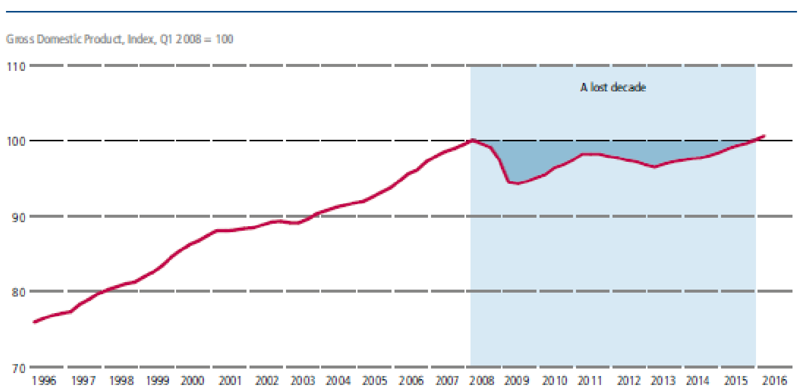
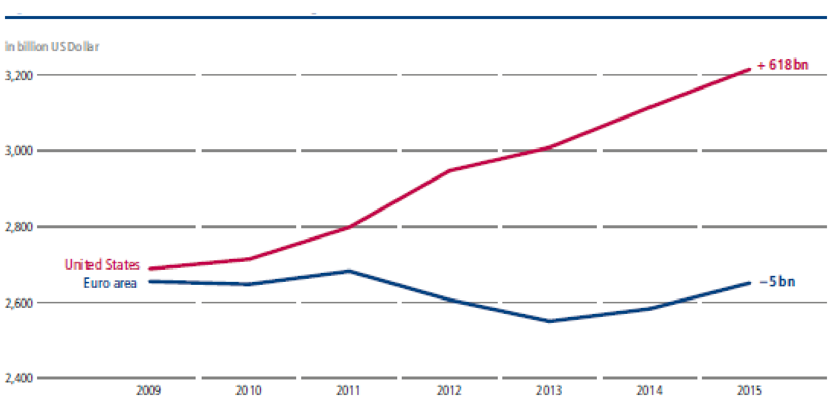
The low-growth, low-interest rate problem lies in the responsibility of governments, not ECB

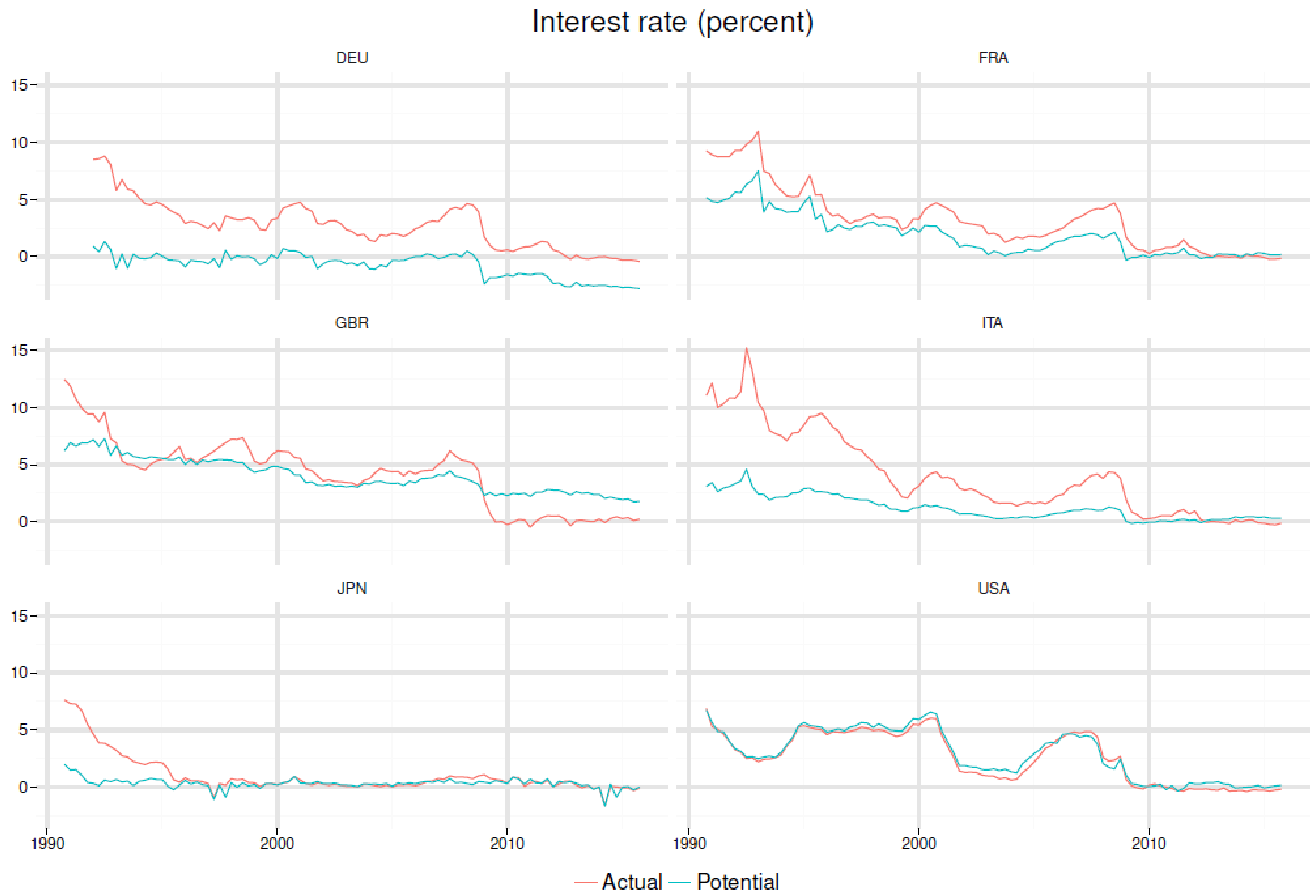
The European lost decade: secular stagnation is mainly a European phenomenon due to the stagnation of investment





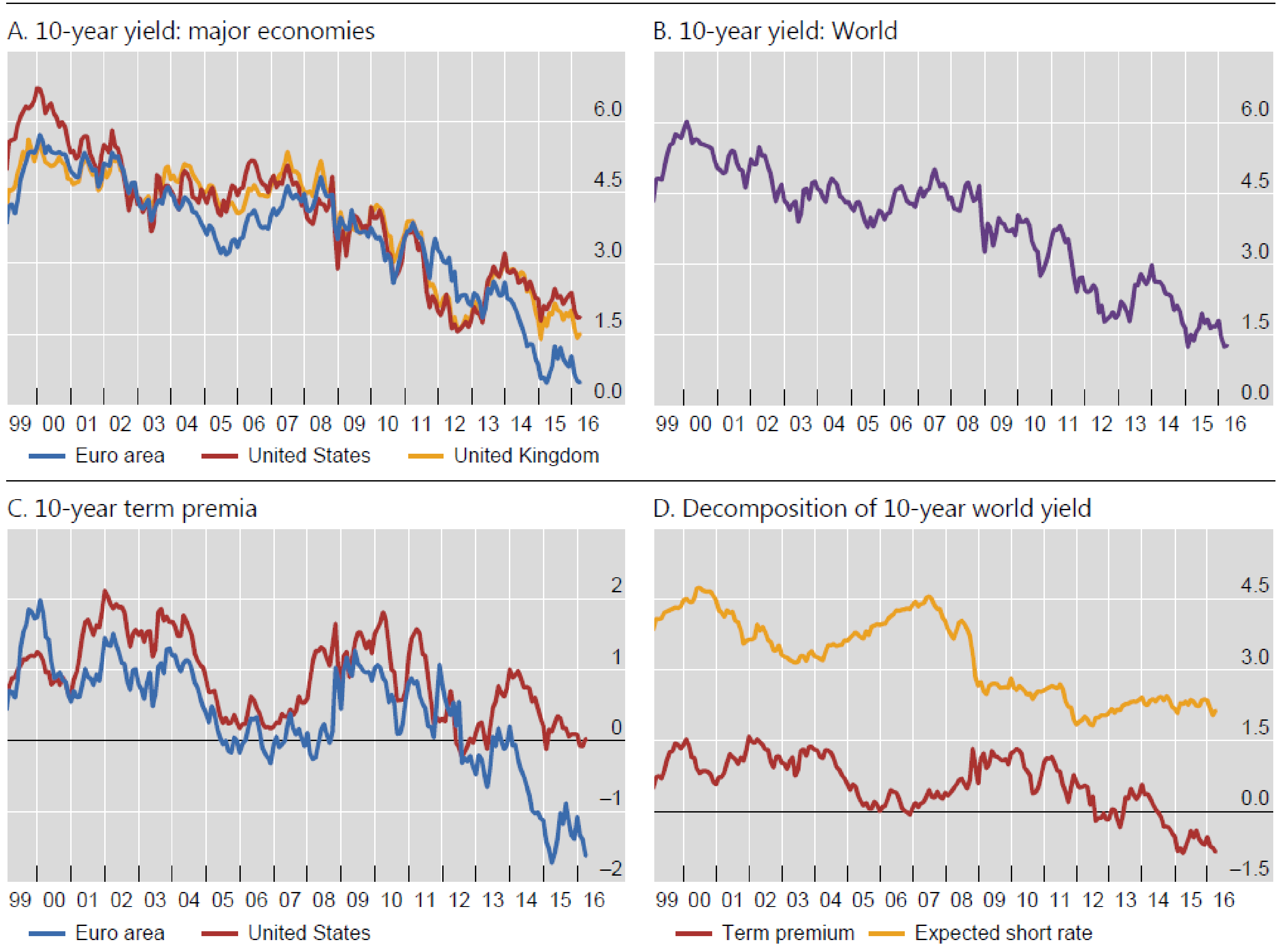
Evolution of natural rates and market rates the main advanced economies

(work in progress of a study group on potential growth)



Evolution of 10-year yields: the collapse of the yield in EMU from 2014 onwards is entirely due to the term premium induced by ECB policy

BIS study

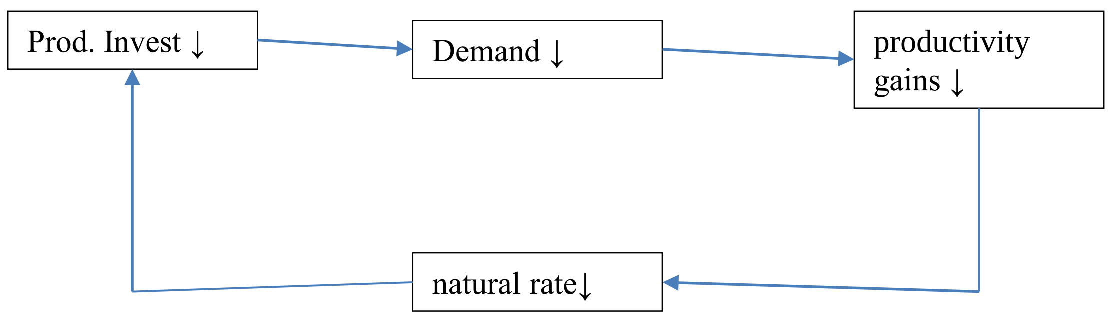


Sources: Bloomberg; Datastream; authors' calculations; Bank of England.

A self-sustaining process of low growth due to the persistent weakness of productive investment

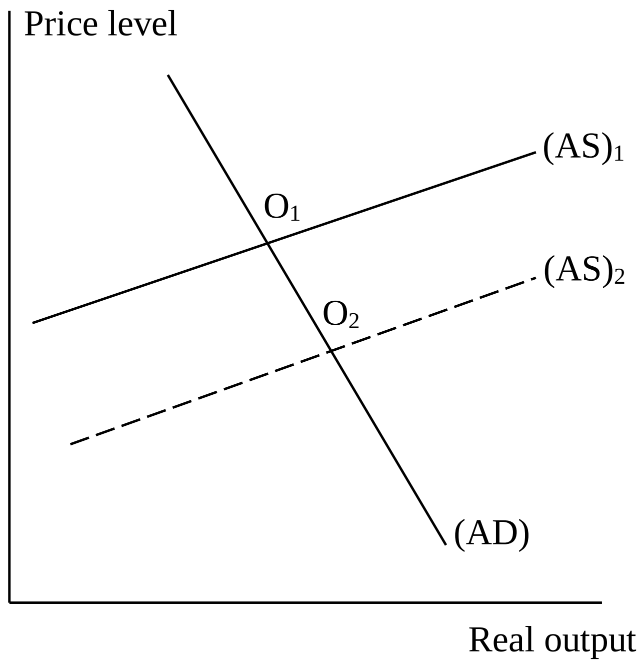
- According to IMF (WEO, April 2015), sagging productive investment is 25% under the level it should have been, had the European economies recovered their pre-crisis trend. About 80% of the slump in productive investment is due to the persistent deficiency in demand.

- Demand and supply conditions interact in a vicious circle:

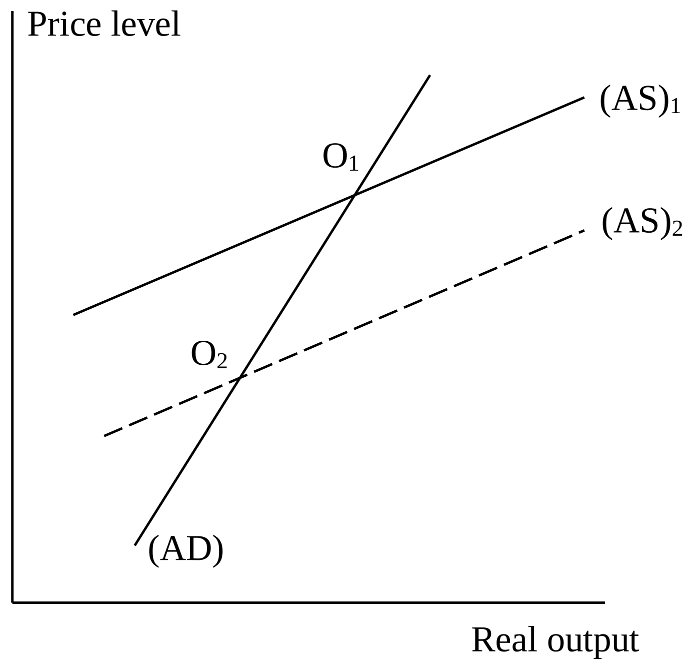


- ↓investment rate is largely endogenous to the responsibility of governments:
  - Failure to clean up and restructure the banking system after the financial crisis
  - Failure of sustained fiscal austerity to boost domestic demand
- International institutions and financial markets are calling for a recognition of the principle of reality by government, leading to active fiscal policy as *investor of last resort* to help ↑ the natural interest rate.

In economies plagued by thwarted deleveraging under ZLB, the impact of supply side policies aiming at reducing unit labor costs are opposite to normal



Normal circumstances:
Output increased, price reduced



ZLB:
Output and price reduced

Theoretical definition of ZLB and limits of monetary policy under secular stagnation

What is ZLB?

- *Neutral nominal rate*= policy rate under optimal macro equilibrium= natural rate + LT inflation expectations (≈ inflation target). If natural rate<0 and inflation expectations too low, the neutral nominal rate gets virtual.

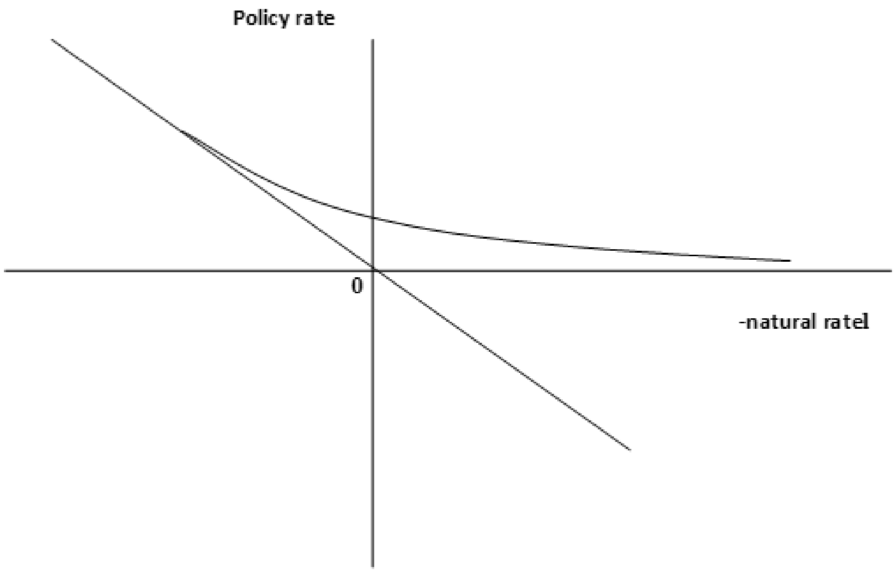
- The central bank can lower its policy rate to the level of *min.rate*:
  - Min rate=0- cost of holding cash

- The optimal policy rate becomes the rate of a synthetic financial product that yields the neutral nominal rate combined with the purchase of a put option whose strike price is the min rate:
  - optimal policy rate= neutral nominal rate + max{min rate, -neutral rate}

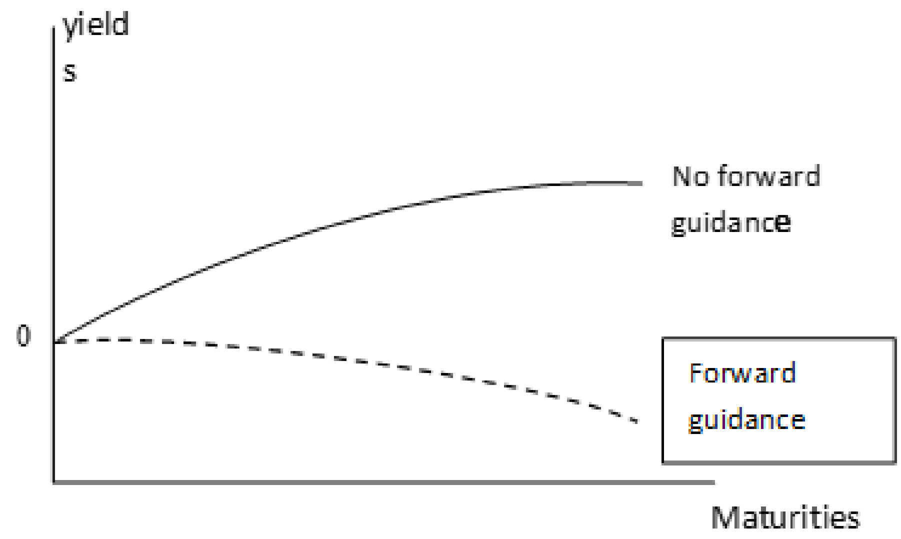
- Options have a time value. If the central bank follows forward guidance policy backed by purchase of public bonds, it carries the option value forward → lower slope of the yield curve up to horizontal. It can even get <0

The non-linear profile of the policy rate

Profile of the policy rate with ZLB



Yield curve with and without forward guidance



ZLB is independent of the physical form of cash, it is intrinsic to the very nature of money

- Money is a collective entity with a dual character:
  - A public institution, e.g. a consistent set of rules making the payment system
  - An ultimate anonymous liquidity accepted unanimously in a given monetary space, as long as collective trust is legitimizing the issuing authority.
  - Cash is what people desire under radical uncertainty as long as its purchasing power is not threatened via too high inflation or arbitrary negative nominal interest rates.
- If trust in the monetary authority is degraded or if there is acute shortage in legal currency, history shows that communities of exchange can always agree on a form of cash independent of the rejected official liquidity: a foreign currency or a real good becomes the common reference of value as a fixed point in a self-fulfilling search process.
- In a monetary system using digital form of money only, the belief that limitless negative interest rates can be relied upon is an illusion. It will destroy trust in the monetary authority. *Communities of people will reconstitute a virtual currency they trust in privatizing the payment system through the block chain*.

The latest ECB innovations have their effectiveness hampered by its inability to impinge upon the natural rate

- March 2016 innovations:
  - Buying corporate bonds: QE at €80bns a month → borrowing costs ↓
  - Paying banks 0.4% to make credit to the real economy (but real estate) offsets -0.4% on non-required reserves

- Which consequences?
  - ECB hoped propagation of ↓ yields on all types of fixed income securities. It largely succeeded.
  - However the transmission to the real economy is problematic beyond a temporary surge in consumption (OECD 2017 forecasts are mediocre).

- Still the perennial obstacles:
  - The problem is the lack of sustained momentum in demand as long as firms cannot or do not want to invest.
  - The so-called structural policies (meaning the forceful attempt to lower labor costs), if applied around ZLB, hamper growth instead of stimulating it.
  - The absentee is the investor of last resort to drag the private sector forward.