Underlying Trends
QE and negative interest rates
Monetary policies have reached their limits

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Monetary policy has reached its limits. Interest rates are in negative territory, and this is now counterproductive. The financial fragmentation and dysfunctions of the interbank market cannot be solved by the ECB alone: disintermediation, economic growth and the relaying of fiscal and fiscal policies are indispensable levers. The ECB faces problems of liquidity on sovereign debt, which clearly shows the limits of an administered market.

The foundations of ECB policy

What the ECB is trying to do is quite clear: i) provide liquidity to banks, ii) keep short-term rates low, iii) anchor long bond yields at low levels while eliminating or mitigating deflationary pressures, iv) ensure favourable financing conditions through low short- and long-term interest rates.

What it is not explicitly trying to do is also clear: i) fund public deficits directly, ii) provide direct support to banks by buying up distressed assets (unlike the US QE) or bank bonds, for example, iii) drive the euro down (unlike Japan, which wants a weaker yen).

What it is doing indirectly: i) reducing sovereign default/insolvency: it is buying up almost twice the net issuance of the entire euro zone; ii) fostering the development of a “non-banking” system: negative rates + a flat curve = weaker bank profitability at a time of digital = expansion in the bond market; iii) contributing to reduced liquidity on fixed-income markets.

Assessing the impact of the ECB’s monetary policy

Monetary policy (QE and interest rate policies): seven channels for transmitting monetary policy to the real economy:

1. **Interest-rate effect:** Drive interest rates as low as possible and keep them there. The ECB has pulled this off.
2. **Spread effect:** Narrow spreads, especially for peripheral countries. The ECB has also pulled this off but to so it is buying up more than twice the net issuance of the entire euro zone.
3. **Wealth effect:** Boost economic agents’ wealth, mainly by driving up the equity and real-estate markets. Mixed results: the equity markets have fallen on the whole since QE was first announced. Buying up sovereign bonds and guaranteeing low rates for a long time is not enough to drive up the equity markets.
4. **Bank lending effect:** Boost bank lending, particularly to SMEs. The ECB has, on the whole, been successful, but:
   – **The impact has been a mere blip in credit surveys.** Many companies are taking advantage of low rates and investors’ quest for spreads to refinance on the capital markets (e.g., Sanofi issued a three-year bond at a rate of -0.50%; no bank can top that).
   – **Mid-market and small cap companies are a cause for concern.** They depend very closely on banks and bank lending to them has fallen for the sixth consecutive year.
5. **Currency effect:** The objective was to drive down the euro, which is a plus for competitiveness. This is not an explicit goal of the ECB (which has no mandate to steer the euro’s exchange rate), but the QE announcement did weaken the euro. Albeit for a brief period – the euro levelled off in 2015 with the drop in emerging currencies, the yuan depreciation, the yuan’s change of regime, and the end of the dollar’s appreciation. Now there are no longer any positive and automatic effects on corporate profits, for example.
6. **“Inflation expectations” effect:** The ECB wanted to eradicate deflationary pressures and trigger a virtuous price-consumption cycle. It has not really been successful at this, at least for the time being. Yes, deflationary risks have receded, but the price-consumption spiral has not reversed itself, and inflation expectations are still very low.
7. **“Confidence” effect:** Achieving a significant and sustained increase in confidence indicators is necessary for investment and growth. QE’s impact here has been mixed, but, clearly, without ECB action these indicators would have dropped once gain.

Overall, the ECB’s monetary policy has been very useful in guaranteeing low rates (and spreads), to make creditors (including states) more solvent and less risky, to limit market volatility... no doubt about it. But everything is somewhat artificial, as this is based on the ECB’s presence in the interest rate markets: the ECB buys more than the total amount of Eurozone net issuance, and it reassures financial markets. As a consequence, long-term interest rates remain at low levels. Two questions at this stage:
– Can the downturn in liquidity have adverse effects on the valuation of these assets?
– How long will this situation last? Has the ECB accepted to resemble - voluntarily or unintentionally - to a “Japanese-style” situation, with an impression of “never-ending QE”, with eventual debt monetization?

In sum, QEs have an impact on financial assets (price, volatility). The table below highlights the criticisms that we identify against QEs and negative rates. Even if we understand the current need for QEs, we must not ignore the shortcomings. Similarly, we can understand the lack of confidence in negative rates. To persevere in this direction is counterproductive.

The QEs' dangers	The dangers of negative rates
1st criticism: QEs are keeping interest rates (short and long) at artificially low levels; **2nd criticism:** The more time goes by, the harder it is to exit QE; **3rd criticism:** They are dampening market volatility artificially; **4th criticism:** They are getting market participants accustomed to a quiet environment; this "new normal" is anything but normal; **5th criticism:** They are skewing asset values; **6th criticism:** They are generating potential bubbles; **7th criticism:** They could be causing financial crises; **8th criticism:** They are encouraging governments to drag their feet on fiscal and tax matters (on the flip side, they are allowing governments to have more proactive fiscal and tax policies without the drawbacks, such as rate hikes); **9th criticism:** While low rates are a tax on savings, QEs (and negative rates) are a subsidy on debt accumulation; **10th criticism:** QEs have shrunk risk premiums and squeezed spreads to such a point that spread-rating matrices mean nothing now. Some investors, for example, can no longer buy bonds, as the spread no longer corresponds to the rating or the risk incurred. What is the solution: no longer invest or revise spread-rating matrices and raise portfolio risk? **11th criticism:** QEs tend to deteriorate market liquidity.	**1st criticism:** They are not truly necessary for access to financing. Companies have access to the capital markets (except SMEs, which rely closely on banks); **2nd criticism:** A reduction in banks' deposits with the ECB if any in no way ensures an additional increase in bank lending to companies in the least favoured regions; **3rd criticism:** Having negative rates in no way guarantees that the interbank market will work better; **4th criticism:** Banks have liquidity (which they then deposit with the ECB) precisely because the ECB is injecting so much of it; **5th criticism:** The reduction of rates into negative territory is undermining banks' profitability (all banks, both core and peripheral); **6th criticism:** By sending short and long rates into negative territory, the ECB is also sending negative signals to the financial markets… and on banking stocks; **7th criticism:** They widen the gap between interest rates and banks' cost of capital.

Conclusion

The ECB will undoubtedly maintain an accommodative monetary policy for the next few years, even if its actions have reached their limits. To reverse the current policy would not make much sense in the current context. But for an impact on growth to be more evident, it is now necessary that income, budgetary and fiscal policies take over. Support for consumption through increases in real disposable income and investment by targeted public spending becomes an inevitable consequence: tax cuts and the revival of infrastructure spending are often mentioned, including in the United States (in the programs of D. Trump and H. Clinton, both candidates in the recent presidential election).

For further details

Drut B. et Ph. Ithurbide – *"ECB QE Monitor"*, Monthly issues, Amundi.
Ithurbide Ph. 2016, *"Low / Negative interest rate environment, secular stagnation... Implication for asset management"*, Amundi Discussion Papers Series #15, April.

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