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The negative rates experiment doesn't look successful

Central banks would be better served by other policy tools

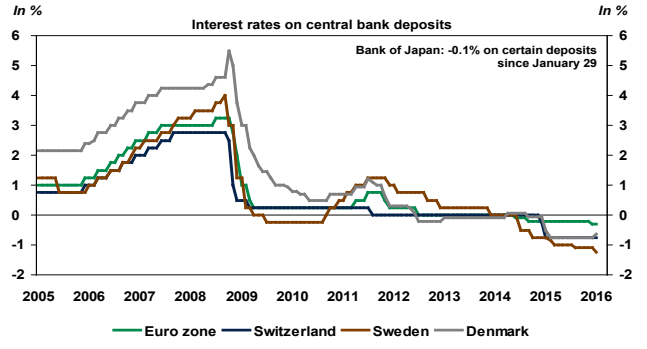
Although a growing number of central banks are resorting to negative key rates, there is no indication that the additional cuts are having any meaningful impact on credit and economic activity. While negative rates have helped weaken the currencies of some economies, they are a dangerous game whose positive effect would evaporate if all central banks resorted to this strategy. Reignited fears about the European financial sector and the negative reaction of Japanese consumers also show the undesirable effects of negative rates. In our view, this strategy should be seriously reconsidered.

NEGATIVE RATES MAKE THEIR WAY TO JAPAN

Monetary policies have been in experimental mode since the last financial crisis. After cutting rates to zero or thereabouts, some central banks had to find other tools, including forward guidance and asset purchases to continue stimulating the economy and prevent inflation from falling too low. Several central banks, starting with Sweden's and Denmark's, opted for another strategy, lowering some of their key rates below zero.

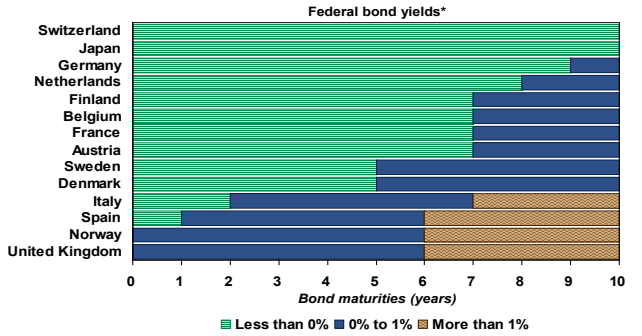
This trend picked up momentum last year when the Swiss National Bank and, more importantly, the European Central Bank (ECB), also opted for negative rates (graph 1). At the end of January, the Bank of Japan (BoJ) joined the party, announcing that it would charge -0.1% on certain deposits. The introduction of negative rates has had a major impact on the entire yield curve, with interest rates going into negative territory even for long-term maturities (graph 2).

Graph 1 A growing number of central banks are adopting a negative rate policy



Sources: Datastream and Desjardins, Economic Studies

Graph 2 Negative bond yields come in lockstep with negative key rates



* Data as of February 29, 2016.
Sources: Bloomberg and Desjardins, Economic Studies

In just a few years, negative interest rates have transformed from a silly idea to just about normal monetary policy. In contrast to 2009, when the Bank of Canada (BoC) considered that it could not cut the overnight rate below 0.25%, it now believes it can drop the rate to around -0.50%. Last year, we published a study on the issues raised by negative interest rates,[1] where we concluded that

[1] Desjardins, Economic Studies, *Economic Viewpoint*, "What should we make of the negative interest rates that we now see in many countries?", May 27, 2015, www.desjardins.com/ressources/pdf/pv150527-e.pdf?resVer=1432732947000.

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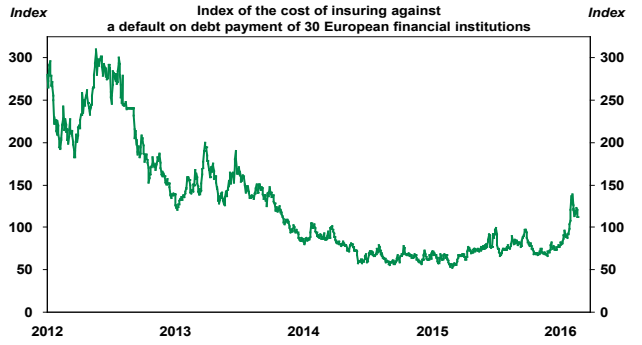
while negative rates could possibly stimulate the economy, they also entailed potentially high costs. Since then, their popularity has continued to grow, as the greatest fears, including consumers withdrawing money from banks and the weakening of the financial system, have not materialized in Europe until recently. Renewed fears about Europe's financial sector (graph 3) and the negative reaction of Japanese households could however be the first signs of the undesirable consequences of negative rates. We therefore have to wonder whether central banks have not erred by adding negative rates to their arsenal.

Graph 3 Renewed fears about European banks



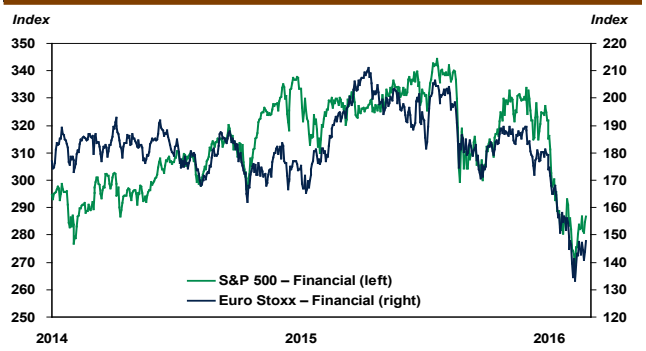
Sources: Bloomberg, Markit and Desjardins, Economic Studies

FEW SIGNS THAT NEGATIVE RATES ARE BOOSTING SPENDING AND INVESTMENT

The conventional monetary policy pass-through mechanism is fairly simple. When a central bank cuts its key rates, financial institutions' interest rates on loans and deposits drop. This encourages spending and investment, at the expense of saving, thereby stimulating economic growth. Theoretically, the effect would be the same whether the decrease is from 3.00% to 2.75% or from -0.25% to -0.50%.

In practice, however, there are a number of reasons why the stimulating effect by the credit channel would not be as strong with negative rates. Recently published studies[2] have found that commercial banks are less likely to lower rates, particularly on deposits, when key rates are in negative territory. This poor transmission of key rate decreases reduces its economic impact and risks sharply eroding bank profitability. Considering the formidable challenges already imposed on big banks as a result of new regulatory requirements, central banks would do well to proceed with caution. Regardless of key rate level, a loss of confidence in the banking sector could drive up financing costs, leading to credit tightening that would heavily impact economic activity. The recent plunge in bank stocks (graph 4) shows that this risk is not to be ignored. Negative bond yields are also placing other financial institutions, especially pension funds and life insurance companies, in a very tough situation.

Graph 4 Recent stock market corrections confirm fragile investor confidence in the financial sector



Sources: Bloomberg and Desjardins, Economic Studies

Beyond the transmission mechanism, there is another good reason why negative rates are not a miracle solution for kick-starting an economic recovery. The Great Depression in the 1930s taught us that there are times when credit and investment no longer react to interest rate movements. The economy is then said to be in a liquidity trap. Without going so far as to say that the world economy is today in this situation, the fact that the sharply declining interest rates of the past few years have failed to spark a surge in investment indicates that the stimulating effect of lower rates is actually quite weak. Intuitively, one might ask why dropping the key rate from 0.25% to -0.50% would reinvigorate the economy when a drop from 4.50% to 0.25% could not. In general, negative rates will tend to be used when conventional monetary policy mechanism has little or no effect.

The positive economic impact of credit expansion through slightly negative rates thus seems marginal and does not justify the risk of weakening the financial system.

THE EFFECT ON CURRENCIES AND ASSET PRICES MAY BE SIGNIFICANT, BUT…

Beyond credit, monetary policy can stimulate the economy through other transmission mechanisms, in particular by affecting currency, asset prices and the confidence of economic agents. In fact, most the central banks that recently adopted negative rates did so, it seems, primarily to weaken their currencies. This was an explicit objective in Denmark and Switzerland. Sweden's central bank and the ECB pointed, however, to the outlook of too-low inflation to justify their negative rates.

[2] For example: Bank of Canada, "The International Experience with Negative Policy Rate", Staff Discussion Paper 2015-13, November 2015, www.bankofcanada.ca/wp-content/uploads/2015/11/dp2015-13.pdf.

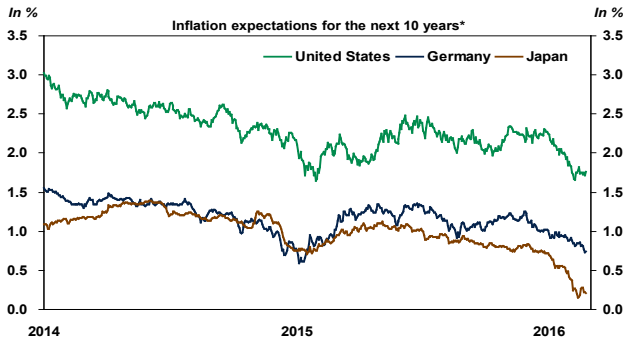
A sharp currency depreciation is a powerful tool to temporarily stimulate economic growth and inflation. Still, there are good reasons why the major central banks do not routinely resort to this tool, mainly because the resulting economic gains are oftentimes at the expense of trade partners. This could incite retaliation from other central banks and go as far as sparking trade wars. As was recently saying the Governor of the Bank of England (BoE), it is a zero-sum game.[3] The Great Depression showed unequivocally that a competitive devaluation is not the answer to a major crisis and could even exacerbate the situation. A return to exchange-rate-oriented monetary policies would be a big step backwards in our opinion.

It is also true that very low or negative interest rates can have a stimulating effect by boosting the prices of some assets. The effect on federal bonds is direct, but all assets that pay some income should theoretically see their values surge in a world of negative interest rates. Once again, this is a very risky strategy for central banks, however, one that could create financial bubbles and precipitate another financial crisis. Asset purchases would also be a more direct tool to use this transmission mechanism.

Lastly, central banks are struggling to master the investor confidence tool. A rate cut, even into negative territory, can be perceived by investors as a positive move that shows policymakers are committed to achieving their objectives. This can be reassuring for investors and keep inflation expectations near the central banks' targets. That said, this positive effect is not guaranteed. The BoJ's recent decision to experiment with negative rates was not well received by the media or the public, and the surge in sales of safes reported by some newspapers does not bode well for confidence. In the euro zone, another rate cut could aggravate fears about the banking sector and, in so doing, sap investor confidence.

Central banks must also recognize that extremely low rates for an extended period of time send a mixed message to economic agents. Since a nominal interest rate is the sum of a real rate and inflation expectations, a negative nominal rate therefore supposes a negative real rate or negative inflation expectations. In the near term, a real negative rate can stimulate the economy but, in the long term, it should reflect the pace of economic growth. If central banks send a message that nominal rates will remain negative for a long period of time, it should not be surprising to see economic agents begin to fear a recession or deflation. In this regard, the sharp decrease in inflation expectations observed in a number of advanced economies does not seem to indicate that the growing popularity of negative rates increased the central banks' credibility where inflation is concerned (graph 5).

Graph 5 Weak inflation expectations still a major problem for central banks



* Calculated based on real return bonds.
Sources: Bloomberg and Desjardins, Economic Studies

ASSET PURCHASES SEEMS TO BE A BETTER TOOL THAN NEGATIVE RATES

Central banks have been in a tough spot since the last financial crisis, unable to get economic growth and inflation back to normal levels. This has prompted policymakers to question their strategies and experiment with new tools. However, negative rates do not seem to be the right course of action. Unless the monetary system is overhauled, this tool only serves to reduce key rates by about an additional 1%, and banks would not pass through the full effect of that decrease. By weakening financial institutions, negative rates could even lead to credit tightening.

The potentially positive effect of negative rates on the confidence of economic agents and on the value of financial assets does not justify their use because, in our view, asset purchases, often referred to as quantitative measures, are a better strategy to get these results. Not only are quantitative purchases practically unlimited, they make it possible to better target certain assets the central bank considers important to support. Plus, unlike negative rates, quantitative purchases are usually viewed positively for the banking sector. If the struggling energy sector began to dangerously hamper Canadian financial institutions, for instance, targeted asset purchases by the BoC would be far more effective at reassuring the markets than a rate cut.

However, there is no denying that negative rates are a good currency devaluation tool. As stated earlier, a return to exchange-rate-oriented policies would however be a big step backwards for central banks. Still, in our view, it's understandable for small central banks in certain specific

[3] Speech of the Bank of England Governor, Mark Carney, "Redeeming an unforgiving world", February 26, 2016, www.bankofengland.co.uk/publications/Documents/speeches/2016/speech885.pdf.

situations, such as in Denmark and Switzerland, to continue using this tool.

In the current context, we therefore believe that central banks that have cut their key rates to near zero and that wish to further ease their monetary policy should look to asset purchases rather than negative interest rates. Besides opening the door to a potential currency war, the uncertain benefits of negative rates are not enough to offset the financial risks. It is therefore reassuring to see the BoE and the Federal Reserve express little interest in negative rates at this time. It will be interesting to see which tool the ECB will choose to use at its March 10 meeting.

In a major financial crisis, it could happen that asset purchases would not be enough to prevent the economy from plunging into a deflationary spiral. In such a case, negative rates would be just as ineffective and central banks, probably in tandem with governments, would have no choice but to opt for much more direct stimulus measures, such as directly financing public spending or tax cuts.[4] Fortunately, there is no indication of such a crisis on the horizon.

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[4] In this regard: Desjardins, Economic Studies, *Economic Viewpoint*, "The central banks still have some ammo left," May 21, 2015, www.desjardins.com/ressources/pdf/pv150521-e.pdf?resVer=1432211877000.