

ECONOMIC VIEWPOINT



Three Years of Negative Interest Rates in Europe Are Hard Times in the Offing?

For three years now, monetary policy in several European countries has been based on negative interest rate. In spite of a stronger economy, it appears that negative rates will continue to shape the European financial landscape for several quarters to come. This *Economic Viewpoint* takes stock of the last three years and focuses on the possible consequences of maintaining negative interest rates over a prolonged period.

The Economy Has Improved Overall, but Inflation Remains Low

Four central banks adopted negative interest rates in 2014 (graph 1): the European Central Bank (in June), the Swedish Riksbank (in July), Denmark's Nationalbank (in September) and the Swiss National Bank (in December). Economic growth was already picking up when negative rates were ordered. Generally speaking, the economic upswing continued in 2015 (graph 2), and buoyancy continued in Sweden before losing steam. Growth stabilized under 2% in the euro zone, and it has lost momentum in Switzerland and Denmark.

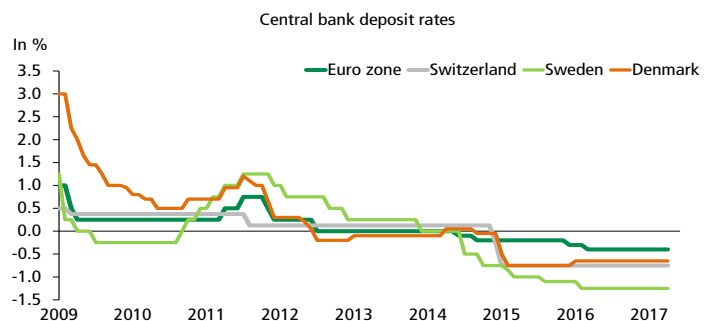
On the job front, improvement is more evident in the euro zone, although the unemployment rate remains high from a historical point of view. It has gone from 11.5% in June 2014 to 9.3% recently (graph 3 on page 2). Unemployment has also dropped in Sweden and Denmark. It ticked up in Switzerland, although it still remains low in comparison with other European countries.

In spite of the economic upturn, inflation has only progressed to a limited degree. Measurements of core inflation have risen over recent months, but overall, they are still well under 2% (graph 4 on page 2). Core inflation appears higher in Sweden, but the Swedish data do not exclude food and energy prices, which add considerable volatility.

The Normalization of Interest Rates Is Expected to Take a Long Time

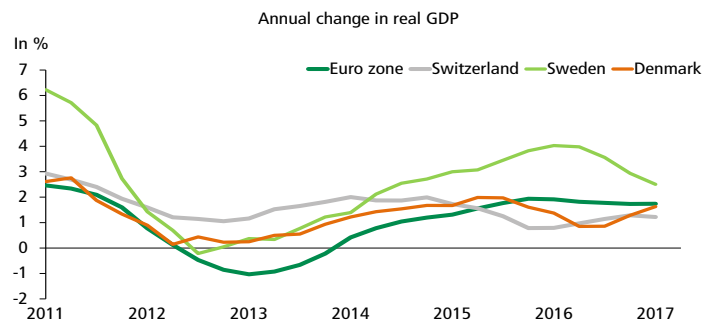
Low inflationary pressure is an indication that the key interest rates of Europe's central banks will remain in negative territory for several quarters to come. The European Central Bank (ECB) policy is particularly important, because it should dictate the pace

GRAPH 1
Three years of negative interest rates in Europe



Sources: Datastream and Desjardins, Economic Studies

GRAPH 2
Stronger economic growth



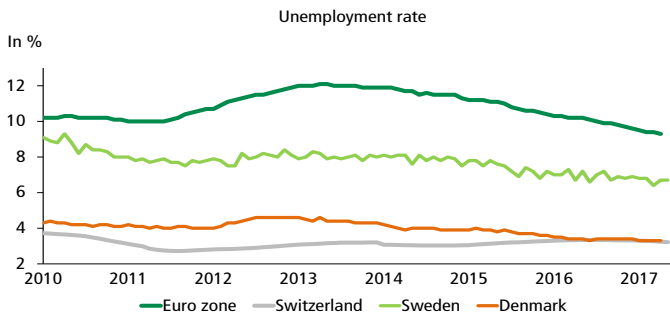
Sources: Datastream and Desjardins, Economic Studies

François Dupuis, Vice-President and Chief Economist • Hendrix Vachon, Senior Economist

Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

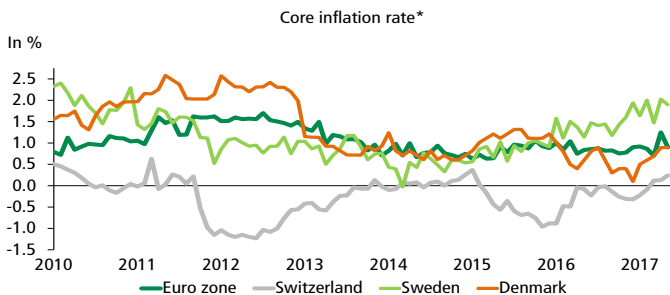
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.
IMPORTANT: This document is based on public information and may under no circumstances be used or construed as a commitment by Desjardins Group. While the information provided has been determined on the basis of data obtained from sources that are deemed to be reliable, Desjardins Group in no way warrants that the information is accurate or complete. The document is provided solely for information purposes and does not constitute an offer or solicitation for purchase or sale. Desjardins Group takes no responsibility for the consequences of any decision whatsoever made on the basis of the data contained herein and does not hereby undertake to provide any advice, notably in the area of investment services. The data on prices or margins are provided for information purposes and may be modified at any time, based on such factors as market conditions. The past performances and projections expressed herein are no guarantee of future performance. The opinions and forecasts contained herein are, unless otherwise indicated, those of the document's authors and do not represent the opinions of any other person or the official position of Desjardins Group. Copyright © 2017, Desjardins Group. All rights reserved.

GRAPH 3
The unemployment rate is falling in most countries



Sources: Datastream and Desjardins, Economic Studies

GRAPH 4
Core inflation is low, but still rising



* Excluding food and energy in the euro zone, Switzerland and Denmark. Excluding the cost of mortgage interest in Sweden.

Sources: Datastream and Desjardins, Economic Studies

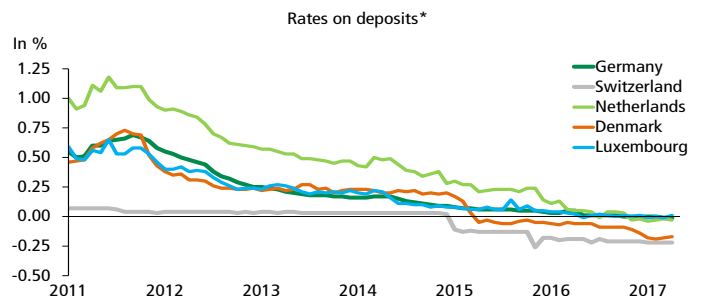
of normalization of monetary policy regardless of the economic and inflationary progress that might be observed elsewhere. The fixed exchange rate policy of Denmark's Nationalbank normally forces it to follow the ECB. A similar constraint is in effect for the Swiss National Bank, as it strives to avoid appreciation of the franc against the euro. The Swedish Riksbank pays less heed to exchange rate, but this variable nevertheless has a considerable impact on Sweden's competitiveness in Europe as well as on the changes in prices and the economy in general.

The ECB appears somewhat more optimistic since early spring; this has encouraged markets to begin anticipating a slowdown in its monetary easing measures. In June, the ECB made no mention of another possible cut in its key interest rate. It now sees economic risks as balanced overall. However, it has not indicated any reduction in its asset purchases before the end of the year, and there is even less talk of an interest rate hike. The poor improvement to its inflation forecasts does not herald any rapid policy change in 2018. The ECB could gradually reduce its asset purchases in the first half of the year and then begin to raise its key interest rates. The intimation is that several months could elapse between the end of the asset purchase program and the start of interest rate hikes.

Retail Rates Have Reached New Lows

Holding key interest rates in negative territory has repercussions on several other interest rates, in particular those on deposits and loans. Over recent years, these rates have dropped to their current historic lows. The posted rates for certain deposits have even fallen into negative territory in Germany, the Netherlands, Luxembourg, Switzerland and Denmark (graph 5). These extreme cases generally apply to corporate deposits or large sums. There still appears to be strong reticence to charging interest on household deposits. As for loans, the official data do not indicate that households or businesses capitalize on negative rates in financial institutions (graph 6).

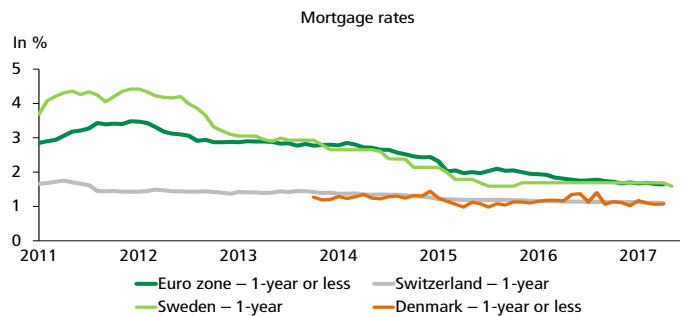
GRAPH 5
Some depositors must pay interest in Europe



* Interest rates on 3-month term deposits of more than 100,000 francs for Switzerland. Rate on corporate demand deposits for the other countries.

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

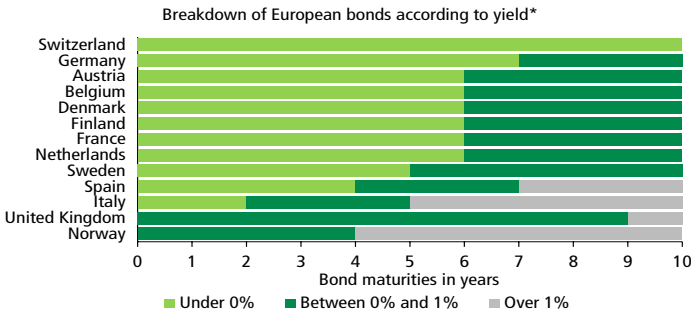
GRAPH 6
Mortgage rates have remained in positive territory, but are still very low



Sources: Datastream, European Central Bank, Denmark's Nationalbank and Desjardins, Economic Studies

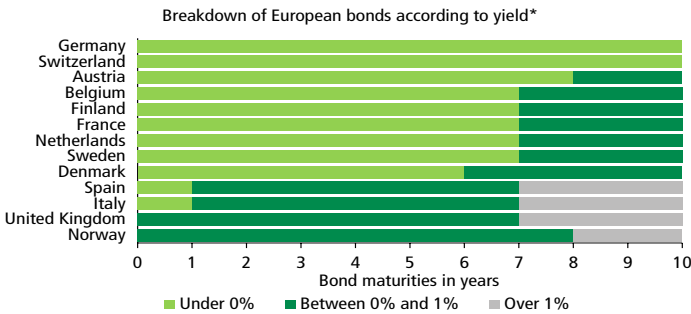
On the other hand, most European governments as well as some companies have benefitted from negative interest rates in the bond market. That being said, it appears that the trend toward negative rates in this market has lost steam over the past year. There are currently fewer bond maturities posting a negative yield than there were a year ago (graphs 7 and 8 on page 3). Bond yields appear to have started to adjust to Europe's economic upturn and to expectations of eventual monetary firming. Spain is one of the rare exceptions, where the number of

GRAPH 7
There are still many negative bond yields...



* Data as at June 27, 2017.
Sources: Bloomberg and Desjardins, Economic Studies

GRAPH 8
... but fewer than a year ago



* Data as at June 14, 2016.
Sources: Bloomberg and Desjardins, Economic Studies

maturities with a negative yield has increased over the past year, due to a drop in the default risk premium.

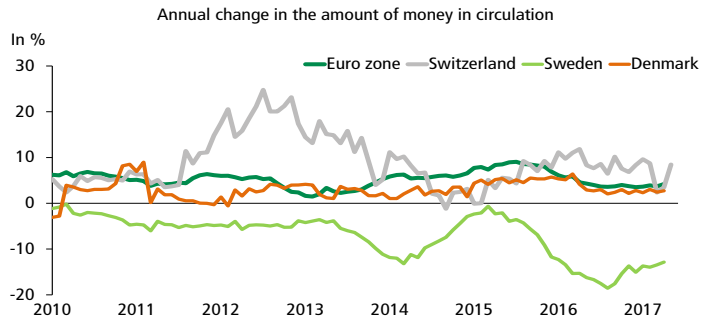
No Flight to Cash

The introduction of negative interest rates had raised some fears that behaviour would change and, in particular, that it could trigger a massive transfer of savings into cash. In such a scenario, it would become very difficult for the financial system to find the capital needed to finance credit and investment. The economy would suffer and central banks would lose influence over the credit channel.

Since 2014, there has been no explosion in the amount of money in circulation in Europe. The trend toward demonetization has even continued in Sweden, although the contraction rate of the amount of money in circulation has slowed in that country over recent years. The strongest acceleration was observed in Switzerland (graph 9).

A number of factors have served to put the brakes on a massive conversion to cash. As a mean of payment, cash can very rapidly become unwieldy, causing delays in transactions due to the

GRAPH 9
The amount of money in circulation has increased further in Switzerland



Sources: Datastream and Desjardins, Economic Studies

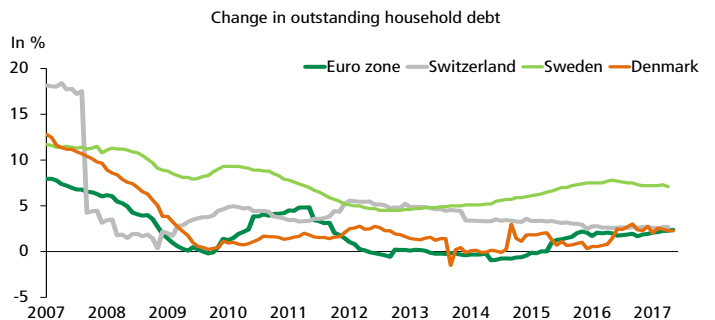
time spent counting. Security issues related to holding cash also generate expenses, such as the purchase of a safe. Lastly, cash is susceptible to degradation, fragile in the event of severe weather conditions and accidents, not to mention the risk of being a victim of counterfeit. Therefore, it would take even lower negative interest rates to incite savers to change their habits.

No Broadly-based Credit Bubble

Rather than encouraging a massive transfer of savings toward cash, low interest rates can simply trigger a lower savings rate and increased consumption, with, in addition, a possible rise in debt levels. This is in fact one of the main transmission mechanisms of monetary policy. Normally, it is desirable to have this mechanism function, but excesses would be a threat to future economic growth.

For the time being, there does not appear to be any excess. The data show a moderate increase in the growth of credit in the euro zone, in Denmark and in Switzerland (graph 10). Current levels remain considerably lower than those observed a decade ago. The case of Sweden is perhaps of greater concern, with annual gains in the credit volume of around 7.5%, but this is

GRAPH 10
Credit is still growing slowly in a number of countries



Sources: Datastream and Desjardins, Economic Studies

nevertheless a lower rhythm than what has been seen in the past.

Higher debt levels are in line with the accelerated rise in home prices in Sweden (graph 11). The annual change in home prices in that country was over 10% in 2015 and it has dropped slightly since. A strong price increase was also seen in Denmark in 2015, but it has now slowed considerably. On the other hand, home price growth have recently picked up in the euro zone; this could cause greater concern if the trend continues.

To lower costs to the financial system, the ECB has undertaken special financing operations to enable financial institutions to borrow large amounts of money at a rate of -0.40%. Economic improvement through monetary easing has also helped financial institutions. Gains in employment reduce losses on loan defaults and the increased volume of credit generates new revenue. In Greece, improved confidence in the banking sector has enable financial institutions to restore their interest margins.

Savers Are Penalized

The scarcity of investment possibilities offering attractive returns creates a difficult context for savers. The same is true for pension funds. To achieve the same savings and pension targets, contributions have to be increased, which can slow down consumer spending. On the other hand, if savings targets are lowered, future consumption will be penalised.

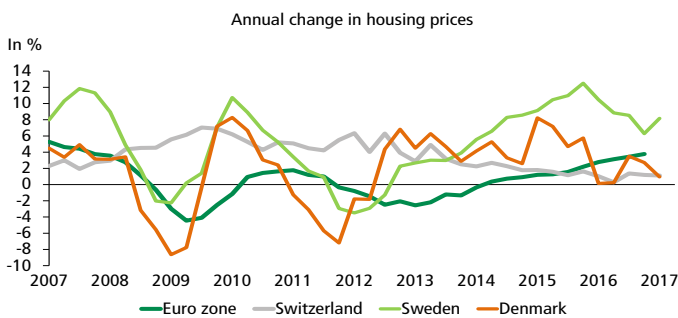
The constraint of low returns can also be compensated for by taking greater risks. Higher risk assets generally offer higher returns. However, increased demand for these assets could lead to an underestimation of risk premiums, opening the door to future corrections and financial tensions.

Governments Will Need to Adapt to Rising Interest Rates

After several years of low interest rates, the future appears more difficult for governments. Bond yields are already showing signs of an upturn and the cost to taxpayers could increase rapidly. It is not clear whether higher tax revenues resulting from a stronger economy would compensate for the rise in interest rates.

This challenge will affect the euro zone particularly given its higher public debt (graph 13). Net public debt has stabilized at over 70% of GDP since 2014. However, net interest payments have been reduced considerably in most euro zone countries over recent years, enabling governments to soft pedal on fiscal recovery measures (graph 14 on page 5). In some countries, the increase in debt cancelled out the gains from lower interest rates, and even more. This is what happened in Slovenia.

GRAPH 11
High growth in home prices in Sweden and rising in the euro zone

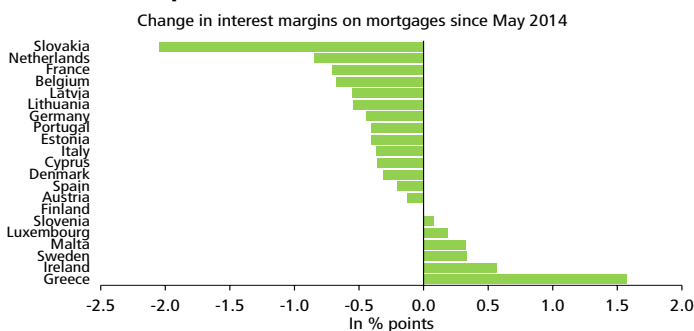


Sources: Datastream and Desjardins, Economic Studies

Reduced Interest Margins

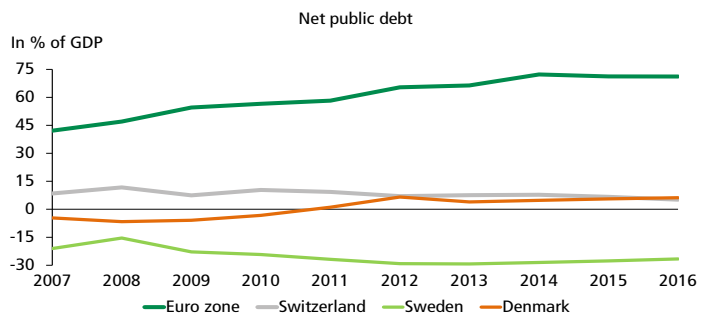
Financial institutions are under new pressures due to negative interest rates. The drop in interest rates on loans and the difficulties posed by allowing interest rates on deposits to fall into deeply negative territory squeeze margins in the banking sector in several countries (graph 12), with a direct impact on profitability. Insurance companies are also penalized by the low interest rates, particularly on life insurance products, for which premiums have been calculated based on the expectation of significantly higher long-term returns. Now these companies must adapt their service offerings.

GRAPH 12
Interest margins for financial institutions have dropped in a number of European countries



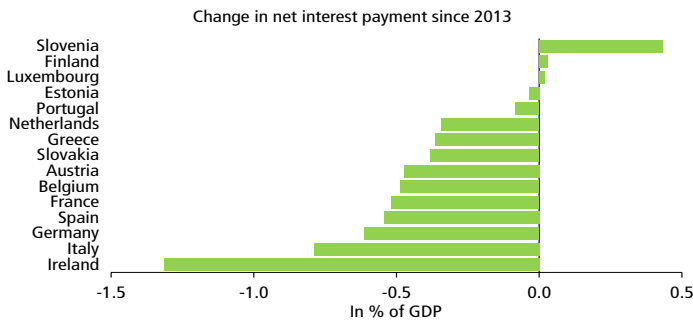
Sources: European Central Bank and Desjardins, Economic Studies

GRAPH 13
The debt burden is significantly higher in the euro zone



Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

GRAPH 14
Nearly all euro zone countries have seen their interest payments drop over the past three years



Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

Lastly, there is cause to be wary of the consequences of a potential external shock, such as a significant economic slowdown or even the end of the economic cycle in the United States. Such a scenario appears plausible to us for 2020, which means that the ECB and other European central banks would have very little time to normalize their monetary policy. It could become difficult to count on governments to support growth, especially in the euro zone, so we would probably have to rapidly revert to negative interest rates. The risk is that these policies might not be as effective in the second round, testing new interest rate lows, and that the negative impact could become too pronounced.

Hendrix Vachon, Senior Economist

One cannot exclude a return of financial tensions related to sovereign debt when the ECB commences monetary firming and bond yields move up more steeply. Even the end of the ECB's asset purchase program could prove to be difficult. The more indebted countries, such as Greece and Italy, could face an escalation in risk premiums. The financial system could also be put to the test due to its exposure to sovereign debt.

Heightened Risk of a More Challenging Future

To sum up, the monetary policies with recourse to negative interest rates deployed in Europe seem to have boosted the economy. However, in the context of negative interest rates, things are not perfect and there are some justifiable fears about the eventual withdrawal of these policies.

It is reassuring that we have not seen massive transfers of savings into cash. For such a scenario to occur, interest rates on household deposits would have to be significantly reduced into negative territory, which financial institutions do not appear to be ready to do, even if their interest margins suffer. We can also be reassured by the fact that we are not seeing an explosion of credit or a new bubble in the housing sector.

It is more disturbing to see that governments have not yet begun to reduce their debt levels to give themselves more leeway and to cope with an eventual rise in interest rates. This rate hike has been timidly initiated in the bond market and should become more pronounced next year when the ECB slows down its asset purchases. The trend toward rising yields could gain momentum, with the first hike by the ECB expected toward the end of 2018.

There is also some cause for concern over the potential effects of negative interest rates on the savings market. When there is a savings deficit, consumption suffers. There could also be a readjustment of risk premiums when savers turn to less risky assets.