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Thinking ahead for Europe

The Negative Rates Club

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For the better part of a decade, central banks have been making only limited headway in curbing powerful global deflationary forces. Since 2008, the US Federal Reserve has maintained zero interest rates, while pursuing multiple waves of unprecedented balance-sheet expansion through large-scale bond purchases. The Bank of England, the Bank of Japan and the European Central Bank have followed suit, each with its own version of so-called quantitative easing (QE). Yet inflation has not picked up appreciably anywhere.

Despite their shared struggles with deflationary pressures, these countries' monetary policies – and economic performance – are now diverging. Whereas the United States and the United Kingdom are now growing strongly enough to consider raising interest rates, the eurozone and Japan are doubling down on QE, pushing policy rates further into negative territory with long-term interests also at record lows. What explains this difference?

The short answer is debt. The US and the UK have been running current-account deficits for decades, and are thus debtor countries, while the eurozone and Japan have been running external surpluses, making them creditor countries. Because negative rates benefit debtors and harm creditors, introducing them spurred a recovery in the US and the UK, but had little effect in the eurozone and Japan.

This is a general phenomenon. By now, most of the world's creditor countries – those with large and persistent current-account surpluses, such as Denmark and Switzerland – have negative interest rates, not only in terms of policy rates, but also the returns on long-term governments bonds and other 'riskless' debt. And it is doing little good.

Despite the disappointing results from low interest rates, central banks in these economies remain committed to them. If it is suggested that QE, or negative interest rates, are unlikely to benefit their economies much, the seemingly overwhelming counterargument is that the notion that negative rates might depress demand should imply logically that raising interest rates would stimulate the economy. But the latter seems obviously absurd.

Basic economics courses cover the curious case of the 'backward-bending supply curve of savings'. In some circumstances, lower interest rates can lead to higher savings. Because lower rates reduce savers' income, they spend less, especially if they have a savings target for their retirement. It is thus clear that lower rates can indeed induce a saver to save even more.

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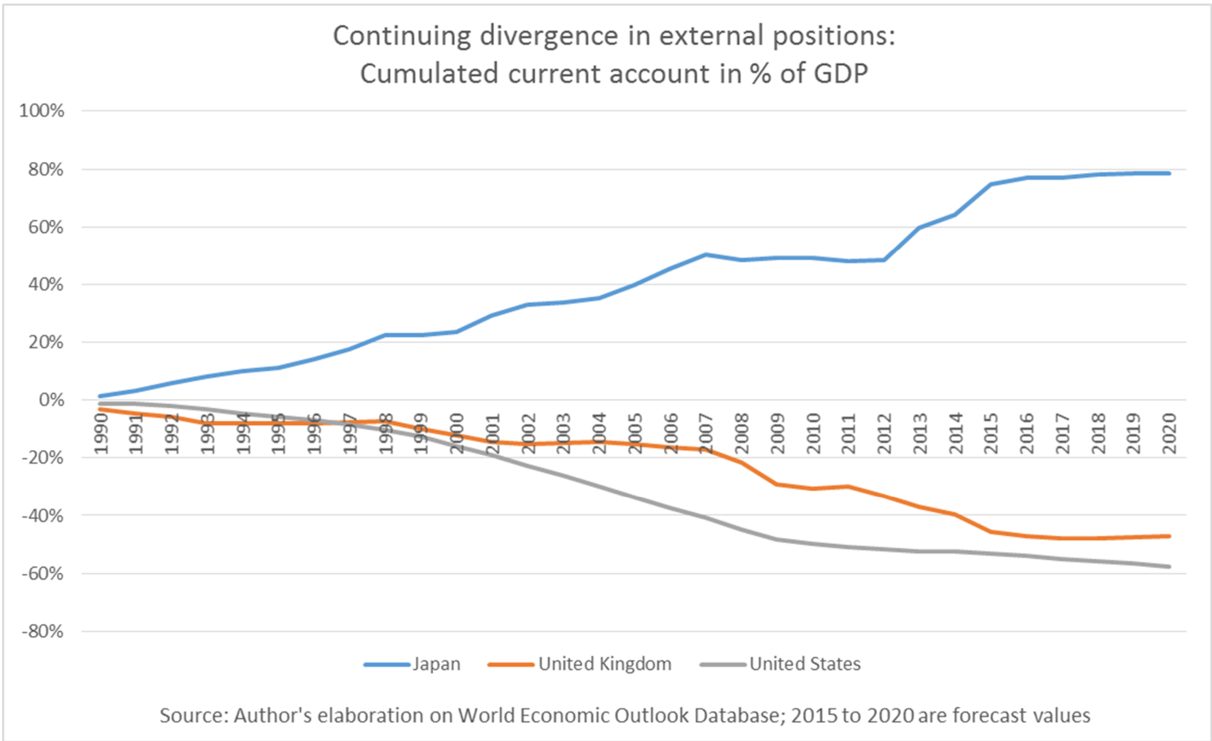
In a closed economy, there is a debtor for every creditor, so whatever creditors lose from ultra-low interest rates, debtors should gain. This implies that in a closed economy, the general rule should hold and that a lower interest rate tends to stimulate consumption and other expenditure. The basis of modern monetary policy-making is thus sound – but only for an economy that is either closed or has a balanced external position so that internally there must be a debtor for every creditor.

But in an (open) economy with a large net-foreign-asset position, there are naturally more creditors than debtors. For a country with large foreign debts, the opposite is true. The effectiveness of monetary policy at the lower bound should thus be different in creditor and debtor economies.

Until recently, this condition did matter, because foreign-asset positions were usually small (as a percentage of GDP). Today, however, these positions in the major industrialised economies are large and increasingly divergent, partly owing to the build-up of leverage that led to the global financial crisis of 2007-08. And, in fact, at the international level, leverage is continuing to grow.

Although current-account imbalances have generally fallen since the financial crisis began, they have not reversed, as shown in the figure below. This implies that the surplus countries continue to strengthen their creditor positions, diverging from the deficit economies.

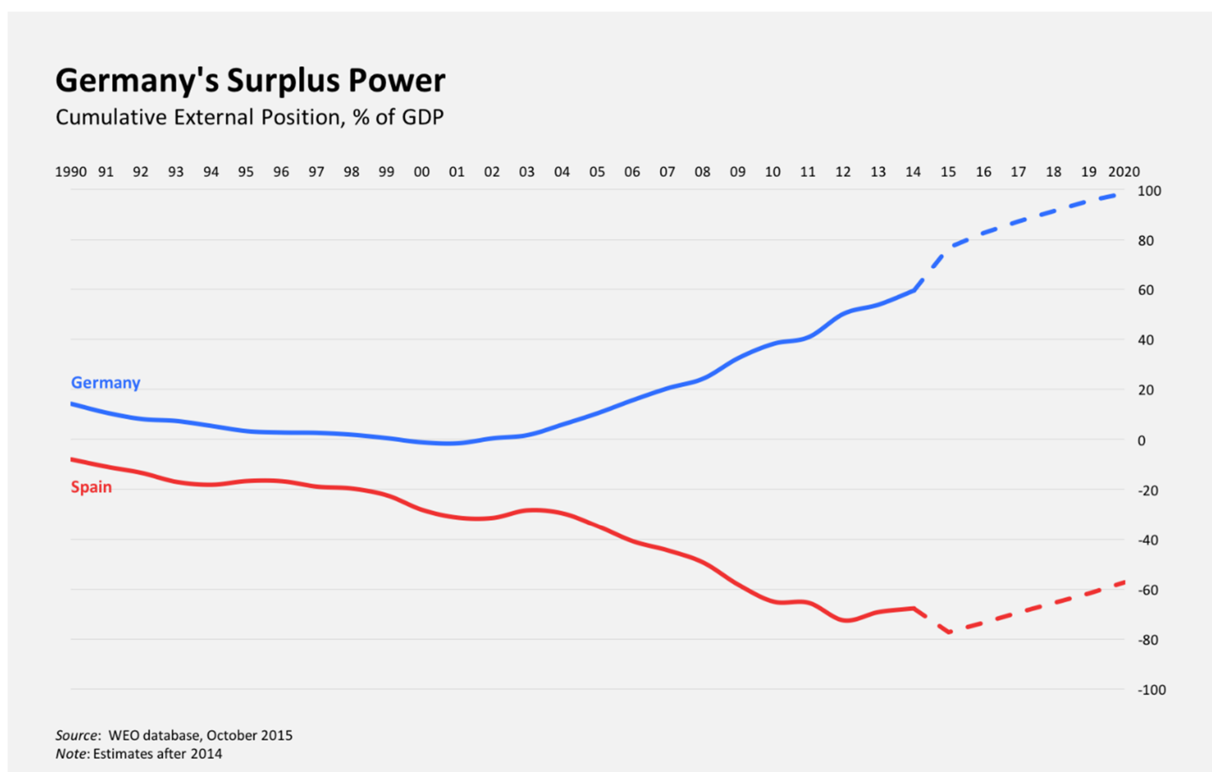


Commodity exporters like Russia and Saudi Arabia, which ran large current-account surpluses when oil prices were high, are the main exception to this pattern of diverging foreign-asset positions. With the precipitous decline in world oil prices since June 2014, their fortunes have reversed. Their export earnings have plummeted – falling by half in many cases – forcing them to run deficits and draw on the large sovereign-wealth funds they accumulated during the global commodity boom. A radical reduction in expenditure has now become unavoidable.

The industrialised economies face very different challenges. Their problem – in a sense, a luxury problem – is to ensure that their consumers spend the windfall from lower import prices. But in the creditor countries, negative rates do not seem to advance this goal; indeed, some external surpluses are even increasing.

This divergence is also playing out within the eurozone. Although it is a creditor economy overall, it comprises debtor countries as well as creditors. The debtor economies, such as Spain and Portugal, now run small current-account surpluses, and are gradually reducing their debt. But the traditional creditors have seen their current-account surpluses grow so much that the debtor/creditor asymmetry continues to increase.

Germany, most notably, has increased its surplus (to nearly 8% of GDP), since the start of the financial crisis and has since then accumulated more surpluses than in its entire previous history. On current trends the German creditor position might rise from 60% of GDP to 100%.



Central bankers are supposed to be patient. Indeed, economists supported the global movement towards central-bank independence precisely because it seemed that central bankers would be less inclined to try to stimulate the economy for short-term gain. But central bankers seem to have become impatient, fretting about low inflation, even though the output gap is slowly closing everywhere and full employment has been reached in the US and Japan.

Creditor countries' central bankers must stop trying to manipulate their economies with more potentially counterproductive monetary easing. Instead, they should allow the recovery to run its course, even if that happens slowly, and wait for the base effect of lower oil prices to disappear. The President of the ECB has recently admitted that his policy might not be effective given strong global deflationary trends. But promising more of something that has not worked is not the right approach.