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ZERO INTEREST RATES, ECB "FISCAL POLICY" AND BEYOND

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ABSTRACT

By considering the ECB interest ratite policy over the period 2012-2021, it is noted that the key rates have followed a decreasing trend, up to reaching the zero or near zero level. The 3 M Euribor touched zero in 2015 and the 10 Y bund in 2020. The inauguration of the zero interest rates policy took place in 2012, in connection with negative rumours against the robustness of the Euro (the most important and significant realization of the EMU). The policy proved efficient from several points of view. It resulted very supportive for most EMU highly indebted governments by strongly reducing their costs for the debt service. To implement this policy, the sustainability of the banking sector has required several special measures: the most important one has been moving the bank deposit rate from the usual positive level to a negative level that may be intended as a custody rate. There have been important consequences in terms of Income distribution among the principal institutional sectors of the economy (households, firms, banks, Government sector). Very synthetically: the Government sector has been advantaged, whereas the private sector has paid, because the return from bank deposits has become negative. The paper concludes by shortly revisiting Keynes' "stamped money", something that turns out very similar to deposits carrying a negative interest rate. A short look to future problems is also included.

Keywords: ECB interest rates policy, Euro, Zero interest rates, Banking sector sustainability, Government debt sustainability and monetary policy, Monetary policy and sectoral income distribution, Keynes' stamped money.
JEL Codes: 3.5 E, E12, E52, E62, G18, G28.

1. An impressive chart

No surprise that after the two crises, financial and real, that hit the Euro Area in 2007-2008, the ECB's guidance of monetary policy was one of easy

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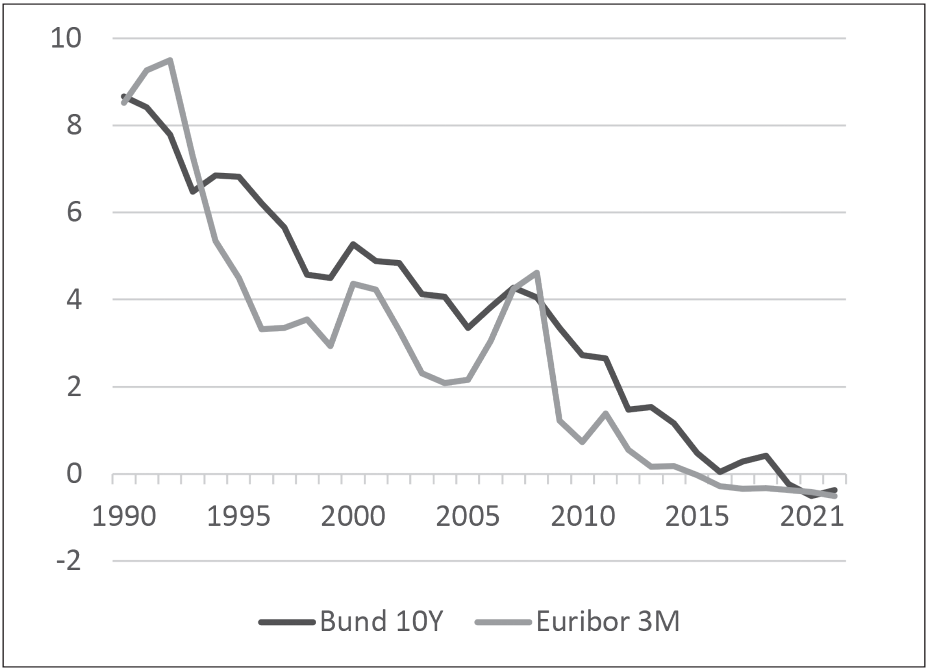
money (quantitative easing): this is a standard reaction of central banks in similar circumstances. But if we look at the chart of the key EMU interest rates from the beginning of 2012, we see that they trend progressively downwards to zero and even slightly less: first the short rates (3m Euribor 2014), followed in two more years by the long rates (10y Bund). To my knowledge, a policy of negative interest rates is unprecedented and requires investigation.[1] For this purpose, I will try to pose few likely questions and hazard some answers.

Fig. 1. *ECB, key interest rates since 1990.*



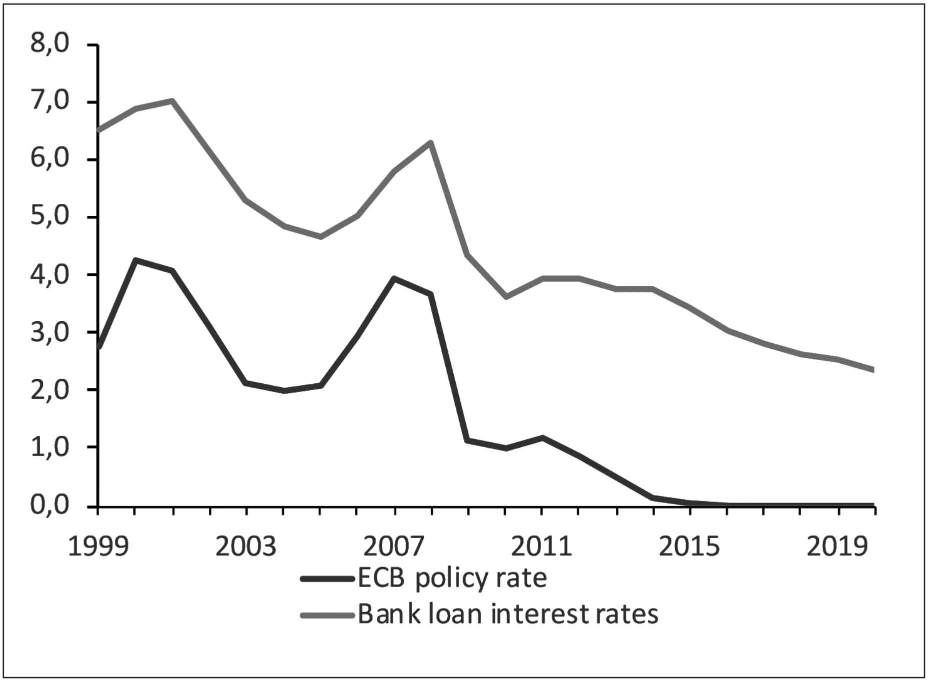
[1] My interest in negative interest rates was originally stimulated by Rogoff (2020). A brief reflection of mine on the subject was published in the Italian edition of the *Huffington Post* on May 22, 2020.

2. How the ECB moved

It was common opinion that the banking business could not survive in a world of negative key interest rates. Moreover, banks have always been accustomed to offer competing remunerations to attract deposits, and zero interest on demand deposits appeared inconsistent with this practice. In fact, the ECB promoted the banking sector's sustainability by offering very favourable financing conditions for the short term, but especially for the long horizon (several types of *long-term refinancing operations*).

In addition, despite negative bond rates, the market rates of bank loans have always remained positive, albeit very low. Furthermore, participating in government bond placement auctions is on average profitable for banks even when market rates are negative because the mean adjudication prices are always lower than the market price.

Fig. 2. *ECB policy rate and bank loan rates since 1999 (EMU start).*



Lastly, it is true that in the past bank deposit rates had always been positive, but nothing prevented banks from posting a negative rate in unforeseen circumstances, requiring depositors to pay for the custody of money.

3. Stopping rumours against the Euro

Such an unforeseen circumstance came at the beginning of 2012, when the Euro, the major accomplishment and symbol of the EMU, was in the throes of crisis. The ECB did not hesitate to assure the market absorption of the bonds issued by the governments of the EMU member countries, especially the highly indebted ones. Concluding his speech at the Global Investment Conference in London on July 26, 2012, Draghi, at that time President of the ECB, made a firm declaration that was later to achieve cult status: "The ECB is ready to do whatever it takes to preserve the Euro. And believe me, it will be enough". Those words were enough to convince "the markets" – *alias* the major potential speculators against the Euro, that the ECB had precise ideas about what to do to defeat speculative temptations. Also, it became clear that buying government bonds without destroying the working of the bond market was possible.

Note that according to the rules, the ECB operated on the secondary market, buying bonds from banks, which have access to the primary (auction) market. With full control of money creation, it was obvious that the market interest rates on government bonds could be moved as desired in the short run. But on a longer horizon, the banking sectors' profitability had to be assured. To maintain a sufficient margin between loan and bond rates on the one hand and deposit rates on the other, the bank deposit rates may need to become negative custody rates. This is what we have seen since the beginning of 2014 up to now, or rather, to the end of 2021. Clearly, questions about the future are reasonable.

In my opinion, the ECB's adoption of zero interest rates to prevent a crisis of the Euro in 2012 and prepare for later debt consolidation showed ingenuity, rather than being a gamble. The real intuition – a novelty in the rules of money and banking guidance – is that a period of zero (or near-zero) interest rates is not only possible, but maintainable for however long a central bank needs to sustain expansionary policies in a highly indebted economy. The novelty of the ECB policy inaugurated in connection with rumours suggesting that the Euro might be in a critical situation (2012) was that of moving the 3m Euribor to the lowest-ever level consistent with enabling banks to obtain a just-sufficient interest margin between loan and bond rates on the one hand and deposit rates on the other (with deposit rates at slightly negative or barely positive levels).

4. Near-zero interest rates and sustainability of government debts

Most governments of the EMU member countries are highly indebted, some more than others: consequently, sustainability is a primary concern for the ECB. For these governments, a time of zero or negligible interest rates is a very favourable opportunity because the new government bonds replacing those coming to maturity permit lower service costs. Additional borrowing, if necessary, enjoys very low costs. True, on the day interest rates start increasing anew, these advantages will be reversed, but in the meantime indebted governments may have the time to make needed reforms and relaunch their economies, avoiding intolerable costs.

5. Present situation (2020-2021) in the EMU

The monetary policy of near-zero interests rates undoubtedly made a fundamental contribution to restoring confidence in debt sustainability, but even a sketchy picture of the present situation (February 2022) of the EMU economy must devote attention to several other factors. In particular, the COVID-19 pandemic, an event of non-economic origin, dealt a further devastating blow to the poorly performing economies. No forecast could have predicted the COVID pandemic years before 2019; in hindsight, it must be acknowledged that near-zero interests rates have done much good in enabling the most heavily indebted governments to adopt Keynesian spending policies with extraordinarily low debt servicing costs. Lastly, we must emphasize the invaluable role played by the 'new view' adopted by the EMU in response to the need to face the consequences of the COVID disaster in a spirit of solidarity. For the first time, the EMU has decided on joint bond emissions to finance a common *recovery and resilience program*. This move has certainly contributed to a new climate of favourable expectations.

6. Financial wealth accumulation and decumulation in the EMU institutional sectors

Here, I focus specifically on the COVID years 2019-2020, when near-zero interests rates and the pandemic operated together. All the EMU governments were able to significantly reduce their debt servicing costs and have compensated for falling national income with large transfers to the private sector to sustain the demand for real goods. In principle, with zero interests rates, one could expect households not to make financial savings. But what happened was precisely the opposite, in the sense that household savings have increased. The reason is that uncertainty about the future always leads to increased demand for liquid assets. In fact, governments have increased their debts, households (and to some extent non-financial corporations as well) have increased their financial wealth (more precisely, they have accumulated bank deposits despite the negative rates), leaving government bonds to banks and other financial intermediaries. In this way, the private sector is financing – almost for free – the government debt in the hands of the banking sector.

Fig. 3. *Households: Bank deposits and loans.*

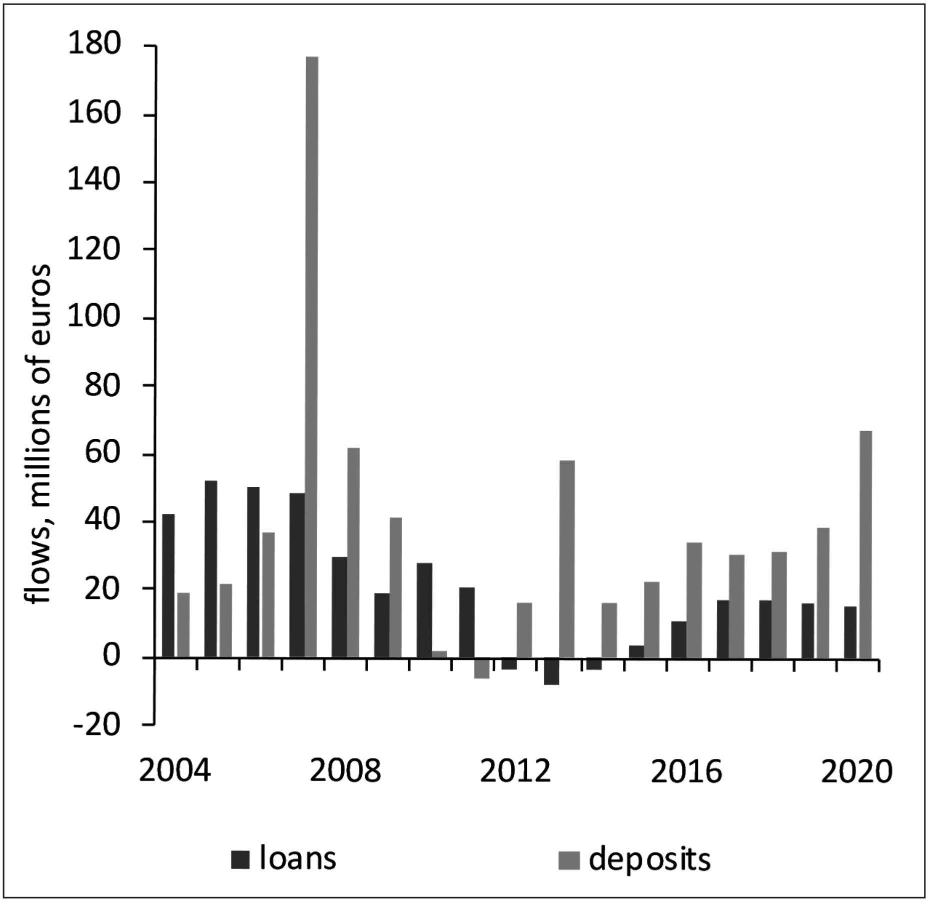
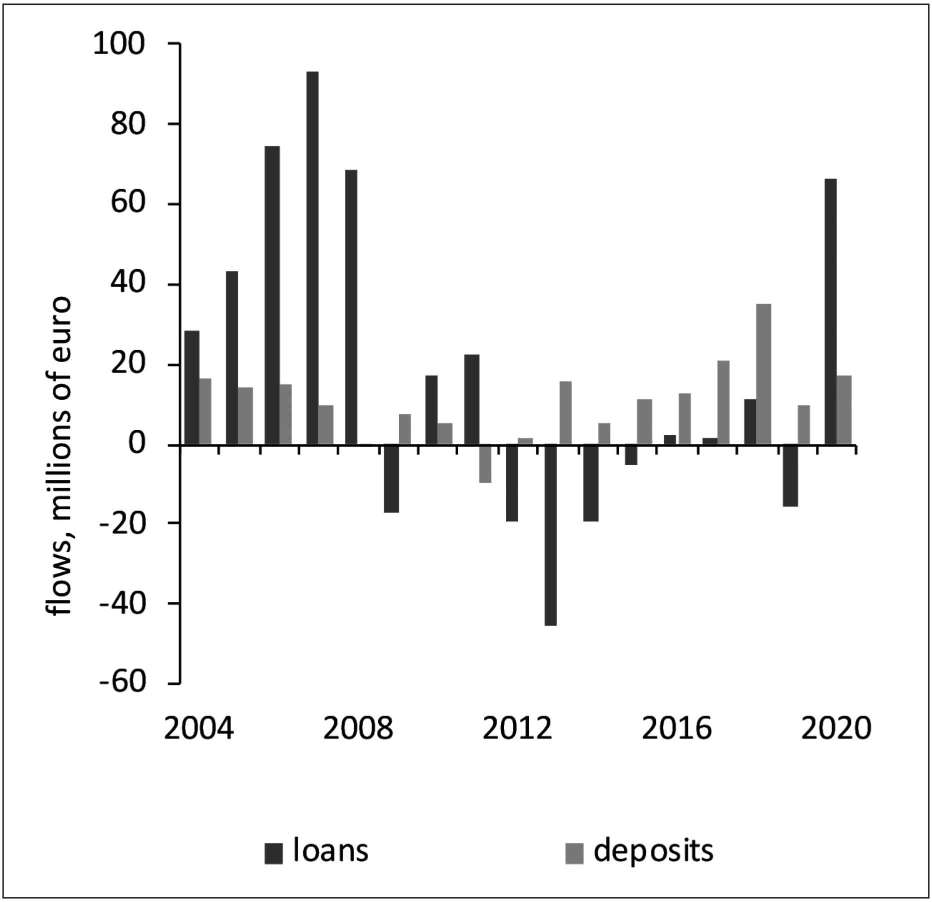


Fig. 4. *Non-financial firms: Bank deposits and loans.*



7. How long can negative key rates last?

At present, this is probably the most debated question. First, if the recent experience of negative key interest rates has been beneficial to the EMU economy overall and to its most heavily indebted governments, have some sectors of this large monetary area been severely hit by the present monetary setup? In the household sector, people who usually kept sums of money largely exceeding their strict transaction needs in bank deposits probably incurred losses before reacting to the new situation with the necessary portfolio adjustments. Others may have perceived the novelty of costly deposits as a violation of one of their civil rights. An accurate assessment is difficult, because some of these people also own bonds bought when interest rates were higher than now and consequently enjoy sizable capital gains. A clear distinction between sectors showing gains and losses should be based on statistics on the financial wealth of the institutional sectors.[2]

If the question is whether a non-minor inflation following the present economic recovery would call for abandoning the low rates, the likely answer is "certainly yes in nominal terms, probably not or not immediately in real terms". Note, moreover, that in a setting of free capital movements and ingenious finance, it seems unlikely that agents would not gradually find ways to avoid custody charges on deposits.

However, to gain a more satisfactory view of the problem, many more details of the scenario should be spelled out. In particular, the changing terms of trade and the prevailing monetary policies in the major economies should enter the picture we want to analyse. In any case, while this article was being finalized (end of February 2022), the unexpected outburst of the Ukrainian crisis obviously made any forecast meaningless.

8. A foray into the history of monetary thinking

It is worthwhile remembering that some economists of the past occasionally explored the theoretical possibility of negative interest rates policy. Keynes, in a few passages of his *General Theory* (1936),[3] devotes considerable attention to Silvio Gesell, a German economist and author of several works on monetary problems. He published a complete collection of all his writings in German in 1916, followed by an English translation under the title *The Natural Economic Order* in 1919. The main reason to mention him in the context of negative interest rates relates to his policy proposal to rely if needed on 'stamped money' to support effective demand. Gesell's *stamped money* consisted of special banknotes, losing their value at a short maturity, but renewable before maturity for a modest fee. Looking carefully, stamped money turns out to be just another name for bank deposits paying negative interests. Considering the incentive to buy real goods that a

2 While revising this, I ran across a very recent joint publication by the Bank of Italy and ISTAT (2022) presenting data on the composition of Italian real and financial wealth in a format matching, at least for Italy, the need I noted above.

3 Chapters 3, III: 23, VI and VII: 24, III.

negative interests rate would produce, Keynes' interest in Gesell's proposal is not surprising.

9. Time to update the role and rules of central banking

On the ECB website, the Bank's objective is still described as that of maintaining the purchasing power of money constant over time. In my opinion, saying this today is not sufficient. Besides statutory definitions, central banks have for decades acted to stabilize the financial markets with the ultimate intent of stabilizing the evolution of the real economy. The more the world economy evolves into a global economy, the more a central bank that sees its task from the perspective of a single, isolated economy where fiscal policy is responsible for the real guidance and the central bank's effort is preventing inflation is reductive. Up to now, international trade has continued to increase, and the global players have shaped a world where the three major currencies – dollar, euro and yuan – maintain a certain degree of stability in their reciprocal exchange rates without ruling out slow adjustments with an eye to their current foreign imbalances. Most of the minor players must take the key exchange rates and the key nominal interest rates as variables over which they have no (or very limited) power. A look at the global world economy shows a tendency to share similar real cycles with leads or lags that rarely exceed a few months. This implies non-independent economic policies.

10. Next to low interest rate policies in the EMU

With specific regard to the EMU, the member country governments seem to have recently taken an important step forward on the path to a common fiscal policy, aiming at reducing their growth disparities. If commodity-led international inflation persists, a low interests rates policy of support for the most heavily indebted countries will necessarily play a smaller part. Up to the beginning of February 2022, the EMU area was expected to return to a growth and stability pact. If this scenario is confirmed, which cannot be taken for granted, the maximum 3 per cent government deficit rule will have to be updated. In my opinion a clear distinction must be made between types of deficit whose multiplier is less than one and types of deficit which promise multipliers higher than one, to prevent perverse combinations of excess private sector saving (due to super-precautionary behaviour) and insufficient public sector deficit (due to blind rules): such combinations can produce catastrophic results. Opportunities for major

EU joint enterprises in the areas of climate control, clean energies, digital transition, AI applications and others offer promising alternatives to the mistakes of the past. Specifically, the investment program for relaunching the economy should not be limited to considering the short-run demand effects on the GDP level, but also include the medium- and long-run adjustment of the sectoral capacity that must accompany the desired growth path and the desired effects on employment.

11. Proposals for the reform of the Stability and Growth Pact

Several proposals have recently been advanced for adopting more sensible budget control rules. Lorenzo Bini Smaghi has published an article which clearly explains why rules assuring no error in determining the maximum admissible deviation from the government deficit spending target – intended as a cycle stabilization instrument – are practically impossible to formulate, the reason being that expected GDP itself cannot be accurately predicted. For this reason, it is likely that the search for an at least satisfactory rule of thumb will not be an easy one. If in addition the common EMU budget were to become a significant percentage of the entire EMU GDP, the problem of defining a maximum admissible budget deficit would probably loose relevance.

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