Twitter Thread by Lena Komileva



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The ECB's long-standing negative rates policy remains unpopular in a union of chronic high savings (demand deficits) & yield-hungry investors. Here I argue that the ECB must do everything it can to escape its liquidity trap of “negative rates forever” CC @elerianm @VMRConstancio

> There\u2019s a strong case to be made for allowing eurozone borrowing costs to fall lower, says @komileva https://t.co/bO86NHutqs
>
> — Bloomberg Opinion (@bopinion) December 14, 2020

First, negative rates are a reflection of a problem. Sub-zero arrived in Europe in 2014 in response to a critical problem of policy credibility – the arrival of the zero lower bound for the ECB’s main policy rate in the face of persistently low inflation expectations /thread/ 2/n

Europe, like much of the developed world, had seen a secular decline in the trend real rate even before the Covid19 shock, reflecting ageing populations and slower trend productivity growth - higher hhlds savings demand, lower business demand for capital #ECB #negativerates 3/n

The structural shock of the pandemic only accelerated the processes that began a decade ago with the Global Financial Crisis and the Euro government debt crises, pushing the eurozone trend rate even lower. #ECB #negativerates 4/n

This leaves the ECB facing a symmetric credibility challenge. In normal times, the ECB policy rate will follow the trend rate lower. If expected inflation adjusts to the demand-determined output gap, then the policy rate must fall below the equilibrium rate to bridge the gap. 5/n

But these are not normal times: the ECB’s excess bank o/n reserves rate is already negative and the effects of a more negative rate on the aging savers and lenders of the Europe’s wealthy but fiscally conservative creditor nations would be extremely politically unpopular. 6/n

This leaves us with the other side of the problem: that of the ECB not doing enough. The ECB’s own inflation projections, with QE and TLTROs extended, signal that even a strong post-pandemic recovery will not close the Eurozone’s inflation gap and meet the ECB’s legal mandate 7/n

So I argue that the ECB must do everything it can now to escape an inefficiency debt trap where the ECB's low rates are not low enough to stimulate demand, leaving the Eurozone in a "negative rates forever" regime, with damaging LT consequences for banks and market efficiency 8/n

Prejudice and collective cognitive bias aside (and I know it's hard, hence the need for a public debate), the experience of the 2020 pandemic shows that negative rates have played a critical role in the ECB's toolbox – in fact without them Europe will be in a financial crisis 9/n

In this article, I call the ECB's negative rates The Great Equalizer, helping to redistribute capital directly into the continent's economic emergencies and benefiting the weakest borrowers the most. 10/n

Let's debunk this: The ECB's -0.5% overnight deposit rate sets the floor for €STR – over 60bps below the US equivalent benchmark overnight bank funding rate! This in turn sets the benchmark for the euro money market curve, which in turn anchors Euro government yield curves. 11/n

The gravity pull of the ECB's NEGATIVE overnight rate, together with the effects of the ECB's asset purchases & loans on closing CREDIT risk spreads, have allowed most euro govnt to fund their Covid programmes in the markets at negative rates. GRE and ITA 10y yields below US!12/n

This, is in a year of record macro volatility, without a full fiscal union, merely 5 years after the sovereign debt crisis! In 2020 governments have transferred stimulus worth 20-30% of GDP into their economies to support businesses and jobs put at risk during the pandemic. 13/n

The combined magnitude of the Eurozone's record double-digit nominal GDP contraction through the pandemic-shaped double-dip recession and the parallel rise in Eurozone public debt to GDP exceeds that of the euro crisis and the GFC combined. 14/n

So, again without the ECB's regime of tiered negative rates + QE + interbank market backstops (TLTRO, PELTRO), each of which plays an integral part, the Eurozone would be in a financial crisis, and we'd be in a Global Financial Crosis 2.0, a decade after the first. 15/n

Does this mean the ECB's job is done and there's nothing more a central bank can do? It's a popular view but this doesn't make it right.

In reality, the Eurozone needs lower real medium-term rates, in order to secure a strong reflationary recovery with market stability. 16/n

Whilst it is impossible to estimate the Eurozone's neural rate in or after a once-in-100yr pandemic, Euro rates still look fundamentally expensive. Chronically weak inflation expectations and the EUR's appreciation vs faster-growing economies – show we're above equilibrium. 17/n

What's more, the economic emergency will outlive the health emergency HT @Isabel_Schnabel We won't return to pre-pandemic levels of economic activity at least in the next two years. Another decade of output and inflation gaps will put further strain on the @ecb's credibility 18/n

If the best hope is a lengthy economic recovery from the coronavirus, debt levels will remain high for the foreseeable future. Europe will need much stronger growth after the pandemic to set public and corporate debt levels on a sustainable path, w/out recessionary austerity 19/n

Thankfully, as I explain in the article, the ECB's dual negative rate system of an overnight deposit rate AND a separate parallel longer-term bank lending rate creates critical policy and political capacity to go further into negative territory, whilst benefiting lenders. 20/n

The ECB's own Bank Lending Survey shows that lenders see -ive rates as having led to cheaper borrowing costs for customers and higher loan volumes, in effect driving the monetary expansion in Europe. For bank margin rates, see the evidence: https://t.co/4RELq7fpyG 21/n

In summary, the political and economic costs of a liquidity trap of a low-growth, low-inflation, high-debt future for Europe would be infinitely greater than the pain of finding the lower effective bound for ECB rates in a recessionary pandemic, in a post-globalisation world. END