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Consequences of present Euro area monetary policy on savings and capital wealth formation

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Parliamentary evening in Brussels

As we all know, the ECB has engaged in a very bold expansionary monetary policy, particularly since the beginning of 2015.

My purpose is not to discuss the QE policy of the ECB.

My mandate this evening is to try and understand the impact of this policy on savings and on investment.

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I – Consequences of QE on European savings

A) The balance between savings and consumption.

Yields - very close to 0 or even lesser – on riskless investments should, normally, dissuade economic agents from saving and induce them into more consumption, which would support growth.

But, contrary to the hopes of many, “financial repression[1]”, especially in Europe, does not always result into an increase in consumption.

Households savings in countries like France and Germany are structurally high (respectively 15% and 17% of incomes) and have remained stable. They ensure more than 80% of the financing of the European economies.

The financial part of those savings is mostly of a precautionary nature (to face life uncertainties, unemployment, old age …) and is also constituted for transmission purposes. The majority of such funds are placed in savings accounts, insurance and pension funds which are themselves invested in “safe” assets.

[1] *Some banks in Germany are beginning to charge their household clients a negative rate on their current accounts (higher than 100,000 €). Some French banks are applying such rates on enterprises.*

When the yields fall or, sometimes even disappear, as a result of monetary policy, it would be logical to see savings switch to equity instruments that can provide, over the longer term, more satisfactory returns, all the more so if investors believe in an upturn of the economy.

In fact, it is that process that took place in the US as a consequence of Quantitative Easing (QE) . With lower long term rates, equity markets rebounded exactly in line with the creation of liquidity by the Fed. That upturn in equity markets triggered a "wealth effect" which contributed to more consumption.

But in the Eurozone, as I will show later, this process doesn't seem to work : no shift to equities, no wealth-effect. Indeed European savers are not the same as those in the US. They are basically risk-averse, and are not inclined to buy shares (which anyway would be, most often, penalized by the tax system).

Perhaps more worryingly, for policy makers, the shift of repressed financial savings to consumption doesn't seem to work either. Indeed, one observes that a significant number of savers are trying to offset lower returns by more savings.

B) Savings, consumption and low interest rates.

Let us look into this crucial issue in more detail[2].

- Gross household saving rate in the Eurozone has been hovering around the high level of 12,5% of disposable income for the last 5 years ***(see Graphs 1 and 2)*** in spite of QE ;
- Germany's household savings ratio remains high and stable over the last 15 years : around 17% of disposable income. And this rate has not been materially influenced by the fall in German Bond yields which have tumbled (from 10% to 0,5%) over the period 1995-2015 ;
- France's household savings also show much resilience at around the - very high - level of 15% of disposable income. There is little correlation between bond yields and household savings behavior ;

[2] *See : « ECB and Europe's oversaving problems » by Paul Jackson – Les cahiers de l'OEE May 2016.*

- Switzerland is an interesting case in point : households savings rate has increased dramatically from 21% in 1999 to 26% since 2015 during the years of monetary expansion and ultra low interest rates ;

- The corresponding figures mark an evolution of 5% to 19% in Sweden and 1% to 11% in Denmark over the same period ;

- In the United Kingdom, the household saving rate surged from 6% to 12% after the Bank of England dramatically lowered its intervention rate from 11% in 2007 to 0.5% in 2009 ;

- Even in the US it now appears that lower interest rates are associated with higher savings (while it was not clear before QE).

I know that we should be careful not to jump from these figures to too simple conclusions.

Some saving behavior may indeed have been impacted (boosted) by the uncertainties stemming from the financial crisis.

One can add that in some countries higher financial and non-financial investment may be associated with larger borrowing, a combination that would not result in a fall in consumption.

Be it as it may, it remains that :

1- When studying the interest rate – savings behavior, we see that the "income" effect (which requires a higher level of savings to offset the consequences of lower or negative interest rates) has been manifest in most European countries, while the "substitution" effect (saving less to spend more) seems difficult to establish (except for the UK and Italy although the picture is unclear in the latter case) ;

2 – this "income effect" is one of the factors that explains the resilience of household savings in Europe during the last years of low interest rates ;

3 – the UK is the only significant case where the "substitution effect" dominates (more spending when rates fall), which also explains the current account deterioration of that country ;

4 – This tendency for large Eurozone countries to maintain or even increase household savings is in line with the increase of the current account surplus of the region :

Eurozone current account surplus (as a percentage of GDP)

	2013	***2014***	***2015***
Eurozone	+ 2,2%	+ 2,5%	+ 3,2%

Source : ECB

The interesting fact (but worrisome for monetary policy makers) is that **the QE years in Europe have been globally accompanied by larger national savings and higher current account surpluses.**

All in all, the European experience does not suggest that extremely low interest rates (or negative ones) are a recipe for economic growth and the revival of consumption, let alone of investment.

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II – Consequences of QE on investment in Europe

A) The behavior of investment in the Eurozone is lackluster.

The gross fixed capital formation trend has been disappointing in the Eurozone as compared with the whole group of advanced countries.

Annual average growth rates of Gross Fixed Capital formation from 2008 to 2017

All advanced countries	+ 0,4%
Eurozone	- 0,8%

Source : IMF – World Economic Outlook 2016

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B) Productive investment (carried out by non financial enterprises) appears quite insensitive to changes in interest rates.

Recent studies[3] have found that only 8% of firms in a September 2012 survey declared that they would increase investment if borrowing costs declined significantly. By contrast, 68% did not expect that any decline of interest rates would lead to more investments. This is all the more striking that interest rates were much higher in 2012 than they are today. These observations are consistent with the more recent ECB surveys.

The determining factors cited by enterprises in business surveys regarding their decision to invest are always :

- Expected sales,
- Future growth,
- Confidence.

Interest rates changes are hardly mentioned in the list of significant factors.

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C) Low interest rates do not seem to boost equity in the Eurozone.

One of the assumed advantages of QE (which reduces long term interest rates) was to dissuade savers from investing in 0 yield riskless assets and to divert them into equity.

This does not seem to take place.

Since the ECB launched its bond purchase program in 2015, the MSCI-EMU Index actually has gone down by 15% which is in contrast with the US experience *(see Graph 3)*. The reasons behind this bearish performance of Eurozone equities are not related to monetary policy, but to the weakness of expectations on economic growth and profitability of non financial corporations

It is clear that low interest rates, if anything, have not boosted the stock market in the Eurozone.

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[3] *See Sharpe and Suarez (2014) referred to in William de Vijlder article in "Conjoncture" - BNP Paribas sept/oct 2016 : "What is driving corporate investment ?".*

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<u>D) In a region where banks account for the overwhelming part of the financing of the economy, it is essential to keep the banking channel open and active. Extremely low interest rates compound the difficulties of that problem.</u>

In the Eurozone, banks represent 70% of total financing of the economy (the reverse in the US where financial markets play the predominant role).

But banks in the Eurozone have been deleveraging over the past years.

- For 4 years (2012-2015) the outstanding amounts of bank credit to enterprises has been reduced by 2% to 3% per year.

There has been a revival of bank credit since 2015 (albeit only 1,8% increase). But Spain and Italy continue to be in negative territory.

- On top of demand driven factors that explain part of the dampening of bank credit, there has been a sharp increase in banking regulation constraints which limits the ability of European banks to expand their business ;

- The low interest rate environment of today compounds this evolution and contributes to erode the average profitability of banks (ROE : 4% in 2015 in EU against 9% in the US) ;

- The envisaged additional constraints on risk weighting ("Basel 4") could amplify this phenomenon and make deleveraging a bigger threat.

While it would be logical - and essential - to preserve the transmission channel of Monetary Policy (i.e. banks ability to lend) we see a continuous move towards more and more procyclical regulatory rules on the banking sector.

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Contrary to what is often pretended, the more monetary policy is well intended and increases its ease, the less investors seem to be tempted to take advantage of it. If “actualization” (discount) rates, as they are set by private investors today, are high and conservative in spite of the low interest rate environment, and if savings are resilient, it is perhaps because the “extreme” consequences of lasting monetary laxity are seen as additional factors increasing uncertainty as well as undermining confidence in future growth. In such an environment, **it is vital that central banks instill confidence and reinforce long term stability signals**.

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Conclusion

The risks incurred by too prolonged an accommodative monetary policy could be huge not only for the future of the economy but also for our society. Even if it’s obvious that the “natural” equilibrium interest rate tends to diminish in an environment of weak growth and high savings, this does not mean that it must become negative.

The interest rate will always remain the price that savers are entitled to expect for having accepted, for a given period of time, to postpone their immediate consumption. To say that such a price should become negative goes against common sense (time would be abolished !) and could bear grave consequences for the future.

How could one calculate with negative rates the returns expected on an investment ?

What would be, in a market economy, the future of long term investment projects that would involve high fixed costs and high risks? who would finance them without adequate remuneration[4] ?
Resource allocation tends to lose its efficiency when interest rates get very low. Indeed, the only projects that can be financed at current prevailing rates are the ones which are viable with very low rates. Less profitable and more risky investments (but perhaps socially more beneficial) could be left aside.

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[4] *More a project is risky and more its profitability is uncertain, more its discount rate (used to determine its present value) must be high, if private markets are to finance it.*

It is a fact that the present European monetary policy is hurting insurance companies and pension funds. These institutions have long term liabilities vis-à-vis their clients. But the yields produced by their assets are edging towards 0. How can those institutions solve this discrepancy[5]? Let's not forget that insurance companies and pension funds used to play an essential role in the buying and holding of long term investment securities as well as in ensuring market liquidity. To make things worse, this fundamental mismatch stemming from extremely low rates, is compounded by regulatory constraint (Basel, Solvency II).

The current preoccupation with the inflation goal should not overlook the dangers of asset bubbles. Negative nominal interest rates are hurting households, insurers and pension funds and are historically unprecedented. Let us not forget that a similar process was at work in the running to the credit crisis.

Truth is unfortunately simple :

It is not through lasting and massive liquidity creation - or even “monetary policy devaluations” - that growth issues can be tackled. Too much debt always leads to bubbles, to search for yield, to higher risks (insufficiently priced) and, ultimately, to crises.

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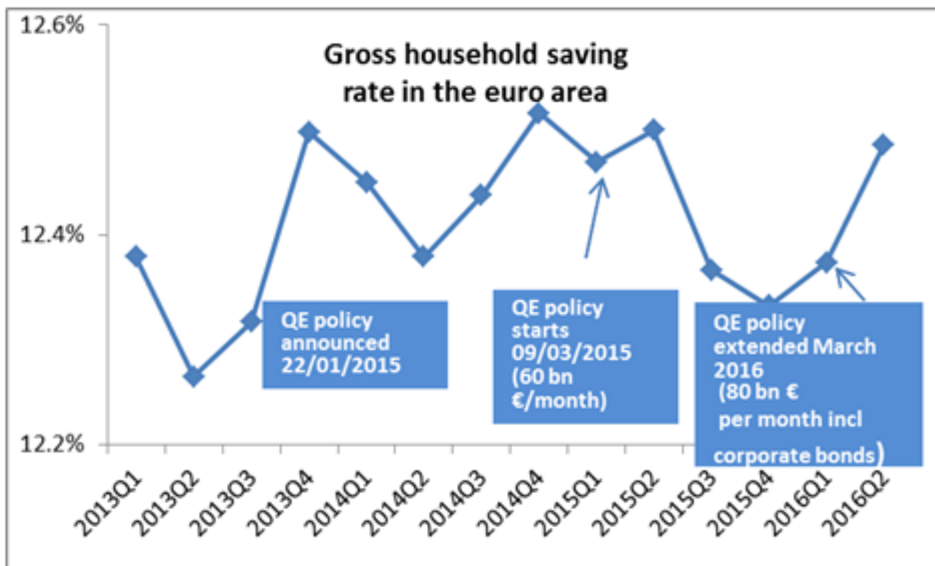
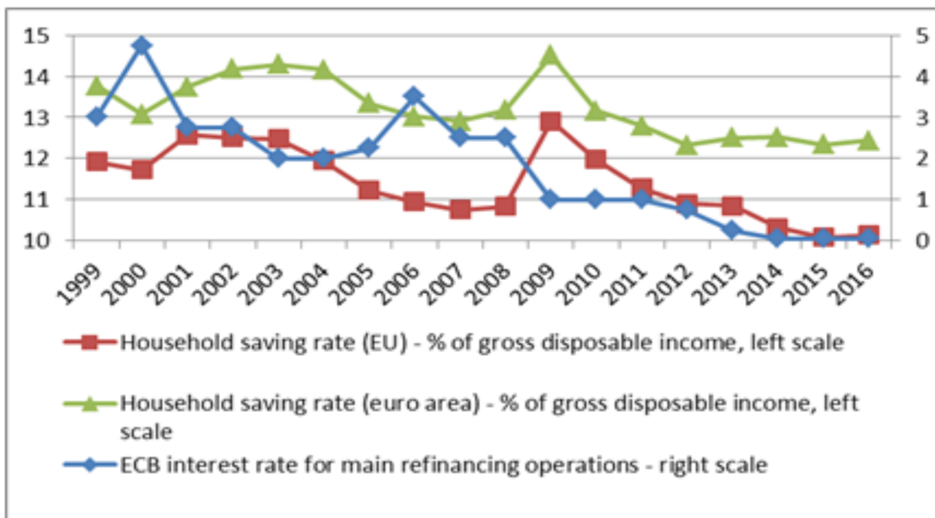
See Graphs Page 9

[5] *US defined benefits pension plans have moved from fully funded in 2000 to 74% funded (end 2015).*

Graph 1



Graph 2



Graph 3