

## Twilight for negative rates as inflation storm gathers

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It is now twilight for negative rates. The ECB in its just published (December 2019) virtual propaganda piece on “A Tale of Two Decades: the ECB’s monetary policy at 20” says as much.

Using latest state of the art econometrics, the ECB authors estimate that negative interest rate policy (NIRP) made a peak contribution of 0.2 percentage points to economic growth in 2017, small compared to a cumulative 2.7 percentage point gain over four years (2015-18) from the other unconventional policies - asset purchase program (APP), forward guidance (FG) and long term repos (LTROs).

Critics can take issue with these estimates. They exclude present and future costs of unconventional policies in the form of massive malinvestment (real estate bubble, bloated export sector) or of the eventual bust when asset inflation turns to deflation. As a practical matter though, saving face for unconventional policies whilst downgrading NIRP will suit ECB Chief Lagarde fine.

The Chief knows that negative rates are unpopular with German savers. She also realizes that the future of monetary union depends on Berlin remaining behind the ECB. That includes implicit approval for its vast operations under the guise of monetary policy to pump funds into Italy and Spain. Christine Lagarde will step up the APP, with a focus on the financing of Green projects, whilst fading out NIRP. Given the strong-likelihood that a Green-CDU coalition government will soon rule in Berlin, that strategy could cement a pact between the ECB Chief and the German Chancellor.

The whitewashing in the report of serious ECB policy flaws in fact suits Chancellor Merkel who in no way is inclined to move towards the Right and win back voters from the anti-euro AfD. According to the official history, the first decade was a big success story for ECB policy – good growth in real incomes and efficient use of conventional tools to hold inflation to the 2 per cent target. The second decade was more challenging due to powerful disinflationary forces, but the ECB has been valiantly fighting these with unconventional policies.

No mention here of the alternative historical narrative: in the first decade the ECB copied the Greenspan-Bernanke Fed’s inflationary monetary policies. generating a bigger bubble and bust in the euro-zone than the US. The challenges of the second decade are related directly to the failures of the first.



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Now, early in the ECB's third decade, monetary inflation long camouflaged in the goods markets by globalization, digitalization, and resource abundance, is emerging into the open. Governments around the world which have been relying on monetary repression tax, levied by their central banks which manipulate interest rates down to very low or even sub-zero level, will switch to inflation tax. Markets are already sensing this looming shift, as illustrated by the simultaneous rise during late 2019 of the gold price, equity prices, nominal long-term US interest rates, and the price of inflation-protected US Treasury bonds.

In Germany, consumer price inflation, if correctly measured to take account of sharply rising house prices, is already higher than in the US. The powerful re-bounce in European equities in 2019, the hot markets in housing across Northern Europe and the booming euro-based carry trades into credit and foreign currencies all testify to virulent asset inflation in the euro-zone. The danger of asset inflation was the proximate trigger to Sweden's central bank leading the way last month in scrapping negative rates – and so it will be for the ECB.

The abandonment of NIRP in Europe and its replacement by ZIRP (zero rate policy) does not amount to a big change. All the chatter, however, in the context of US inflation leading the way higher whilst the Fed holds down interest rates, will likely mean an Indian summer for the euro. But winter lies not far beyond as global asset inflation turns to deflation, and Europe's fragile banking system implodes.

EUR/USD chart since inception of the EUR in Jan, 1999



Source: <https://www.macrotrends.net/2548/euro-dollar-exchange-rate-historical-chart> Euro Dollar Exchange Rate (EUR USD) - Historical Chart



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