The Real Story behind Negative Rates

After months of intensive debate, on June 11, 2014 the ECB reduced the rate on its deposit facility from zero to – 10 bps. Effective September 10, 2014, the rate was reduced by a further 10 bps to -20 bps.

So what?

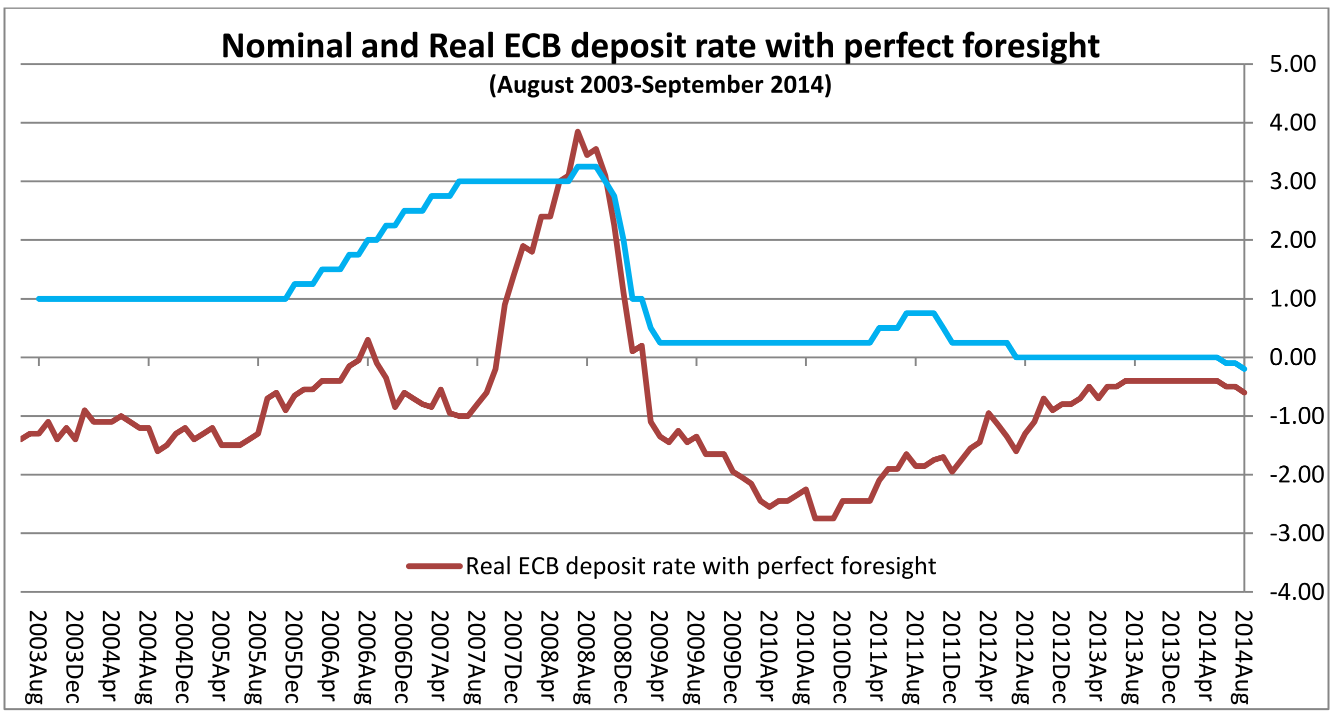
The truly baffling element of the discussion about negative rates is that it has been completely centered on *nominal* interest rates and that for at least two generations even beginning economics students have been grilled that it is "real", not "nominal" interest rates that matter. Examining the *real* ECB deposit rate, a few rather surprising facts emerge[1].

The real deposit rate has risen steadily since October 2010—for almost 4 years.

The real deposit rate is higher than it was pre-crisis.

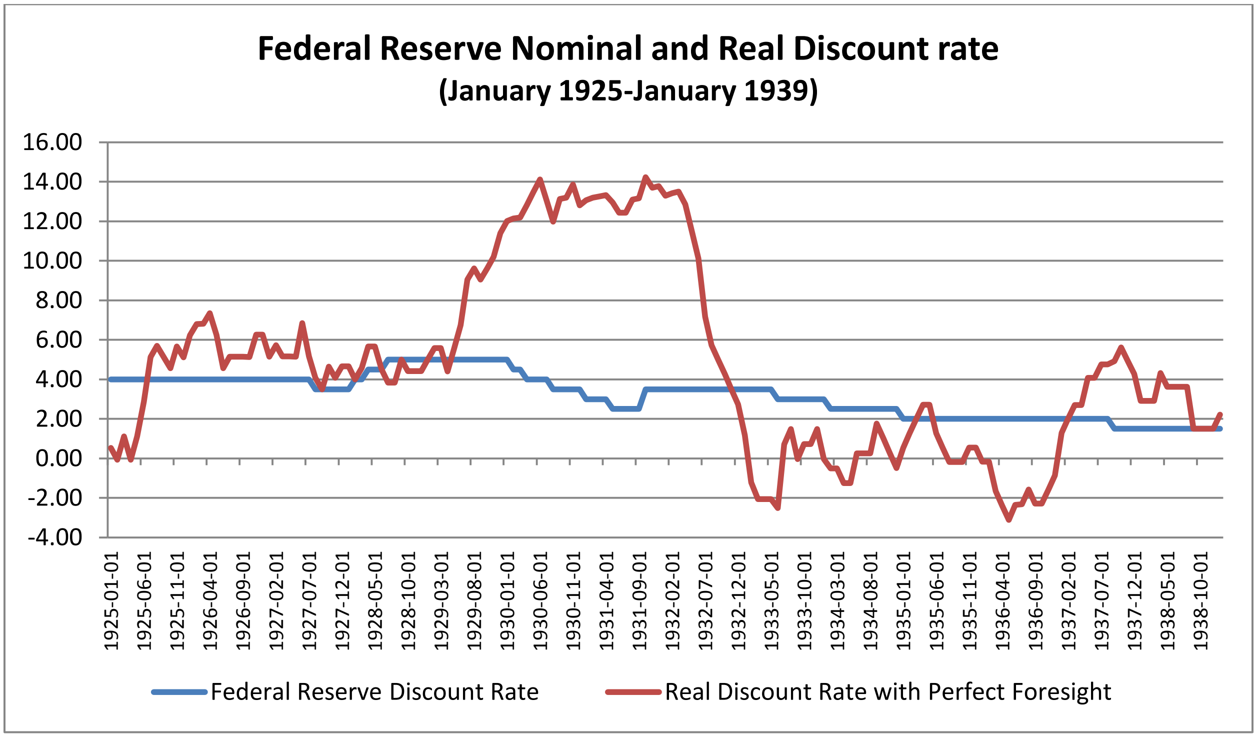
Although the nominal rate has never been lower, the real deposit rate has spent exactly 50 percent of the time since December 1999 at a *lower* level than it is now.

The impact on the real deposit rate resulting from changes in the nominal rate set by the ECB have been dwarfed by changes in the real deposit rate caused by changes in inflation since the crisis.



[1] The nominal deposit rate has been adjusted by annual inflation in the following 12 months. This real rate concept may be described as "perfect foresight" since it assumes expectations of inflation are correct, ex post. For the last year, current annual Eurozone HICP inflation was used as the deflator (0.4 percent).

Perhaps even more amazing is that confusion about real and nominal rates was a contributing factor to the Fed's failure to more aggressively fight deflation during the Great Depression. The graph below shows that changes in inflation dwarfed in magnitude changes made in the Fed's discount rate.



Source: St. Louis Federal Reserve FRED database and author's calculations.

Was this long debate about going negative nominal "much ado about nothing". Seems so.

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