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Central Banks / Global Economy

The ECB and the negative rates dilemma

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Last March, in its monetary policy meeting, the European Central Bank (ECB) decided to delay the expected interest rate rise, having announced that reference rates will remain at current levels at least through the end of this year - instead of until summer 2019 – as had been previously announced. This decision was no great surprise, given the weakness of the European economy and, in fact, the announcement, at some point, of an additional delay until mid-2020, is fairly likely.

However, at the same time, a more prolonged situation of negative rates - the interest rates for deposits has been below zero for almost half a decade - has triggered concerns in the ECB that, over time, the effects of persistently low rates could reduce banks' interest margins and profitability with negative effects on financial stability in the longer run. In its last monetary policy meeting, the central bank clearly stated in its announcement that it will consider possible measures to mitigate the side effects of negative rates, if any, on banking intermediation. In particular, the penalty for parking liquidity in the ECB is of -0.4% (the deposit rate), equal to 7.5 billion euros for the Eurozone banks. However, this cost is being mostly borne by the banks of central countries like Germany and France, basically due to the significant increase in surplus liquidity -up to 1.9 trillion euros -, and is concentrated for technical reasons in these countries since the beginning of the asset purchase programme (APP), better known as quantitative easing.

What options is the ECB considering? Among the measures being considered to alleviate the side effects of negative rates is the tiered system of reserves, which is being implemented by other central banks, such as Japan, Switzerland and some of the Scandinavian countries. This instrument has already been discussed in the past by the ECB and ruled out on the grounds of complexity, as the Eurosystem poses particular problems in terms of geographical fragmentation and the heterogeneity of its banks. The system would consist of setting a limit to surplus reserves at a negative rate, with different remuneration tranches for reserves over and above the mandatory level. This measure would help to reduce the cost of negative rates for the banks and assist the central bank to keep them at negative rates for a longer period if required for monetary policy reasons.

In any event, if the ECB should eventually choose this or any other measure it will be very prudent, ensuring that the benefits of negative rates for the economy are maintained, while at the same time mitigating such side effects. The premise of the monetary authority will be to avoid interfering in the transmission of the monetary policy; that is to say, it must avoid any tightening of financial conditions. In this context, the challenge for the ECB is managing expectations with regard to monetary policy very well, given that once the central bank has significantly lowered its growth outlook for the Eurozone and has announced a new liquidity provision at the start of the year, this measure could be construed as the ECB paving the way to reduce interest rates even further if necessary.

The decision on whether or not to adopt these types of instruments will most likely not be made imminently, as the central bank has stated that it is a matter that must be analysed in more detail; and, moreover, there are discussions within the ECB regarding the suitability of implementing these types of measures. Over the coming months we must be on the lookout for any news on the matter and, in the event that the ECB should once again delay rate-increase expectations, the likelihood of such measures designed to alleviate the effects of the negative rates being implemented will increase significantly.

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