

Eurozone

About negative interest rates

- The ECB reopened the debate over the effective floor for its interest rate policy stating it is considering another cut in its deposit facility rate.
- The negative rate policy is intended to loosen financial and monetary conditions, in particular through its effect on the exchange rate.
- The effects on lending and long-term rates are more mixed. In both cases, other monetary policy instruments – particularly quantitative easing – are more crucial.

At the press conference that followed the ECB's latest monetary policy meeting, Mr Draghi hinted at the possibility of another cut in the deposit facility rate as early as March. "We decided to keep the key ECB interest rates unchanged and we expect them to remain at present **or lower levels** for an extended period of time" said the introductory statement.

Assets can be held in the form of either (non-interest-bearing) cash or (interest-bearing) securities, and interest rates represent the return required by the lenders to forgo liquidity. In theory, interest rates cannot then be negative. In practice, however, holding cash comes with costs. These derive, for instance, from storage and transportation. While there is a lower bound to interest rates, this floor actually stands below zero.

Five central banks are currently operating with negative rates, including the European Central Bank¹. This policy is implemented through the Deposit Facility rate (DFR), which has been negative since June 2014 and currently stands at -0.30%. In concrete terms, this means that commercial banks pay a penalty of 0.30% on the amount of excess reserves they deposit with the ECB whether on the deposit facility or current account.

The ECB's monetary policy consists of a corridor formed by three interest rates: the interest rate on the main refinancing operations (*refi* rate) and two rates on permanent facilities – the deposit facility and the marginal lending facility – marking the lower and upper limits respectively of the corridor. By setting its policy rates, ECB influences the overnight interest rate (Eonia) in the interbank market which fluctuates within the corridor.

Until October 2008, the central bank's refinancing operations took the form of a variable-rate tender, with the ECB setting the minimum rate (*refi* rate). Banks were served in descending order of the interest rates they bid for. Since the alternative option was to raise funds in the interbank market, Eonia naturally settled at a level close to the refinancing rate.

¹ The others being the Swiss National Bank, the Denmark National bank, the Swedish National Bank and since January 2016 the Bank of Japan.

Policy rates and Eonia

— Refi; — Deposit Facility Rate — Marginal lending facility rate — Eonia

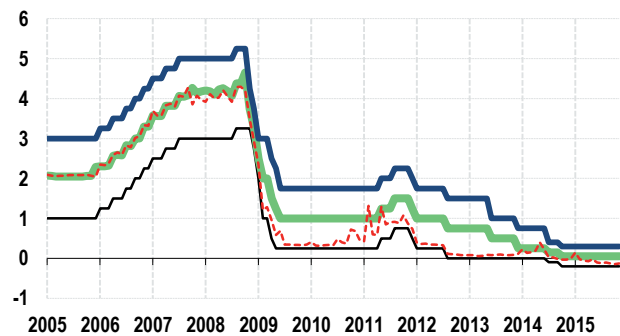


Chart 1

Source: ECB

Since October 2008, the ECB conducts its refinancing operations at a fixed rate (the refinancing rate), for unlimited amount. This change has led to a rise in excess liquidity, compounded by the launch of longer-term refinancing operations (LTRO) and direct purchases of assets as part of its quantitative easing (QE) programme. In response to this abundant liquidity, Eonia has moved closer to the DFR, which is now the ECB's "key" rate. As a result, Eonia has been in negative territory since September 2014. This has not led to disruptions in the interbank market. What matters is not the absolute level of rates, but the difference between the deposit facility rate and the refinancing rate: a bank with excess liquidity will agree to lend funds in the interbank market at a higher rate than the deposit facility rate. A bank requiring liquidity will call on the interbank market, if it can obtain funds at a rate below the refinancing rate.

The ECB's objective is to move inflation back towards a level close to 2% in the medium term. In the current situation, characterised by insufficient demand, sufficient stimulus is needed to close the output gap and revive an upward trend in inflation. This implies that the ECB can ease financial and monetary conditions enough to bring real market interest rates towards a level that would restore full employment – known as the equilibrium interest rate.

The real equilibrium interest rate is not observable or constant over time. At most, it can be estimated, notably from trend growth, which suggests that it has declined almost continuously over the past few decades. With the crisis, the prolonged period of deleveraging, and consequently, the savings glut, probably pushed the real equilibrium rate down into negative territory.



Given the lack of inflation in the eurozone, the ECB has no other option than to adopt a policy of negative nominal interest rates to obtain negative real interest rates. But that is not the only reason. Although the exchange rate is not an objective of monetary policy *per se*, it directly influences the orientation of financial and monetary conditions. In a highly insightful speech he gave in Amsterdam in April 2014² (i.e. before the DFR was lowered into negative territory), Mario Draghi stated the growing importance attached to the exchange rate in the assessment of price trends in the eurozone. In the same speech, he carefully outlined the ECB's reaction function: an undesired tightening in financial and monetary conditions (hence an appreciation of the euro) calls for a response by the central bank via its interest rate policy. Indeed, the switch to a negative DFR in June 2014 triggered a sharp decline in the euro. The depreciation came to a halt in spring 2015, then went into reverse, especially since mid-november : the nominal effective euro exchange rate against 38 partners is up by over 5% since then. Therefore, it was no surprise to see that Mr Draghi hinted at the latest press conference at the possibility of another cut in the deposit facility rate after referring to euro appreciation as a source of tension affecting financial and monetary conditions.

The most visible and rapid effect of a cut in the DFR is on the exchange rate. A weaker euro supports inflation, firstly in a direct, but fleeting manner, by driving up the cost of imported goods, then secondly and more fundamentally, by stimulating external demand and growth.

The effects on lending are not as clear-cut. While a negative DFR represents an incentive to put reserves into circulation in the interbank market and reduce fragmentation, the transmission to the real economy is not automatic: the volume of credit hinges to a large extent on whether there is demand for investment, and this remains limited in the eurozone. What's more, a negative deposit rate means that banks' excess reserves incur a cost, which may dent their profitability and trigger less favourable lending conditions. It is worth noting that new loan origination does not reduce the amount of excess liquidity in the banking system as a whole, since the new loans are matched by the creation of new deposits, and so the excess liquidity is merely transferred from one bank to another. The only way of making the excess liquidity subside is to reduce the banking system's exposure to the Eurosystem, something that is not going to happen with the QE.

The effects on the yield curve depend largely on expectations of future monetary policy and, to an even greater extent, on other monetary policy instruments, such as quantitative easing. This point is crucial. While the central bank has direct influence over short-term rates, the effectiveness of its policy depends on the extent which its monetary stimulus is transmitted across the yield curve. This is because the interest rate that matters for investment decisions is not the overnight rate or even the one-year rate, but rates over periods of between five and ten years. In principle, long-term rates are largely determined by current and anticipated short-term rates. To this extent, the reduction in benchmark rates tends to exert downward pressure on long-term rates.

² See <https://www.ecb.europa.eu/press/key/date/2014/html/sp140424.en.html>

Short and long interest rates

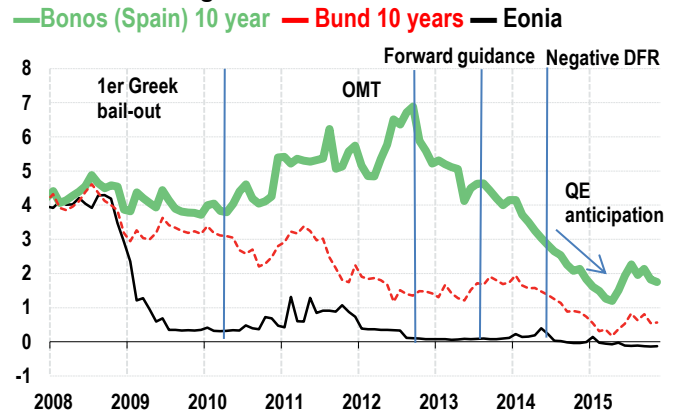


Chart 2

Sources : Thomson Reuters, ECB

Nonetheless, other factor can interfere with the policy transmission. For instance, the term structure can steepen due to higher perceived risk of default. In the area close to the effective lower bound, the transmission process depends on expectations to a great extent. If the market anticipates that the lower limit has been reached, future short-term rates can only increase, thereby putting upward pressure on long-term rates. As a result, the central bank's communication is crucial. By reopening the debate over the actual lower bound for its interest rate policy – previously considered to have been reached at -0.2% – the ECB has created fresh leeway for its conventional policy.

Nevertheless, at lower bound of interest rates, QE is becoming key. Through its sovereign debt purchases, it enables the ECB to wield direct influence over long-term rates. The other expected effect of quantitative easing is to raise inflation expectations. It is important to remember that investment decisions are based on real and not the nominal borrowing terms. These may tighten when inflation expectations dip lower and when rates are at the floor. The quantitative easing programme can create new leeway for monetary policy by raising inflation expectations, which is not yet happening in the eurozone.

The benefits of a fresh reduction in rates derive first and foremost from the euro's exchange rate. The effects on lending are not as clear-cut. While lending should continue to gain momentum in the eurozone, the pick-up will come more from measures supporting lending (LTRO) and quantitative easing than from a cut in the DFR. As to long term rates, their evolution will mostly depend on non conventional monetary tools, namely forward guidance and QE. The efficacy of monetary policy will also depend crucially on the ECB's ability to raise inflation expectations – an objective it has yet to achieve.