The ECB Negative Interest Rate Policy

European Central Bank

On June 5, the European Central Bank announced a new interest rate policy. For now, the ECB will pay negative interest rates on reserve deposits owned by commercial banks and held at the ECB. The purpose of this article is to explore the ECB negative interest rate policy.

The table below shows current interest rates:

Key figures at a glance	
Marginal lending facility	**0.40 %**
Main refinancing operations (fixed rate)	**0.15 %**
Deposit facility	**– 0.10 %**

(Table from http://www.ecb.europa.eu/home/html/index.en.html)

The ECB has a FAQ about this policy at that is actually pretty good, especially regarding the impact on households (none).

Why a Negative Interest Rate?

The idea is simple. Reserves kept as deposits at the ECB will be charged 0.10% per year. The ECB wants banks to lend those reserves, stimulating business investment and the economy. By penalizing reserve holdings, the ECB hopes to encourage lending.

Like any central bank, **the ECB requires banks to hold a fraction of deposits as reserves.** Items that can be counted in bank reserves include **vault cash and reserve deposits at the ECB. A third category, borrowed reserves, is also allowed. In ECB-speak, borrowed reserves are "Main refinancing operations," federal funds are the "Marginal lending facility" and reserve deposits are the "Deposit facility."**

The ECB argues that lowering the interest rate on main refinancing operations by 10 basis points (0.25% to 0.15%) requires an equal reduction on deposit facility interest rates (from 0% to -0.10%). There is a point to maintaining a difference between the two interest rates because you want to discourage banks from borrowing reserves as a substitute for holding reserves. **Remember that when a bank borrows reserves, the bank is the borrower and the ECB is the lender. A positive interest rate means the bank pays the ECB that interest rate for borrowing reserves.**

Isn't it possible for banks to avoid the negative deposit rate? For example, can't they simply decide to hold more banknotes?

If a bank holds more money than is required for the minimum reserves and if it is not willing to lend to other commercial banks, it has only two options: to hold the money on an account at the central bank or to hold it as cash. But holding cash is not cost-free either – not least since the bank needs a very safe storage facility to warehouse the banknotes. So it is unlikely that any bank would choose to do this. The more likely outcome is that banks either lend money to other banks or pay the negative deposit rate.

But reserve deposits are different. The bank is the lender and the ECB is the borrower. A negative interest rate transfers money from the lender to the borrower. In other words, banks will have to pay the ECB 0.10% per year times their reserve balance at the ECB.

Strategies for Banks to Avoid This Interest Rate

One obvious way for banks to avoid paying this interest rate is to **simply not hold any reserves at the ECB.** That means the bank's **total reserves would consist of vault cash and borrowed reserves. The ECB can, of course, turn down a bank's request to borrow reserves. Will any bank dare to hold their entire reserve balance as cash? The ECB doesn't think so. This is their statement from the FAQ mentioned earlier →**

The ECB Statement on Operations

(Click here for the full source.)

> ***Monopoly supplier of monetary base***
>
> *The Eurosystem is the sole issuer of banknotes and bank reserves in the euro area. This makes it the monopoly supplier of the monetary base, which consists of*
>
> - *currency (banknotes and coins) in circulation,*
> - *the reserves held by counterparties with the Eurosystem, and*
> - *recourse by credit institutions to the Eurosystem's*

> *deposit facility.*
>
> *These items are liabilities in the Eurosystem's balance sheet. Reserves can be broken down further into required and excess reserves.*
>
> *In the Eurosystem's minimum reserve system, counterparties are obliged to hold reserves with the national central banks (NCBs). Beyond that, credit institutions usually hold only a small amount of voluntary excess reserves with the Eurosystem.*
>
> *By virtue of its monopoly, a central bank is able to manage the liquidity situation in the money market and influence money market interest rates.*

Conclusion

We live in interesting financial times. That ancient Chinese curse seems appropriate today. Frankly, nobody knows whether the ECB's new policy will work or not. If the real problem is a lack of demand for quality loans, then paying 0.10% per year to avoid riskier loans may seem like a pretty good deal. The ECB is implicitly assuming the problem is lack of loan supply. I'm skeptical of this – not just in the Eurozone, but in the U.S. as well.

Cyprus

Queueing at a Cyprus Bank: Too Late, Suckers

Reports today put the **Cyprus haircut at 60% of deposit balances in excess of €100,000. This is startling, as rumors were in the vicinity of 40%. What happened?**

In reality, I have no idea. But this is a blog so I'm allowed to speculate. €100,000

"But Prof. Lima," you say, "we thought Cyprus banks were closed. Where did those deposits vanish? And how did anyone get to them?"

Kids, if I knew the answer to that I'd be either retired or in jail. For sure I wouldn't be writing this blog. **But here's a guess.** Cypriot banks have, according to rumors, quite a bit of experience with various methods of moving funds around. And **you can be sure that the Cypriot bankers were far more afraid of the Russian mafia than the European Central Bank**. I'll go out on a limb and speculate that **the Russians will not be getting much of the haircut. A whole bunch of their deposit balances are no longer there. Leaving the suckers …, er, strike that, the regular customers holding the bag.**

Which leads me to remind you of a simple fact. **If there's**

going to be a run on a bank, it's best to be near the beginning of the line. Or have a high-speed internet connection directly into the bank's computers.

If you'd like actual information, the New York Times has a pretty good article.

Are Markets Stupid?

Are markets stupid? Or what? Today's (July 26) worldwide rally was apparently sparked by this statement from Mario Draghi (from the Wall Street Journal):

'[The European Central Bank is] "ready to do whatever it takes to preserve the euro," which analysts say could include Spanish bond purchases and further stimulus.'

This statement is positively Krugman-esque. Serious economists know there are limits to monetary policy. A central bank can, at best, create money. (In the U.S. with our current excess reserves trap, the Fed's ability to influence M1 is debatable at this point.) Mr. Draghi seems to think a central bank can solve all problems. He should learn some economics. We know that, like most institutions, there are limits to what monetary policy can accomplish.

It's Greek to Me

It's Greek to me. The Greek prime minister is on Twitter. I follow him. Usually his tweets are in Greek followed a few minutes later by the English translation. Saturday, there were 13 consecutive tweets in Greek, no translation. Suspicious.

Greek PM: 13 and Counting

The last 13 tweets by Greece’s pm have been exclusively in Greek. Normally he follows a Greek tweet with an English translation. Not now. What’s he trying to hide? I can read a little Greek, but this calls for crowdsourcing.