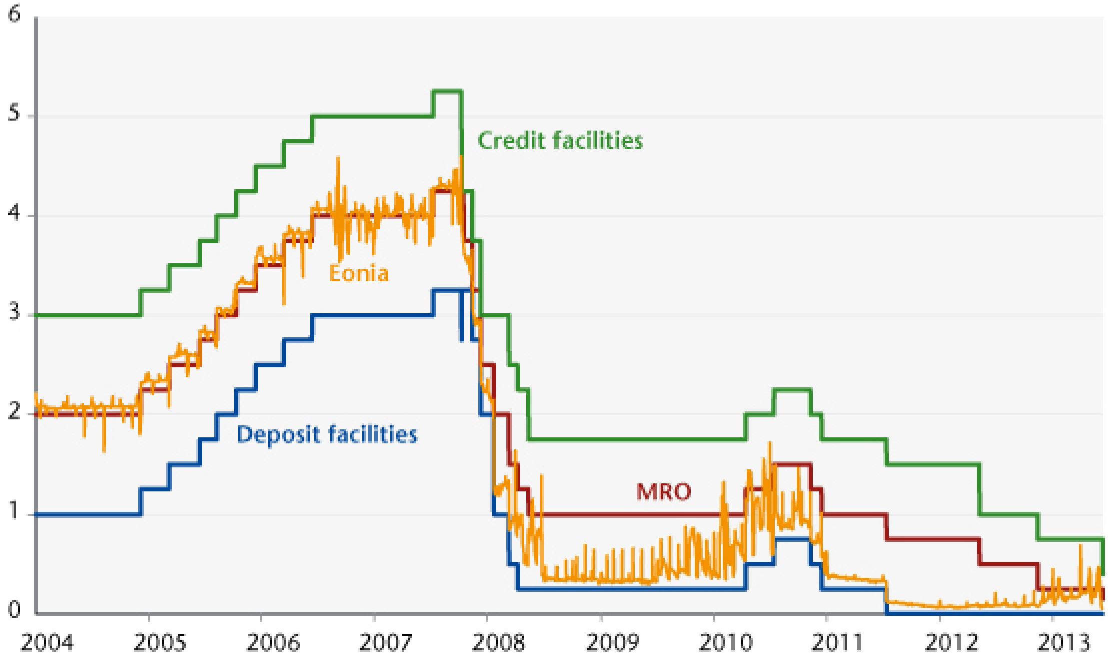
Why a negative interest rate?

Christophe Blot and Fabien Labondance

As expected, on 5 June 2014 the European Central Bank (ECB) unleashed an arsenal of new unconventional measures. The aim is to curb deflationary tendencies in the euro zone. Among the measures announced, the ECB decided in particular to apply a negative interest rate to deposit facilities. This unprecedented step deserves an explanation.

Note that since July 2012, the rate on deposit facilities has been 0%. It now falls to -0.10%, meaning that a bank depositing cash at the ECB will have its deposit reduced by that rate. Before considering the repercussions of this measure, it is worth clarifying the role of deposit facilities. The ECB's activity is baed on loans to credit institutions in the euro zone through the channel of main refinancing operations (MRO) or long-term refinancing operations (LTRO). Prior to the crisis, these operations were conducted at variable rates based on an auction mechanism, but since October 2008 they have been conducted at fixed rates. The refinancing operation rates must allow the ECB to influence the rate charged by credit institutions for interbank loans (Euro OverNight Index Average rates, or Eonia) and, through this channel, the entire range of bank rates and market rates. To ensure the Eonia is not too volatile, the ECB provides the banks with two facilities: credit facilities, enabling them to borrow from the ECB for a period of 24 hours, and deposit facilities, enabling them to make cash deposits with the ECB for a period of 24 hours. In case of a liquidity crisis, the banks thus have a guarantee of being able to lend or borrow via the ECB, at a higher for credit facilities or a lower rate for deposit facilities. These rates can then be used to regulate fluctuations in the Eonia, as shown in Figure 1.

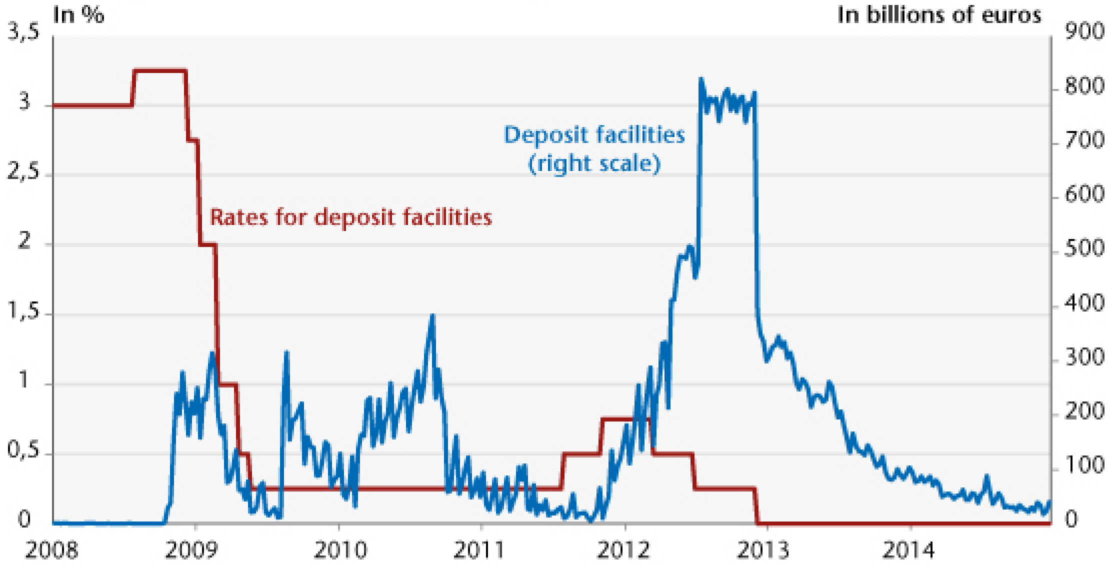
Figure 1. Main ECB rates and EONIA rate



Source: ECB.

In practice, until the collapse of Lehman Brothers in September 2008, banks made little use of deposit facilities, indicating that the interbank market was functioning normally. The situation has radically changed since then, and the amount of deposits left with the ECB has fluctuated to a greater or lesser extent, depending on concerns over the sovereign bond crisis (Figure 2). The height of the crisis in spring 2012 coincided with a peak in the amounts deposited by the banks, which had excess liquidity. Over a period of three months, around 800 billion euros (equivalent to just under 10% of euro zone GDP), paid at 0.25%, were deposited by Europe's banks. In the context of fear of a euro zone collapse and uncertainty about the financial situation of financial and non-financial agents, the banks have been depositing poorly compensated sums with the ECB. They chose to do this rather than to exchange the excess liquidity in the money market or support activity by lending to companies or buying shares. It was not until Mario Draghi's statement in July 2012 that the ECB would do "whatever it takes" to support the euro zone that confidence returned and these sums fell. It was also then that the rate went down to 0%, further reducing the incentive to use the deposit facilities. The level of deposits fell by half, from 795.2 billion euros to 386.8 billion. Since then, they have declined gradually, but are still high, especially given that they receive no interest. In the last week of May 2014, there were still 40 billion euros in deposits (Figure 2).

Figure 2. Rates and levels of deposit facilities with the ECB



Source: ECB.

This situation prompted the ECB to set a negative rate in order to encourage commercial banks to reallocate this money. We can be sure that once the negative rate applies, the level of deposits will quickly drop to zero. Even so, this will mean an impulse of only 40 billion euros, and further action will be needed to support the real economy. On its own, this step by the ECB has certainly not convinced the markets that it has dealt with the situation.

The ECB has thus once again demonstrated its proactive approach to curbing the risks facing the euro area. Its reaction can be compared to the response of Europe’s other institutions, which have struggled to fully take on board the depth of the crisis. Looking outside the euro zone, it is noteworthy that the US Federal Reserve and the Bank of England moved with greater speed, even though the risk of deflation was lower in the United States and the United Kingdom. This active approach is perhaps no stranger to the renewed growth seen in these countries. The ECB's action is therefore welcome. Now we need to hope that it will stave off the risk of deflation hanging over the euro zone, a risk that could have been avoided if the euro zone's governments had not generally adopted austerity policies, and if the ECB had taken less of a wait-and-see attitude.

No surprises from the Fed*

By Christine Rifflart

Not surprisingly, at its meeting on 29 and 30 October the Monetary Policy Committee of the US Federal Reserve decided to maintain its unconventional measures and to leave the federal funds rate unchanged. Since the end of 2012, the Fed has been making massive purchases of securities (government bonds and mortgage debt) at a rate of $85 billion per month. The aim is to put pressure on long-term rates and to support economic activity, including the real estate market.

The Federal Reserve, which is committed to a strategy of transparency and communication aimed at orienting investor expectations, also confirmed that it will hold the rate at between 0 and 0.25% so long as: the unemployment rate is greater than 6.5%; forecasts of inflation over 1 to 2 years do not exceed the long-term inflation target, set at 2%, by more than a half-point; and long-term inflation expectations remain stable. According to our forecast in October (see [The United States: capped growth]), the unemployment rate, which was 7.2% in September, could fall to 6.9% by end 2014. Finally, inflation, which was at 1.5% in the third quarter of 2013, should not exceed 1.8% in 2014. In these conditions, no rate increase is expected before the second half of 2015. Policy will thus remain particularly accommodating.

There is greater uncertainty about the withdrawal of the unconventional measures than about keeping long-term rates at artificially low levels. A cessation or reduction of these measures was announced last May and is thus expected by the markets, and in any case they were not meant to last. Between May and September 2013, foreign private and public investors had anticipated the beginning of their withdrawal and began offloading some of their securities. This influx of securities depressed prices and led to a one-point increase in long-term public rates in just a few weeks. But the fragile character of growth, inadequate job creation and especially the public relations efforts undertaken by the central banks to reassure the financial markets led to putting off the actual date the purchases are to be curtailed. Long-term rates fell once again, and have continued to fall in recent weeks following the October budget crisis.

If, in retrospect, it appears that it was premature to anticipate an early withdrawal of the unconventional measures, the question of timing still remains. In its press release, the Committee stated that any decision will depend on the economic outlook as well as on a cost-benefit analysis of the programme. However, the economic situation is not expected to improve in the coming months. If Congress reaches a budget agreement before December 13, this will certainly be on the basis of cuts in public spending. This new fiscal shock will further dampen growth and penalize the labor market yet again. The issuance of new debt, which was compelled in 2013 by the statutory debt ceiling, might then grow very slowly in 2014 due to budget adjustments. Faced with this moderate growth in the supply of securities, the Federal Reserve could reduce its own purchases to the benefit of other investors. This could help maintain equilibrium in the securities market without a sharp fall in asset prices.

This normalization of monetary policy instruments should not be long in coming. But there are risks involved, and a sharp rise in long-term rates cannot be excluded. The markets are volatile, and the events of May and June have not been forgotten. But much of the movement has already been taken on board by the markets. The Federal Reserve will therefore have to beef up its communication strategy (by for example announcing in advance the date and scope of its decision) if it is to succeed the difficult balancing act of maintaining a highly accommodative monetary policy while gradually dispensing with its exceptional measures to maintain low interest rates. Let us assume that the exercise will be a success. Long-term public rates, at 2.7% in third quarter 2013, should not exceed 3.5% by the end of 2014.

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*This text draws on the study “Politique monétaire: est-ce le début de la fin ?” [Monetary policy: Is it the beginning of the end?], which is to appear soon in the OFCE 2013-2014 outlook for the global economy.