Isabel Schnabel: Going negative: the ECB’s experience

SPEECH

Speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the Roundtable on Monetary Policy, Low Interest Rates and Risk Taking at the 35th Congress of the European Economic Association

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In June 2014, the ECB was the first major central bank to lower one of its key interest rates into negative territory.[1] As experience with negative interest rates was scant, the ECB proceeded cautiously over time, lowering the deposit facility rate (DFR) in small increments of 10 basis points, until it reached -0.5% in September 2019. While negative interest rates have, over time, become a standard instrument in the ECB’s toolkit, they remain controversial, both in central banking circles and academia.[2]

In my remarks today, I will review the ECB’s experience with its negative interest rate policy (NIRP). I will argue that the transmission of negative rates has worked smoothly and that, in combination with other policy measures, they have been effective in stimulating the economy and raising inflation.

On balance, the positive effects of the NIRP have exceeded their side effects, in particular when taking into account the compensating effects of other policy innovations, such as the two-tier system and our targeted longer-term refinancing operations (TLTROs).

At the same time, like with other unconventional policy measures, side effects are likely to increase over time, if the negative interest rate environment were to persist for too long. As negative rates are, by and large, a reflection of broader slow-moving adverse macroeconomic trends, the pandemic is a wake-up call for governments to foster innovation and potential growth, and to reap the benefits from further European integration.

Setting the scene

Over the past few decades, the global macroeconomic environment has changed in ways that pose significant challenges to the conduct of monetary policy.

Sustained demographic shifts, global excess savings and a slowdown in productivity growth have all contributed to a secular decline in the real equilibrium rate of interest over the last 20 years in most advanced economies, though estimates are fraught with a considerable degree of uncertainty (**Chart 1**).[3]

Central banks have responded in different ways to the fall in equilibrium rates. As the global financial crisis broke and conventional policy space was exhausted, most central banks resorted to forward guidance as a means to provide additional accommodation. Some started purchasing government bonds and other securities.

The ECB, for its part, tailored its non-standard measures to the structure of the euro area economy, where banks play a significant role in credit intermediation. In essence, this meant providing ample liquidity for a much longer period than under the ECB’s standard operations.

In mid-2014, however, when downside risks to the inflation outlook intensified, additional accommodation was required. Negative interest rates were a crucial part of the measures that the Governing Council adopted at the time.

The idea was, broadly speaking, twofold: to trigger a repricing of the expected future path of short-term interest rates by “breaking through” the zero lower bound and to encourage banks to provide more credit to the economy.

Empirical evidence suggests that negative rates ultimately delivered on both objectives.

Transmission of monetary policy in an environment of negative policy rates

After the DFR was lowered into negative territory, the entire 3-month Euribor forward curve shifted down further and eventually traded fully in negative territory, and it even started to exhibit a slight inversion (**Chart 2**).

In other words, the ECB had succeeded in shifting the perceived lower bound on interest rates firmly into negative territory, supported by forward guidance that left the door open for the possibility of further rate cuts.

This restored a fundamentally important element of monetary policy: the possibility for the market to anticipate further policy cuts and to thereby frontload policy accommodation. The zero lower bound was no longer constraining market expectations.

As the market started repricing the full expected future interest rate path, the effects of the cut in the DFR extended well beyond short-term rates. A decomposition analysis by ECB staff shows that the NIRP contributed to shifting euro area sovereign yields downwards across the full maturity spectrum, with a peak around the five-year segment (**Chart 3**).[4]

These effects were reinforced by a compression of the term premium: negative rates strengthen the incentives of investors to rebalance their portfolios towards longer-dated securities. The propagation of a rate cut in negative territory was therefore materially stronger along the yield curve than for a conventional rate cut, which typically has very little impact on longer maturities.

Negative interest rates reinforced the effects of our asset purchases for the same reasons: when banks' excess reserves are remunerated at negative rates, there is a strong incentive to reduce them by shifting into riskier assets, such as longer-dated government bonds.[5] This strengthens the portfolio rebalancing channel of asset purchases.

This "hot potato effect" also extends to bank loans, which was the second objective of lowering rates into negative territory. With the start of negative rates, we have observed a steady increase in the growth rate of loans extended by euro area monetary financial institutions (**Chart 4**).

An ECB meta-analysis of various studies corroborates the view that the use of the NIRP had a positive impact on loan growth.[6] The analysis shows that, since the start of the NIRP regime in mid-2014, the growth of loans extended to non-financial corporations (NFCs) would have been lower in the vast majority of counterfactual scenarios of non-negative policy rates (**Chart 5**). In addition, several empirical studies exploiting bank-level data confirmed the causal link between negative policy rates and loan growth.[7]

Taken together, these findings suggest that the lowering of policy rates into negative territory fostered monetary policy transmission in the euro area, as evidenced by the strong pass-through from policy rates to market rates and higher loan growth.

Effect of negative policy rates on bank profitability and bank lending

In spite of these positive effects on the effectiveness of monetary policy, the NIRP has often been criticised for its potential side effects, particularly on the banking sector.

Since banks are generally reluctant to pass on negative rates to their retail clients, mainly for competitive, but also for legal reasons, the funding conditions of deposit-taking institutions typically fail to drop in tandem with the decline in lending rates. This affects banks’ interest margins and hence profitability. This effect is particularly pronounced for banks with a high deposit-to-asset ratio.

Financial market participants seem to have internalised this constraint. Studies document that a surprise hike in the policy rate has a negative effect on banks’ stock prices in normal times, but a *positive* effect in an environment of negative policy rates, which is increasing in the dependence of banks on deposits as a source of funding (**Chart 6**).[8]

In the extreme, the effect could be such that banks charge higher interest rates on their lending activities, thereby reversing the intended accommodative effect of monetary policy. That is, the zero lower bound has been replaced by an “effective lower bound”, which coincides closely with the so-called “reversal rate”, which indicates the level at which additional policy cuts would start to become contractionary, or the rate where holding cash, net of storage and security costs, would become more attractive than holding bank deposits.[9]

There is considerable uncertainty as to the precise level of the “reversal rate” and current estimates suggest that the ECB has not reached the effective lower bound.

Yet, data on the volume of overnight deposits held by households in the euro area confirm the negligible pass-through of negative policy rates to banks’ retail deposit rates (**Chart 7**).

As a result, only a very small proportion of retail deposits are currently remunerated at negative rates (**Chart 8**).

By contrast, banks more frequently charge negative rates on deposits held by NFCs.[10] Within the euro area, this primarily applies to Germany, Luxembourg and the Netherlands (**Chart 9**).

There is also evidence that negative rates affect a growing proportion of the deposits held by NFCs, suggesting that the pass-through associated with negative policy rates has increased gradually over time (**Chart 10**).

This is in line with empirical studies that demonstrate that the pass-through from policy rates to corporate deposit rates intensifies as rates become more negative. This induces firms to decrease their cash holdings through investments, thus supporting the standard monetary policy transmission mechanism.[11]

Interest rate margins, however, are only one part of banks’ profitability. Even though banks are reluctant to pass on negative rates to retail clients, and have only cautiously started doing so for firms, the impact of negative rates on banks’ profitability is much broader.

In particular, by stimulating aggregate demand, negative rates have measurably contributed to an improvement in the macroeconomic outlook, thereby enhancing credit quality.

As a result, according to ECB staff analysis based on a sample of large euro area banks, the NIRP had a negligible effect on bank profitability over the period from 2014 to 2019 (**Chart 11**).[12] The negative effects from lower net interest income and the charge on excess reserves were broadly compensated by a reduction in loan-loss provisions.

In addition, two additional policy measures by the ECB have actively contributed to mitigating the impact of negative rates on bank profitability with a view to protecting the bank lending channel.

The first is the adoption of a two-tier system through which a significant portion of excess reserves are exempt from negative rates.

The second is our TLTROs through which banks can secure borrowing at highly favourable rates, provided they extend sufficient credit to the real economy.

In other words, the introduction of a “dual rate” system, where the pricing of TLTROs deviates from our key policy rate, directly lowers the funding conditions of banks and thereby compensates part of the costs that banks accrue by not being able to pass on negative rates to some of their customer base.

Effect of negative policy rates on bank risk-taking

A second concern is the effect of negative policy rates on banks’ risk-taking behaviour, induced by a search for yield. A number of recent studies investigate the risk-taking behaviour of banks in an environment of negative policy rates.

For example, Heider, Saidi and Schepens (2019) show that the introduction of negative policy rates by the ECB induced high-deposit banks to incur more risk by lending to borrowers with a larger return-on-assets (ROA) variation than low-deposit banks (**Chart 12**).[13] But even though the borrowers of high-deposit banks show a higher volatility of returns, they exhibit lower levels of leverage and the same level of profitability as the borrowers of low-deposit banks.

In a similar vein, Bubeck, Maddaloni and Peydró (2019) investigate how negative policy rates affect banks’ investment choices in their securities portfolios.[14] The authors find that high-deposit banks tend to increase their holdings of high-yield securities in an environment of negative deposit rates, especially relative to low-deposit banks (**Chart 13**). These search-for-yield effects are stronger for less capitalised banks, which could raise concerns for financial stability.

Bittner et al. (2020) also consider the real economic effects of negative rates.[15] On the basis of credit register data, they provide empirical evidence that the borrowers of high-deposit banks in Germany, where the pass-through of negative rates is limited, are riskier but that they increase investment and employment more strongly after receiving credit, thereby supporting monetary transmission to the real economy.

It is precisely through such effects that higher risk-taking by banks may be a feature rather than a bug, as long as it does not raise financial stability concerns.

A longer-term perspective

In spite of the overall positive assessment of the ECB’s experience with negative interest rates, a persistent period of negative rates may pose additional challenges.

It cannot be taken for granted that negative effects on bank profitability from depressed profit margins can be compensated by lower loan-loss provisions also in the future.

Research based on a broad sample of pandemics by Jordà, Singh and Taylor (2020) suggests that pandemics were typically followed by a long period of depressed economic growth and a sustained drop in the real natural rate of interest (**Chart 14**).[16]

This implies that, absent a forceful policy response, the current pandemic is likely to put substantial pressure on banks’ profitability due to rising loan-loss provisions and defaults, at a time when euro area banks’ profitability is already depressed, mostly due to structural reasons (**Chart 15**).[17]

While the ECB can mitigate potential negative effects, solutions to the underlying structural causes go beyond the remit of monetary policy.

These problems include problems of overbanking and a lack of pan-European mergers, which would require the completion of the European Banking Union, as well as the advancement of the capital markets union, which have become ever more important in response to the coronavirus (COVID-19) pandemic.

The medium- to long-term growth outlook after the pandemic will depend to a large extent on whether public spending at national and European level, mainly through the European Recovery Fund, is used wisely to foster the euro area’s growth potential, and thereby to raise real equilibrium rates, in particular through investments that foster the transition to a carbon-free and more digitalised economy.[18]

Concluding remarks

Let me conclude by emphasising three key points.

First, the ECB’s negative interest rate policy has been successful in turning the zero lower bound into an effective lower bound well below zero and supporting bank lending. This fundamentally improved monetary transmission and helped to stimulate the economy and raise inflation.

Second, negative rates can have side effects on banks' profitability and risk-taking behaviour. That said, the experience of the euro area over the past few years suggests that the positive effects dominated, supported by the use of other policy measures that directly mitigate the costs of negative rates.

Finally, side effects are likely to become more relevant over time. Since negative rates largely reflect adverse macroeconomic trends outside the remit of central banks, a forceful policy response by governments to the pandemic is indispensable for raising potential growth, thereby paving the way for positive interest rates in the future.

Thank you for your attention.

Russia: Statement by the High Representative/Vice-President Jose

The preliminary test results from the Charité – Universitätsmedizin hospital in Berlin indicate that the Russian opposition leader Alexei Navalny was poisoned during his stay in Siberia. We are grateful to the Charité – Universitätsmedizin Berlin staff for their treatment of Mr Navalny and wish him a prompt and full recovery.

The European Union strongly condemns what seems to be an attempt on Mr Navalny's life. It is imperative that the Russian authorities initiate an independent and transparent investigation on the poisoning of Mr Navalny without delay. The Russian people, as well as the international community, are demanding the facts behind Mr Navalny's poisoning. Those responsible must be held to account.

[Service Charter: second quarter 2020 results available]

August 24, 2020 [*About the EUIPO*]

Service Charter: second quarter 2020 results available

The results of the second quarter of 2020 show the effects of the measures taken by the Office to help customers cope with the difficult situation presented by the COVID-19 pandemic.

Two time limit extension decisions by the Executive Director – [Decision No EX-20-3] and [Decision No EX-20-4] – were issued concerning all procedural deadlines, including the opposition period. These time limit extensions caused a delay in the registration of EUTMs and international trade marks, with the corresponding impact in the Service Charter results.

The affected timeliness indicators are the EUTM fast track registration, EUTM standard track registration and IRs registration. The Office is closely monitoring this situation and as the two extension decisions came to an end during May, the compliance level is expected to recover during the third quarter.

The Cancellation timeliness indicator continues in action needed. Last year, the Office started implementing a set of measures to improve this area in a sustained manner over time. The results of these measures show a steady improvement in the cancellation timeliness results and currently all pending cases are being notified in compliance with the Office standards, even considering the specific and difficult circumstances due to COVID-19. The Office is positive that it can maintain this situation and a steady state regime will be reached before the end of 2020.

As regards the quality and accessibility indicators, targets are being met. The Office works to provide a continuously improving and evolving service, tightly aligned with users' needs and expectations.

See the Service Charter

Media advisory – Press briefings ahead of the informal meetings of EU defence ministers of 26 August, and foreign affairs ministers (Gymnich) of 27-28 August 2020

The press briefings ahead of the informal meetings of EU defence ministers of 26 August, and foreign affairs ministers (Gymnich) of 27-28 August 2020 will be virtual and take place on **Tuesday, 25 August 2020** at

– 14.00: informal defence

– 14.45: Gymnich

These briefings are "off the record" and will be given by EEAS senior officials.

In order to ask questions remotely, EU accredited journalists can register using this link.

Journalists who already registered for previous FAC press conferences do not need to register again.

Deadline: Tuesday, 25 August 2020, 13.00

Further instructions will be sent to all registered participants approximately half an hour after the deadline.

For more information, visit the website of the German Presidency:

Informal Meeting of EU Defence Ministers of 26 August 2020

Informal Meeting of EU Foreign Ministers (Gymnich) of 27-28 August 2020

EASO publishes a COI report: Venezuela Country Focus

On 20 August 2020, the European Asylum Support Office (EASO) published a Country of Origin Information (COI) report titled 'Venezuela Country Focus'.

This COI report is a joint initiative of EASO and the Secretariat of the Intergovernmental Consultations on Migration, Asylum and Refugees (IGC)[1].

The report addresses the main topics and questions raised by international protection authorities, decision-makers, and COI researchers. It covers recent developments in the economy, political and security situation, and the humanitarian situation. The report also discusses the most recurring targeted profiles by the government and its security forces. It describes activities of armed pro-government civilian groups (colectivos), including targeted profiles, modus operandi, relation with the government and security forces, and state response for victims of colectivos. Final chapters describe identity and courts documents, entry and exit procedures, and the situation of lesbian, gay, bisexual, trans (LGBT) persons.

Some findings of the report include:

- The mass emigration of Venezuelans constitutes one of the largest in recent Latin American history. While the number of Syrians who left their country reached 6.5 million in seven years (2011-2017), the number of Venezuelans who left their country reached 4 million in four years (2015-June 2019).
- Venezuela has one of the highest homicide rates in Latin America, despite a decrease in 2019. Armed groups, both domestic and foreign, operate in Venezuela, with distinct objectives, modus operandi, political loyalties and relations with the state.
- Colectivos exert political and social control in neighbourhoods where they operate, and have become instrumental in the use of coercive control over protests through the use of violence and often in coordination with security forces.
- The nature of protests changed in the first months of 2019, with more targeted demonstrations emerging to protest the deterioration of living standards and the humanitarian situation. Security forces allegedly subjected persons who participated in protests to 'serious abuse and ill-treatment' while in detention in order to punish them, force confessions, or incriminating others.
- Authorities allegedly engaged in forced disappearances, including for political reasons, to impede the defence of the person while the detention is carried out. Security forces have also allegedly been involved in extrajudicial executions.
- Venezuela has established a complex system to eavesdrop, harass, and

digitally and physically monitor the population, including through the CLAP food boxes and the Homeland Card (Carnet de la Patria). Social control has intensified during the pandemic.
- A systematic and widespread policy of repression in Venezuela for those who are critical of the government was identified by sources. The government and security forces target journalists to silence on what is occurring in the country. Human rights advocates and members of civil society organisations are prosecuted under both the criminal justice system and the military penal jurisdiction, as an ‘exemplary punishment’ to block the work of other human rights organisations. The ‘Law Against Hate’ has been one of the legal instruments used for these prosecutions.

The report was drafted by an independent COI expert, James Restrepo, in accordance with the EASO COI Report Methodology. The report draws on information from 14 oral sources interviewed for this report, apart from a large variety of publicly available sources. It was reviewed by experts from: Canada – Immigration and Refugee Board (IRB) of Canada, and Immigration, Refugees and Citizenship Canada (IRCC); Norway -Norwegian Country of Origin Information Centre, Landinfo; Switzerland – State Secretariat for Migration (SEM), Division Analysis (Länderanalyse SEM), and United States – Refugee Asylum and International Operations (RAIO), US Citizenship and Immigration Services (USCIS).

Venezuelan applications for international protection in the EU+ increased considerably since early 2019 and peaked between November 2019 and February 2020. In 2019, Venezuelans launched twice as many applications, over 45 000, as in 2018. In the first quarter of 2020, the number remained similar to the last quarter of 2019 (over 13 000) but already in late March applications began to decrease in the context of restrictive measures to halt the spread of the COVID-19 pandemic. Spain has remained the main destination country: in the period January 2019 – March 2020 about nine in 10 applications in the EU+ were lodged in Spain.

The report can be downloaded from the EASO COI portal.

[1] IGC participating states are: Australia, Belgium, Canada, Denmark, Finland, Germany, Greece, Ireland, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, United Kingdom and the United States.