ECB hints at additional monetary stimulus: should it mitigate the side effects of negative interest rates?

RYO YAMADA
ECONOMIC RESEARCH OFFICE

MUFG Bank, Ltd.
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At its 6 June meeting, the Governing Council of the European Central Bank (ECB) extended its forward guidance on interest rates, which will remain unchanged 'through the first half of 2020' rather than 'through the end of 2019'. In addition, at a speech on 18 June, President of the ECB Mario Draghi stated that 'In the absence of improvement, such that the sustained return of inflation to our aim is threatened, additional stimulus will be required’. Draghi even went as far as to mention specific easing measures such as: 1) enhancing forward guidance, 2) further cuts in policy interest rates and mitigating measures to contain side effects of negative interest rates, 3) restarting the asset purchase programme (APP).

Draghi explained these additional monetary stimulus measures in the context of uncertainty about Brexit negotiations, uncertainty about vulnerabilities of certain emerging market countries, and uncertainty about global trade growth, which have all extended since the previous meeting in March. They are also likely to take into account the recent deterioration in industrial production (currently in negative territory in YoY terms) and the slowdown in consumer price inflation (CPI) since November last year.

Looking at the specifics of the ECB's additional monetary stimulus package, it is clear that a large scale reintroduction of the APP would be impractical because it would require changes to the fundamental rules of the programme, for example raising the issue limit for Germany. (This currently limits holdings of any given bond issue to 33%). Still, rate cuts are highly likely and have already been priced in by market participants. This means that we must keep a close eye on the side effects of negative interest rates on monetary and financial institutions (MFIs). The extent of these will not be limited to negative interest rates on banks' excess reserves. Eurozone banks' lending margins (the margin between interest charged on loans and interest paid on deposits) have been shrinking in both corporate and household sectors since the introduction of negative interest rates (Chart 1), and are expected to shrink further if the ECB cuts interest rates. Eurozone MFIs have outstanding loans totalling around 12.5 trillion euros. However, current loan growth of around 3% YoY (Chart 2) (due to balance sheet factors) does not offset the drag from compressed lending margins (due to cut interest rates). If the ECB is to cut interest rates further, it is likely that they will introduce tiered interest rates or specific measures with the aim of mitigating the side-effects of negative interest rates.

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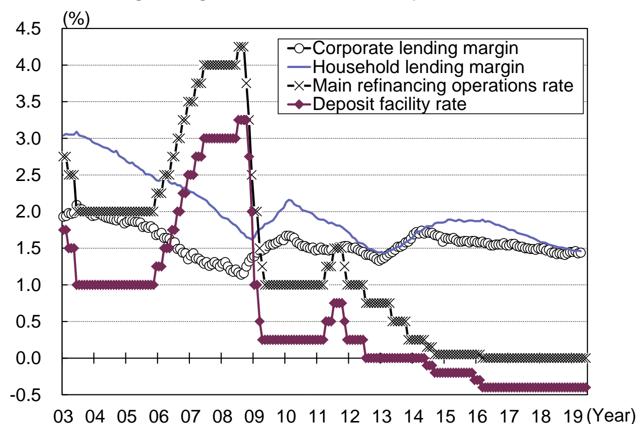
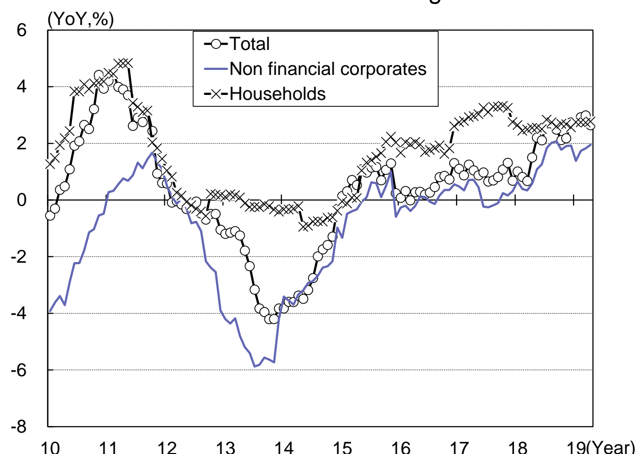
Chart 1: Eurozone Banks' Corporate and Household Lending Margins and ECB Policy Interest Rates



Source: ECB, MUFG Bank Economic Research Office

Chart 2: Eurozone MFIs' Outstanding Loan Balances



Source: ECB, MUFG Bank Economic Research Office

For further details, please contact the Economic Research Office, MUFG Bank

Managing Director, Rei Tsuruta Tel: +81-(0)3-3240-3204

Written by Ryo Yamada <riyou_yamada@mufg.jp>

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