

ECB: Never a dull moment

The latest comments from members of the European Central Bank have suddenly given rise to rate cut fantasies. Don't get carried away



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Comments from ECB President Mario Draghi at yesterday's ECB watchers conference have given rise to speculation about further easing, and were followed by further drops in bond yields. In his speech, Draghi said that *"we will continue monitoring how banks can maintain healthy earning conditions while net interest margins are compressed. And, if necessary, we need to reflect on possible measures that can preserve the favourable implications of negative rates for the economy, while mitigating the side effects"*. At the same time, Draghi also added that *"low bank profitability is not an inevitable consequence of negative rates"*. These comments were also echoed by ECB Chief Economist Peter Praet and ECB Vice-President Luis de Guindos and got even more [support from a Reuters story](#), quoting ECB sources that the ECB was investigating several options, including a so-called tiered deposit rate.

To bring or not to bring relief - the long discussion

Let's try to put all these comments and rumours into perspective. The discussion on adverse side-effects on banks from the negative deposit rate is not new but has actually been ongoing for a long while. However, up to now, the ECB has been hesitant to present a clear-cut view or analysis. Press conferences since October last year have seen a kind of back-and-forth on this issue. Up to

now, the overwhelming view has always been that negative interest rates have been good for the economy, with hardly any negative effects on banks. The latter part of this view has now started to shift, even though one should not forget that all targeted longer-term refinancing operations (TLTRO) up to now have been instruments to mitigate adverse side-effects on banks due to the built-in incentives. The discussion on whether there could be more to mitigate had already started in the run up to the March meeting, with speculation on combining new TLTROs with some relief, e.g. through hike(s) of the deposit rate or tiering systems.

This morning, in a recorded interview on Bloomberg TV, Peter Praet hinted that the ECB was indeed looking into possible options to mitigate the side-effects from negative interest rates but that there had to be a monetary policy case to justify any tiering. In our view, this is correct. There are currently much bigger challenges for banks' profitability than the negative deposit rate, and a tiering system will not make an unprofitable bank suddenly profitable. Therefore, the ECB will have to investigate whether the negative deposit rate actually leads to a smaller (or more expensive) supply of loans than a zero deposit rate or a tiering system.

A tiering system? Some thoughts

There are at least four risks, in our view, to introducing a tiering system:

1. It could be perceived as a sign that the ECB is preparing for a "low for much longer" period
2. It could actually complicate the pass-through of monetary policy to the real economy; depending on the technical details of such a system
3. Rapid introduction of a tiering system could be perceived as yet another "free lunch" for the banking sector
4. While a tiering system would open the door to further rate cuts, these cuts would mainly be seen as exchange rate manipulation rather than supporting the bank lending channel

All in all, despite all the market excitement, all of these latest comments should be seen as an attempt by the ECB to demonstrate that it is not running out of ammunition. The most likely next step is still the announcement of the detailed conditions for the third batch of TLTROs (at the June meeting). Introducing a tiering system will be investigated but probably only announced in case the economy has not started to rebound by June. In fact, there is a balancing act between the details of the next TLTROs and a tiering system. The more favourable the conditions of the next TLTROs, the less urgent the need for mitigating measures. Consequently, we expect the ECB to remain rather cautious and not act hastily. Still, one thing is for sure: low interest rates for longer are the new reality.

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