

2014-09-23

PRESS RELEASE

The how and why of a negative rate for the deposit facility

(Article for the September 2014 Economic Review)

During the summer of 2014 the Eurosysteem cut its inflation projections for the euro area up to 2016. During August, the financial markets also indicated a significant fall in medium-term inflation expectations. Moreover, the decline in current inflation and the fall in other business cycle indicators, including GDP, showed that the euro area's economic recovery was losing momentum. Faced with the risks that a prolonged period of low inflation might present for the maintenance of price stability and, more generally, the revival of activity, the Governing Council of the European Central Bank (ECB) decided at its meetings in June and September 2014 to take a significant package of measures, including a double cut in the key rates and a reduction in the deposit facility rate from 0% to -0.1% on 11 June 2014, and then to -0.2% from 10 September 2014.

With these measures, the Eurosysteem becomes the first central bank of a large currency area to take its deposit rate into negative territory. In simple terms, the negative rate means that banks have to pay in order to deposit their surplus liquidity with the Eurosysteem. It is all the more important to understand this move into uncharted waters since the current financial environment of the euro area features a liquidity surplus on the money market and persistent fragmentation of the banking system.

Given its dual role in the implementation of monetary policy, the reduction in the deposit facility interest rate, taking it into negative territory, implies a more accommodative monetary policy stance and safeguards the incentives for interbank trading while reducing the cost of Eurosysteem refinancing for the banks.

Although a negative deposit facility rate implies lower returns for savers, a cut in the real rate is warranted to support economic activity, and hence inflation. Furthermore, it will permit a return to higher rates in the future. The analysis also shows that the net costs of Eurosysteem refinancing for the banking system have fallen since the beginning of June, even if the dynamic impact of the negative rate on bank profitability is harder to estimate.

Finally, it should be noted that the effectiveness of cutting the deposit facility rate below zero has to be assessed in real time, taking account of the effects of interaction with all the other monetary policy measures announced in June and September. In particular, the targeted longer-term refinancing operations being launched in September 2014 should encourage efficient transmission of the negative rate to the real economy. In addition, combined with the purchase programmes of asset-backed securities and covered bonds, to be launched in October, they should considerably increase the liquidity surplus on the money market, in accordance with President Draghi's stated aim of increasing the Eurosysteem's balance sheet to the levels prevailing at the beginning of 2012.