Tuesday Comments

Tuesday March 29, 2016

The European recession of 2012 – 2013 is long gone but it sure doesn't feel that great. Unemployment remains high (10.4%) and there is little growth (1% for last year). What's a central bank to do? The European Central Bank (ECB) is really good at creating acronyms, so in keeping with that tradition, it created a new one...NIRP.

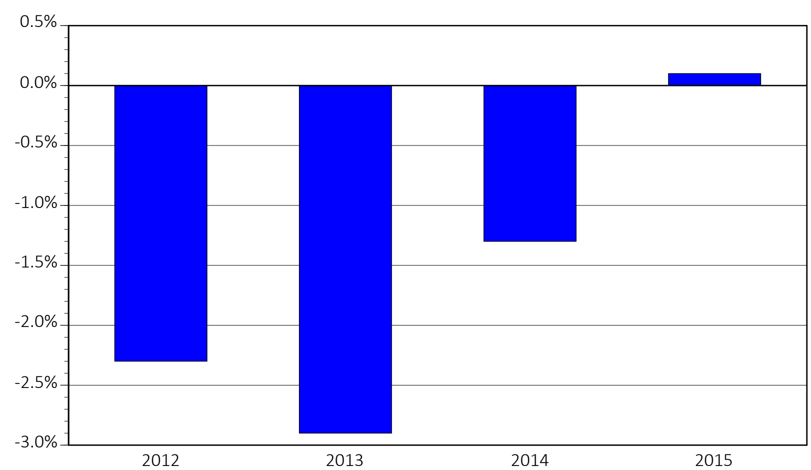
The ECB currently has a Negative Interest Rate Policy, referred to as NIRP. In June of 2014, the ECB first ushered in the NIRP era when it reduced its Deposit Facility Rate from 0% to -10 bps. And just this month they reduced that rate from -30 bps to -40 bps. Why would they do such a thing?

Banks with excess reserves can hold them only in cash or place the excess reserves overnight at the ECB in the deposit facility at the Deposit Facility Rate. A bank, of course, could reduce its excess reserves by: 1) lending them to other banks (in the interbank market) for some term, such as one month (current one-month interbank rate is -33bps) or, 2) lending them to private borrowers in something called a loan.

The chart below outlines loan growth since 2012 in the 19 countries that share the common currency.

Monetary Financial Institution (MFI) Loan Growth per Year

Source: European Central Bank



As opposed to the healthy U.S. loan growth we recently illustrated, **there is no loan growth in Europe**. Lending creates economic activities that increase the demand for goods and services. Healthy loan growth creates a growing economy, while no loan growth is symptomatic of little or no demand to borrow or willingness to lend. This is the European problem.

Negative interest rates (rather NIRP) can be viewed as a tax on banks for not lending.

The interest rate on the deposit facility creates a floor on short-term interest rates. No bank would lend out its excess reserves at rates below this facility since it can lend at a higher rate elsewhere, which includes one week Euribor or other maturities with less negative rates.

Therefore the deposit facility rate is **the rate of return a bank can get by supplying its excess reserves** to the ECB. The other two key ECB rates are the Main Refinancing Rate (currently zero) and the Marginal Lending Rate (currently +25 bps), which are **the marginal costs to a bank of demanding liquidity** from the Central Bank.

As Administrative Rates, the European Central Bank can stipulate any rates it so desires on liquidity. Europe ended up with negative rates because there has been no growth in loans.