Negative Interest Rate Policy of the ECB and other Central banks

Driver for global economic growth and impact on banking sector

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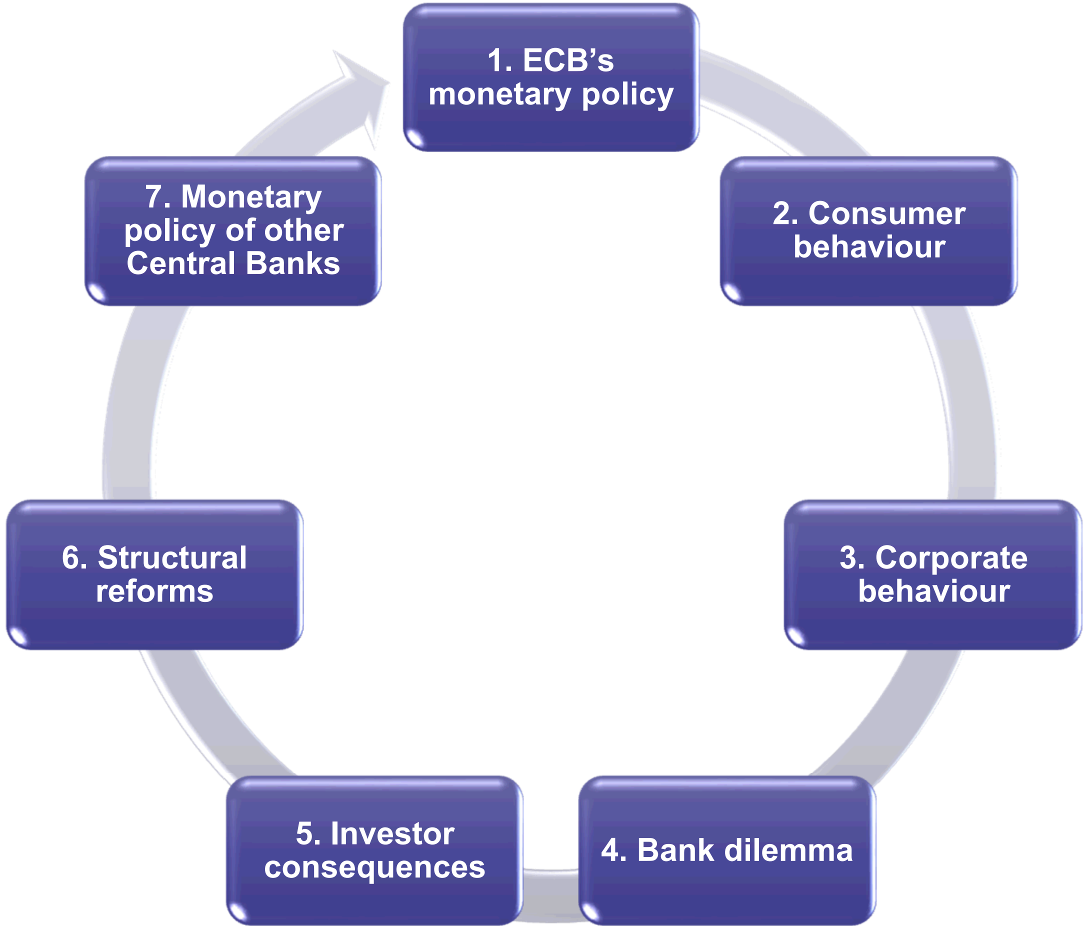
Frankfurt, March 2016

Key points

- ING's survey show that a further lowering of saving rates will most likely not lead to increasing consumer spending as this is mostly dependent upon consumer confidence. It surely puts banks between a rock and a hard place however.
- Recent Business confidence figures show that corporates do not seem to believe that the loose monetary policy of the ECB will resolve the underlying issues. As result investments are not expected to increase anytime soon.
- Banks are reluctant to pass on the negative rates to the retail savers. Compensation for margin compression is mostly sought for by introducing floors and increasing margins and fees on the asset side therewith actually hampering credit provision.
- Low interest environment force pension funds and insurance companies to take drastic measures like more risky investments potentially leading to financial bubbles and decreasing pay-outs to participants/clients negatively impacting consumer spending.
- The loose monetary policy of the ECB enables countries to delay structural reforms required to tackle obstacles to the fundamental drivers of future sustainable economic growth.
- Without sustainable economic growth resulting from structural reforms, the individual Central Bank actions trigger reactions of other Central Banks to avoid economic growth is 'stolen away' from them by rate moves.
- This potential negative feedback loop of continuous decreasing interest rates has an impact on the banking sector.
- **The current fragile state of the European economy requires continued monetary accommodation to lift demand and inflation expectation but in parallel a structural reform agenda is required to address the underlying structural issues in Europe.**

1. Monetary policy of Central banks



ECB's monetary policy targets

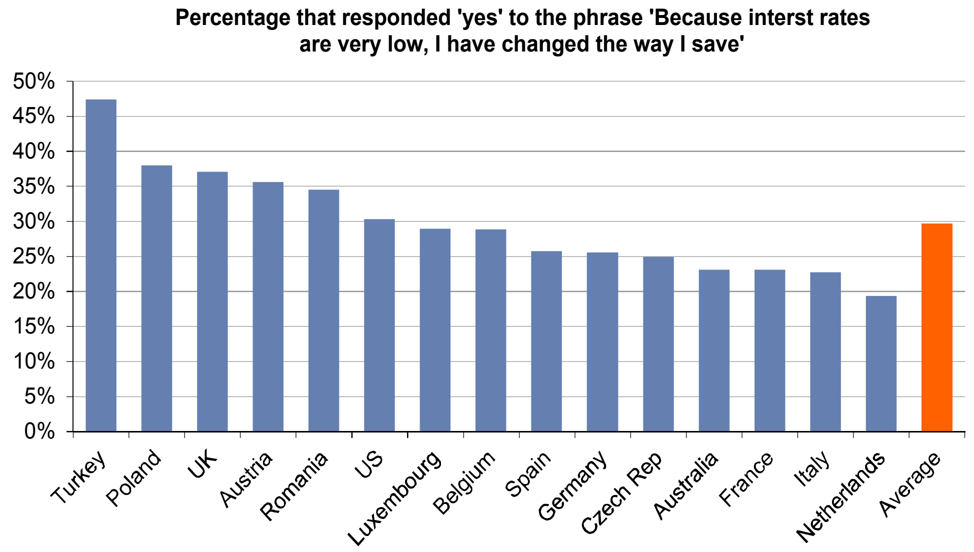
- The primary objective of the ECB's monetary policy is to **maintain price stability** with inflation rates close to 2%.
- In order to achieve this inflation rate, an adequate level of **consumer spending, corporate investments** and in the end **economic growth** are required.
- The decision to lower rates over the past years, accompanied by a number of other measures, was made to **stimulate banks to provide credit to the economy** and to **incentivize consumer spending**.

Question: Does this policy work and what is needed additionally to come out of this downward spiral?

2. Consumer behaviour (1)

Reaction of savers – Based on ING International Survey (IIS)

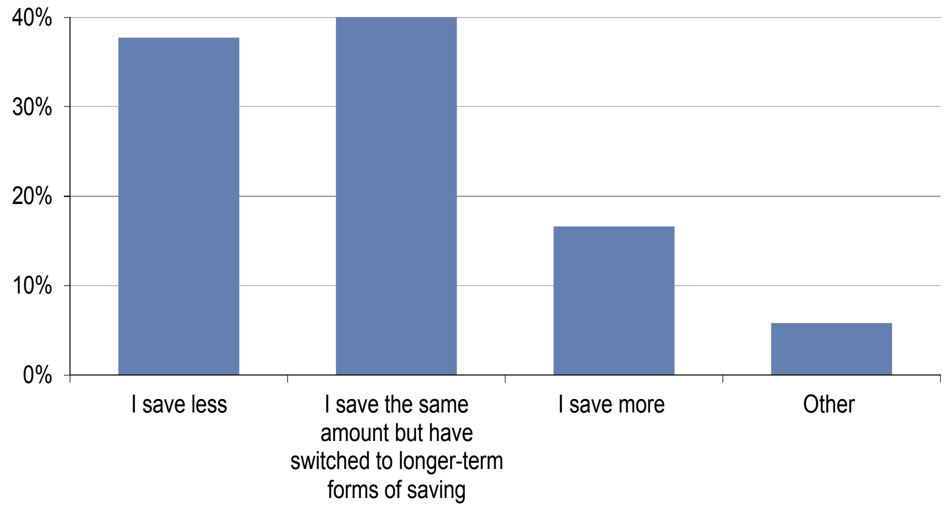
Fig 1 Nearly a third of savers have changed their behaviour due to low rates



Source: ING International Survey (IIS)

- Low rates have prompted 31% to change their savings behaviour.
- 40% have saved the same amount, but have switched into longer term forms.

Fig 2 How have you changed the way you save?



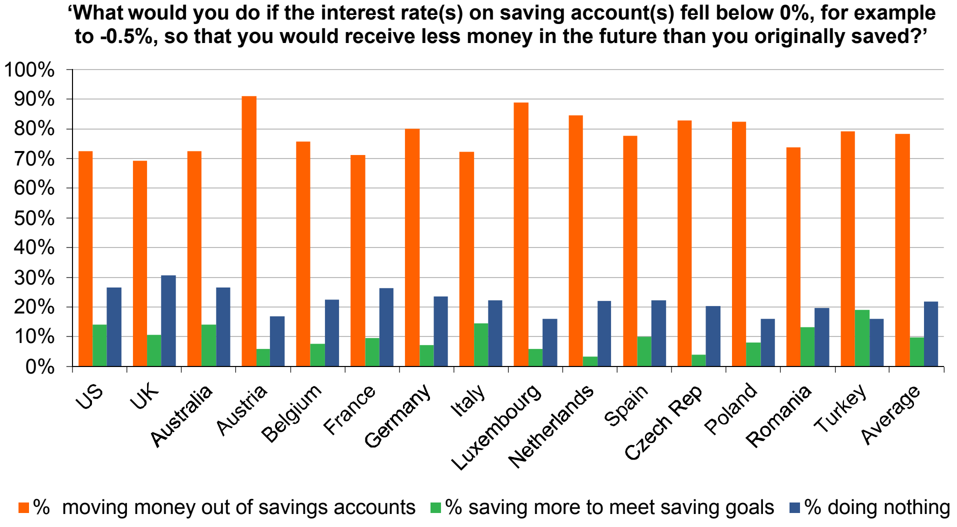
Source: ING International Survey

- 38% have been saving less, with the Germans and Austrians leading the way, and the Dutch trailing.
- 17% of those who have changed their behaviour have actually saved more…

2. Consumer behaviour (2)

Reaction of savers – Based on ING International Survey (IIS)

Fig 3 Nearly 80% of savers would respond to negative interest rates

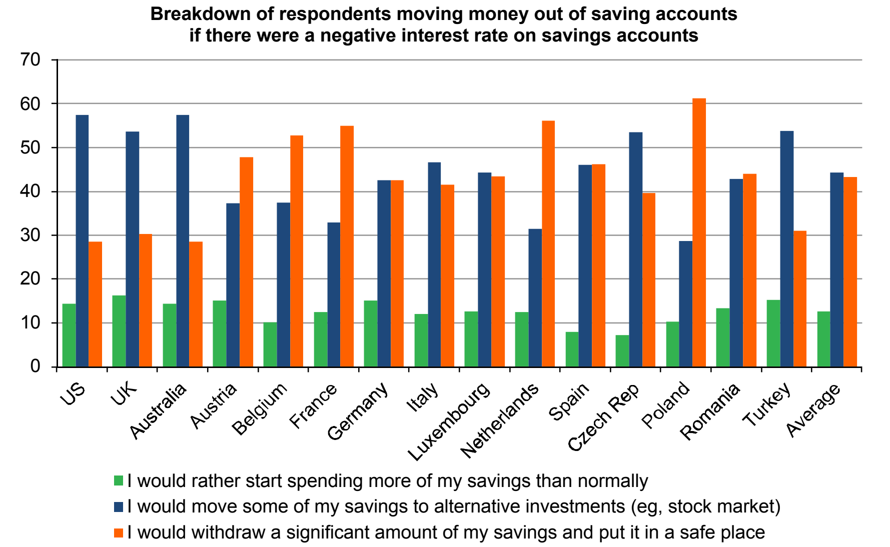


Weighted by country, age, gender and region, significance tested on 95% level. As respondents were allowed to choose more than one answer, the country total may exceed 100%.

Source: ING International Survey

- The strength of feeling revealed about negative rates is striking, only 23% would not react.
- This is an application of the concept of 'loss regret', people feel pain of losses twice as strongly as they feel the pleasure of a gain of similar magnitude.

Fig 4 Switching into investments and hoarding cash are the most popular options



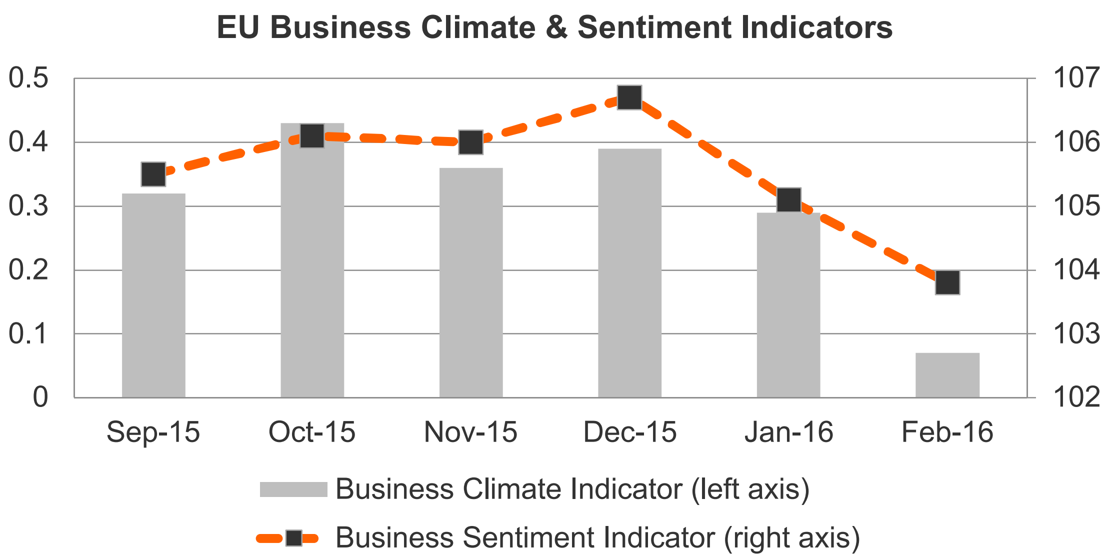
As respondents were allowed to choose more than one answer, the country total may excee 100%

Source: ING International Survey

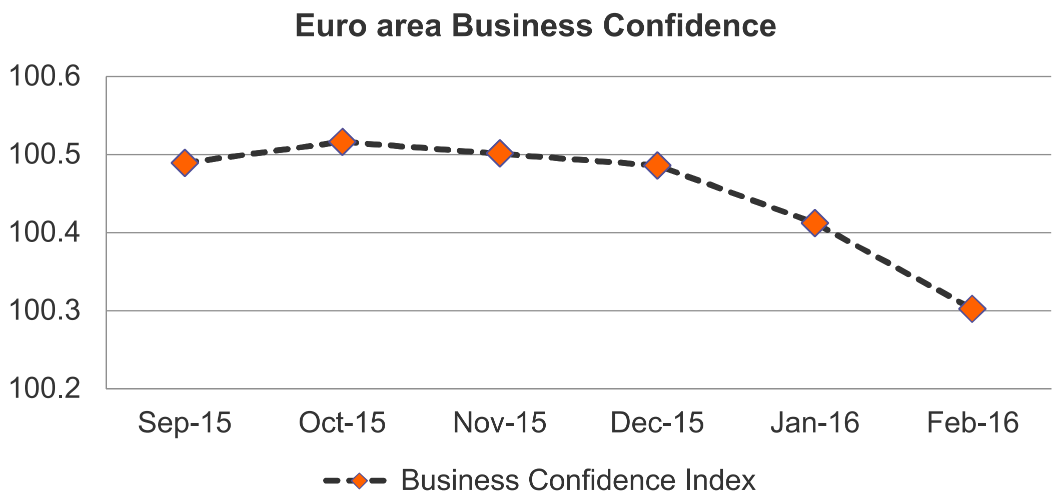
- 10% would spend more, nearly the same as those who intend to save more….
- The rest either switching to alternative investments like mutual funds (by which market risks are entering the retail world) or even hoarding cash….
- Banks face tough choice between a profit margin squeeze and a potentially big deposit outflow.

Further lowering of saving rates will most likely not lead to increasing consumer spending as this is mostly dependent on consumer confidence. It surely puts banks between a rock and a hard place however…

3. Corporate behaviour



Source: European Commission



Source: OECD Data

- Business indicators are decreasing in the Euro Area over the past months indicating at decreasing confidence in sustainable economic growth .
- As result we see a trend of companies returning cash to shareholders via dividends and buybacks, in order to boost short-term returns, meaning that capital will not be reinvested in more productive activities.

Corporates do not seem to believe that the loose monetary policy of the ECB will resolve the underlying issues and as result investments are not expected to increase anytime soon.

4. Bank dilemma resulting from negative interest rates

<u>**Challenges for banks**</u>

- **Customer behaviour**; How do clients react to negative rates? Which rates can banks forward to their clients (private vs. companies)?
- **Margins**; Under pressure. Earnings capacity of banks are challenged
- **Products**; What to do with products where client rates are based on (negative) interest rates?
- **Derivatives**; What will happen to swaps where the variable part is based on negative interest rates? Does one party receive both fixed, as well as variable interest?

<u>**Bank reaction thus far…**</u>

- Banks in these regions have started charging negative rates to short-term professional counterparties.
- Banks have not yet started charging these negative rates to their retail customers in fear of large deposit outflows.
- In order to mitigate the negative profitability impact, banks seem to have reacted mostly by putting floors- and increasing margins on the lending products and also by increasing fees for the various services the banks provide.
- Additionally, banks are undergoing fierce cost reductions and as result are e.g. massively closing branches.

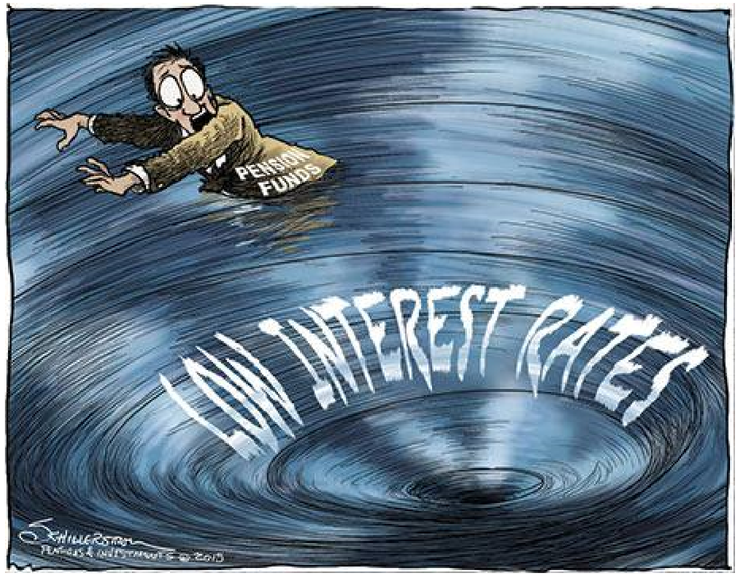
Banks are reluctant to pass on the negative rates to the retail savings. Compensation for margin compression is mostly sought for by introducing floors and increasing margins and fees on the asset side therewith actually hampering credit provision.

5. Reaction of investors like pension funds and insurance companies

- The current low interest environment poses a significant risk for the long-term financial viability of pension funds and insurance companies.

- The coverage/capital ratios of pension funds and insurance companies are increasingly pressured due to low rates forcing them to take drastic measures.

- These measures are mostly twofold:
  - Search for yield via more risky investments potentially leading to financial bubbles and;
  - Decreasing pay-outs to participants/clients negatively impacting the purchasing power of consumers.



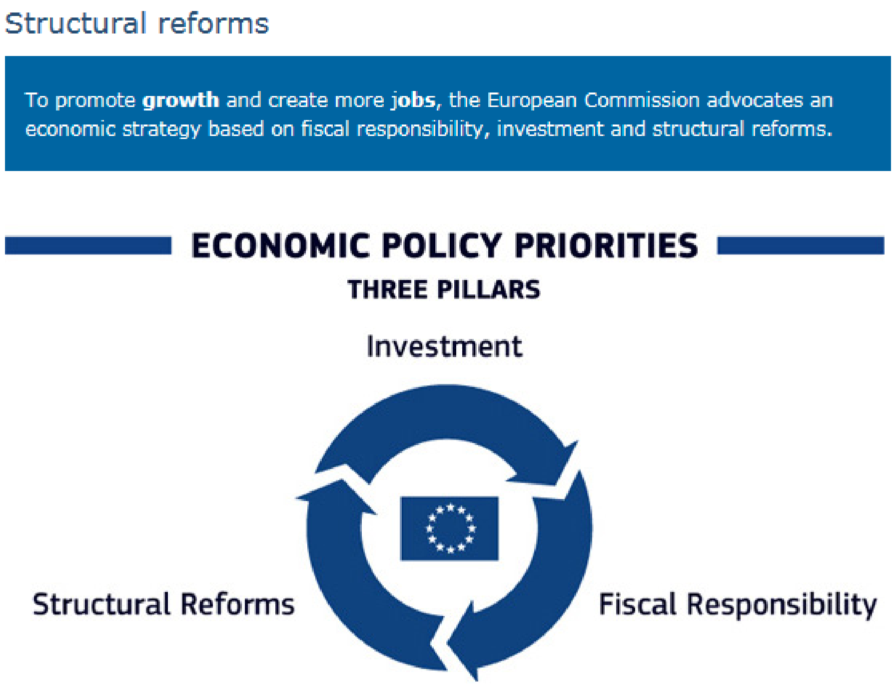
Low interest environment force pension funds and insurance companies to take drastic measures like more risky investments potentially leading to financial bubbles and decreasing pay-outs to participants/clients negatively impacting consumer spending.

6. Structural reforms

- Structural reforms throughout can lead to a sustainable economic growth in the Euro area.

- These structural reforms are not always desired by politicians as these include unpopular measures for example to liberalize the labour markets and to increase competition in product and service markets.

- The loose monetary policy of the ECB and other Central Banks does not enforce discipline on politicians to implement the required structural reforms.



Source: European Commission

The loose monetary policy of the ECB is enabling countries to delay structural reforms required to tackle obstacles to the fundamental drivers of future sustainable economic growth.

7. Reaction of other Central Banks….

Central Bank moves

- In 2009, the Sweden's Riksbank became the first Central Bank to put interest rates into negative territory.
- Since then, the ECB, Danish National Bank, Swiss National Bank and the Bank of Japan have joined the bandwagon.
- The consequence of lowering interest rates by Central Banks is that this leads to a depreciation of the domestic currency making the specific currency area more competitive vs. other areas.

The world economy in the end is a 'zero sum world'. This means that without sustainable economic growth triggered by structural reforms, the individual Central Bank actions trigger reactions of other Central Banks to avoid economic growth is 'stolen away' from them by rate moves.

Conclusion: The ECB can’t do it alone….

- The ECB clearly recognizes that the current fragile state of the European economy requires continued monetary accommodation in order to lift demand and inflation expectations.

- In parallel however a **structural reform agenda** must be set-up to address the real underlying structural issues:
  - In order to enhance the **effectiveness of the monetary transmission**:
    - Bank, corporate and also country balance sheets must be strengthened further and;
    - Free flow of funding and liquidity should be stimulated across Europe.
  - In order to **raise productivity and increase convergence** in Europe:
    - The structural gaps in labour, product and capital markets should be addressed in Europe with diverging solutions across countries.
  - Labour participation should be increased in order to **mitigate the impact of aging** in Europe.
  - The **European migrant crisis** should be addressed as it poses a high risk on financial and political stability in Europe.
  - Other ???

The current fragile state of the European economy requires continued monetary accommodation to lift demand and inflation expectation but in parallel a structural reform agenda is required to address the underlying structural issues in Europe.