Ultra-Easy Monetary Policies: Risks and Benefits for the Financial System

Olivier GARNIER
Group Chief-Economist
The conventional benefits and risks of easier monetary policies for the financial system

- **Benefits**
  - Cheaper and more abundant funding / Wider net interest margins
  - Lower delinquency and default rates
  - Increased value of assets (including legacy assets)
  - Stronger credit demand

- **Risks**
  - Zombification of the economy
  - Excessive risk taking (‘reaching for yield’)
    - Carry-trades
  - Asset price bubbles

- **Lower risk-free short rate**
  - Steeper yield curve (‘bull steepening’)
  - Lower credit risk premium / higher equity price
Why ‘this time might be different’ for the financial system

- Zero or even negative interest rate term premium
  - Central banks’ bond purchases

- Negative interest rates
  - ‘Tax’ on excess banks’ reserves

- Changes in financial regulation
  - Capital / Leverage ratios
  - Liquidity ratios (LCR, NSFR)
  - Resolution / Bail-in (TLAC, MREL)
  - Levies on bank balance sheets (systemic risk tax, contributions to resolution fund, …)
The vanishing term premium due to central banks’ interventions (and new regulations)

The demand for safe and liquid assets is exacerbated by new regulations:

- Prudential ratios
- Collateral (to make wholesale markets safer)
Negative term premium (TP): a key risk to financial stability if sustained for a long period of time (1)

- The key role of the TP for the financial system
  - Pricing of maturity transformation
  - Minimum discount rate for LT asset and liability valuation → balance sheet implications
- A negative TP increases the maturity mismatch between the supply and demand for savings, while discouraging bank maturity transformation
  - Savers: greater reluctance to commit their savings to LT instruments
  - Borrowers: more willing to issue LT debt
  - Maturity transformation risk shifted outside the banking system in a more opaque way?
- Liquidity risk replacing maturity risk?
  - Increased liquidity mismatch between assets and liabilities in investment funds…
  - … just when secondary market liquidity is drying (regulation on market-making activities)
- The exit strategy: how to normalize the TP?
  - Using central bank intervention in interest rate swap market as an additional policy instrument during the exit period?
Euro area: short rates are likely to fall into deeper negative territory as excess reserves increase with ECB purchases.
The potential distortionary consequences of negative interest rates

- **Flight to paper currency?**
  - Creation of ‘ash reserve accounts (that only hold currency) or vault cash bonds or ETF
    - Analogy with the development of US MMMFs in the 70s when high inflation drove market interest rates above the regulatory ceiling on deposit rates
  - Lower and more unstable money multiplier

- **Negative impact on retail banks’ profitability**
  - Charging significant fees on retail deposits is unlikely due to legal, commercial and political obstacles

- **Forcing liquidity out of the banking system by discouraging banks to take wholesale deposits**
  - Further discouraged by:
    - LCR: higher run-off rates for wholesale deposits
    - Levies on bank liabilities
  - Shift into the shadow banking system?
Conclusion

- The combination of regulatory changes and ultra-low/negative interest rates for a long period of time may encourage ‘bad’ (rather than ‘good’) disintermediation
  - Disintermediation driven by regulatory arbitrage and search for yield (instead of providing a more diversified pool of financing to the nonfinancial sector)

- How to make more consistent financial regulation, macro-prudential policies and unconventional monetary policies?