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

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The conventional benefits and risks of easier monetary policies for the financial system

- **Lower risk-free short rate**
  - Steeper yield curve (‘bull steepening’)
  - Lower credit risk premium / higher equity price

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

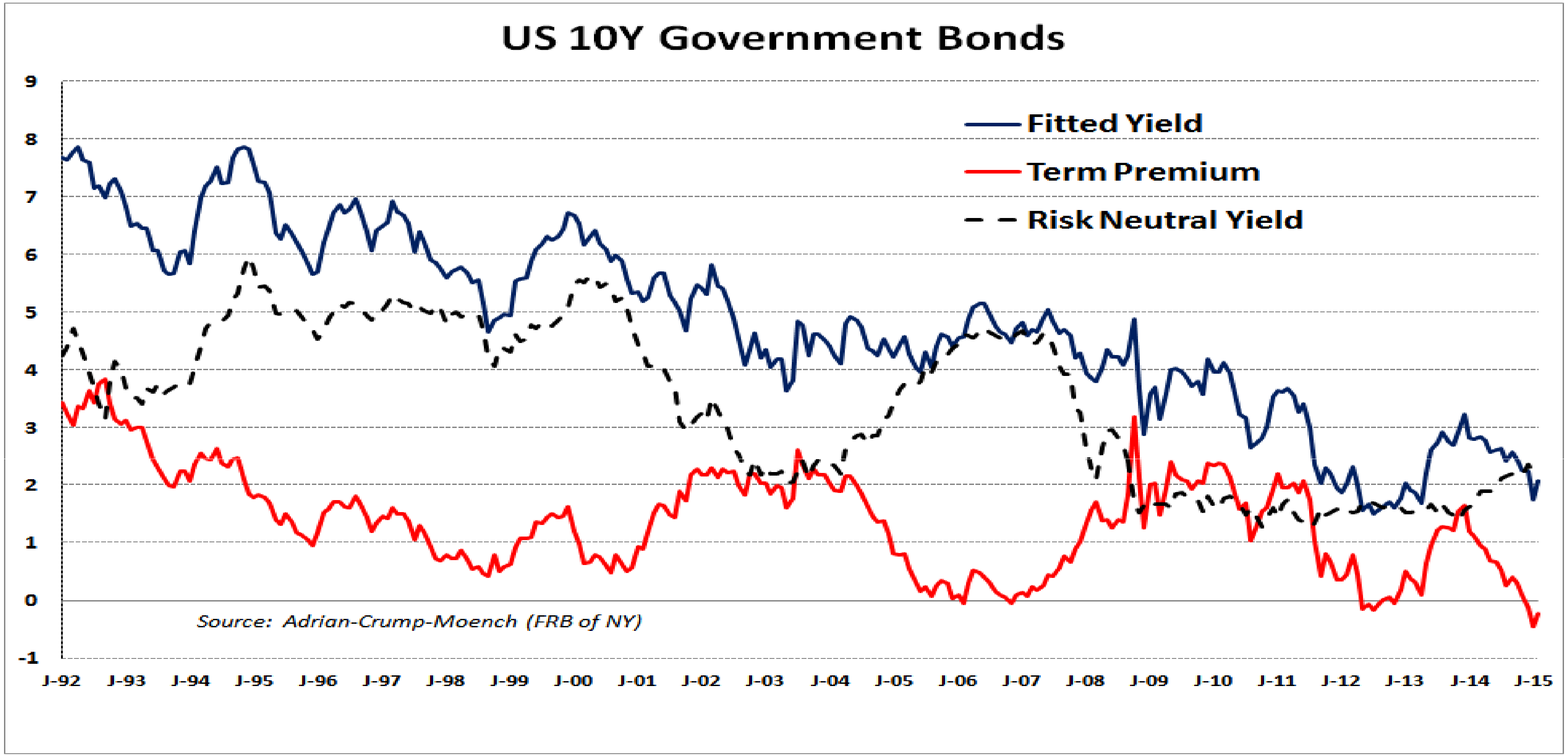
Risks

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

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)

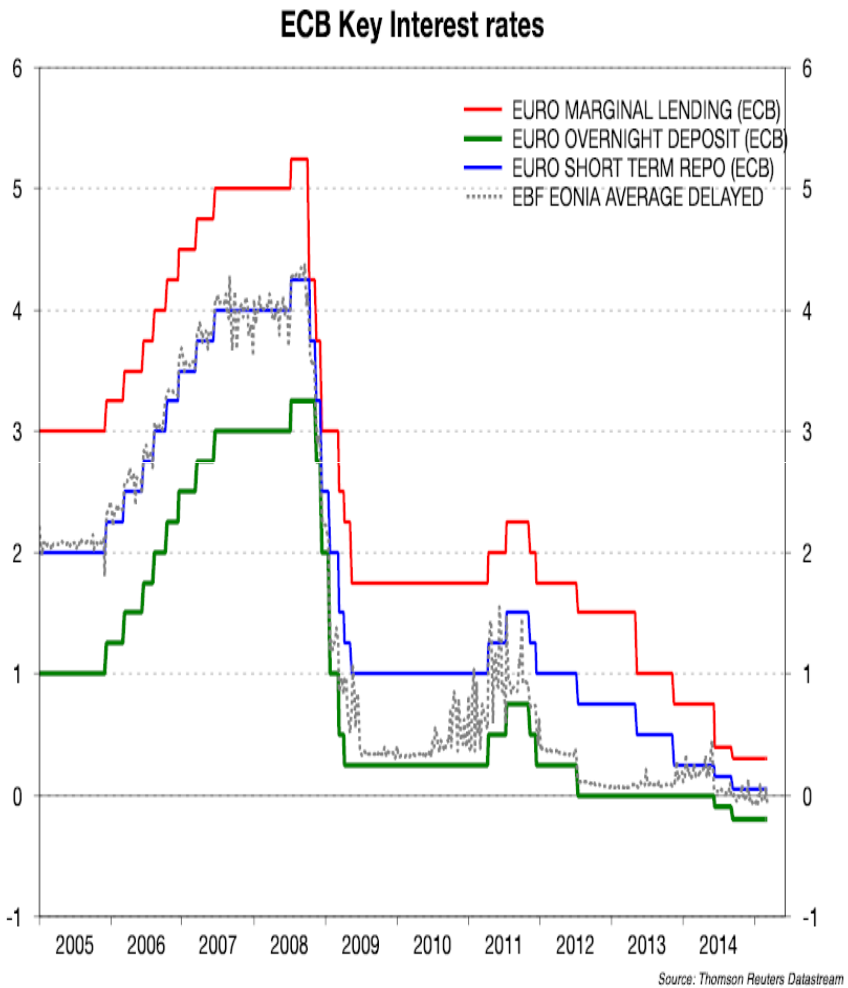


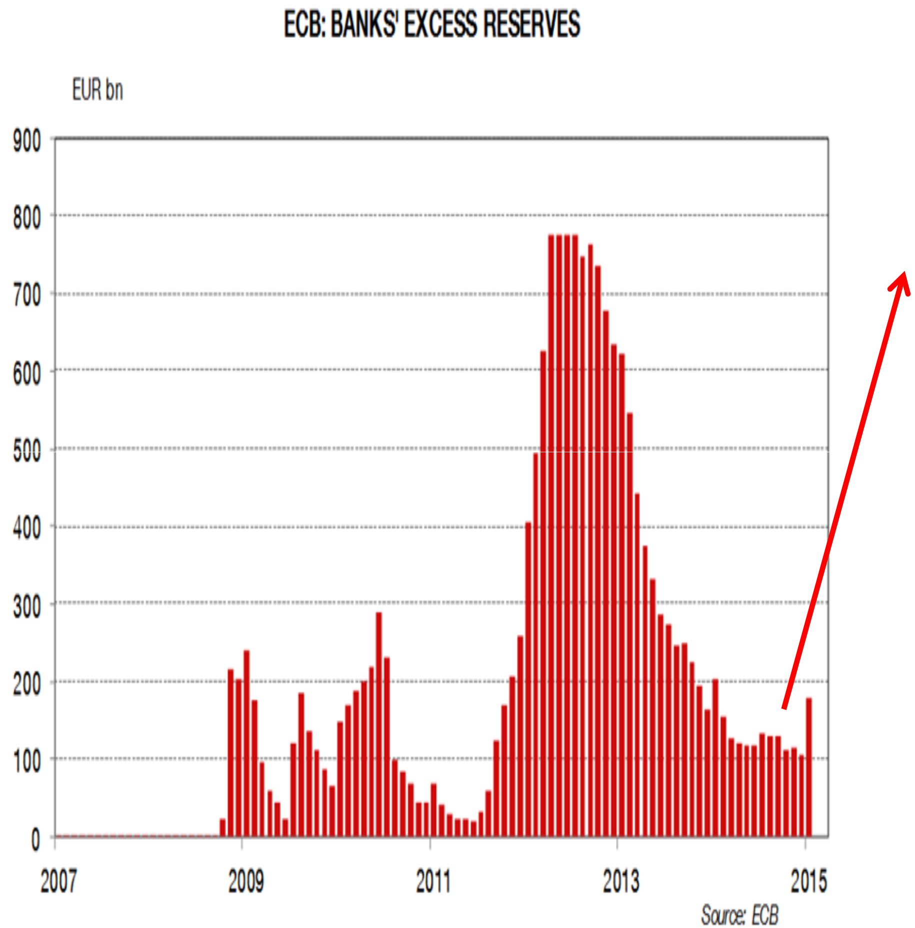
- **The demand for safe and liquid assets is exacerbated by new regulations:**
  - Prudential ratios
  - Collateral (to make wholesale markets safer)

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?**