

Macro Weekly

Group Economics

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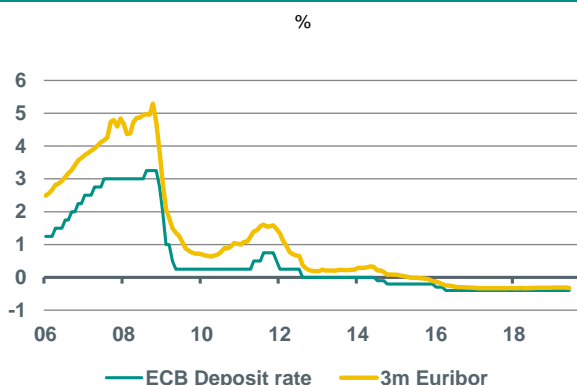
How low can interest rates go?

- We expect the ECB to cut its main policy rates deeper into negative territory, with the key deposit rate dropping to -0.6%
- With risks to economic growth to the downside, this raises the question of how much further interest rates can drop
- The key limiting factor is adverse effects on the banking system, which could lead eventually to lower interest rates being counter-productive
- Other central banks in Europe have more negative interest rates but not that much lower than where ECB policy rates are now
- We think that further room for manoeuvre on interest rates is limited and asset purchases will remain the ECB's main policy tool

Further rate cuts are on the horizon

We expect the ECB to cut its main policy interest rates further. We expect a further 20bp of reductions (one 10bp reduction in September and another one early next year), which would take the key deposit rate to a low of -0.6%. The deposit rate anchors market interest rates, and we are likely to see the benchmark 3m Euribor rate trending to around -0.5%. Following strong signals from ECB President Mario Draghi, most economists also see interest rates dropping further. A survey by Bloomberg News showed that the consensus of analysts is now for an interest rate reduction in September. Financial markets are also pricing in fully a further reduction in policy interest rates. With risks to the economic outlook to the downside, this raises the question of how far the ECB could reduce interest rates if the outlook deteriorates.

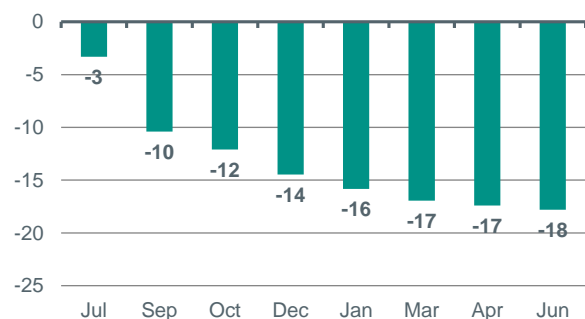
ECB deposit rate and benchmark interbank rate



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Market pricing for interest rates

Expected change from current levels, derived from Eonia swaps, bp

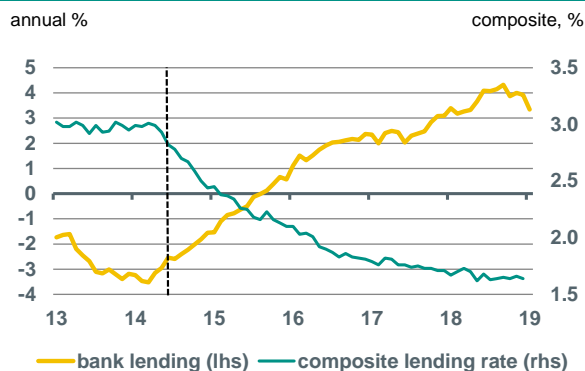


Source: Bloomberg, ABN AMRO Group Economics

Experience with negative interest rates positive up until now

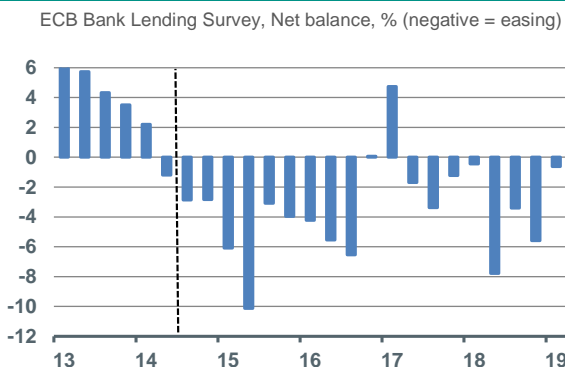
Despite warnings about the potential risks of negative rates over the last few years, the experience of negative interest rates in Europe has been on balance positive. Since the deposit rate was cut into negative territory (in the middle of 2014), bank lending has expanded, lending standards have eased and bank profits have improved (see charts below). Crucially, lower interest rates have supported economic growth more generally, helping to increase bank loan demand and lower provisions for the banking sector.

Bank lending and interest rates to companies



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Bank lending standards to companies



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Headwinds from negative interest rates may increase

This positive experience has given the ECB the confidence to cut interest rates further. Having said that, the adverse effects on the banking system may build over time. Although bank lending rates have fallen, retail deposit rates fell much less as they have been anchored close to zero. This theoretically should squeeze banks' interest rate income. Up until now interest rate income has been resilient, but the impact of lower bank lending rates on interest income may take time to fully come through. This is because a significant proportion of outstanding debt is long-maturity and at fixed rates.

Meanwhile, banks hold safe securities as part of their liquidity buffer. The drop in the ECB's policy rates tends to boost the value of these debt securities so is a positive for banks initially. However, the income from these securities will drop and in many cases will become negative over time as banks roll over their holdings. Finally, banks already face a charge of 40bp of holding their excess reserves at the ECB. For the eurozone banking system as a whole it is a relatively modest cost right now (around 6-7% of profits). However, that cost will rise going forward as the ECB cuts interest rates. In addition, the excess liquidity in the banking system will rise as the central bank will likely resume asset purchases.

Measures to offset the impact

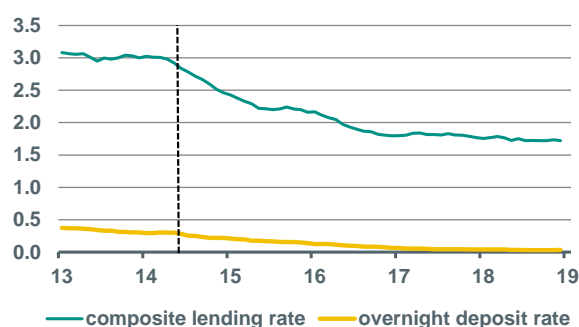
The ECB has said that it would monitor the impact of negative interest rates on the banking system and take measures to offset the impact if necessary. We take a look at two measures the ECB could consider, but neither is straightforward. One possibility is to introduce a tiered deposit rate system. This would involve charging the negative deposit rate only a proportion of banks' excess reserves hence reducing the cost to banks. Other central banks in Europe have employed such a system. In the eurozone context, it would be difficult to design such a system as it is a more heterogeneous environment.

In particular, there are large differences in excess liquidity between banks in different countries. Allowing all banks to hold the same proportion of excess reserves cost-free would actually mean that many banks with low excess reserves at the moment would be able to increase them. They would have an incentive to do so as they could switch from their negative yielding short-dated government debt securities into cash at the ECB (which would then be at zero cost). It would support the income of these banks but could cause significant dislocation in short-dated government bond markets. So this is something that could complicate the design of the system from a eurozone perspective.

A second possibility is to make the TLTRO more generous in terms of the borrowing rate and to extend the maturity. However, this too could cause issues, by allowing some banks to be dependent on central bank loans for long periods.

Eurozone bank interest rates

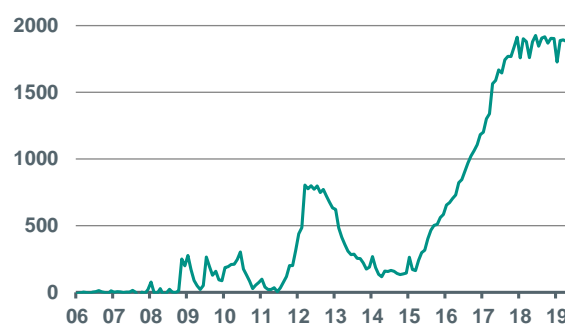
average for companies and households, %



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Eurozone banks' excess reserves

EUR bn



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Squeeze on bank interest rate margins still an issue

The measures above would not tackle the problem of the coming squeeze on bank interest rate income from the narrowing gap between lending rates and deposit rates. Indeed, further reductions in the deposit rate may not actually be passed on to bank lending rates for this reason. This means that interest rate reductions would no longer be fed through to the real economy. This situation would only change if banks were willing to charge negative rates on retail deposit accounts, which does not seem likely in the foreseeable future.

Further rate cuts are all about the currency

One could then ask what is the point of further rate cuts? We think the main rationale for reducing the deposit rate further in this environment is to cap euro strength against the background of rate cuts by the Federal Reserve. If the ECB did not cut rates, a stronger euro would further dampen growth and inflation in the near term and is therefore unwelcome.

Lessons from other central banks

Other central banks in Europe have cut their policy interest rates in negative territory, though not too much more negative than where the ECB's deposit rate is right now. The Swiss central bank has its equivalent of the deposit rate at -0.75% and the Danish central bank's deposit rate is at -0.65%. Although Sweden's central bank has its deposit rate at -1.1% and it has been as low as -1.25%, that rate is not the key driver of interbank rates in Sweden so the situation is not comparable to the way monetary policy works in the

eurozone. If the ECB cuts its deposit rate by another 20bp to -0.6%, it would be very close to lowest levels we have seen for comparable policy rates at other central banks in Europe. Coincidentally, the Swiss and Danish central banks each use their negative policy rates as an instrument to meet a target for the level of their currencies.

Room for manoeuvre is limited

Overall, we think that the room for further rate cuts beyond the 20bp that we have in our base scenario is limited. In an environment where the equilibrium interest rate (the rate which neither stimulates or restricts economic activity) is likely very low and downside risks to growth are building, this means the ECB needs to turn to other measures. In particular, we think that asset purchases will remain the ECB's main policy tool going forward. Against the background of the more challenging environment for monetary policy, it is understandable that ECB President Draghi's calls for fiscal stimulus have become louder.

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The Macro Weekly will take a break next week. Normal service will resume the week after.

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