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An unusual monetary policy action

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Last week, the business world was taken by surprise by an unusual monetary policy decision.

The European Central Bank (ECB) for the 18-member countries of the Eurozone decided to charge a negative interest rate of one percent on deposits over and above the statutorily required reserves kept by commercial banks (banks).

A negative interest rate means that banks, which have excess liquidity, have to pay a fee of one percent for parking their funds at ECB.

Statutory reserve deposit ratios

Banks by lending create deposits in favour of borrowers, thereby increasing money supply. Monetary authorities enforce certain proportion of banks' liabilities, mostly deposits of individuals, business houses and institutions be kept with central bank. Known as statutory reserve deposit ratios (SRDRs), they inspire confidence in the banking system by ensuring not all deposits accepted by banks are loaned away for interest rate income.

The SRDRs were used as monetary policy tool as well for reducing or expanding money supply. A higher SRDR would leave less of reserves with banks for lending, and vice versa. However, in modern days, central banks use indirect, market oriented tools and rely less on SDRS. Recognizing SRDRS work as a tax by denying banks interest income and banks do keep reserves to meet unexpected withdrawals, Australia, Canada, New Zealand, Sweden and England have discontinued SRDRs

In our region, 6 island countries with independent currencies do have SRDRs. For example, Fiji and Vanuatu have SRDRs of 10 percent and 7 percent respectively.

The US Federal Reserve and ECB have SRD ratios at 10 percent and 2 percent respectively. However, these two central banks were paying some interest on the reserves, a practice Fiji had also adopted for a while. In Fiji, the rate of remuneration interest on reserves was fixed at 50 basis points below overnight policy rate (OPR). Fiji's current OPR is 0.5 percent and hence the rate of interest for remunerating bank reserves with central bank is zero percent.

Reason behind ECB move

The eurozone has had negative growth for two years: minus 0.6 percent in 2012; and minus 0.4 percent in 2013. Inflation in eurozone which was 0.7 percent came down to 0.5 percent in May.

During recession with falling prices, banks are hesitant to lend as they are not sure about the return of the borrowed funds. Their fears are based on the pessimistic climate aggravated by deflation.

During deflation, profits decline. Consumers postpone consumption waiting for further fall in prices and delay borrowing for auto loans and housing. So, banks in eurozone keep their excess reserves with central bank as a safe place for them.

For fighting deflation and for boosting economic activities, last week ECB cut benchmark interest rate to a record low: 0.15 percent from 0.25 percent. Also announced was a €400 billion package of cheap funding for banks at cheap rates for loans to manufacturing companies.

Short of steps of the kind adopted by the US Federal Reserve, known as quantitative easing, for pumping money each month by purchasing bonds, ECB has been doing all that it could do.

What surprised the business world was its move to tax the banks at the rate of one percent on excess reserves kept idle with them. The negative interest rate is expected to act as a disincentive and make banks lend more.

Will it work?

Forcing banks to lend out their excess liquidity is not new. Two Scandinavian central banks experimented with negative interest rate. Although the Swedish central bank introduced it in 2009, it was not implemented. In July 2012, Denmark bank began to charge negative official interest rate. The purpose was different from what ECB has in mind. It was to discourage inflows of funds which were strengthening the Danish currency, since Eurozone investors facing low interest rates were seeking higher returns in Denmark.

Negative interest rate worked for Denmark. Funds flowed out and the currency weakened.

The ECB's objective is to fight deflation. No doubt, a weakened euro will promote exports. Imports will become more expensive. That will feed inflation. After all, ECB's objective is just that!

The big question still remains: Will there be a higher lending?

Danish experience showed that the effect on the real economy was zero.

So, that will only lead to one avenue left: quantitative easing of the kind the US and UK adopted: pumping in money each month. It has stopped deflation, although recovery is slow.

The latest news from UK is: housing prices are soaring. The IMF has issued a warning of credit bubble.

That is another story!

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