AT A GLANCE

Monetary Dialogue September 2018

Abundant liquidity and banks' lending activity: an assessment of the risks

Background

Since the start of the global crisis, the European Central Bank (ECB) opted for a huge increase in the liquidity allocated to the banking system in order to encourage lending to the economy. The liquidity increase went through various refinancing instruments such as Targeted longer-term refinancing operations, which granted loose refinancing conditions for banks. Similarly, the rate on the deposit facility, which banks use for their overnight deposits with the Eurosystem (the ECB and the euro area national central banks), have been set negative since June 2014 and currently stands at -0.4%. Despite the penalization applied, banks have continued to accumulate important own excess reserves on their account in the national central banks.

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It is generally acknowledged that the level of liquidity in the banking system does not represent a problem for their activity and that ECB measures have proven to be successful in boosting the banking credit activity. Some critics, however, point at the risks of continuing this strategy, arguing that ample liquidity allocation could trigger riskier lending behaviour in banks as they are confronted with a shortage of good quality credit demand.

For the September 2018 session of the Monetary Dialogue, the Committee on Economic and Monetary Affairs (ECON) of the European Parliament has asked experts to analyse the risks related to the abundant liquidity and banks' lending activity. References to the relevant in-depth analyses are provided below.

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
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In-depth analyses of the September 2018 Monetary Dialogue

Negative Interest Rates and the Signalling Channel by Kerstin Bernoth (Hertie School of Governance, DIW Berlin), Alexander Haas (DIW Berlin)

While negative interest rates stimulate the real economy by enhancing credit supply and improving the wealth situation of firms and households, they might come with side effects with regard to banking and financial stability. In an assessment of the trade-off between the ability of a central bank to use negative policy rates to signal lower future deposits rates, against the potential costs on bank profitability, the paper finds that the signalling effect dominates. Thus, a negative interest rate policy is an effective monetary policy tool, even when deposit rates are bound by zero.

Excess Liquidity and Bank Lending Risks by Zsolt Darvas and David Pichler (Bruegel)

Low interest rates and excess liquidity in the euro area might create financial stability risks. The paper clarifies the notion of excess liquidity and highlights that its current level is primarily the result of ECB asset purchases. It concludes that financial stability risks in the euro area are low, but increased home bias and housing prices necessitate full attention from the macro-prudential authorities. Monetary policy tools are ill-suited to fostering financial stability objectives.

Abundant Liquidity and Bank Lending Activity: an Assessment of the Risks by Andrew Hughes Hallett (Copenhagen Business School) and Addilyn Chams-Eddine (School of Public Policy, George Mason University, USA)

This paper assesses the risks facing the euro area banking system, as it returns to normal financial conditions without ECB support. In the first part the authors argue that risks to bank lending mainly stem from the transmission of external monetary policy effects that may not be aligned with ECB policies. The second part of the paper therefore offers some ideas on the need to moderate spillover effects from outside monetary policies or events. The authors also review how far new prudential policies, regulatory measures and/or policies can be used to mitigate those unfavorable risks.

Post-crisis Excess Liquidity and Bank Lending by Corrado Macchiarelli (Brunel University London and London School of Economics)

With the Asset Purchase Program, the ECB has supplied significant amounts of liquidity into the financial system starting from 2015, resulting yet into a new upswing in excess liquidity. The expanded asset purchase program broadly coincided with further cuts in the ECB's deposit facility rate. Against this background, this note assesses the ECB policy of negative rate on the deposit facility and discusses the associated risks in the context of an excess liquidity overhang for the euro area, including risk-appetite for banks.

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