Implausible truths

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This year the Eurosystem, the central banks of the euro zone, which are public entities, will pay approximately 140,000 million euros to European private banks. Of this, Spanish banks will receive around 10 billion euros, which will be paid by the Bank of Spain. This enormous figure only refers to the interest payment for the deposits that the banks keep in their central bank, the Bank of Spain for the Spanish banks. It is equivalent to approximately 1% of the GDP of the euro zone.

How is this amount obtained?

It is not possible to make an exact calculation of the final amount that the Eurozone central banks will pay to the banks. It will depend on the evolution of interest rates and the level of bank deposits in the Euro system. But it is not difficult to make a reasonable estimate.

At the end of March, banks had 4,035,917 million euros deposited in the Eurosystem. Assuming that this figure is reduced somewhat this year, and assuming an average rate of 3.50% for 2023 (higher if rates continue to rise), we obtain the figure of 140 billion.

These deposits are largely the result of the bond purchases made by the ECB in the last decade, as part of the extraordinary monetary policies (the so-called quantitative easing or QE). But until just over a year ago, central banks paid nothing for these deposits (in the jargon, "deposit facility", sic) as rates were at 0% or even negative! But inflation came along, not surprisingly, and they started to raise interest rates. At the end of 2022 they were at 2.5%, now at 4%.

Will this produce losses for central banks?

Yes, and large ones, because what they will pay the banks for their deposits is a lot, and they will not be able to neutralize it with the yield of their investments. A large part of the central banks' bond portfolio has very low, zero or even negative interest rates. The net impact of both effects will translate into significant losses in central banks' income statements.

For example, the Bundesbank is likely to have to receive a public capital injection (a bailout), as reported by the agency that audits German public bodies.

Is all this important?

Very important. All this involves a redistribution of income from the state to the private sector. From the national treasuries, through their central banks, to the banks. With this money, the States would be able to meet many of their citizens' needs.

If this continues, the Eurosystem will have to eliminate or reduce its dividend transfers to national governments. Paul de Grauwe estimates that this loss of national government revenue will be in the order of 1% of eurozone GDP and, if nothing is done, will lead to an equivalent increase in the public deficit, requiring additional fiscal austerity in the future.

Does this have to be the case?

Absolutely not. Let us continue to ask questions: why should banks be remunerated for holding liquid reserves at the central bank, is this remuneration necessary to conduct monetary policy, and are there alternative policy procedures that avoid making large interest payments to banks?

Many economists take it for granted that banks' deposits at their central bank should be remunerated. But this is a recent phenomenon. Before the start of the euro in 1999, most European central banks, with the exception of the Bundesbank, did not remunerate balances in excess of the banks' required reserve requirement. Under pressure from the Bundesbank, the ECB started this practice in 1999. The US Federal Reserve did not introduce remuneration until 2008, in the midst of the crisis.

In other words, until before 2000, the general practice was not to remunerate bank balances. This made sense: banks did not remunerate their customers' demand deposits, and provided liquidity to the real economy, to businesses and households. It is difficult to find a rational economic justification why banks should be remunerated by the State for keeping their money in the central bank while companies and households should accept not to be remunerated.

The payment of interest on deposits to banks has another unfortunate consequence. It transforms long-term government debt into short-term debt. Most of the government bonds held by the Eurosystem have been issued at very low, even zero or negative, interest rates. This means that the governments that issued them are protected for some time from interest rate hikes. By paying an interest rate of around 4% on bank reserves, and thus reducing government revenues, the central bank now transforms this long-term debt into very short-term debt, forcing an immediate increase in interest payments on consolidated government debt.

There are alternatives put forward by some economists. For example, a better policy would be to combine the sustained sale of government bonds with the mandatory cash ratio increase to banks at the central bank. If banks' balances were not remunerated, many would buy government bonds or other assets. The current reserve requirement is at an all-time low of only 1% and could clearly be raised.

Moreover, if progress is made in reducing the Eurosystem's huge balance sheet by selling part of the bonds held by central banks, it is true that losses that have been latent until now will materialize, but bank deposit balances at central banks would be reduced, thereby reducing interest payments.

I conclude. The current situation, which is historically unprecedented, is not only unfair, but also indicates problems of competition in the banking sector, problems in Europe's financial structure, and problems in the management and implementation of monetary policy. For the good of all, the silent central banks must face up to the current situation and correct it. But, above all, it is the politicians who must react: this is a political issue of the first order that should not be left to the technicians alone.

"There are truths more implausible than lies" said a Portuguese politician recently. And, I add, they are still true. And the one exposed here is, almost unbelievable and very uncomfortable.

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