



EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB-PUBLIC

COURTESY TRANSLATION

Christine LAGARDE
President

Mr Marco Zanni
Mr Valentino Grant
Mr Antonio Maria Rinaldi
Members of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 17 November 2023

L/CL/23/202

Re: Your letter (QZ-027)

Honourable Members of the European Parliament, dear Mr Zanni, Mr Grant, Mr Rinaldi,

Thank you for your letter, which was passed on to me by Ms Irene Tinagli, Chair of the Committee on Economic and Monetary Affairs (ECON), accompanied by a cover letter dated 28 September 2023.

Regarding your first question, let me first mention that the transmission of our monetary policy relies on being able to effectively steer short-term money market rates. These constitute the first step in the transmission chain that ultimately determines the interest rates faced by firms and households, shaping their investment and spending decisions and allowing us to bring inflation towards our medium-term target. To steer short-term money market rates, any deposits that banks hold with the Eurosystem, in excess of their minimum reserve requirements, must be remunerated at the policy rate consistent with our intended monetary policy stance, which is currently the rate on our deposit facility. In general, this mechanism can temporarily have positive or negative effects on bank profits.

Our previous monetary policy actions created a high volume of aggregate excess liquidity, associated with long-term lending operations and bond purchases. These measures were taken as a response to the low-inflation environment prevailing in the aftermath of the euro area sovereign debt crisis and, more recently, to prevent an unwarranted tightening of financing conditions during the pandemic crisis that would have been inconsistent with our intended monetary policy stance at that time.

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As part of monetary policy normalisation, last year we started to shrink our balance sheet. This has been happening at a very fast pace – since last autumn, banks have repaid €1.6 trillion in outstanding loans under the third series of targeted longer-term refinancing operations (TLTRO III). More recently, the run-down of our monetary policy asset portfolio related to the asset purchase programme (APP) has also been contributing to a decline in our balance sheet, thereby further reducing excess liquidity in the banking system.

The increase in the remuneration of excess liquidity deposited with the central bank generates a positive mechanical impact on banks' gross income. At the same time, the transmission of our monetary policy tightening is gradually pushing up banks' funding costs. In general, while the mechanical impact on gross income dominates at first, the broader consequences of higher interest rates on bank profitability are less clear-cut over the medium term. First, the impact is heterogeneous across banks as, depending on their asset and liability management and specific circumstances, the interest income on banks' assets may rise more slowly than their funding costs. Second, the transmission of monetary tightening compresses lending volumes and increases costs associated with loan loss provisions due to the slowdown in economic activity. These effects are slower to emerge but, over time, tend to weigh on banks' profits. In this context, we will continue to monitor whether the transmission of our monetary policy via the banking system remains adequate.

Regarding your second question, in July the Governing Council decided to set the remuneration of minimum reserves at 0%, effective as of the beginning of the reserve maintenance period starting on 20 September 2023. This decision aimed at preserving the effectiveness of monetary policy by maintaining the current degree of control over the monetary policy stance and ensuring the full pass-through of the Governing Council's interest rate decisions to money markets. The decision was also taken to improve the efficiency of monetary policy by reducing the overall amount of interest that needs to be paid on reserves in order to implement the appropriate stance. The key policy rates, and not minimum reserve requirements, are our main tool for adjusting our monetary stance.

Finally, as you are aware, we are currently reviewing the operational framework, including the role that minimum reserve requirements will play within the new framework. As I explained at my latest hearing at the ECON Committee, we aim to conclude this review by spring 2024, and I will of course report to the Committee on the outcome.

Yours sincerely,

[signed]

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