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Technical note on the transmission of ECB interest rate policy

Provided to Deputy Pearse Doherty (8 September 2023)

Query:

If the Central Bank would be able to provide a brief technical note on the transmission of ECB interest rate policy (specifically the deposit rate), outlining:

A. the relationship between the deposit rate and the deposits held by credit institutions with the Central Bank and ECB;
B. and the relationship between the ECB interest rate and commercial bank deposits.

Part A: ECB deposit facilities

At end-June 2023, Irish resident credit institutions held just over €4.3 billion in current account balances (which includes balances held to cover the minimum reserve requirements) at the Central Bank of Ireland (Central Bank) and just under €84 billion euro in deposit facility balances at the Central Bank.[1]

Minimum reserves are reserve balances that credit institutions are required to hold with their Eurosystem national central bank. Credit institutions are required to hold a minimum amount equivalent to 1% of specific liabilities, mainly customers' deposits.

In terms of the current remuneration of different balances:

- Minimum reserves are currently remunerated at the ECB's deposit facility rate (DFR) which is 3.75%.

[1] This data can be seen on the ECB website (June 2023 is the most recent published data): Financial statement of the Eurosystem. The total balance sheet position for Irish headquartered credit institutions was €367 billion in June 2023; with €280 billion held as deposits with Irish residents.

- Reserves held by credit institutions in the Central Bank's current account, that are in excess of their minimum reserve requirement, are remunerated at 0.00%.
- Balances held on the deposit facility are remunerated at the ECB's deposit facility rate (DFR), which is currently 3.75%.

On 27 July 2023, the Governing Council of the ECB decided to set the remuneration of minimum reserves at 0% (Press release here). The change will become effective as of the beginning of the reserve maintenance period starting on 20 September 2023. Balances held on the deposit facility will continue to be remunerated at the ECB's deposit facility rate.

Access to the deposit facility is granted to monetary policy counterparties of the Central Bank. Typically, monetary policy counterparties place reserves in excess of the minimum reserve requirements in the deposit facility to receive the DFR, rather than leaving them unremunerated in the Central Bank's current account.

In the current conditions of ample liquidity, the interest paid on the excess reserves that credit institutions hold in the deposit facility is the Governing Council's main instrument for setting the monetary policy stance in its fight against above target inflation.

Part B: ECB interest rate pass-through to retail banks

Monetary policy is transmitted to the economy, and ultimately to inflation, through a number of channels. One of these is through the interest rates set by banks on loans and deposits.

The key ECB interest rates started to increase in July 2022, and have increased sharply by 425 basis points since then. As mentioned above, the deposit facility rate (DFR) is currently 3.75%, and is currently the main ECB policy rate influencing market rates.

Central Bank data in Figure 1 shows that interest rates have changed for both business and households in terms of loans and deposits.[2] Lending rates to businesses appear to have responded quite strongly in both Ireland and the euro area. Interest rates on outstanding mortgages in Ireland have risen by more than the euro area average, due to the share of tracker mortgages in the Irish market and high shares of fixed mortgages in some other countries. Interest rates on new mortgages, by contrast, have risen by less in Ireland than the euro area average. Meanwhile

[2] See this link for retail interest rate statistics up to June 2023.

interest rates on overnight deposits appear more sluggish in terms of responding relative to the euro area. It is worth noting that overnight deposits make up the overwhelming majority of Irish household deposits.[3] Overall, the average interest rate received on all household deposits has increased by considerably less in Ireland than the euro area (see Figure 2). This is due to a combination of: (i) slower pass-through on household overnight deposits and (ii) the fact that there has been very limited new flow of term deposits in Ireland, which have seen more meaningful increases.

Recent research carried out by the Central Bank provides early evidence of monetary policy transmission by looking at the strength of interest rate pass-through from ECB policy rates to a range of loan and deposit products offered to firms and households in Ireland and the euro area. This model based analysis can account for other important macroeconomic and financial factors that may affect pass-through, such as inflation, the state of the labour market and government bond yields. It then statistically tests whether pass-through is different in this monetary policy tightening cycle[4] and whether pass-through in Ireland differs from peer countries in Europe. The analysis was carried out using the most recent published data, which has information on retail interest rates up to June 2023.

Results show that while retail interest rates faced by firms and households are reflecting increases in the key ECB policy rates since July 2022, there is variation across loan and deposit products and across euro area countries.

For the euro area, pass-through to household deposits is weaker in this cycle while it is also weaker for business overnight deposits. For mortgages, pass-through appears to be in-line with historical norms, while for business loans and business term deposits, pass-through is stronger.

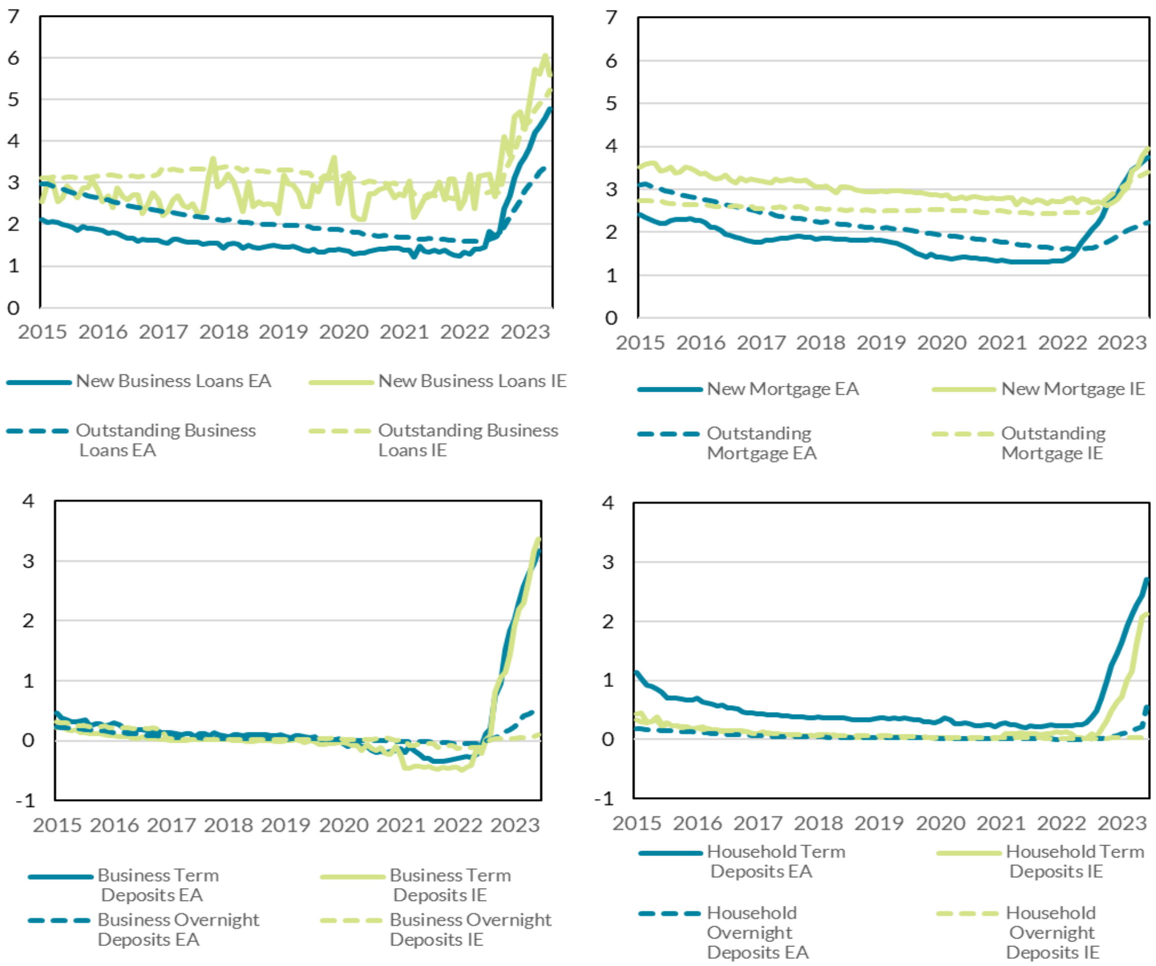
Pass-through in Ireland is broadly the same as euro area pass-through for several products. However, pass-through has been weaker in Ireland to interest rates on new mortgages and to household deposits.

[3] Interest rates reported represent the rate agreed between the credit institution and its customer, and may differ from rates advertised by the credit institution. For example, the weighted average interest rate reported may be impacted by a relatively small number of high net worth counterparties.
[4] The previous tightening cycle, which began in November 2005, also featured nine rate increases. That cycle covered almost two years and the total increase in the key interest rates was 200 basis points.

In recent weeks, a number of banks have made announcements in relation to increasing their interest rates on a range of their deposit products. We would expect that this channel of transmission will continue to strengthen.

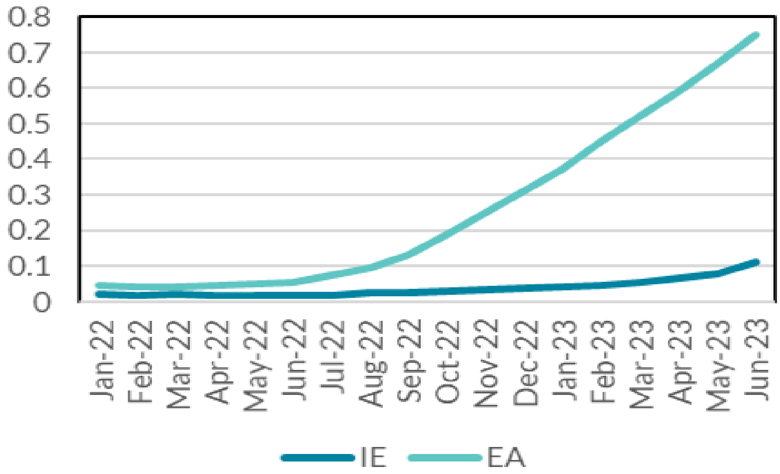
Understanding how long and how variable the lags will be during this period is more challenging due to the considerable changes in the economy and the financial system since the last major tightening cycle, more than 15 years ago. We will continue to monitor the strength and speed of transmission using a wide array of indicators.

Figure 1: Interest rates across product types; Ireland and euro area



Note: these charts show the time series of interest rates of loan and deposit products in both Ireland (green) and the euro area (blue), January 2015 to June 2023. “Term deposits” refers to deposits with agreed maturity.

Figure 2: Weighted average interest rate on term and overnight deposits in the euro area and Ireland.[5]



[5] Weightings to calculate weighted average interest rate are based on stock of overnight and term deposits.