

Why European Central Banks Will Suffer Steep Losses



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Private banks get billions from the ECB and European taxpayers will foot the bill

In September, the president of the Dutch central bank wrote what may have been the most remarkable letter of his career: it said that the ECB's interest rate hikes will lead to losses for De Nederlandsche Bank (DNB) for the first time since 1932. Several countries throughout the eurozone are facing a similar problem. To absorb the losses of their central banks, European taxpayers risk having to pay tens or even hundreds of billions of euros a year. Meanwhile private banks get that same amount of money without having to do anything in return. The ECB now stands ready to make a crucial policy decision to determine whether billions in taxpayer money will again flow to the banking sector.



Klaas Knot, President of De Nederlandsche Bank, is giving a lecture on a conference in celebration of the euro's twentieth anniversary

On 20th September 2022, the board of the Nationale Bank van België (NBB) went into a panic. The Belgian central bank is owned half by the state and half by private shareholders. Unlike most other

The NNB [press release](#) made it clear in the very first sentence what had caused the sudden drop in share price: 'The Nationale Bank van België took note of the letter written by Mr Klaas Knot, President of De Nederlandsche Bank, to Mrs Sigrid Kaag, Dutch Minister of Finance, with the subject heading "letter regarding DNB's capital position", which was published yesterday on the DNB website.'

It was not the Belgian central bank, but its Dutch counterpart which had caused the panic.

What had happened? On September 9th, the president of De Nederlandsche Bank, Klaas Knot, sent a letter to the Dutch Minister of Finance, Sigrid Kaag. On September 20th, DNB [published](#) the letter on its website. Its news on the monetary situation in the eurozone was so explosive that it shocked the Belgian central bank's private shareholders. **This resulted in them doing something that the state - which is the sole shareholder of the central bank in other euro countries - cannot do: they decided to sell off their shares.**

Knot's letter

What was it in Knot's letter that so scared the Belgian shareholders? Well, it was a profit warning: 'The current high inflation was not foreseen and therefore necessitates a tightening of monetary policy. This will lead to interest-rate hikes and subsequent losses for DNB.' In essence, this meant that the ECB decided that the national central banks had to pay higher interest rates to private banks than DNB had expected.

Knot's Belgian counterparts had remained silent on the similar problems that they faced, but the publication of the DNB letter put them on the spot. The NBB had to admit that 'based on its most recent risk scenarios' the bank was expecting losses too, adding: 'The risk analysis indicates that losses will further increase over the coming years.'

This problem is not limited to Belgium and the Netherlands, but will affect all countries of the eurozone. It is the first time since the Great Depression of the 1930s that multiple central banks will make a loss.

The explosive growth of reserves

The losses originate in the explosive growth of central bank reserves, due to the so-called Quantitative Easing (QE) policy. Because interest rates could not be lowered any further and to counter the threat of deflation, the eurozone's national central banks bought up tens of billions (varying from 20 to 120 billion) of government and corporate bonds each month. They did so through the so-called Asset Purchase Programmes, which were financed with central bank reserves, the interbank money that the central bank creates itself.

In addition, private banks were able to borrow central bank reserves very cheaply, via targeted longer-term refinancing operations (TLTROs). They would sometimes even receive money on these loans, as the loans had a negative interest-rate for prolonged periods of time. Off the record, bankers were often heard calling these TLTROs 'a gift from the central bank'. European private banks have made ample use of this free money: at present, there are approximately [2200 billion euros](#) worth of extremely cheap long-term loans on their balance sheets.

Up until a few months ago, when interest rates were still negative, that mountain of reserves did not negatively affect the profitability of the central banks in the eurozone. While private banks could borrow cheaply via TLTROs, they also had to pay the central banks negative interest on their central bank reserves. This provided the national central banks with a source of income.

The ECB has now raised the interest rate on most of these reserves to 0.75 per cent, with the idea that banks would simply pass these interest rate hikes on to the client. That would make saving more attractive, borrowing more expensive, and investing less profitable – with the aim of discouraging spending and thus curbing inflation.

But as policy rates were raised, the excess liquidity in the banking system suddenly became a cost item: the central bank now pays the private banks 0.75 percent interest on their excess reserves. Meanwhile, the income on the interest on government and corporate bonds that the central banks acquired through the Asset Purchase Programmes remains minimal. After all, these securities date back to the period of negative interest rates.

DNB is expecting a loss of a total of 9 billion euros over the period 2023-2026. A simple calculation shows that the cost to the public could become much larger. With the current interest rate of 0.75 per cent, DNB pays the banks approximately 1.6 billion annually. If the ECB should raise the policy rate in the short term to 3 or 5 percent, the interest expenses on reserves would rise to 6.5 or even 10.7 billion per year.

For the joint European central banks, the reserves are already costing 30 billion a year. If the interest rate rises to 3 or 5 percent, our central banks will lose between 120 billion and 200 billion euros per year. The ECB cannot disclose the exact figures, but it has confirmed to *Follow the Money* that ‘the Eurosystem central banks will face a reduction in their net income and even face net losses.’

It is worth noting that the losses at DNB and the [Bundesbank](#) are above the average because they took a tough stance during the euro crisis. For the Public Sector Purchase Programme, the northern central banks did not want to [share risk via the](#) capital key, which is normally used to distribute risk over the national banks within the European central banking system. As a result, the northern central banks now own bonds with lower interest rates than the central banks of the southern euro countries. For example, the interest rate on Italian and Spanish government bonds is higher than the interest rate on Dutch or German bonds. Had the Northern European countries opted for risk sharing with other euro countries, their income from interest would now be higher.

Central banks are presenting the losses as if they come as a complete surprise, but rising interest rates were a predictable scenario. In 2021 the ECB conducted a [strategy review](#) of its monetary policy for the first time since 2003, but it did not take into account the consequences of rapidly rising interest rates.

Lex Hoogduin, professor of financial markets at the University of Groningen and former DNB director, calls this ‘a blunder’. ‘When you have created such a large amount of reserves, you need to plan for rising interest rates. You cannot simply assume that interest rates will remain low forever.’ According to him, ECB executives failed to critically examine their own policy in their strategy review. ‘In that respect, it was as if they had lost their grasp of reality.’

These financial buffers, however, seem to be insufficient, at least for the Dutch central bank. In its letter to the Ministry of Finance, DNB writes about the expected losses and also stipulates how the state, as its sole shareholder, may have to step in to supplement DNB's capital. The bank supervisor does not have sufficient capital buffers to withstand these losses - in that sense, it did not comply with the requirements it imposes on private banks. This time it may not be the commercial banks which come under their supervision, but the guardians of the banking sector who may have to be bailed out by the taxpayer.

However, DNB does not mention any of the policy options that the European Central Bank could use in order to prevent the eurozone's national central banks suffering huge losses. In this way, it distracts from the fact that it is a decision – and not a foregone conclusion – to have the taxpayer pick up the bill for their unconventional monetary policy. If the ECB chose a different strategy, it could raise interest rates to combat inflation, without the necessity for public bailouts of Europe's central banks.

Let's examine the available policy options. The cause of the central banks' losses is obvious: a combination of a large amount of reserves and the interest paid on them. When interest rates rise, the costs for a large amount of excess reserves increase rapidly. The obvious solution is to 'mop up' the excess liquidity. The central bank can do this by selling the government and corporate bonds it purchased on the financial markets. While quantitative easing creates central bank reserves, so-called quantitative tightening destroys them.

However, this would immediately lead to greater losses for the central bank, as the value of most of these bonds has since fallen below their purchase price. Moreover, the huge supply from the central banks would put further pressure on their market value. In that case, the market interest rate against which European governments finance themselves would also rise further. Countries with high government debts could face serious financing problems immediately. Large financial institutions holding bonds (such as banks, pension funds and insurers) would also face large losses. This is not a realistic option. *On the surface*, the ECB appears to be stuck between a rock and a hard place.

Higher reserve requirements

But there are other conventional policy instruments to bring down inflation that do not involve the ECB spending taxpayer money. For example, the ECB can raise reserve requirements and abolish or lower the interest rate on (parts of) the reserves. In that way, the ECB would make private banks contribute their fair share to the monetary tightening, while reducing the public burden.

In the past, increasing or decreasing the reserve requirement for banks was a frequently used instrument in the central banks' toolbox. The higher the requirement, the more reserves private banks must hold. This creates scarcity in reserves and simultaneously increases the effectiveness of the interest-rate instrument. Raising the reserve requirement was used, for instance, to [curb](#) high inflation in the 1970s. Since the 1980s – when the idea that creating money was best left to market forces was put into practice – the use of this policy tool gradually waned. In some countries, the reserve requirement has even been abolished.

However, a return to a conventional monetary policy can be achieved with a decent increase in reserve requirements. In 1998, just before the introduction of the euro, the ECB Governing Council itself [gave](#) three

When the rate was increased on secondary loans, the reserve requirement was 2 percent in 2014, the ECB lowered that obligation to 1 percent. By law, the reserve requirement is allowed to rise to [10 percent](#). That means the ECB still has a policy margin of 9 percent at its disposal on this instrument, which can be used at any time.

Asked whether the central bank is considering raising reserve requirements, the ECB replied to *Follow the Money* that it is 'currently analysing the issue, but it is too early to be more specific at this stage about possible options.'

Having interest on central bank reserves is not self-evident

In addition, the ECB has various interest-rate instruments at its disposal. It can set the interest rate at which banks borrow reserves, and it can, independent from that rate, determine the remuneration on deposited reserves.

It used to be common practice to set high reserve requirements without any interest paid to private banks. The most influential economist of the last century, John Maynard Keynes, wrote in 1930: 'It is right and reasonable that the member banks should contribute, in the shape of non-interest-bearing deposits held by them with the Central Bank, the bulk of the resources which are required for the safety of the highly economical and efficient system, the existence of which enables the member banks to be so comfortable and profitable.' Private banks profit from a stable monetary system, so why shouldn't they pay for its maintenance?

After all, liquidity buffers were introduced to compensate for excessive risk-taking by banks and to make the monetary system more secure. The digital central bank reserves are the modern equivalent of cash or gold bars in a vault. There is no obvious reason to pay interest on them: they are not loaned out, and banks are not exposed to any risk by holding them. The reserves are simply the monetary foundation upon which our financial system is built. As the Greek philosopher Aristotle said in the third century BC, 'Money is sterile'. It is not meant to multiply by itself. In fact, most religions consider it immoral when that happens. 'Using money to make money' has traditionally been considered a sin within Christianity and Islam.

Despite this ancient convention, central bankers on both sides of the Atlantic have become increasingly susceptible to the argument that the reserve requirement is an inappropriate tax on banks. The economists of the Chicago School, led by the famous Milton Friedman, [argued](#) that private banks should be compensated for the 'forfeited' income from interest due to reserve requirements.

When the American central bank, the Federal Reserve, tried to implement interest payments on reserves without the consent of the American Parliament in 1978, they got a clear reaction from their political superiors. In a letter from both the House and the Senate Banking Committees, Congressmen [wrote](#): 'We believe that unilateral action to pay interest on reserve balances would constitute a blatant usurpation of Congressional powers and would raise profound questions about the continued independence of the Federal Reserve.'

With remarkable foresight the letter continued: 'In the absence of legislative limitations, the payment of interest on reserve balances, however modestly begun, could ultimately add billions of dollars to the federal deficit and could be viewed as a precedent for carte blanche authority for the expenditure of

first to silently cross the rubicon: when asked by *Follow the Money*, it could not recall when interest payments on reserves were first introduced. In Europe, interest payments on required reserves became common practice with the introduction of the euro.

When it suited the banks, it was possible

What makes the central banks' present silence on the option of reducing interest payments on reserves even more remarkable is that the ECB has been using this policy measure for the past three years. On 30th October 2019, the ECB set up a [two-tier system](#), exempting part of the banks' excess reserves from interest payments.

This happened when policy interest rates were negative, which meant that banks had to pay for their reserve deposits with the central bank. The ECB accommodated private banks with an exemption: they no longer had to pay interest on a large part of their reserves. However, the ECB abandoned the tiering system on 8th September 2022. If this measure was possible when it favoured the banks from 2019 to 2022, why wouldn't it be possible to leave part of the central bank reserves unremunerated now, instead of asking the taxpayer for money?

On 12th October, Reuters [cited](#) anonymous sources from within who claim that the central bank is considering various options to reduce the interest payments on reserves, including reinstalling the two-tier system and changing the terms of the TLTROs. 'Paying interest on these excess reserves deplete central banking profits, limiting their ability to pay cash into national budgets and depriving the state of vital income. [...] Central banks could even deplete their own capital, possibly forcing governments to recapitalize lenders.' *Follow the Money* confronted the ECB with these rumours, but the ECB says it is still 'too early' to comment on which policy options it is considering.

In the United Kingdom, a similar debate is going on about whether to stop private banks from being remunerated on their reserve balances. Bankers do not [favour](#) this option, as it would decrease their profitability.

Guardians of bank profitability

Miguel Ángel Fernández Ordóñez, the former president of the Spanish central bank, points out that the role of central banks has changed during the last decade. He argues that central banks have *de facto* become the 'guardians of bank profitability'. During the past decade of low interest rates, all kinds of support measures, such as the two-tier-system and TLTROs, were implemented to support the profitability of banks. With interest rates rising, it seems that the central bank is once again throwing billions into the banks' laps. Risk-free reserves – which, like cash and gold bars in a vault, normally yield no returns – are now providing the banks with high yields, whilst market rates for deposit holders at these banks are still nowhere near that rate.

In response to *Follow the Money*, the ECB said that its monetary policy, including the bond holdings purchased through the Asset Purchase Programmes, is designed to fulfil its mandate 'even if pursuing this policy could temporarily result in a reduction in the reported financial results'. For the ECB, their own losses are not a priority. 'Our mandate is to maintain price stability, not to generate central bank profits.'

The ECB is once again faced with decisions that will have large redistributive effects. It can single handedly prioritise the interests of private banks over the public interest. In a democracy, such choices should not be made by unelected central bankers who have no political accountability. This therefore warrants a thorough review of the checks and balances in our monetary system, especially with regard to the power of central banks.

Bank taxes

If European central bankers choose to pay large amounts of interest on central bank reserves, governments can intervene with an option of their own: they can simply choose to raise bank taxes. Belgium is already considering this move. In Spain, the government is arguing that the 'extraordinary' profits enjoyed by the banking sector warrant a 'windfall tax' on banks. The Spanish government has drawn up a proposal and officially asked the ECB for its opinion on the matter.

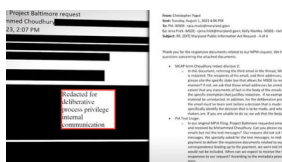
The largest banks in Spain oppose the proposal. Gonzalo Gortázar, chief executive of CaixaBank, [said](#) to the *Financial Times* on 20th October that 'banks are not likely to have extraordinary profits' but are instead still recovering from 'a long period of very low returns'. He believes that the tax is 'counterproductive because in an economic slowdown, we need a strong banking sector'.

Higher bank taxes would result in a triangular interdependency in which central banks pay interest to private banks, governments replenish central banks' equity, and private banks' surplus profits are taxed to cover these government expenses. It is a cumbersome, roundabout approach, but it can be a last resort to prevent passing on the costs of the ECB's unconventional policies to European citizens. In other words, it would prevent taxpayer money ending up once again in bankers' coffers.

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