EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB-PUBLIC

COURTESY TRANSLATION

Christine LAGARDE
President

Ms Manon Aubry
Member of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 5 May 2023

L/CL/23/109

Re: Your letter (QZ-011)

Honourable Member of the European Parliament, dear Ms Aubry,

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

Please note first of all that the European Central Bank (ECB) has a mandate, as laid down in the Treaty on the Functioning of the European Union, to maintain price stability in the euro area. The settings of all our monetary policy instruments – including the interest rate on the deposit facility – are aimed at pursuing this mandate, also if doing so temporarily results in increased financial gains for commercial banks, a worsening of the financial results of the ECB and national central banks (NCBs), and lower or no profit distribution from the NCBs to euro area governments.

With regard to your question concerning the increased interest earned by euro area commercial banks as a result of rate hikes, in the current environment of high excess liquidity, the ECB's monetary policy influences overnight interest rates, and thereby financial conditions, through the rate of interest it pays on banks' excess reserves. This allows the ECB to set the stance of monetary policy in a way that ensures inflation will return to our 2% medium-term target in a timely manner. From a monetary policy perspective, the interest income that commercial banks are currently receiving on their reserves is a side-effect of the higher policy interest rates that are needed to achieve price stability. Corrective action would only be warranted if this interest income had an adverse impact on the transmission of our monetary policy and thereby interfered with our ability to deliver price stability. In addition, a full assessment of the overall impact of rate hikes on banks' financial results would also need to take other factors into account. For example, under current conditions, banks may be experiencing valuation losses in their securities portfolios, higher funding costs and lower lending volumes.

As far as the finances of Eurosystem central banks are concerned, interest expenses are indeed higher owing to increases in the interest rates paid on commercial banks' reserves. These higher interest expenses are not matched, at least for now, by an equivalent increase in interest income earned on central bank assets (such as government and corporate bonds held for monetary policy purposes), as these largely have fixed rate coupons and a longer duration. It is therefore expected that Eurosystem central banks will face a temporary reduction in net income before interest revenues rise again. It should be noted that the current reduction in net income follows a long period in which Eurosystem central banks registered relatively large profits – approximately €300 billion before tax and general provisions over the last ten years alone. In line with principles of prudent financial risk management, the Eurosystem used part of the profits received over this period to build up financial buffers (such as general provisions and reserves) in preparation for future financial losses, which started to materialise in 2022. At the same time, as major shareholders of euro area NCBs, euro area countries also benefited from the distribution of large central bank profits. Please note, however, that the rules governing the distribution of NCBs' profits and the coverage of their losses are laid down in individual central banks' legal frameworks and therefore vary across countries.

Finally, as a result of our monetary policy, the Eurosystem's balance sheet is already on a declining trend. This reflects repayments under our targeted longer-term refinancing operations and the fact that principal payments from maturing securities in the asset purchase programme portfolio are not being fully reinvested. Over time, this will lead to a decline in excess reserves held by commercial banks and a decrease in the interest paid on those reserves. Meanwhile, higher interest rates will result in higher interest income on central bank assets. These two effects will lead to a gradual improvement in the Eurosystem's net income.

Yours sincerely,

[signed]

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