Does the ECB subsidize banks by paying them interest on their central bank deposits?

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Paul de Grauwe of the London School of Economics and Yuemin Yi of University College London have discovered a "money machine" of the European Central Bank (ECB): it allows banks to get rich while they sleep.[1]

In exchange for the bonds the ECB bought from them, the banks received central bank deposits, so-called reserves, amounting to 4.6 trillion euros. Since the ECB pays interest on these, the authors calculate that even at the deposit rate of two per cent, the banks receive income amounting to 92 billion euros. With the latest increase to two and a half percent, this figure has risen to over 100 billion euros. The authors see this as an unjustified subsidy that must be eliminated.

But what would happen if the ECB stopped paying interest on deposits? Banks with large balances would try to lend them to other banks on the money market. With the oversupply of reserves, the interest rate would fall towards zero and would thus undermine the ECB's interest rate policy.

Banks are obliged to hold a share of currently one percent of the customer deposits held with them as minimum reserves with the central bank. De Grauwe and Yi propose that the ECB tie up the banks' balances with it by increasing the minimum reserve rate and paying no interest on the minimum reserve.

To tie up a large part of central bank balances, a rate of at least 20 per cent was needed. But then the instrument acted like a tax on bank deposits. In the 1970s, high reserve ratios of the Bundesbank led to bank deposits being shifted to Luxembourg, where there was no minimum reserve. Today, the money would flow to London - to the detriment of the financial centres in the euro area.

But is the interest on reserves really a subsidy to the banks? One has to ask how the banks got the reserves. First, they had acquired government bonds, i.e. they had granted a long-term loan with a fixed interest rate to the state. By selling the bonds to the ECB, they remained creditors of the "state", if one regards the ECB as a part of the state.

The banks' reserves can therefore be seen as a short-term loan with a variable interest rate to the state. It is then nothing special to receive higher interest income when interest rates rise.

From the point of view of the "state", this is similar to a house builder who took out a mortgage with a variable interest rate during the low-interest phase and is now suffering from a high interest burden. So if the states now receive less central bank profits because of the high interest payments of the ECB to the banks, this is a normal outflow of this form of state financing.

The problem cannot be solved overnight, but only in the longer term by the ECB reducing its bond holdings again and thus also the interest-bearing central bank deposits of the banks.

[1] https://cepr.org/voxeu/columns/monetary-policies-do-not-subsidise-banks