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ECB: Monetary Policy and the Euro Area

The ECB is in a corner. Its rates are close to 0% with the refi rate at 0.25%. Lowering it at 0.1% would not change the picture and is probably not the recipe to bring the Euro exchange rate lower. In November when the refi rate was cut from 0.5% to 0.25%, the impact on the euro/dollar parity was hardly seen. The deposit facility rate is at 0%. Taking it lower would bring it in negative territory. Is such a move, which could destabilize banks, reasonable just before the Asset Quality Review? Probably not.

So the ECB could increase its liquidity to supplement the Zero Lower Bound problem as it has been done in other central banks. But there are questions on the kind of assets it can buy: Not public debt, not banking assets as during the LTRO because 2014 is the year that will settle the Banking Union. And now the OMT is at risk after the German constitutional court decision.

All this is problematic as deflation threats. The adjustment mode within the Euro Area leads to reduce costs and to follow the global economic cycle that is picking up. The risk of deflation is not null but what are the tools the ECB needs to fight it?

At its last meeting, the monetary policy committee of the European Central Bank has decided to let unchanged its strategy. The refi rate remains at 0.25% and no new operation that could bring supplementary liquidities has been announced.

The message perceived during the press conference was that the current monetary policy stance was consistent with the European business cycle upswing and with the fact that low inflation rate (no deflation expected by ECB) will eventually converge to the 2% target.

Mario Draghi has renewed the forward guidance: "interest rates will remain low or lower for an extended period". He has mentioned downside risks on the economic activity but he wasn't feared by the risk of deflation. In other words, except in the case of a negative shock on the Euro Area economy, the ECB is comfortable with the current monetary policy stance and will act only if it is necessary. That will probably be confirmed at the March meeting. The ECB will present its new forecasts until 2016. They will probably show a convergence to the 2% target.

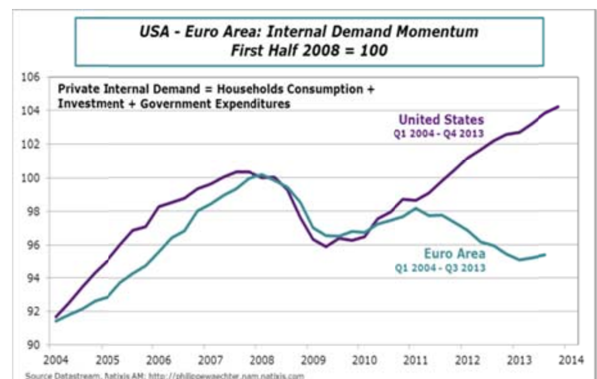
Nevertheless there are still a lot of risks concerning the Euro Area and can be under ECB responsibility. I will not speak on structural reforms as they are not in the ECB perimeter.

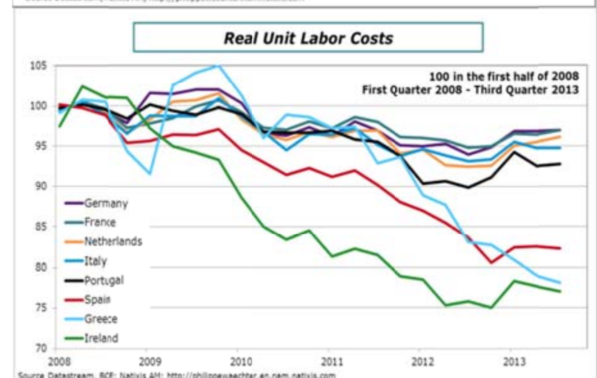
There at least four issues which have to be managed by the European Central Bank.

The first is related to the risk of deflation.

Inflation rate, for the Euro Area, was low in January at 0.7%. Greece and Cyprus are already in deflation. Portugal, Spain and Ireland have an inflation rate just above 0%, Italy and France have a rate below 1% and Germany is hardly above 1%.

This low change in price is not a question related to commodity prices. It reflects mainly the adjustment process in the Euro Area. Since internal demand follows a low momentum (see the chart comparing US and EA internal demand), there is an intra-euro area adjustment. This is called an internal devaluation or how for a country to improve its competitiveness by reducing its costs.





As euro is still very expensive the only way to gain competitiveness is for each country to reduce its costs. That's what has been seen in most peripheral countries except Italy. That's a phenomenon that can also be seen in France with new labor contract that are settled generally at a lower wage than in the past contracts. (The chart on the right shows Real Unit Labor Costs).

In other words, as a large part of each country's trade is with its Euro Area partners, competition is more sever. Each Euro country is trying to improve its competitiveness within the zone. This means that there are pressures on costs and specifically on labor costs in most European countries. The search for competitiveness will not push companies to scale up their prices.

This framework is at risk as it could create downside pressures on prices. We cannot exclude a scenario of deflation except if a strong rebound in growth is expected. We cannot currently imagine such a change.

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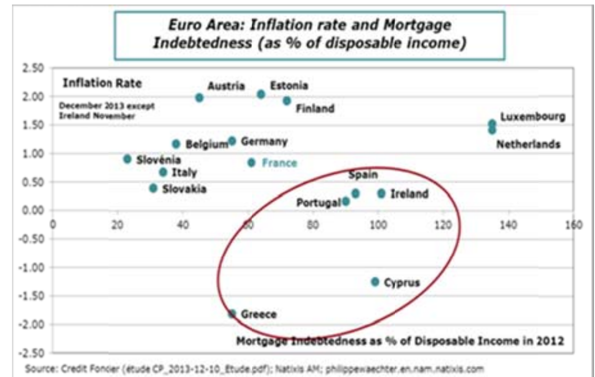
In case of deflation, the impact is to weaken internal demand. There are two classical effects. One is on wages which are trending downwards, reducing the possibility of nominal illusion and the other is to postpone purchases as prices will be lower in the future. These are classical effects of deflation. This will reduce internal demand and will not create for companies incentives to invest.

But for the Euro Area the situation can be more complex as in numerous countries households' indebtedness is at a high level. That's what is shown on the chart on the right.
In the Netherlands and Luxembourg, indebtedness rate is high but the inflation rate is above 1%. But for the five countries within the red circle there are risks.
In deflation, the real value of debt is increasing and real income is stable or decreasing. This means that in every indebted household, the arbitrage in his budget is changing as debt takes a larger place. This is a situation where internal demand can be weakened rapidly, leading to recession.



Last November the ECB has reduced its refi rate on the first alert of deflation (inflation rate dropped at 0.7% in October) but doesn't want to move again as the ECB mantra is to say that inflation rate will not go on negative territory and will eventually converge to 2%.
It's hard to imagine a kind of soft landing. As Euro exchange rate is high, competition for Euro Area countries is mainly inside the Area. Can we imagine that this situation will not have long lasting effects? Moreover, France, Italy and Spain are exporting middle quality goods on average. With a euro as high as it is, it's not easy for each country to improve its own position outside the Euro Area. This is an incentive to increase competition within the Euro Area.
That's why the ECB has to change its monetary policy stance and to adopt a more accommodative strategy. That could boost the Euro Area. That's what is said in a recent note by the Conseil d'Analyse Economique in France. See the note here.
Nevertheless, this issue has not been addressed by Mario Draghi in his last press conference earlier this month.

The second issue in Europe is fragmentation of the financial system.
Fragmentation reflects different financial conditions within the Euro Area that shows a lack of homogeneity. There are a lot of reasons for that: public debt level, risks attached to the banking system, growth prospects. In the Euro Area, in 2011/2012 there was a period where countries were not perceived as a homogenous block. That was noticed by the divergence on 10 year bond rates between Germany and France on one side, Italy and Spain on the other.

This spread has been reduced progressively after the ECB announcement on OMT during spring 2012. OMT is the capacity for the ECB to buy short term bonds (under 3 year) on the secondary market and at the demand of a country. The threat of an ECB intervention and new institutions (Treaty on Governance, European Stability Mechanism, ..) in the Euro Area have helped to reduce the spread between Germany on one side and Italy and Spain on the other (see the chart, Italy has the same profile than Spain).

In the short run, OMT seems to be no longer available after the German constitutional court decision. Expectations supposed consistency between OMT program and German constitution. In fact the court in Karlsruhe has a doubt and asked the European Court of Justice to take the decision. In other words, they disagree with the OMT procedure but didn't want to endorse the responsibility of this decision that would dramatically reduce the ECB capacity to intervene.

In other words, with the OMT, the ECB thought it could become a lender of last resort which is the main quality of a central bank in a crisis period. (The Federal Reserve, the Bank of England and all central banks throughout the world have the capacity to be a lender of last resort. A lender of last resort is just an institution that can take on its balance sheet the risk that no one else wants to manage. That's why this is essential in a period of crisis). With the German court decision, this could change and reduce the impact of the OMT and the capacity for the ECB to act as an intertemporal institution (taking charge of the risk between today and the future)

One good thing is that the final decision will come from the European Court of Justice. The decision will apply to every European country and may be the Euro Area situation will not depend anymore on one country decision.

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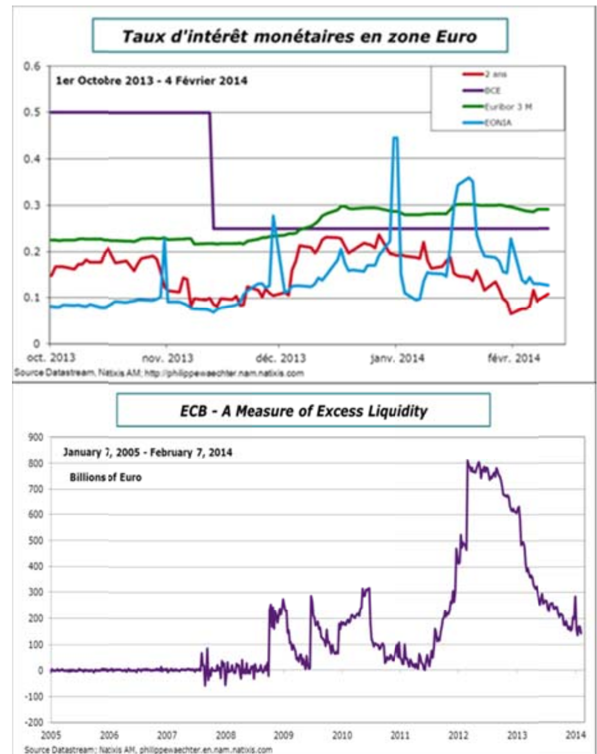
If the European Court accepts that the ECB is the lender of last resort like every central bank in the world, then this could reinforce the consistency of the area. Nevertheless this issue is at risk.

The third issue is on short term interest rate and liquidity.
Since the end of 2013 the volatility on short term interest rates has increased a lot. Before, the overnight rate (EONIA) was stable and below 10 basis point. As it is shown on the chart below its trajectory has changed. Mario Draghi noticed that this volatility didn't transmit to longer rates and he considered it was a proof of the ECB credibility and the stabilizing impact of forward guidance.

This volatility comes from a reduced level of liquidity and from the fact that LTRO will have, in early spring, a duration below one year.
(LTRO is an operation that was put in place in early 2012. It was an exchange of assets between banks and the ECB. Its duration was three years but banks after one year could start reimbursing the operation. In fact there were two operations one on December 21, 2011 and the other on February 29; 2012).



One specific measure of liquidity in the money market is the "excess liquidity". It reflects market operations from the ECB to the banking system on one side and the reserve requirement and technical measures on the other. With the 2 LTRO in 2011 and 2012, excess liquidity peaked at EUR 800bn. But after one year banks started to reimburse and now the level is close to EUR 150bn (February 7). It's probably not enough to limit the overnight rate volatility.

The link with volatility and forward guidance from the ECB were the two main reasons to expect a new liquidity operation from the ECB.
On the one hand higher liquidity could reduce the volatility and on the other hand liquidity for three years was a good guide for lower interest rates for an extended period.

For the ECB a new operation is complicated to manage. The question is to know which kind of asset it can purchase. Everywhere in the world, the central bank, acting as a lender of last resort, is able to buy government bonds. In a period of crisis it's just a way to manage the turmoil. In their excellent book "This time is different" Carmen Reinhart and Ken Rogoff shows that, at the end of a financial crisis, public debt has increased significantly. So a central bank can buy this debt to displace the risk in the future avoiding a too brutal adjustment in the short term.

But the ECB cannot do that. Until now it was manageable and there was a rationale for that: As the main sources of financing the economy are banks, the most efficient way to improve the situation was to have a deal between banks and the ECB. In the USA, the main financing source of the economy is financial markets, so the deal is between markets and the Fed.

Now the situation has changed in the Euro Area for the following reasons
1 – During the two LTRO operations, banks have bought sovereign debt with the liquidity coming from the ECB. It was not really used for new loans to companies and mainly to small and medium enterprises.
Beyond this question of efficiency, the ECB is now constrained by the Banking Union. This latter is a construction that wants to dissociate risk between governments and banks. The ECB cannot accept that liquidity goes mainly on sovereign bonds. So this kind of operations is no longer available except if it is very constrained by rules on how to use the liquidity. But in that case, will banks come at the operation? Not sure
2 – The ECB cannot buy sovereign debt on the primary market and purchases of it on the secondary market (SMP operations) were very specific at a moment in time. It is not renewable.
3 – Now there is an implicit limit on OMT after the decision of the German constitutional court
4 – The ECB would like to buy securitized assets corresponding to SME's loans from banks. But this market which was broken by the crisis in 2007/2008 isn't large enough for this kind of operations.

So what could be the sources of new liquidity? What kind of assets is available for the ECB to be able to manage correctly its monetary strategy? As it was shown and said on excess liquidity issue, there is a need for more liquidity. They will probably come by the end of sterilization of the SMP operations. When these

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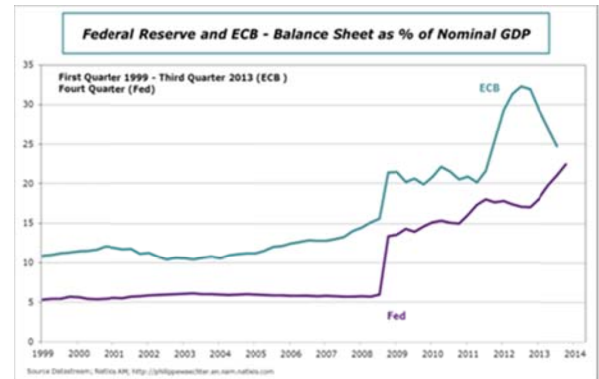
operations were put into place, the ECB said it was just a way to manage the risk and it should have no impact on its monetary policy. The amount purchased was sterilized by short term operations on the money market. The ECB could stop sterilizing and by the way increase liquidity by around EUR 175bn.
If as it was perceived from Draghi's speech, the Euro Area follows the global business cycle upswing, this could be sufficient. It will not affect behaviors (of banks or investors) and is limited in time. But this framework is available only if there is no negative shock in the Euro Area.

The fourth point is a message from the ECB
In the United Kingdom, in Japan, in the USA the message from the monetary authorities is to ease the global adjustment process. The issue is to favor the convergence to potential growth. The message is clear by reading the size of each central bank balance sheet. It increases a lot. In the Euro Area, the ECB balance sheet is trending downward. The chart shows the Fed and the ECB's profile as percentage of GDP.
The change in the ECB profile comes from the two LTRO operations. The reimbursement has not been matched by another kind of operation that could increase liquidity.
This has an effect on investors' anticipations and is probably a source of an expensive euro.



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