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No further monetary policy relaxation

by Michael Heise

The European Central Bank has not heeded calls to relax policy further. It has neither cut rates nor laid down precisely how long they will remain at record lows. It has also ignored repeated calls to conclude new long-term refinancing transactions to halt or slow down the decline in its balance sheet. And it is absolutely not following the US example of remaining on the expansionary path until unemployment drops below a certain level. That is prudent, in order to reduce the risk of new financial market bubbles.

A central bank that guarantees low interest rates for an extended period and floods the markets with liquidity is literally inviting investors to purchase higher yielding investments with low-interest central bank loans and speculate on profits. It is an illusion to believe that yet more central bank liquidity and even lower interest rates can jump-start lending to businesses. The downward trend in lending in the eurozone has nothing to do with a shortage of liquidity, it stems from the politically desired risk avoidance on the part of banks and a steep decline in business investment activity. Nor does the decline in the ECB's balance sheet reflect a lack of liquidity but, on the contrary, indicates a gradual return of confidence among the banks in the efficiency of the traditional money market. It is encouraging that many banks no longer think it necessary to stash large liquidity cushions at the central bank in the knowledge that they can again turn to the interbank market if needed. However, one problem is that not all banks have ready access to the money market, with some still reliant on central bank funding. For them the central bank is the lender of last resort. It is essential that the ECB fulfills this role by guaranteeing all banks an unlimited allocation of liquidity against collateral until the middle of next year.

By contrast, further rate cuts, new long-term liquidity offers and a pre-commitment for a longer spell are not advisable. Rather, as markets return to normal, steps should be taken to normalize monetary policy as well. The longer cheap excess liquidity is pumped into the markets, the more difficult it will be to withdraw this medicine at some point without triggering severe ructions on the markets. It makes sense to keep rates low as long as the economic recovery is still shaky and inflation still very low. But once the signs of improvement intensify, as I expect, rate hikes need to be discussed as well. That would at least put a damper on all too risky financial market transactions and provide a small consolation for savers who are currently suffering real losses on their bank deposits.