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The Unconvincing Case for Further ECB Loosening

by Michael Heise

After more than five years of major monetary accommodation, the European Central Bank (ECB) is still under pressure to loosen even further. On the surface the evidence seems convincing: Inflation is too low, credit is not flowing freely and surplus liquidity is declining. The ECB's shrinking balance sheet is seen as a signal that its policy is too tight, supposedly one reason for the stubbornly high external value of the euro that might eventually jeopardize the fragile recovery.

However, on closer inspection, the arguments start to show some cracks. Take inflation. It is low but certainly not the harbinger of an expectation-driven deflationary spiral. On the contrary, falling prices are the result of improved productivity and declining wages. Structural reforms are finally working as the euro-zone periphery is regaining competitiveness by internal devaluation. Nothing to complain about.

Or take the subdued loan development. Bank loans are still declining in the euro zone. But again, this is ongoing evidence of a necessary and welcome adjustment process. After the pre-2008 credit boom, banks have started to de-risk their balance sheets; households and firms are busy repairing their finances. If anything, the level of debt is still too high in the euro zone. Although the debt ratio (total debt as a percentage of GDP) has been edging down slowly since 2012, it is still elevated, standing at around 95% of total output for the non-financial corporate sector and at roughly 70% for the private household sector at the end of 2013. Pre-bubble ratios of 80% and 60%, respectively, are still miles away.

Compare this to the situation in the United States, where households slashed their indebtedness to levels last seen at the beginning of this century. But it was no picnic. American banks wrote down billions of loans and, as a result, credit development stayed in reverse gear for 12 straight quarters. The decline had already begun at the end of 2008; from peak to trough, loans fell by more than 9%. In contrast, in the euro zone loans have been declining year-on-year for just eight quarters, beginning as recently as in the first quarter of 2012. The total fall amounts to less than 6% so far. Given the much larger role of euro-zone banks in financial intermediation to begin with, it is a fair assumption that they are still only halfway there. To restart the credit machine right away would be rather counter-productive.

But what about the ECB's own shrinking balance sheet? Again, it is important to take a second look. It is not the ECB that is actively pulling liquidity out of markets. The ECB is on the receiving end. Banks are voluntarily returning liquidity. If anything, this development signals the return of confidence among banks: Banks are again confident enough to get liquidity in the inter-banking market if needed. That is the reason why they continue to reduce their contingency cash holdings. The upshot: Even if the ECB were to attempt to stem the returning liquidity tide, the effect would be zero because it is certainly not the lack of liquidity that is holding back the credit flow to the real economy.

In dubio pro reo. The case for further policy loosening is not convincing—dismissed. But that is not to say nothing should be done. The ECB is in an exceptional position, being responsible not only for monetary policy but also for the coordination of macro-prudential banking supervision and (very soon) for micro-prudential supervision in the form of the Single Supervisory Mechanism. It should use its new powers vis-à-vis banks to make them write down their bad debt. Furthermore, macro-prudential tools can be used in an anti-cyclical way, i.e. either to prevent or at least mitigate the build-up of bubbles in a boom, or to incentivize lending in a recession. The macro-prudential measures such as higher or lower capital requirements could be country-specific, but they would apply to all banks in the respective market.

Use of such measures would be a more targeted approach than the blunt tools of interest-rate cuts or quantitative easing. An easing of standards for new business in targeted market segments—for instance, small-business loans—would avoid the pitfall of extremely low interest rates being (mis-)used to refinance legacy assets and practice debt forbearance on a grand scale. In any case, no policy instrument—be it monetary, micro- or macro-prudential—can or should prevent deleveraging in principle. The sooner balance sheets are repaired the better. This is the clear lesson from Japan. It has some implications for the forward guidance of the ECB.

Forward guidance is now all the rage in monetary policy. Presently, it is being used only in one direction: to reassure financial markets that central banks will not raise interest rates for an unspecified "extended period." This breeds complacency and provides fertile ground for new bubbles. After all, the message is clear: No one has to worry about cheap refinancing; time is on your side when it comes to balance-sheet cleansing; and in the meanwhile, ultra-cheap financing is an invitation to earn some extra yield.

In its current form, forward guidance is ill-designed to shorten the adjustment process and make the recovery more robust. It would be better for the ECB to turn the message around and to tell market participants that the window of low interest rates will be closing sooner rather than later, thus adding more urgency to reforms. This would not derail the banking sector—it would hardly affect lending to healthy corporates or real business activity for that matter. As we know: Life will punish those who dally.

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