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Refrain from further rate cuts

by Michael Heise

At the beginning of the year eurozone inflation fell to 0.7%. That fueled the debate whether the European Central Bank should agree on further expansionary measures at its February meeting. That would not be advisable. Yes, inflation is currently below the ECB's reference value of close to 2%, but this deviation is not critical. The current inflation rate is being pushed down by lower energy prices, a positive but probably temporary feature. More importantly, in a number of countries falling unit labor costs are keeping price levels stable or, as in Greece, actually pushing them down. This is not only desirable but also vital in order to bolster external competitiveness and, closer to home, purchasing power and domestic demand. It is no coincidence that economic sentiment is improving in those countries with major adjustment needs. For the first time in a long while capacity utilization in the eurozone has risen and lending terms for small and medium-sized companies are no longer being tightened but relaxed. Stable inflation is not prompting consumers to sit on their wallets, rather we are seeing a fall in saving rates in most countries.

Further rate cuts are not called for, but further liquidity assistance, yes. Many banks still have only limited access to the money market. And this problem could be exacerbated by the upcoming bank review. An adequate supply of liquidity is therefore essential. But liquidity does not have to be provided practically free of charge. Merely the prospect of slightly higher interest rates could speed up the necessary balance sheet adjustments at banks. Higher money market rates would give banks with excess liquidity at the central bank an incentive to channel the funds back into the market. Persistently weak lending to companies is not a counter-argument since in many eurozone countries private sector deleveraging is a necessary process that has not yet been completed. The important thing now is to maintain the flow of credit to profitable companies keen to invest, many of which are in the SME segment. This nuanced problem merits attention, but cannot be deduced from trends in overall lending.

The risks of protracted low interest rates are manifold: High risk appetite among investors and the growing risk of financial market excesses, waning reform zeal among governments, and savers clobbered by extremely low interest rates. Nor do they have an incentive to step up savings to accelerate stalling asset accumulation. While fully understanding central bank wariness about jeopardizing the nascent economic recovery, the risks and side-effects should not be overlooked. The ground needs to be prepared for an about-turn in interest-rate policy by removing the easing bias from the forward guidance. This step at least should not be delayed any longer.