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False hopes in monetary policy

by Michael Heise

It is striking: Whereas the ECB's recent decision to pump more liquidity into the markets is applauded and greeted with relief abroad, in Germany the critics prevail. Is it really wise to place such hopes in the ECB's expansionary policy, as many Anglo-Saxon financial economists do? I think not. There are weighty arguments that have so far not been convincingly refuted by the acolytes of quantitative easing.

We are not embroiled in an economic crisis necessitating the deployment of the final resort – some call it the nuclear option. Yes, eurozone growth is still puny and prices are falling as a result of the oil-price slide and wage restraint in a number of peripheral countries. But this drop in prices is welcome and will provide a major shot in the arm for consumption and growth in the eurozone this year. By contrast, the impact of the additional monetary policy measures on growth and prices is unclear. Unlike in the USA, monetary policy in Germany and other euro countries operates largely via the bank channel, direct company financing via capital market bonds does not play a central role. Liquidity injections for the banking sector will do little to boost bank lending. The dearth of lending has nothing to do with a lack of liquidity but stems from regulatory requirements on the capital base and the reduction of balance-sheet risks. And an improvement is now in sight, with lending standards gradually being relaxed. That there is no shortage of liquidity can be seen in the fact that the liquidity offered by the ECB so far has not been fully taken up, despite highly attractive maturities and mini interest rates.

Alongside the questionable economic benefit of the fresh injection of money, the nasty side effects also need to be considered. These include the mounting risks being taken on the financial markets. Safe securities yield practically nothing these days. On German government bonds up to five years maturity investors already have to pay on top. And now the central banks will fuel additional demand for securities, with scant private-sector sellers in need of liquidity on the other side. The upshot: high prices and extremely low yields become entrenched. Anybody wishing to offer their clients decent returns has to climb further up the risk ladder. Other side effects include the hampering of private asset accumulation, especially in the low-wage segment, and the danger that much-needed reforms in weaker economies will be postponed because the ECB will provide a fix anyway. We should not pin our hopes for 2015 on monetary policy but rather hope that businesses gradually exit deleveraging mode and rediscover their thirst for capital.