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Monetary policy: Back to normal?

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MONETARY POLICY: BACK TO NORMAL?

Only a few weeks ago the markets practically took it as read that the European Central Bank would reduce its key interest rate yet again in 2013. In the wake of ECB president Draghi's press conference at the beginning of January, however, such expectations have all but vanished. Does this mean that a normalization of monetary policy, and possibly even a genuine interest rate policy turnaround, is on the cards? We must not forget that the current situation, where the key rate is hovering around zero, well below the rate of inflation, was the result of a decisive reaction on the part of the ECB to the escalating crisis that threatened to jeopardize monetary union. Even though risks remain, there are clear signs that the debt crisis is easing.

In a severe crisis ultra-loose monetary policy is appropriate to shore up the economy but, left in place too long, it can do more harm than good, devaluing savers' assets in real terms and providing a false basis for companies' investment decisions. Even projects resulting in a loss of value – i.e. generating returns below the rate of inflation – would be being financed. One might argue that a low key interest rate does not necessarily mean an equally low long-term rate, because the latter is significantly affected by longer-term inflation expectations. Although this is basically correct, developments in Japan nevertheless demonstrate that an ultra-loose monetary policy does not always stoke inflation expectations and that, with rates close to zero, a lid is placed on interest rate rises at the long end of the market.

Let us take a closer look at the current situation on the interest markets: yields on 10-year German government bonds are currently around 1.7%, around half a percentage point higher than last year's absolute low point. And at approx. 0.25%, the three-month interbank market rate (EURIBOR) is still around 0.5 percentage points below the key interest rate. Over the course of the crisis the significance of the unsecured money market has diminished significantly, with banks suffering from low credit ratings being hardly able to access it at all, due to the high levels of distrust among banks. In general, however, they did and do not need to tap additional liquidity on the interbank market, because the ECB is providing such liquidity to an unlimited extent. Banks with a high credit rating, which continue to have access to the money market, only rarely seek liquidity on the interbank market thanks to the generous reserves they generally have been able to accumulate. So it doesn't come as a surprise that the EURIBOR, the rate at which a bank with an excellent credit rating is willing to provide unsecured euro market funds to an equally highly rated bank, is currently so low.

No further rate cut on the cards

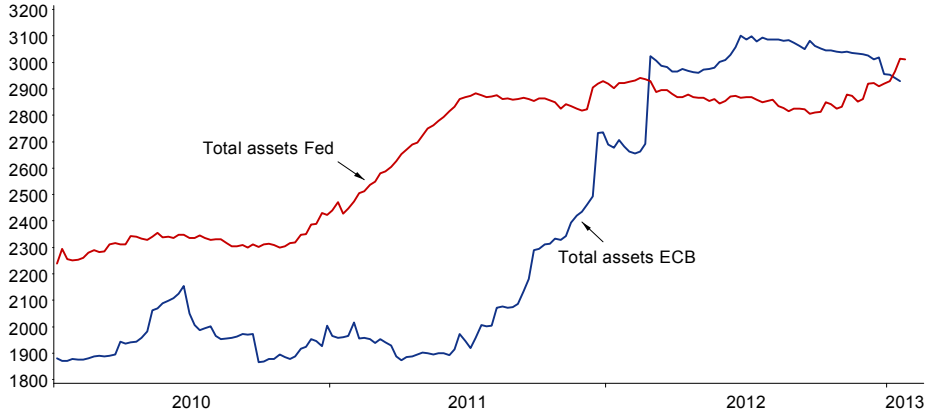
EMU: ECB main refinancing rate, 3m money rate and forward rates

Source: EcoWin.

In the meantime, however, EURIBOR futures have begun to move up. Without doubt, this is the result of frustrated expectations regarding interest rate cuts, but even more so of the significant degree to which bank liquidity has been skimmed off because the ECB allowed banks to pay back any funds they had received through LTRO transactions early, after just over a year. 287 banks had declared their intent to pay back EUR 137bn on January 30 of this year. It is estimated that, by the end of February 2013, the return volume will be between EUR 200bn and 300bn. Without a doubt, this return of funds to the ECB constitutes an initial move out of crisis mode, possibly even the beginning of the abandonment of ultra-loose monetary policy. We can assume that the ECB's balance sheet, which was expanded dramatically as a result of the debt crisis, will fall significantly over the coming months. It has already been on a gentle downward trend for some months now.

Balance sheet of Eurosystem and US Fed

Total assets in EUR/USD bn



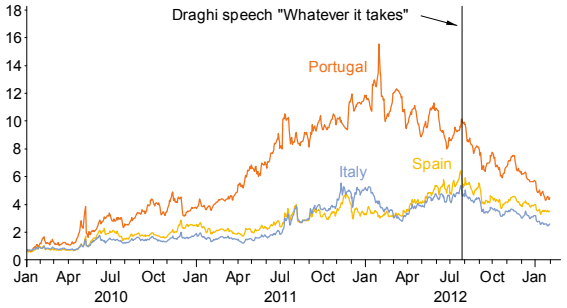
Source: EcoWin.

However, the balance sheet shrinkage is unlikely to match the extent of the early LTRO returns, because banks which still need significant liquidity, but hope to evade being stigmatized, will also pay money back. Instead, they will borrow shorter-term funds from the ECB or seek refinancing on the interbank market again. First and foremost, however, it is the banks with good credit ratings and high reserves which will pay back their LTRO funds and move increasingly towards covering any occasional liquidity requirements on the interbank market again. As a result, it is to be hoped that interbank trading will pick up again on a sustained basis. In that case, the three-month EURIBOR is likely to gradually creep back up towards the ECB main refinancing rate.

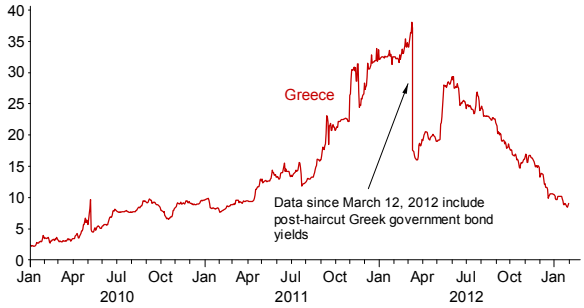
The high volume of LTRO funds being paid back, however, is only one of the signs of respite on the financial markets. The risk premiums on crisis-country government bonds are falling astonishingly fast, the spreads on European corporate bonds with varying credit ratings have largely returned to normal and even the TARGET balances, the subject of much attention from economists, are now on the way down. For instance, the net claims of the German Bundesbank within the Eurosystem (TARGET2) dropped from EUR 751bn in August 2012 to EUR 656bn in December 2012.

EMU: Financial markets no longer in crisis mode

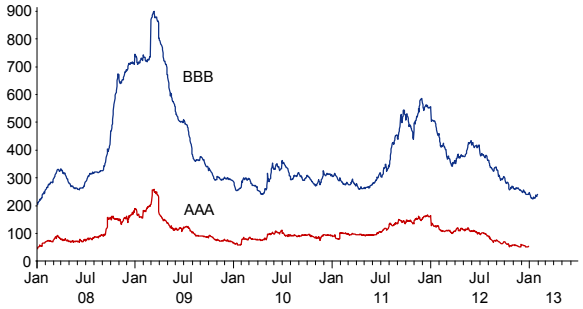
Spread over 10yr German gov't bonds, percentage points



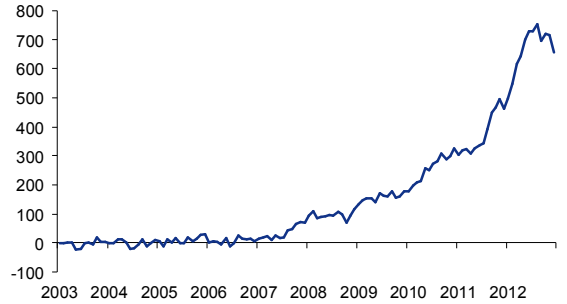
Spread over 10yr German gov't bonds, percentage points



Spreads on corporate bonds, EMU over German gov't bonds (maturity 7-10 years), basis points



Net claims of Bundesbank within the Eurosystem (TARGET2), EUR bn

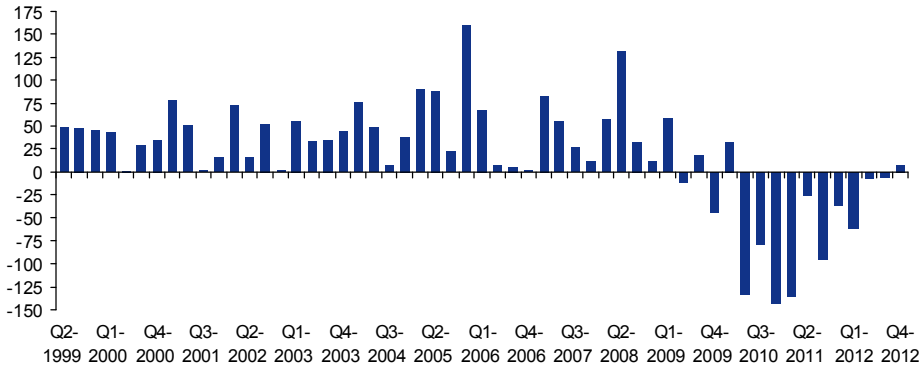


Sources: Deutsche Bundesbank, EcoWin.

This drop in TARGET balances is a significant indication that trust among commercial banks is gradually increasing again. After all, the number of cross-border bank loans in the euro area has plummeted in recent years as a result of the crisis, meaning that crisis-country banks were forced, on a massive scale, to finance themselves via their central banks. This meant that the central bank system, with its TARGET balances, replaced the private sector as creditor. If TARGET balances are now decreasing, this indicates that private loans are again flowing to southern countries. For instance, in Q4 last year, commercial banks in the euro area increased their cross-border net receivables in the euro area again for the first time since Q1 2010, and the trend towards a renationalization of the euro financial market has not continued of late.

Renationalization of eurozone financial market coming to an end

Change in net outstanding cross-border financing in the euro area in EUR bn (q-o-q)



Sources: ECB, own calculations.

Now, however, the President of the Ifo Institute, Hans-Werner Sinn, argues that the markets have only calmed down because politicians are hitting on ever new ways of forcing the taxpayers of the European countries that are still healthy to foot the bill. What he refers to is the possibility of the ECB's OMT program and of the ESM rescue fund providing aid to banks. In our opinion, however, this argument falls short. The crisis countries have now made significant advances towards adjustment with their current accounts now more or less balanced, thanks to export growth and lower import levels. This means that one of the structural causes for TARGET balance growth has been removed. So there are fundamental reasons for trust to return.

There are now many factors suggesting that the debt crisis has calmed down for the long term, although it is irrefutable that risks remain, for instance that the will to reform might weaken as a result of changes in the political landscape following elections. In the - more likely - scenario of increasing economic stability in the crisis countries as a result of structural reforms, the European financial markets are also likely to continue to stabilize gradually. So the question that emerges for the ECB is how to continue to normalize its monetary policy. It could discontinue its policy of providing unlimited liquidity, but it would be more advisable to slightly raise key interest rates, which are currently far below the rate of inflation, while maintaining its unconventional monetary policy measures. This would have the advantage that banks would not risk getting into liquidity problems during tricky consolidation phases, but that interest rates would no longer remain at such extraordinarily low levels. It would also counter the misallocation of savings.

It is difficult to say, however, what might be the best time for raising interest rates. In this context, a key question certainly is whether inflation expectations will remain as firmly entrenched as they have been. If inflation expectations remain stable, the ECB can afford to wait until economic recovery in the euro area is certain. The drastic rise in the external value of the euro constitutes yet another argument against speedy interest rate hikes.

While it is debatable exactly what would be the best time for the ECB to abandon its current monetary policy, its fundamental strategy should not be in doubt: it needs to continue to be guided by the need to keep prices stable, while taking account of the stability of the financial system. It seems appropriate to recall this guiding principle at a time when other central banks are undergoing paradigm shifts that might be seen to justify the pursuit of an ultra-expansive monetary policy for years to come. Among these "new" concepts are the increasing orientation of the Fed towards quantitative labor market reference values, the new, ambitious inflation target of the Japanese central bank, as well as considerations in the UK designed to set monetary policy a target for nominal GDP growth.

The excessive policy of monetary expansion pursued by the major central banks was justified when the financial system was still on the brink of collapse and the future of monetary union was in doubt. However, such policy cannot be continued in the long term without having inflationary consequences for the financial markets or the real economy. The growth and employment problems that emerged as a result of the bursting financial bubble and the resulting debt crisis in the euro area need to be combated by other economic policy means than monetary policy, which, from a global perspective, did in fact contribute to financial market excesses and excessive debt levels. Therefore it is to be hoped that the central banks of other major countries will also refrain from long-term expansion strategies and from using arguments such as low growth to justify a continuation of the crisis policy of recent years.

Such concepts are not suited to the euro area in any case. Many economies are undergoing a phase of adjustment following past excesses on the credit and real estate markets that were caused, last but not least, by expansive monetary and fiscal policy and the convergence of interest rates at extremely low levels. Putting a stop to this process of adjustment by pursuing ultra-expansive monetary policies, keeping interest rates low and implementing a certain nominal growth path or a certain employment target for individual countries or the eurozone as a whole using monetary policy means would jeopardize both financial market and price stability. Cutting back on public and private debt in the euro area is a must, and this cannot be done without accepting a certain drop in demand and employment. What is important is that inflation remains low, allowing the eurozone economies to safeguard their competitiveness even in view of a relatively high external value of the euro.

The ECB can and should make itself heard. After all, it will not be able to distance itself fully from the excessively expansive policy pursued by its partner institutions in other economic regions. Given that the economy is partly still in recession and certainly fragile in many eurozone countries, it would not be helpful were the value of the euro to rise sharply. Such tendencies might also cause the ECB to hold on to its very expansive course for rather too long. Instead, a desirable development would be for central banks across the globe to agree on an exit from their crisis policy mode. Given that there are pretty clear indicators of economic recovery at the beginning of 2013, a gradual and prudent exit should, in fact, be possible.

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