DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

ECONOMIC AND MONETARY AFFAIRS

The ECB's Next Steps

Briefing Note

Abstract

The Euro area is recovering from recession and inflation has moved above the ECB's target, so the recent decision to raise policy rates was not a surprise. Rate increases, however, will be damaging to peripheral countries that are in recession and implementing contractionary fiscal policy. The financial strains caused by further rate increases also run the risk of creating financial instability that may spread around the Euro area. Despite these considerations, the ECB needs to focus on its core mandate of controlling inflation, so it cannot place a great weight on peripheral financial stability problems when setting interest rates. The better arguments for a slow pace of rate increases relate to the temporary nature of the inflationary pressure from commodity prices and the weakness of the Euro area economy. The ECB can still assist the periphery with a well-designed lender of last resort programme for its banks. ECB officials should stop threatening to withdraw from lending to these banks and instead announce that they are setting up medium-term facilities.

IP/A/ECON/NT/2011-01 **June 2012**

(Part of the compilation PE 457.361 for the Monetary Dialogue) EN

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

AUTHOR

Karl WHELAN
University College Dublin

RESPONSIBLE ADMINISTRATOR

Doris KOLASSA
Policy Department Economic and Scientific Policies
European Parliament
B-1047 Brussels
E-mail: poldep-economy-science@europarl.europa.eu

LINGUISTIC VERSIONS

Original: EN
Abstract: DE, FR

ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its monthly newsletter please write to: poldep-economy-science@europarl.europa.eu

Manuscript completed in June 2011.
Brussels, © European Parliament, 2011.

This document is available on the Internet at:
http://www.europarl.europa.eu/activities/committees/studies.do?language=EN

DISCLAIMER

The opinions expressed in this document are the sole responsibility of the author and do not necessarily represent the official position of the European Parliament.

Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the publisher is given prior notice and sent a copy.

CONTENT

1. INTRODUCTION 2

2. MACROECONOMIC CONSIDERATIONS 3

- **2.1 A Difficult Environment for a Common Monetary Policy 3**
- **2.2 The Threat to Price Stability 3**

3. FINANCIAL STABILITY CONSIDERATIONS 7

4. THE ECB AND PERIPHERAL BANKING SYSTEMS 8

- **4.1 Non-Standard Measures and the Separation Principle 8**
- **4.2 More Clarity Required. And Fewer Threats. 9**

REFERENCES 9

1. INTRODUCTION

In the years prior to the start of European monetary union, there was a heated debate about whether or not the Euro project would succeed. Many academics, in particular those based in the US, were sceptical of the prospects for success. The proposed Euro area did not meet the usual definition of an optimal currency area, it was argued, so a one-size-fits-all monetary policy would be a failure. Given large structural differences across the participating economies, it was argued that the Euro area was likely to suffer from asymmetric shocks and, without access to monetary policy or exchange rate tools, countries that were hit by these shocks would find it difficult to adjust. Negative comparisons were made with other large currency areas, such the United States, because of the weakness of labour mobility across European countries and the absence of a centralised system of fiscal transfers.[1]

As the Euro's first decade proceeded without any major problems, the criticisms of sceptics of EMU were increasingly viewed as having been misplaced.[2] Today, however, these old criticisms are coming back to haunt the European Central Bank. The Euro area is suffering from a set of asymmetric shocks that are more serious than any envisaged by either the founders of the Euro or their critics. The core of the Euro area has recovered from recession and price inflation for the area as a whole is currently above target but countries in Europe's periphery such as Greece, Portugal, Ireland and Spain are suffering from severe slumps.

The absence of any common fiscal framework is being felt more severely than anticipated by the Euro's founders. Enthusiasts for the EMU believed that countries could use fiscal policies to offset asymmetric shocks. However, the countries in the periphery are facing serious fiscal problems and their governments are tightening their belts despite being in recession. They are now also faced with a monetary policy tightening as the ECB makes its decisions based on Euro-area considerations.

Furthermore, the Eurosystem turned out to have a significant weakness that generally went unmentioned during the pre-EMU era. While EMU created a single monetary policy, banking supervision and deposit insurance was left with national authorities. Years of cheap credit helped to fuel property booms in Spain and Ireland and, once these bubbles burst, national authorities have been left with the responsibility to recapitalise insolvent banks. These countries are also coping with serious private debt overhang problems, without having any recourse to inflating these debts away via monetary policy.

The crisis of the past few years showed that the Eurosystem was completely unprepared for dealing with systemic banking crises. In particular, there was no agreed mechanism for resolving insolvent banks. The sorry tale of Anglo Irish Bank, which saw the ECB lending large amounts to allow an insolvent bank pay off its bondholders and the Irish government picking up the bill for recapitalisation of a dead bank, has become a textbook case for how not to deal with a banking crisis. The problems linger on with the ECB still providing life support to banks in Greece, Ireland and elsewhere, years after the crisis began.

In this paper, I review the decisions facing the ECB in the coming months. Section 2 discusses the ECB's upcoming monetary policy decisions from a standard macroeconomic angle, as the Governing Council weighs the risks of inflation stemming from recovery in the core against the risks of worsening the situation in the periphery. Section 3 discusses the financial stability implications of increasing monetary policy rates. Section 4 then focuses on the measures required to support peripheral banking systems.

[1] See Krugman (2011) for a good summary of the arguments against the merits of European Monetary Union.
[2] See Jonung and Drea (2010) for a critical discussion of the attitude of US economists to the EMU.

2. MACROECONOMIC CONSIDERATIONS

This section discusses the macroeconomic arguments for and against interest rate increases over the coming year.

2.1 A Difficult Environment for a Common Monetary Policy

The past few years have seen the ECB Governing Council undertaking momentous decisions, such as the removal of limits on the amount of funds offered in refinancing operations and the decision to purchase peripheral sovereign bonds in its Securities Market Programme. However, the next few years are likely to represent its most difficult period yet in relation to the Council's interest rate decisions. During the period in which the Euro economy was in recession and financial markets were severely disrupted, there was a strong case for cutting interest to low levels and keeping them there for some time, so there were little grounds for disagreement among participating member states about the right course of action.

The current situation is more complex. The Euro area economy as a whole has now exited from recession but the pace of recovery has been very uneven. The European Commission's Spring forecasts project France and Germany to grow at 1.8 percent and 2.6 percent respectively and some other member states are growing very strongly. For example, Finland is projected to grow by 3.7 percent this year and Slovakia is projected to grow at 3.5 percent. In contrast, some of the peripheral countries are still in deep recession: The Commission anticipates that the Greek economy will contract by 3.3 percent this year while Portuguese real GDP is forecasted to fall by 2.2 percent. The Spanish and Irish economies appear to be doing little better than stagnating.

Against this background, the one-size-fits-all monetary policy is likely to come under more criticism from citizens of countries who feel that the policy is not appropriate for the conditions prevailing in their countries, particularly the peripheral countries that are already applying severely contractionary fiscal policies.

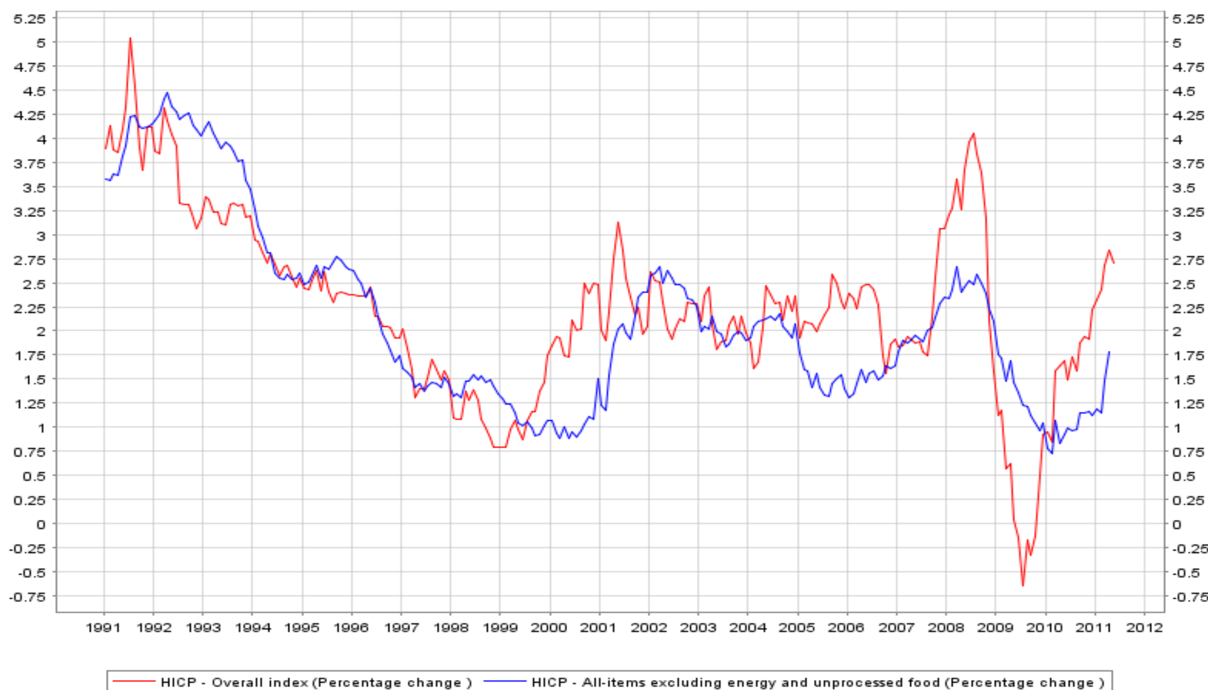
Despite these criticisms, the Governing Council has little choice other than to follow its mandate and focus on Euro area aggregates and on the risks to price stability in the area as a whole. With inflation running above the ECB's target level of just below two percent and the Euro area economy as a whole recovering, the arguments for holding the policy rate at the historically low level of one percent weakened considerably over the past few months, so the recent decision to raise the rate by 25 basis points is hard to argue with. The appropriate debates about ECB interest rate policy at this point should be about the speed with which rates are raised and how high they should go.

2.2 The Threat to Price Stability

From a macroeconomic perspective, I believe the principle arguments for adopting a slow pace of interest rate increases have little to do with the weak economic conditions in peripheral countries. Rather, they have to do with the extent of the threat to price stability and the underlying macroeconomic conditions in the Euro area as a whole.

In relation to price stability, Euro area HICP inflation is currently running close to 3 percent, so the concern about this rate being above the ECB's target is understandable. However, as with the last time inflation exceeded its target in the Euro area, during 2008-2009, the recent jump in inflation is largely the result of a surge in food and energy prices. Core inflation, calculated by removing food and energy prices, remains below 2 percent, though it has moved up over the past few months (see Figure 1).

Figure 1: Total and Core Inflation in the Euro Area



The increase in food and energy prices has, of course, been a global phenomenon that other central banks have also had to cope with. In the case of the Federal Reserve and the Bank of England, the decision has been taken that the latest jump in commodity prices represents a temporary threat to price stability and thus policy rates have not been increased despite the rise in headline inflation.

The ECB's response so far has been limited to only one small interest rate increase. However, despite similar price developments to those in the UK and US, the official language of the ECB has been more hawkish, with further increases in rates clearly signalled. In addition, members of the Executive Board, such as Lorenzo Bini Smaghi have been warning against the value of core inflation measures, pointing to the longer-term trend rates of increase in food and energy prices being above those for other consumer prices due to increasing global demand.[3]

My judgment is that the ECB should not be greatly concerned with the threat to price stability at present and while it is hard to argue against moving policy rates up from their current very low levels, there is a strong case for a slow and gradual pace of rate increases.

- Despite the return to growth, the overall Euro area economy remains quite depressed with real GDP still below the previous peak level of 2008:Q1 (see Figure 2). The unemployment rate stands at almost ten percent (see Figure 3) which is well above the levels that prevailed prior to the recession when inflationary pressures were limited. Overall, there appears to be plenty of "slack" in the Euro area economy as a whole, so we are not likely to see inflationary pressures arising from an excess of aggregate demand over aggregate supply. In addition, evidence from

[3] Bini Smaghi's column on this subject is available at www.ft.com/intl/cms/s/0/d8b5ee4c-8c81-11e0-883f-00144feab49a.html.

the US and UK of slowing growth warrant against being too bullish about the prospects for the global economy over the next year.

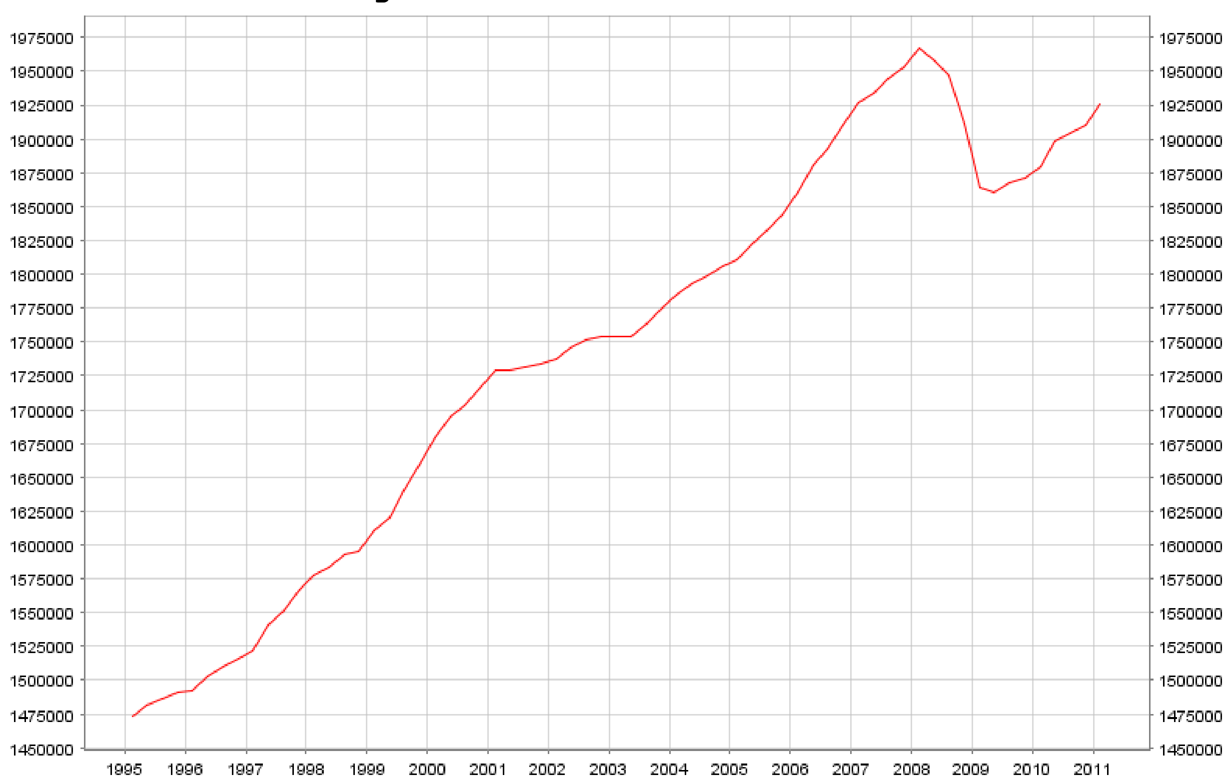
- While Bini Smaghi makes a good point that growth in emerging markets has tended to make commodity prices grow faster than other prices over the past decade, this observation calls for modifying the use of core inflation measures rather than getting rid of them altogether. The average gap between total and core inflation in the Euro area since 1999 has been three tenths of a percentage point, so a relatively small adjustment of this type is the best way to adjust for the long-run trends that Bini Smaghi alludes to.

- More generally, discussions of commodity price surges often invoke the idea that they are a harbinger of more general price increases. However, what is more common is for periods in which commodity prices jump to new highs to then be followed by periods in which they decline. The recent fall in oil and other commodity prices probably signal that the inflationary pressure from these sources has already peaked.

- Extended discussions of "second round effects" of commodity price inflation are a regular feature of ECB press conferences. Ultimately, whether upticks in price inflation become permanent depends largely on whether they feed through to inflation expectations. So far, available evidence suggests that these expectations remain firmly anchored. The average inflation rate expected by the participants in the ECB's Survey of Professional Forecasters for both 2012 and 2013 is 1.9 percent.[4]

- Finally, despite ECB concerns about "ample liquidity", the growth rate of M3 is well below the rates recorded in the years prior to the financial crisis (see Figure 4).

Figure 2: Real GDP in the Euro Area



[4] These results are available at www.ecb.int/stats/prices/indic/forecast/html/table_3_2011q2.en.html.

Figure 3: Unemployment Rate in the Euro Area

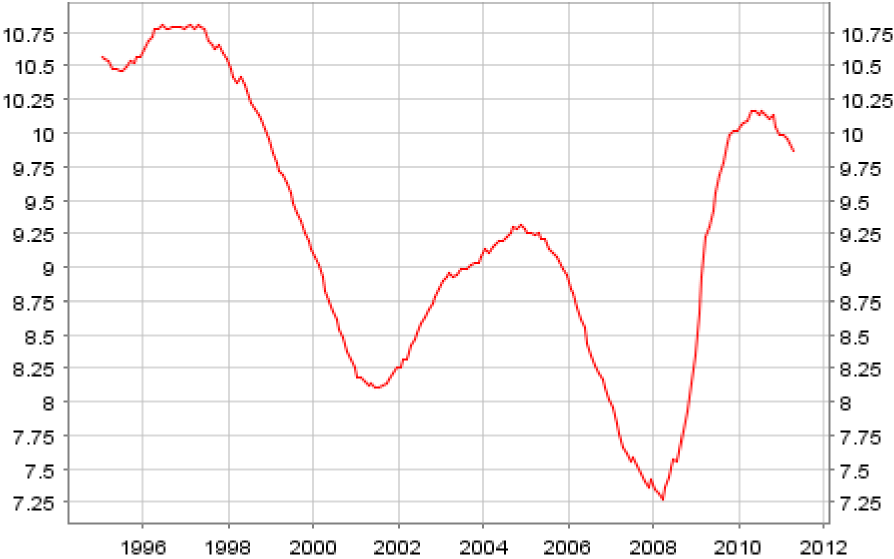


Figure 4: Growth Rate of Euro Area M3

3. FINANCIAL STABILITY CONSIDERATIONS

The previous discussion omitted any references to the financial stability implications of further rate increases. However, a common argument that has been raised in recent months is that the current problems with sovereign debt and banking stability are likely to worsen if the ECB raises interest rates and, to the extent that these problems influence the financial stability of the Euro area as a whole, this could argue against rate increases.

There is little doubt that ECB interest rate increases are going to be damaging to peripheral economies. Indeed, it is particularly unfortunate that mortgage markets in Greece, Ireland, Portugal and Spain are dominated by variable rates loans. For countries that have experienced housing bubbles, such as Ireland and Spain, mortgage rate increases will only exacerbate problems with default and negative equity. For peripheral banks, ECB rate increases will thus increase their cost of funding and lead to rising loan losses on household and business loans.

The increased financial tension due to ECB interest rates increases will not be limited to peripheral banks. These rate increases will also place more pressure on governments that are backstopping their banking systems. Furthermore, with holdings of peripheral bank and sovereign debt dispersed throughout the European banking system, these increased financial pressures may lead to widespread contagion.

These problems will all need to be taken into consideration by the Governing Council when formulating policy. However, they are unlikely to prevent further rate increases. Discussions of ECB interest rate policy tend to lose sight of Jan Tinbergen's famous rule that multiple policy targets generally require multiple policy instruments. The ECB's main refinancing rate is a powerful tool. However, it cannot be expected to do everything. We cannot expect the ECB to control inflation, cure household balance sheet problems, recapitalise banks and ease the sovereign debt crisis, all via judicious setting of its policy rate.

While the ECB has a role to play in resolving the economic problems of the European periphery and its potentially contagious effects, other actions must be taken to address the series of weaknesses affecting the Euro area.

- Household balance sheet problems cannot be easily or quickly solved and economic recovery in some parts of the Euro area will be restrained by the need to deleverage. However, recovery will be aided by policies that recognise when individual household debt burdens are unsustainable and implement necessary restructuring.
- Weak banking systems need to be recapitalised and depositors protected. However, if banks are insolvent, then private sector creditors need to share the burden with taxpayers.
- Fiscal imbalances need to be addressed. If countries have lost access to sovereign bond markets, then facilities such as the EFSF and the upcoming European Stability Mechanism can be used to provide breathing space to successfully implement fiscal adjustment. However, where sovereign debt burdens are not sustainable (as appears to be the case in Greece) a restructuring to achieve sustainability is far preferable to "extend and pretend" strategies that prolong uncertainty and delay the inevitable. If this leads to losses on the ECB's portfolio of Greek debt that then requires member states to recapitalise the Bank, then so be it. The ECB's current communications strategy of representing any kind of Greek default as a disaster—which appears to be partly inspired by concerns about the implications of a restructuring for their own balance sheet—is unhelpful.

4. THE ECB AND PERIPHERAL BANKING SYSTEMS

I have argued that the problems of the European periphery's banks should not play a key role in determining the Governing Council's decisions about ECB interest rates. However, the ECB still has a crucial role to play in helping to resolve the macroeconomic problems of the periphery. While the ECB's interest rate instrument should be used to ensure price stability in the Euro area, its lending operations to peripheral banks are a key instrument in maintaining financial stability. Unfortunately, the ECB has not been clear about how its policy on lending to peripheral banks is going to evolve. Indeed, its senior officials are continuing to send mixed signals on this important policy area.

4.1 Non-Standard Measures and the Separation Principle

The global financial crisis of 2008 saw a profound collapse in interbank markets. This led to the ECB adapting its lending procedures, moving away from auctioning off fixed amounts of credit via variable rate tenders to a commitment to provide whatever liquidity was requested by banks (subject to collateral requirements) at a fixed interest rate. This was combined with a shift to accepting a wider range of collateral and providing more credit at longer horizons such as three months, six months and (at one point) one year.

As the world economy began to recover in late 2009 and early 2010, ECB officials began to give speeches about their plans for an "exit strategy".[5] While the exit strategy discussed in these speeches partly referred to the removal of the policy of holding interest rates at historically low levels, it also referred to the removal of the "non-standard" credit measures. Indeed, it was often assumed that the provision of an unlimited amount of credit could not be combined with a policy of interest rate increases based on concerns about price stability.

In recent months, the ECB's discussion of its strategy has been refined. Some aspects of the non-standard measures have been removed: The one-year operation was not continued and there have been some restrictions on the eligible collateral framework. However, the ECB did not remove the key measures relating to unlimited liquidity provision before embarking on raising its policy rates by 25 basis points in April.

President Trichet had signalled this development in his previous press conferences. In January, he noted that "*we take decisions regarding the non-standard measures independently from the decisions that we take in relation to the interest rates to help restoring a more normal transmission of our monetary policy decision, being commensurate with the disruption or anomalies that we are observing in some market segments*." By February, this idea had been elevated to a "separation principle."

This decision to separate the decisions on interest rates and non-standard measures is welcome. A policy that doesn't set a limit on the amount of liquidity being provided could, in theory, lead to a large increase in credit and thus trigger a rise in inflation. In reality, this is not what is occurring with the non-standard lending measures. As can be seen from Figure 4, Euro area money growth is restrained. And the countries whose banks are availing of large quantities of ECB credit, such as Ireland and Greece, are seeing falling levels of loan balances and tight credit conditions. This is because the ECB lending to the banks in these countries is not fuelling balance sheet expansion. Rather, it is replacing market funding that has deserted these banks, which are now looking to deleverage their balance sheets.

[5] See, for example, this September 2009 speech by President Trichet: www.ecb.int/press/key/date/2009/html/sp090904.en.html

4.2 More Clarity Required. And Fewer Threats.

The role the ECB has played in supporting banking systems in Greece, Ireland and Portugal has given it a key role in the EU-IMF programmes that these countries have received. In the Irish situation in particular, the key trigger for the programme was not the inability of the government to borrow in sovereign bond markets but rather the ECB's concern about the banking crisis and the unhappiness of its officials with the increasing levels of support they were providing to the Irish banks.

The relationship between the ECB and the peripheral economies has become extremely complex. However, it is clear that ECB officials have regularly used the implicit threat that they can withdraw their support for peripheral banking systems, or else continue to provide funds to "persistent bidders" at interest rates that are perhaps considerably higher than are charged to other countries, as a way to obtain actions they deem necessary.

In relation to Greece, ECB officials have been using the threat of the withdrawal of the eligibility of Greek sovereign debt as collateral for open market operations to put forward their argument against any debt restructuring. In the case of Ireland, it is known that Irish government officials have requested that assurances be provided that the ECB will continue to provide sufficient liquidity to Irish banks over the next few years, perhaps via a special medium-term facility. However, no such assurances have been provided. And without greater clarity on the timeframe for repaying their loans to the ECB, it will remain impossible for even recapitalised Irish banks to obtain market funding.

The ECB's strategy of threatening peripheral banking systems (and the regular coverage this receives in the media) has become one of the destabilising factors that have contributed to worsening the current crisis. It is time for this poorly-thought-out strategy to cease. The ECB's obligations under the European Treaty mean that it cannot help peripheral countries via keeping interest rates low for the next few years. But it can continue to act as a lender of last resort to the banks in these countries in a way that reassures (rather than worries) financial markets.

REFERENCES

- Bini Smaghi, Lorenzo (2011). "Ignoring the Core Can Keep Inflation at Bay", *Financial Times*, June 1st 2011.
- Jonung, Lars and Eoin Drea (2010). "It Can't Happen, It's a Bad Idea, It Won't Last: US Economists on the EMU and the Euro, 1989-2002", *Econ Journal Watch*, vol. 7(1), pages 4-52, January.
- Krugman, Paul (2011). "Can Europe Be Saved?", *New York Times*, January 12th 2011.
- Trichet, Jean Claude (2009). "The ECB's Exit Strategy", Speech at the ECB Watchers conference, September 4th 2009.