The ECB Tries Again

In June the European Central Bank announced a series of new steps to counter deflation. "Better late than never" was the response of many of the critics. But rather than bemoaning the failure of President Draghi & Co. to move earlier, it is more productive at this stage to ask: are the central bank's measures now up to the task? Will they work, in the sense of taking deflation off the table and giving a boost to economic growth?

One thing is clear: the ECB's conventional measures, reducing its benchmark interest rate from 0.25 to 0.15 per cent and charging commercial banks 0.1 per cent on the money they deposit with the central bank, will make little difference. A ten-basis-point reduction in the cost of borrowing from the central bank, or even of borrowing on the interbank market, will not do much to stimulate commercial bank lending. It will do almost nothing to compensate the banks for the risk of lending to small and medium-size enterprises facing weak demand for their products. And if the ECB thinks that a 0.1 per cent charge on balances warehoused at the central bank will impel the banks to put their liquidity to work, it will quickly discover that lenders have plenty of other places to park their idle funds.

This, of course, is just another way of saying that conventional monetary policy has run its course. Larger cuts in interest rates, starting from higher levels, would make more of a difference. But the reality is that European monetary policy is already being made in an environment of near zero interest rates where, hoopla about negative deposit rates notwithstanding, further changes in interest rates are little more than symbolic.

Thus, if policy is going to make a difference, policy will have to be unconventional. Here the ECB unveiled two – or, more accurately, one and a half – new initiatives in June. First was its "Targeted Long-Term Refinancing Operation," or TLTRO. Starting in September, this will allow banks to borrow for periods as long as four years so long as they are using the funds to lend to households and companies. This measure is intended to "target," as it were, a key obstacle to economic recovery, namely the continued decline in bank lending to the nonfinancial private sector, which was down yet again, by two per cent year over year, this past May.

Specifically, financial institutions will be able to borrow up to seven per cent of their loans to companies and individuals, exclusive of mortgages, in two tranches in September and December. This means that they will be able to borrow roughly €400 billion, or some US$550 billion, cumulatively over four months. Recall that the Federal Reserve, under QE3, had been injecting $85 billion a month into U.S. financial markets before starting to taper in December. This makes TLTRO look like a substantial commitment. And there may be more coming after December.

Still, there are grounds for questioning whether it will make a difference. Borrowing at 0.25 per cent, the likely cost of funds under TLTRO, even for as long as four years, will do little to compensate banks for the risk of default by their borrowers. Weak banks with inadequate capital and an inheritance of nonperforming loans will be reluctant to take on the risk of more of the latter. BIS researchers Leonardo Gambacorta and David Marques-Ibanez showed in a 2011 working paper what many observers already knew intuitively, that banks with weak core capital are especially reluctant to expand their lending, regardless of the current cost of funds.[1]

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1 L. Gambacorta, D. Marques-Ibanez: The bank lending channel: lessons from the crisis, BIS Working Papers, No. 345, 2011.

The Asset Quality Review and third round of bank stress tests may correct this situation. But not if the European authorities again soft-pedal the need for banks to raise their capital ratios. And not if they permit the banks to raise those ratios simply by reducing their loans and investments.

Then there is the fact that banks can already borrow short-term from the ECB at 0.15 per cent, 10 basis points below the likely cost of tapping the TLTRO. They can roll over those short-term borrowings at will. Draghi has made clear that benchmark interest rates will remain at current levels for at least two more years. Locking in funding at 0.25 per cent for four years will be attractive only if banks expect interest rates to start rising after two years. Neither U.S. experience, nor the weak growth prospects of Europe itself, provides much basis for this expectation. And, without expectations of higher interest rates, TLTRO may be substantially unsubscribed.

The additional "half an initiative" announced in June was that the ECB would study the possibility of security purchases. These would be similar to the security purchases undertaken by the Fed, which has been buying Treasury bonds and mortgage-backed instruments. Here the problems to be "studied" are several. The eurozone, unlike the U.S., has not one Treasury bond market but many. Buying German bunds will have little effect, since their yields are already strikingly low. Buying the bonds of Greece or another troubled Southern European country would be politically contentious. And attempting to finesse this problem by buying the bonds of all member states, in proportion to their capital in the ECB, would mean devoting very considerable resources to a program with marginal impact, since Germany would account for the single largest share. It would mean little bang for the buck (or for the euro).

Moreover, the problem in Europe is no longer the inability of governments to borrow. To the contrary, yields on new sovereign bonds issued by Ireland, Portugal and – dare one say – Greece are strikingly low. Rather, the problem is the cost of borrowing for households and firms.

What, if anything, can the ECB do about this? Past experience suggests that it will have to narrowly target its security purchases. In a study for the Federal Reserve Bank of Kansas City, Arvind Krishnamurthy and Annette Vissing-Jorgensen found that the impact of Fed purchases of Treasury bonds was essentially limited to Treasury bonds.[2] To affect yields on other securities, the Fed had to purchase those other securities.

The ECB is contemplating the possibility of similarly purchasing securitized corporate and household loans. But in Europe, unlike the U.S., securitization markets are small, reflecting the continent's bank-based financial system. While European policy makers are seeking to jumpstart securitization markets, their success is uncertain. And even if they ultimately succeed, considerable time will have to pass before any ECB security-purchase program has a significant stock of securities to purchase.

These cautions should not be taken as a council of despair. If ECB officials conclude that the impact of TLTRO and securities purchase will be marginal, they should not give up hope; rather, they should strive to do more. There are other creative ideas out there. Jeffrey Frankel of Harvard suggests that the ECB should buy foreign bonds with the goal of pushing down the exchange rate, and through that channel fostering expectations of inflation rather than deflation. For some ECB governing council members, this may be a bridge too far. If so, it is incumbent upon them to explain what they will do instead and why, to paraphrase President Draghi, "believe me, it will be enough."

2 A. Krishnamurthy, A. Vissing-Jorgensen: The Ins and Outs of LSAPs, Federal Reserve Bank of Kansas City, 2013.