LOW INTEREST RATE POLICY OF THE EUROPEAN CENTRAL BANK (ECB)

Introductory thoughts on the current situation

As the lack of sufficient information for the calculation of the price index is generally known, the ECB no longer sets the objective of achieving the statistical annual rate of zero per cent of price increase but aims for an annual increase of slightly less than two per cent. The task of the ECB is symmetrical by nature – both too high and too low inflation rates should be avoided. In reality, the rate of appreciation has remained considerably below the desired level for several months in the European Economic and Monetary Union and this development is continuing. The same also applies to the base inflation rate, i.e. without taking into consideration developments in energy and food prices. The reasons are besides the continuing stagnation of labour productivity also the decline in economic activity since 2009 and the related decrease in demand – particularly in the euro zone countries affected by crisis – adjustment of excessively high prices in certain countries and the continuing decline in oil prices and cheaper energy imports. The decreasing distance to the zero level at which – generally speaking – the so-called disinflation becomes deflation, is stirring up the sometimes very controversial discussions on urgently necessary investments that the ECB should make and on its role as the guardian of the currency.

Deflation is a continuous process, so the issue is not just about temporary falling prices. Its characteristic signs are decreasing GDP growth rates, increase in unemployment, salary cuts and the resulting spiral of price changes heading below the above-mentioned zero level. Real interest rates are increasing. Such a situation is particularly problematic for such enterprises and households which have a high debt burden to begin with. If the continuation of the decrease in prices is confirmed, the demand will be increasingly put off to future periods and the pressure on prices will increase. This trend will restrict the conclusion of contracts according to which the decrease in prices will lead to an increase in real burdens. For instance, loan contracts and contracts of employment, considering the servicing of loans and personnel expenses. Disinflation, on the other hand, only means a decreasing rate of price increases (second derivative!), i.e. a statistically established decrease in inflation.

When looking at the European Economic and Monetary Union as a whole without taking into account special situations in certain countries, the main objective first of all is to stop disinflationary developments in order to prevent the first signs of sliding into an economic depression. For that purpose, the ECB takes above all the following measures which have given rise to quite a few heated disputes:

- lowering of base interest rates;

- quantitative easing (QE): it consists in the purchasing of loans, mortgage-backed notes (real estate backed notes and also asset-backed securities (ABS)) by the ECB. If these transactions are performed with government loans acquired by the ECB in trading markets, it is called quantitative easing through outright monetary transactions (OMT). Quantitative easing can be used when the central bank has reduced base interest rates to zero or an even lower level and needs to continue expansive monetary policy to support the economic situation. Transactions of this type serve their purpose when the functioning of the chain of monetary policy is ensured. The impaired functioning of the transmission process between issuing banks, credit institutions and real economy has to be restored. Through purchases, the claims of the current holders of different notes that would be payable sometime in the future are turned into liquidity that can be used now. In other words: tied-up equity is released. Commercial banks are able to issue more loans and have more opportunities to acquire funds;
- targeted longer-term refinancing operations (TLTRO) with the initial duration of three years[1] and now four years.

The main reason why economic recovery has not been achieved until now is the excessive loan burden in most countries of the eurozone. Many companies, households and also certain EU Member States have set themselves the goal of reducing their high debt burden. But this also reduces the demand, and enterprises tend to receive less orders. On the other hand, commercial banks – bearing in mind the lack of equity in balance sheets with risky assets – are issuing less loans. *Summa summarum*, more debts are currently repaid than acquired. Thus it is understandable that the ECB has lowered base interest rates as much as possible, made borrowing conditions easier and uses longer repayment periods. In addition, the central bank is ready to reduce the loan burdens in the balance sheets of banks and open possibilities for issuing more loans through programmes for purchasing of loans.
It is questionable to what extent it is possible at all to direct the development of real economy in the current economic conditions with measures of monetary policy implemented so far and planned for the future. It is not certain at all that expansive monetary policy would induce European banks issue more loans and encourage enterprises, on the other hand, to borrow more for innovation and investments to enliven the economic situation. In principle, additional economic growth cannot be created by only measures of monetary policy just because of favourable development of financing opportunities. Monetary policy cannot remain successful without comprehensive reforms (above all flexible labour markets, reduction of bureaucracy, taxation systems favouring economic growth) or government policy focused on infrastructure, education, research and innovative investments, also online services[2].

[1] The TLTRO measures applied at the end of 2011 and beginning of 2012 in the amount of approximately one trillion were called „Big Bertha“ according to a large cannon used in World War I.
[2] Similar to Digital Agenda (Digitalen Agenda) in Germany.

The aim of the ECB policy is to change the current direction of price developments to bring the inflation rate back to an average level of a little less than two per cent. Therefore the ECB lowered on 5 June 2014 again to minus 0.2% the discount rate it had lowered to minus 0.1 per cent already in June 2013. Negative discount rate means in a sense charging penalty interest on funds deposited with the ECB. This is in principle similar to a tax charged on bank deposits. This is intended to encourage banks to issue more loans to real economy. This, however, assumes in its turn that banks are able to bear the risks related to issuing of loans and are ready for that. But this is not the case everywhere in the eurozone. Another objective is to induce banks with excessive liquidity to display more readiness for transferring such funds through interbank market to the disposal of credit institutions with insufficient potential for deposit creation.

It is questionable whether banks will comply with the ECB wishes in the current situation, bearing in mind penalty interest rates. Negative base interests rates may lead to undesirable responses instead – banks will namely begin to avoid the direction set by the central bank. Firstly, banks may transfer the extra costs to their clients in the form of higher loan interests rates (and bank charges) which would not be appropriate at all in the current economic situation. Secondly, banks may see the way out in early repayment of expensive loans to reduce their balance with the central bank, instead of increasing the funds in circulation by issuing new loans. In addition it should be born in mind that negative deposit interest rates may affect the impact of direct transactions performed for monetary policy reasons within quantitative easing programmes. This will happen when banks are unable to use the revenue earned from the sale of government notes for issuing loans which are justified in their opinion but have to “park” the revenues temporary at the central bank, paying penalty interest rates for that.

According to Article 123 of the Treaty on the Functioning of the EU, the ECB is not allowed to perform national financing. In that sense, the central bank is not allowed to take over national loans directly from the issuer. The issue of whether the central bank violates the provisions of Article 123 also by acquiring national debt from aftermarkets has caused controversial discussions. As such direct transactions of monetary policy do not directly increase national budgets, this is in principle not regarded as national financing. The aim of direct transactions is just to reduce the interest rates paid on notes by the respective governments and thus to help them to acquire new loans from capital markets.

In May 2010 the then President of the ECB Jean-Claude Trichet gave in to the pressure of the Member States and declared its intention to purchase the national debt of countries in crisis through the quantitative easing programme through third markets in unlimited amounts. The aim of this measure was to stop the disintegration of the Monetary Union. Already the announcement of such a purchase programme lowered the risk premiums of loans of problematic countries. The countries which were not included in the support programme did not, however, particularly like the planned selective implementation of the intervention measures. Besides there was some apprehension that countries in crisis may no longer feel the pressure or make efforts to reduce the national debt or implement systematic structural reforms or at least do not perceive a sufficiently strong pressure. However, it would be absolutely necessary to carry out thorough adjustments in such countries to achieve their economic recovery within the European Union.

The Governing Council of the ECB adopted the expanded quantitative easing programme on 22 January 2015. According to this programme, in addition to other programmes already started,[3] government loans with good rating[4] can be taken off the market from March 2015 to initially until September 2016, using 60 billion euros of the ECB funds monthly. The total amount for this period is 1.14 trillion euros. The plan described is considerably different from the conception declared in 2010 as funds will not be used selectively any more for the purchasing of government debt of countries in crises. Instead, all member states are involved now in the programme. Consequently, it was necessary to determine first the criteria for the distribution of the liquidity **added to the market** among government notes of different countries. The key to such distribution will eventually determine which countries will benefit most from the purchase programme, or, in other words – the national governments for which the financing conditions are most favourable *ceteris paribus* (other conditions being equal).

Two methods of distribution were discussed: either distribution on the basis of shares of each member state in the ECB (equity) – in principle, according to the economic capacity of each Member State – or distribution according to the total volume of outstanding government debt capitalised through the market (market depth). Decision-makers must have seen clearly possible spillover effects of one or the other key of distribution that would not necessary contribute to the achievement of the objective. The Governing Council of the ECB decided to follow the participation in the ECB capital in the distribution. Purchasing of notes without any upper limits which would take into account the specific situation in different countries would have led to the payment of the largest parts of the programme volume to Member States with strong economy, such as Germany. Consequently, the interest burden of these countries would have decreased more than that of economically much weaker countries. In order to avoid that, the central bank will purchase no more than 33 per cent of the outstanding national debt of each country.

The decision of the ECB to allow central banks of the Member States to purchase government notes and have them bear the risk of losses violates the rules of common monetary policy. Such policy is namely based on the principle of joint liability. With the renationalisation of liability risk the monetary policy is increasingly approaching financial policy. However, the fact that countries suffering from excessive debt burden – which is the whole point of the matter – no longer sufficiently perceive the controlling effect of loan risk charges, has an even more important impact.

In order to alleviate such unwanted effect even to some extent, according to the Governing Council of the ECB, 20 per cent of loans purchased from open markets will still be subject to joint liability, and ECB in its turn will assume 8 per cent of

[3] Such as mortgage-backed notes and credit-backed securities.
[4] Also issuers implementing programmes of EU institutions and support programmes.

the risk for the volume of purchases. The central banks of the Member States will bear the remaining 80 per cent of the risk. This means that the taxpayers of each Member State eventually take the responsibility as they can be regarded as the 'passive owners' of the central bank of their country[5].

With an additional decision that loans would only be purchased from countries which comply with their contractual obligations according to the decision of the Council of the EU, the Governing Council of the ECB could have expressed more clearly the absolute necessity of structural reforms and lay an even stronger emphasis on this admonishing appeal. It would surely have increased the willingness of the countries concerned to implement measures oriented to the future. This, however, raises the issue that the ECB could have exceeded the limits of its competence by influencing such decisions which do not directly concern the financial area. Evaluating the conformity of the ECB measures with basic principles of monetary policy, a fundamental issue arises: what is monetary policy and what are its limits?

Bearing in mind the quantitative easing programmes, we have to clarify another particularly important issue. Should the ECB be allowed to purchase also asset-backed securities (ABS) besides notes with ordinary guarantees and transparent notes? Such notes are based on numerous loans of similar type which have very different guarantees. The problem with loan packages is that the guarantees of their different parts have been insufficiently documented and are therefore difficult to assess. Such complex financial instruments make it possible not only to diversify but also to hide the risks. Extremely risky U.S. mortgage claims sold internationally but poorly documented and wrongly assessed led to the catastrophe caused in 2008 by subprime loans, which grew into the global financial and economic crisis. Since then such loan packages are no longer trusted and have acquired the image of “toxic securities” or “securities from hell” or even “weapons of mass destruction”. As they can be abused, so-to-say, to obtain new liquidity at any time, purchasing ABS securities by the ECB means a special risk for the European Union which is known to be liable for the ECB. Thus we will reach again the community of taxpayers from all Member States. Therefore the ECB which acts in public interests should be allowed to purchase only simple and transparent premium securities with the lowest risk (senior tranches). ABS securities, on the other hand, are extremely complex and untransparent as they contain a large number of notes of different quality. The probability of default risk of such security packages can be assessed at best only the bank which has compiled them. And this only in case the bank is aware of the concentration and correlation risks between the loans within the package. Therefore it is difficult for potential buyers to recognize the ABS securities with a high default risk (mezzanine tranches).

At the beginning of 2011 the targeted longer-term refinancing operations (TLTRO) started with the aim of facilitating the performance of the main duties of banks – namely supplying enterprises with external capital – in increasingly more regions.

[5] See this train of thought in: Sinn, Hans-Werner, Europas Schattenbudget, Deutsches Handelsblatt, 09.02.2015, p. 48.

Local companies of Southern Europe in particular require generous loans. This depends not only on the capacity, i.e. the ability of a bank to create deposits, but also on its willingness. Banks accept loan applications only from applicants with sufficient payment capacity. Improvement of payment capacity is not the task of monetary policy. It can be globally influenced through financial policy at best through making the respective changes in the economic environment.

In the current economic situation it seems to many credit institutions more profitable and considerably less risky to refinance their activities with long-term loans (TLTRO) and thus to purchase national debt with high interest rates or repay expensive bank loans instead of issuing additional loans to enterprises. So it is not surprising that the first "round" of intermediation of loans of targeted longer-term refinancing operations (TLTRO) in 2011 and 2012 did not achieve its objective. Therefore the loans of targeted longer-term refinancing operations will be issued in the future with the condition that banks should increase their existing volume of loans according to the volume of long-term loans issued (funding for lending). In parallel with this decision the periods of such loans of the central bank have been extended from three to four years. This, however, applies only if the volume of loans increased through loans of targeted longer-term refinancing operations (TLTRO) is retained during that period. Otherwise the loans will have to be repaid in already two years.

It is quite questionable whether the objective of the measure will also be achieved this way. Like before, banks can use funds of targeted longer-term refinancing operations (TLTRO) for purchasing government debt and simply repay to the ECB the loans two years later. If it is intended to stop the behaviour countering the actual objective of the measure, much tougher conditions should be imposed on the granting of loans. For instance, one possibility would be to require actual evidence on the purposeful use of the funds according to strict requirements. Also penalty interest rates could be imposed. Neither precaution has been planned for now. Thus banks will not be expected to provide at least a part of the liquidity to the disposal of enterprises and households. Consequently we cannot very much hope that the decrease in the volume of loans in eurozone could be stopped according to the expectations of the ECB.

Although the external value of currency is not among the possible objectives of the central bank policy, the exchange rate may contribute to the positive effect of the current ECB policy after all. As the euro liquidity interest rates of banks are extremely low or even penalty interest rates are applied, the investment of capital outside the eurozone is constantly increasing. The subsequent decline in the exchange rate of the common currency generally increases the competitiveness of local enterprises, however. Such trend is supported by the preparations of the U.S.A. and U.K. for starting changes in the development of interest rates during this year. If this in its turn boosts export volumes, the economic measures initiated can still stop the price decrease trends.

Decreasing interest rates have an impact on the economic situation of enterprises not only in the same direction with the change (i.e. decrease) in exchange rates. They have a both positive and negative impact also through costs and equity quota. Decreasing interest rates have a positive impact on the costs of external financing also when existing loans with higher interest rates are repaid with new loan contracts with lower interest rates. On the other hand, also the discount rate is lower with decreasing market interest rates, and this determines the present value of long-term obligations required for the second column of the pension programme financed by enterprises. The lower is this rate, the higher is the present value of payments made by an enterprise for the financing of the second pension column of its staff. This in its turn forces enterprises to form considerably larger reserves in the balance sheet and this reduces the position of the equity.

The decision of the Governing Council of the ECB of 22 January 2015 to bring additional 1.1 trillion euros to the financial markets within the next 19 months will lead to fast appreciation of assets as we see according to the developments in the U.S.A., U.K. and Japan. Such developments are also supported by the ECB purchases and therefore there will be even less attractive investment opportunities. Such developments will benefit segments of the population who are already wealthy and have a lot of real estate and rich security resources. On the other hand, bearing in mind actual decrease in the value of money, low interest rates are a disadvantage for individuals who have deposited euros for their old age pension. A long period of low interest rates may increasingly aggravate social gaps.

Low interest rates have also an impact on banks which are mainly engaged in classical deposit and loan activities.[6] Decreasing margins between the interests of creditors and debtors are the reason why it becomes increasingly difficult for such banks to earn reasonable profits. This may induce them to focus more on the risky areas of investment banking in their future activities. Also life insurance companies which had earlier invested the insurance premiums paid by clients largely in long-term government debts, have increasing difficulties with providing attractive profit to their clients during a longer period of low interest rates. Therefore also such companies may become increasingly venturesome in investing the funds entrusted to them. It is planned to stop such a trend with the Solvency II capital standard which is a development of the currently effective strict capital rules of 73/239/EEC and will enter into force in the whole Europe in 2016. This will require insurance companies to secure risky transactions with more capital.

The Bank for International Settlements is worried that extremely low interest rates may cause excesses in financial and real estate markets and admonishes central banks not to delay stopping their expansive monetary policy but start preparations for it and start it as soon as possible. If this is started too late, there may be not enough scope for monetary policy during the next recession for countermeasures accompanying fiscal policy. It has been noticed even now that the funds released are not used in real economy but are starting to create “bubbles“ in financial markets.

[6] In Germany these are above all savings banks and cooperative banks (Sparkassen und Genossenschafts-banken).

Be that as it may, we can still state about the eurozone – in the current situation where we have a general economic recession are there is no particular hope for the rise in prices, the expansive monetary policy is in principle *still* justified for now.

In April, 2015

Manfred O. E. Hennies
Kiel/Warder
Germany

Matti Raudjärv
Tallinn/Pirita-Kose and Pärnu
Estonia