MONETARY POLICY AND FORMATION OF INTEREST RATES[1] UNDER CONSIDERATION OF THE PRESENT SITUATION

Manfred O. E. Hennies[2]
University of Applied Sciences, Kiel

Introduction

The present economic situation in the European Union (EU), with the exception of particularities in some countries, is mainly characterised by the fact that the need for credit instruments in the economy as a whole is lower than the money supply. This explains why conventional monetary policy measures are largely ineffective. For this reason the European Central Bank (ECB) has, for some time, been prompted to resort to unconventional measures.

Generally speaking the fundamentals of monetary systems, in free-enterprise structured national economies, are analysed to emphasise the dependence of those responsible for monetary policy and their restraints. Thus current problems and possible measures or solutions can be more closely analysed.

Rudiments of Interest Rate Formation

Interest rates in a market economy are defined, on the one hand by the supply of money and on the other hand by the extent to which this is utilized for productive, consumer and speculative purposes, as well as for precautionary reserves and to finance public spending. The pluralistic expression "Interest" refers to the level of interest rates. This is formed through supply and demand in the individual sectors of the capital markets.

The banking sector, mainly the commercial banks, have a strong influence on the interest rates. The commercial banks offer customers the chance to deposit money, which will be needed at a later date, in current accounts or to invest in passive transactions. This enables the commercial banks to use these funds, after putting aside the minimum reserve, to provide further credits for their customers. This transfer of funds occurs through lending. In the case of such transactions the bank transfers the credit amount to the customer's current account, thus creating, at the level of the surplus return, bank deposits. In this way the banks, in their entirety, increase the amount of money in circulation (money multiplier).

The declared goal of the ECB is to keep the annual inflation rate in the target area, set down verbally and numerically concretized by legislation, to around 2%. For that purpose it is important to control the amount money in the economy which, other

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[1] The full article "Geldpolitik und Zinsbildung unter besonderer Berücksichtigung der Gegenwärtigen Situation" is is available on the CD enclosed with this publication.

[2] Dr. Manfred O. E. Hennies, Professor emeritus, University of Applied Sciences, Kiel; manfred.hennies@fh-kiel.de

things being equal, is a vital factor for the overall demand for goods and services and, therefore for the development of conjuncture and price levels, and to maintain this target level. In addition to the required conditions of use for the commercial banks, set down by the ECB to guarantee stability, the fixed interest rate on the main refinancing operations is the main control device.

This key interest rate is the price level, together with the financial resources gained through passive transactions, at which the credit institutions receive their liquidity from the ECB and through which they are able to expand the basis of their lending business. An increase or decrease in key interest rates, set by the ECB, leads to an increase or decrease in the costs for refinancing. A decrease in interest rates leads to a decrease in the cost of Central Bank credit, but does not necessarily make credit institutes more likely to increase refinancing. Furthermore, the commercial banks must be given the opportunity to place these additional funds, in the form of credits, back into the national economy. This is the case when businesses and private, as well as public households require extraneous financing at a similar level and are prepared to borrow. Moreover, the economically orientated banks are only prepared to refinance and enter into lending transactions, if in spite of the costs and risks involved, they receive high enough interest as income.

Current Problems of Interest Rate Formation and Solutions

At present, the ECB is striving, through its zero interest rate policy, to avert the dangers of deflation. Complementary quantitative easing (QE) and the resulting drop in returns on bought up securities will hopefully lead to the commercial banks giving more credits to small and medium-sized enterprises which are unable to, or have difficulty in financing themselves through bonds. In the end, the main aim is to increase economic growth, or in the case of some countries, to set it in motion. The methods being used by the ECB to solve the financial policy problems must, however, be seen critically.

→ By infiltrating Central Bank money into the money cycle to a greater extent than ever before, since the introduction of the European Monetary Union, interest rates have sunk to an extremely low level. The ECB is trying to succeed, where fiscal policy has so far failed, in reinstating real economy conditions which will enable the realization of financial political aims. The zero interest policy blocks every attempt to achieve market-orientated interest rates and violates the fundamental principles of a market economy. Interest rates lose their selective function. This leads to financial resources being used for projects which, within a market-orientated interest rate formation, would have proved unprofitable. In the meantime, this may provide a positive impulse for economic development, but in the long term the misrouting of financial production factors leads to a reduction in a possible gain in efficiency and therefore destroys growth potential. This can also negatively influence international competitiveness.

→ The ECB's zero interest policy has led to a shrinking, to the lowest level, of the margin between the interest earned on credit and the refinancing costs, thereby

weakening the basis of the lending business for the credit institutions. The result is that bank deposits yield little or no interest. This, furthermore has already led to some banks charging account holders negative interest if their assets reach a certain level. The diminishing interest on deposits has led to a tendential reduction in saving. This is problematical for the banks because money deposited provides them with a source of liquidity. If the decrease in investment was, in reality, a result of less saving and more spending, this would have a positive effect on economic growth. For countries suffering economic depression and struggling to boost their economy, such developments could be helpful.

→ If a continuation of the zero interest policy, and the accompanying profit cuts, were to cause the banks to increase the cost of borrowing, then we would have a situation exactly opposite to that which the ECB hopes to achieve. The case shows how contra productive, even contradictory a policy of zero interest rates is.

→ On the other hand, if this compensation of earnings were to fail it is to be feared that, in the long run we would see more cases of bankruptcy in the banking sector and an increase in branch closures. This would have far reaching consequences for the economy as a whole. Unemployment amongst bank employees would increase and the banking sector would diminish, which would be a disadvantage for the economy and society as a whole. Local communities, private households and small and middle-sized businesses rely on the services of the local bank. This applies to regional and private customer services and in particular advisory services and external financing.

In this context it must be taken into account that the commercial banks are a vital element for the ECB in the implementation of its conventional monetary policy. In this respect, member states with a high concentration of branch banks could, through leaving the market and tightening the branch network, become more efficient in implementation of monetary policies.

→ Low loan interest causes difficulties for cautious investors such as insurance companies and pension funds. Experience shows that these financial institutions are hardly able to fulfil their obligations to their clients. Classic contracts such as capital life assurance with continued high interest guarantee can no longer be refinanced and become a dead weight. Such difficulties have been intensified by stricter regulations as in Solvency II, meaning that insurance firms and credit institutions are required to secure investments with high equity capital.

Currently economic recovery is not making headway. Since the monetary policy measures applied so far have largely failed, the question is now what can be done to stimulate national economic development. Whether conventional fiscal policy measures would be more successful is debatable, particularly as the room for maneuver is limited politically by constraints on debts.

Rather than issuing credits the commercial banks tend, because of constantly prevailing financial uncertainty, to deposit their reserves with the ECB, to invest

speculatively or to move capital to flexible channels. This has lead, in political circles, to the idea that instead of pumping further liquidity into the money circuit, the financial market could be avoided altogether and the funds passed on directly to potential consumers. This idea came originally from Milton Friedman who coined the term "helicopter money" in 1969. The aim is to widen the financial base for overall economic demand thereby creating the premises for surge in demand and initiating economic growth.

In general, helicopter money injected into the money circuit, regardless of its source, could lead, because of the resulting substitute effect, to an artificial reduction in demand on the capital markets. As a result interest rates would fall further than in the case of the zero interest policy. The aforementioned allocation and structure problems would be more severe. For this reason the idea of helicopter money is not the answer.

Conclusion

The zero interest policy which violates all principles of free economy should be abolished as soon as possible. It is vital that we return to a policy which does not lead to misallocation of national economic resources and structural distortion. In a currency area in which the individual countries often differ greatly in structure, and economic fluctuations vary, economic problems cannot be solved by implementing a uniform global monetary policy for all. By no means can we expect this to create real economic parameters for a policy based on financial stability. This is the responsibility of fiscal policy. The pragmatic solution to the present problems is to be found in a goal orientated coordination of monetary and fiscal policy.