SWP Comments

Stiftung
Wissenschaft und
Politik

German Institute
for International and
Security Affairs

Collateral Damage from ECB Strategy

Ultra-loose Monetary Policy Has Little Benefit – and Harms Many

Heribert Dieter

2015 will be a defining year for the European Central Bank. It is expected to start buying up government bonds from member states from the end of January. This means the ECB is entering into significant risk and becoming dependent on the fiscal policy of the member states. As the example of Greece demonstrates, the central bank is thus making itself – along with other state creditors – vulnerable to blackmail. Governments can threaten to stop servicing their debt, forcing the ECB to continue financing them. Furthermore, the reasoning for starting to finance member states is spurious. The supposed risks of deflation are actually small: while the prices of apples and heating oil have fallen, those of machine tools and consumer durables have not. At the same time, it is becoming increasingly apparent that the depreciation of the euro brought about by the loose monetary policy harbours huge disadvantages for many of Europe's trade partners – from Switzerland to the US.

The ECB has announced its change in policy to great fanfare – due to the great risk of deflation it has to buy up government bonds. The ECB plans to purchase government bonds with a volume of up to one trillion euros, starting from the end of January 2015. The key questions here are: Is there really a risk of deflation? How would the purchase of government bonds on the secondary market change this? And has the ECB taken the right measures up to now in order to stabilise Europe's financial markets?

The wrong diagnosis

Even the ECB's recent analyses are unconvincing. While it is true that prices are declining in some member states of the European Monetary Union (EMU), this is far from a harmful development. Within a monetary union there is no option to increase the competitiveness of companies (in Greece, to give a concrete example) by devaluing the currency. The only way of doing this is to reduce prices, and that is precisely what is happening at the moment. Greek companies have no other alternative if they want to make their goods and services more economically attractive.

However, Greece is a special case within the eurozone. Prices in Greece fell by 2.3 percent in 2013 and 2.2 percent in 2014, while in Germany they increased by 2.1 and 2.2 percent respectively. Prices in the other

Professor Heribert Dieter is a Senior Associate in SWP's Global Issues Division and Visiting Professor for International Political Economy at Zeppelin University (Friedrichshafen).

crisis nations were stable in 2013 and 2014. In Spain, for instance, they have remained almost unchanged since 2009. So adjustments in the eurozone are taking effect, although very slowly.

For the eurozone as a whole there is no need to leap into action. The 0.2 percent decline in consumer prices in December 2014 compared to the previous month was almost entirely due to the sharp fall in the prices of energy and some agricultural products. Unprocessed agricultural products became 1.0 percent cheaper, while energy prices fell by as much as 6.3 percent. Discounting these product groups, the prices of which are always subject to large fluctuations, prices in the eurozone increased by 0.8 percent compared to December 2013.

Moreover, the ECB should think through the consequences of its own policies more carefully. It is trying to simultaneously reach two mutually exclusive goals. On the one hand, it wants banks to reduce their risks in order to become more resistant to future crises. This is certainly a sensible undertaking. It involves the banks strengthening their equity base and exiting from particularly high-risk investments. On the other hand, the ECB wants the banks to grant more credit. But the financial sector is hesitant – and therefore attracting criticism from the ECB.

Deflation for oil, not for machines

What we are seeing is definitely not across-the-board deflation, but falling prices of certain goods – apples and heating oil, for example, but not other product groups. This is crucial in terms of assessing the risk, as a dangerous level of deflation is only present if consumers and investors believe that they will be able to make cheaper purchases at a later date. This is clearly not the case: consumers are not putting off major purchases and car drivers are not waiting to fill up their tanks. Investors are cautious, but not because they believe they will be able to purchase machinery more cheaply in the future. Concerns over serious deflation also appear overstated because trade unions today – unlike in the 1930s – are able to prevent wages being cut.

Furthermore, inflation expectations have certainly not declined. The financial markets are anticipating an inflation rate of 1.6 percent in five years. Certainly, oil and other commodities will ensure that overall price levels decrease again in 2015. But from 2016, when the effects of cheaper oil have been priced in, inflation rates can be expected to rise significantly.

In the past the central banks have accorded no great importance to large fluctuations in the prices of commodities and agricultural products, and this is sensible policy. It would have been absurd to place additional burden on the economy by tightening monetary policy when oil prices were on the rise. Today, when the reverse is true, it would be fitting to show the same level of composure. The ECB should simply ignore the drop in energy prices – a drop that considerably benefits Europe's economy.

Upon close inspection there is nothing new or surprising about the way that commodity and agricultural product prices have developed. Russia's sanctions against agricultural imports from the EU – a reaction to previous punitive measures from the European side – have led to a surplus in supply that is weighing heavily on prices. The situation of the oil markets is not dissimilar. There is currently a huge surplus in supply and oil is being traded on the spot markets at the lowest prices seen in a long time. In six months the price has fallen from over 110 dollars to under 50 dollars per barrel.

From a historical perspective, however, oil remains expensive. In 1999 crude oil cost around ten dollars a barrel. The very high price levels we have seen in recent years made investments in new, unconventional sources attractive. This increased the supply, leading to lower prices. The same applies to many other commodities, from iron ore to coal and copper, where prices are falling across the board. This refutes the

long-held theory that this time everything is different and commodity prices will now permanently remain at a high level.

This is painful for countries such as Venezuela and Russia, which are dependent on high oil prices. A look at recent economic history reveals the extent of this dependence. In 1999 Russian GDP stood at 195 billion dollars and 1,300 dollars per capita. In 2013 Russian GDP amounted to 2.1 trillion dollars, a more than 10-fold increase, and the per-capita growth was equally rapid, rising to 14,600 dollars by 2013. With the combination of significantly lower oil prices and a strong decline in the exchange rate, the Russian central bank certainly does have a problem. But why is the ECB creating one for itself?

The silent introduction of a liability union

So if, upon closer inspection, price trends cannot be regarded as a sufficient motive for purchasing government bonds, the question arises as to what goal the ECB is pursuing with this measure. A fact is that the ECB is moving into uncharted territory here. Faced with the possibility of default in Greece – more likely since the victory of the Syriza movement led by Alexis Tsipras in the election on 25 January – it seems sensible to consider the risk of further countries defaulting on debt.

Up to now the ECB has prevented any chance of default by participating in the rescue measures for Greece. In doing so it has single-handedly – and without corresponding legal protection – declared itself a preferred creditor. The ECB is therefore claiming a status that the International Monetary Fund has enjoyed for decades. Debts to the IMF are always serviced. Even Argentina paid back its debts to the IMF in full – even though Nestor Kirchner's government had to borrow from Venezuela, then led by Hugo Chavez, to do so.

Yet what method would be employed if one of ECB's major borrowers, Italy for instance, stopped servicing its debts? Such a scenario may seem utopian to some, but calls for Italy to exit the eurozone can already be heard today from two major political groups – Lega Nord and the Five Star Movement. Since the ECB intends to expand its balance sheet by more than one trillion euros, by purchasing government bonds of the same volume, the sums at stake are enormous.

If a country such as Italy were to become the main beneficiary of the bond purchasing programme, the ECB and its shareholders could be faced with a huge default risk. Suppose the ECB buys Italian bonds with a value of 500 billion euros on the secondary market; this would be a gamble for EMU members. Germany would be shouldering a risk of around 140 billion euros.

Is this kind of scepticism appropriate? Looking at the history of European rescue policy, doubts over the supposedly risk-free nature of the ECB programme are justified. When the IMF, the ECB, the European Stability Mechanism (ESM) and bilateral donors took over previously private debts in 2011, liability risks for the public sector were categorically ruled out. This proved to be a false assertion. The public creditors are already having to subsidise Greece today. The country pays an average interest rate of 2.4 percent on public debt – lower than the top performer Germany, which has to cough up 2.7 percent on average. That means the remaining eurozone states, including some considerably poorer than Greece, are subsidising Greek society.

This makes the results questionable enough already, but the bill may be about to grow even bigger. Greek politicians and some German economists, such as Marcel Fratzscher, head of the German Institute for Economic Research (DIW), and Henrik Enderlein from the Hertie School of Governance, are now calling for another debt cut for Greece. This would entail a burden of 50 billion euros – for Germany alone.

Interesting here is how the ECB justifies the purchase of government bonds on the secondary market. Rapidly increasing risk premiums for government bonds of EMU

member states has led to a "critical financial situation," the ECB explains, adding that under these circumstances it must ensure that it can properly carry out its monetary policy mandate – hence the purchase of government bonds.

Leaving aside the fact that the ECB and its President Mario Draghi want to cancel out market reactions, the question arises as to what "critical financial situation" we are currently facing. The interest rates on government bonds of European debtors are at record low levels. There is absolutely no reason to correct temporary overreactions of the markets. The purported goal of having interest rates on government bonds return to normal levels has been reached even without a bond purchasing programme. So what purpose does it serve for the central bank to now begin indirectly financing EMU member countries?

One often overlooked factor is that the prohibition of directly financing member states, as per Article 123 of the Treaty on the Functioning of the European Union, does not necessarily mean that purchasing government bonds on the secondary market is permitted. According to Council Regulation 3603/1993, purchasing debt instruments on the secondary market is also prohibited. This detail was also ignored by the Advocate General at the European Court of Justice when he formulated his Opinion of 14 January 2015 on the decision to purchase government bonds.

So what lies behind the ECB's plans? It seems that the central bank is desperate to find a justification for its reckless venture. Since the interest rates have fallen so sharply – though without stimulating growth – the ECB is now, as previously mentioned, invoking the spectre of deflation. Meanwhile, the numerous side effects of Draghi's medicine are being ignored.

The most significant side effect is that it will give the crisis-ridden countries, particularly Italy, a false sense of security. Despite faltering reforms, a lack of growth and declining industrial production in the country, the risk premiums for a country like Italy will not rise. Thanks to the ECB, they will continue to fall. The question is, how much longer do national economies such as Italy or France need to implement reforms? And what will the ECB do if changes do not materialise, despite having bought more time for adjustments? What is its exit scenario in this case?

Yet the side effects do not end there. By purchasing government bonds, the ECB forces private investors to opt for other assets, often carrying higher risks. This adds to the danger of price bubbles in markets such as real estate or equities. The ECB does not recognise this risk. It assumes that monetary policy can influence economic development, even in the crisis that has been ongoing since 2008.

The Bank for International Settlements (BIS) holds a decidedly different position on the matter. It stresses that we are experiencing what is known as a balance sheet recession. Unlike during a conventional phase of economic weakness, banks in this situation focus on improving the quality of their balance sheets. This diminishes the direct impact of interest rate cuts by the central banks, but not of the side effects. The liquidity flows into risky assets, with the emerging markets currently receiving the lion's share. Should they start experiencing turbulence, the negative effects will be felt in the OECD countries as well.

In January 2015, the possibility of Greece exiting the eurozone set off alarm bells, as it is generally believed this would harm both the country itself and the eurozone. Greece, the German economist Enderlein says, would then have great difficulty in getting back on a path of growth. The Greek people's savings would be wiped out; the entire eurozone would be hit by serious turbulence. But should an exit by Greece or another EMU member really be viewed so negatively? Or could Greece even benefit if it introduced an undervalued currency?

The case of Argentina

It is well known from development economics that national economies with an overvalued exchange rate often have considerable difficulty generating growth. The other side of this equation is that an undervalued currency has positive effects on economic development. From Greece's point of view, its own currency, the euro, has a high value. The country's firms are finding it tough to compete, both on the global market and domestically. This is why, as previously mentioned, they are making the painful adjustment of cutting prices.

A new currency would solve this problem. There are numerous examples in economic history of how devaluation can have a beneficial effect. Argentina's situation around the turn of the millennium is a dramatic case in point. For a long time the Argentinians had clung to an exchange rate regime that was even anchored in the constitution. Like in Greece a decade later, the IMF used a number of loans to maintain the illusion that Argentina could retain the exchange rate of 1:1 to the dollar. And, as in Greece today, the consequences of the overvaluation were dramatic. The economy stagnated, unemployment was high, and finally the IMF, led by Horst Köhler, recognised that there was no hope for its policy. In 2001 the fund denied Argentina new loans, the house of cards came tumbling down and Argentina entered a turbulent period.

However, this phase only lasted for a few months. Thanks to the peso's devaluation to around a quarter of its previous value, a small Argentinian economic miracle began to take shape. From 1999 to 2001 national GDP had declined by an average of 2.7 percent per year, before plummeting 11 percent in 2002. But from 2003 to 2007 the economy grew by 8.6 percent per year. An interesting point here is that Argentina, contrary to the expectations of many observers, was inundated with capital inflows after the devaluation and the default. Argentinians who had invested their capital abroad during the years of overvaluation brought back their money after 2002 and invested it at home.

Debt cut for Greece?

A similar development could be expected in Greece. It is misguided to believe that many Greek savers would suffer if the country reintroduced its own currency. In fact, a large number of wealthy Greeks already shifted their capital abroad some time ago. It is estimated that over 280 billion euros of Greek money has been deposited in Switzerland alone. Naturally it is impossible to give precise figures here, as we are talking about money that has been hidden from the tax authorities. But it seems plausible to assume that the Greek capital stockpiled abroad amounts to a considerable volume. Furthermore, in recent years the country's citizens have significantly increased their cash reserves. In other words, most of the money is protected from devaluation, whether it is in Switzerland or underneath the mattress at home.

Moreover, it would be dangerous to make further concessions to Greece. The country is already paying a smaller proportion of GDP for interest payments on public debt than other, less indebted countries. While Greece spent just 4.2 percent of GDP on interest in 2014, Italy and Portugal had to pay 4.5 and 4.6 percent respectively on interest on their sovereign debt – although their debt levels are considerably lower. Particularly in Portugal, which has had to endure a tough austerity programme just like Greece, further preferential treatment of Greece could be viewed as unfair. In other countries too, where the standard of living is lower than in Greece, a sense of irritation over the continued funding of Greece is growing. These nations include Slovakia, Slovenia and the Baltic states.

Although loud protests can be heard from Greece about the lower standard of living, upon closer inspection this proves to be an exaggeration. Certainly, per-capita GDP has fallen by 25 percent since the start

of the crisis. However, Greek incomes also rose by 36 percent in the first years of its EMU membership – that is three times the average increase of EMU members. Today average incomes in Greece are still 8 percent higher than they were before the introduction of the euro.

There were also calls for a generous debt cancellation during previous crises. In 1999 Russia demanded a restructuring of its debts to its public creditors organised in the Paris Club. Then Prime Minister Vladimir Putin and his Finance Minister Mikhail Kasyanov wanted to force Germany and the other creditors to forego 50 percent of the outstanding debt. In Germany's case this was the considerable sum of 10 billion dollars. The federal government at the time refused, and when crude oil prices rose Russia was able to repay its loans to its public lenders without any problems.

There are believed to be notable oil reserves in Greece too. In 2014 test drilling has begun to explore these reserves. Athens is hoping for additional revenue of between 375 and 600 billion euros over the next 15 to 20 years. Foreign Minister and PASOK President Evangelos Venizelos plans to use this money to boost the pension and health insurance funds. From the perspective of the country's creditors, however, the proper thing to do would be to first pay off Greece's debts to the European taxpayers.

The unforeseeable consequences of the liquidity glut

The case of Greece very clearly shows the risks associated with disproportionate lending. Yet the ECB continues to pursue a policy that seeks to solve economic problems by flooding the markets with liquidity. After over five years of ultra-loose monetary policy, the question arises as to why this approach is not actually bringing the desired results.

The IMF's Independent Evaluation Office (IEO) recently examined this issue and came to some very noteworthy and plausible conclusions. The loose monetary policy was bound to fail from the outset, the IEO says, because private households and companies use this situation primarily to reduce their debts (deleveraging). It is therefore not possible to boost demand with cheap capital. The analysis of the Bank for International Settlements is almost identical. After a serious financial crisis, BIS Chief Economist Hyun Song Shin says, monetary policy has less of an influence. Investors in the real economy are unsettled and therefore delay investments, he explains, while monetary policy mostly influences the financial markets, and there its effects are negative.

The IEO goes on to say that the generous monetary policy of the major central banks, including the ECB, has negatively impacted developing and emerging countries because debtors there have engaged in highly speculative carry trades: they have borrowed money in Europe and the US to invest in emerging economies. What they chose to ignore was the exchange rate risk. If monetary policy were to normalise, which would mean interest rates in countries such as the US significantly rising, the major currencies would be expected to increase in value. Debtors from developing and emerging economies could then quickly run into troubled waters since they have to service their debt in dollars, but are generating returns in their domestic currency. There are considerable sums at stake here. Debtors from developing and emerging countries have issued bonds with a volume of 2.6 trillion dollars, three quarters of which are denominated in dollars.

The ultra-loose monetary policy has therefore not achieved its goal of stimulating the domestic economy, but it has brought about significant side effects. BIS Chief Economist Shin calls this monetary policy – in the cautious language of central banking circles – “somewhat problematic”. The BIS fears that the ultra-loose monetary policy is creating risks in the financial system that can no longer be controlled by the banking supervisors. In Shin's view, the central banks should tighten monetary policy without delay.

Both the Federal Reserve and the ECB have pushed investors into higher-risk assets with their policy of prolonged low interest rates, probably at the expense of financial market stability in the US and Europe. Most of all, the liquidity glut has increased the risks to financial stability in the emerging nations. The sharp rise in their debt levels has been a key factor in the growth of the overall indebtedness of all states, private households and companies (excluding the financial sector) from 174 percent of global GDP in 2008 to 212 percent in 2013. The escalation was especially dramatic in China, where debt grew from 145 to 217 percent of GDP. China's rising debt, in particular, is not sustainable. The country's economic growth in recent years has been financed with credit, and coupled with the Chinese property bubble the country's situation is reminiscent of that of the US or Spain before the outbreak of their financial crises.

Is the ECB cooperating with the Fed?

In 2015 the Federal Reserve is likely to take the step it has previously indicated and raise interest rates. Anticipation of this move on the financial markets is already causing the euro to fall against the dollar. But does it make sense for the ECB to allow the currency to be undervalued? Whom does this policy benefit, and whom does it harm?

We know from previous periods when there was a clear gap between US and European interest rates that the exchange rate of the dollar can temporarily overshoot. In the early 1980s Paul Volcker, then Chairman of the Fed, opted for a very restrictive monetary policy in order to combat high rates of inflation. The Bundesbank and other European central banks did not follow the US policy of high interest rates – which led to the value of the dollar against the German mark doubling between 1980 and 1985. At the peak of this trend one dollar cost 3.47 German marks.

That came as a welcome boost to European companies, but for their American competitors it was fatal. In that period the deindustrialisation of the US accelerated. Moving factories abroad was extremely lucrative, not least because of the expensive dollar. But would today's US government tolerate another period with an overvalued dollar? It is true that the US has returned to a path of growth. The OECD is forecasting real growth of 3.1 percent in 2015, following 2.2 percent in 2014. However, the reindustrialisation of the USA that has been observed in recent years would be put at risk by a sharp rise in the value of the dollar. The Fed will not allow this to happen.

This has triggered concerns that the risks to financial stability will continue to grow. Cheap money will encourage price bubbles on both property and stock markets. There are numerous examples in economic history of the negative effects of a monetary policy that ignores the risks that stem from sharply increasing asset prices. Japan provides a particularly drastic example. In the late 1980s it allowed a double asset price bubble to form – in equities and real estate – and the country is still battling the consequences of this misguided monetary policy 25 years after the bubbles burst.

The ECB must know what is at stake for the US. Recognising that property and stock markets are booming in certain European countries, the ECB should cooperate with the Fed in increasing interest rates over the course of 2015 in order to prevent dramatic consequences for the dollar/euro exchange rate.

Of course this would attract heavy criticism. In Southern Europe there would probably be very loud complaints about this kind of policy reversal by the ECB. But we must consider what would happen if the ECB were to accept a significant weakening of the euro. This would be a major hindrance to Europe's future economic cooperation with the US. Europe would be valuing short-term political and economic goals more highly than long-term cooperation with the US. While the Europeans are currently negotiating with Washington over a comprehensive trade partnership, they

would be placing great monetary policy burdens on the Americans. In other words, the strengthening of cooperation in the TTIP free-trade area would be counteracted by new tensions in the area of currency.

If the ECB is hoping to increase inflation in the eurozone by devaluing the euro, this is a risky game to play. Firstly, it is difficult to control what is known as imported inflation. Secondly, both the US and the rest of the world would have to be prepared to tolerate a European devaluation strategy. Should China and other emerging economies not do so, there would be a risk of entering into a currency devaluation race that harms everyone, like in the 1930s.

The ECB is changing Europe

The further loosening of ECB policy is changing Europe without there having been a serious debate about whether this is desired. Criticism voiced primarily by the Bundesbank and German observers has gone virtually unheard. The majority in the ECB's Governing Council is supporting the further loosening of monetary policy and views the associated risks as small. Yet this nonchalant attitude is unconvincing. After the costly and still ongoing Greek rescue operation Europe is stumbling on towards new risks. The ECB is becoming dependent on the fiscal policy of its debtors – and now has hardly any influence on the implementation of reforms. Other European societies are being made liable, yet there is no way for the Finns, for example, to influence Italian fiscal policy.

Over 20 years after the signing of the Maastricht Treaty, a core element of this agreement is being turned on its head. The Maastricht criteria on new and total debts were meant to protect well-managed economies from the risk of contagion from states with frivolous fiscal policies. Today not only is such contagion possible, but ECB policy is actually mutualising debts. The central bank is entering into great risks and those negatively affected can do nothing to defend themselves. The German government should remind the ECB of one thing above all: a devaluation race with the US is not in Europe's interest, and therefore coordinating Europe's monetary policy in 2015 with that of the Fed is more important than once again cutting the financing costs of Southern European crisis nations.

© Stiftung Wissenschaft und Politik, 2015
All rights reserved

These Comments reflect solely the author's views.

SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3−4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

ISSN 1861-1761

Translation by
English Express e.K., Berlin

(English version of SWP-Aktuell 2/2015)