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Expansive central bank: The Only Game in Town

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The Council of the European Central Bank (ECB) further loosened its monetary policy on 10 March 2016. In view of the decline of the leading economic indicators and the excessively low inflation in the Eurozone, the bundle of measures introduced by the ECB is necessary. But, to paraphrase Mohamed El-Erian, the expansive central bank policy is “ the only game in town”. Effective fiscal policies and structural reforms have been a long time coming. At least the effectiveness of the central bank policies, while it has declined, does still exist.

These are the most important measures:

Negative interest rate policy: the interest rate on deposits held by commercial banks with the central bank will be cut by 0.1 percentage points to minus 0.4%.
Higher purchase volume: as of April, the central bank will step up its monthly purchases of securities on the secondary market from EUR 60bn to EUR 80bn until at least March 2017.
Purchases to include corporate bonds: as of April, the central bank will not only buy government bonds but also corporate bonds (issued by non-banks) with good ratings (investment grade).
Refinancing: banks can refinance in four tranches for four years each at the interest rate for main refinancing operations, which has been cut to zero percent. If lending exceeds a certain referential number, the interest rate will fall even further and become negative.

No interest rate reversal in sight

The yields of safe government bonds remain very low in the foreseeable future. The central bank expects unchanged rates for a sustainable period of time – or even lower ones, should the data deteriorate. Yield increases, if any, would then only be of a temporary nature.

Incentives for higher risk

The incentives for investors to look for investment alternatives that promise a better rate of return (along with a higher degree of risk) have risen. Those alternatives are for example below-investment grade corporate bonds and equities in the Eurozone, and bonds with positive yields in foreign currency. The status quo exacerbates the desperate search for yield by investors. This supports the prices of risky asset classes. However, this entails a rising level of instability on the financial markets.

Lending is supported

At the same time, the incentives for banks to expand their lending volume have increased as well, while the negative effects of the negative interest rate policy on the profitability of banks are mitigated. The hope is for the measures to prolong the moderate economic upswing in the Eurozone. Only then would any rise of the prices of risky assets on the financial market not be seen as overshooting.

Stable (positive) inflation expectations as the ultimate goal

The problem is that the central bank can only offer few incentives for a significant increase in credit demand. At least if the ECB measures are successful, the long-term inflation expectations will remain stable (positive) and real interest rates (i.e. interest rates minus inflation) therefore negative. To this extent the central bank can be successful in preventing further deterioration, because rising real interest rates triggered by falling inflation expectations, or even expectations of deflation, would be particularly negative in the current situation.

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