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The New Strategy at the European Central Bank

The European Central Bank (ECB) announced changes in the way it conducts monetary policy at its monthly press conferences in June and July 2014. The goal of the new strategy is to strengthen the influence of the ECB in shaping market expectations and guiding macroeconomic performance. The 5 June press conference focused on measures to jump start economic activity in the euro area; the 3 July press conference introduced new procedures for making and communicating monetary policy decisions. If the strategy works, the euro area economy should experience a more robust economic recovery; if it fails, the Governing Council of the ECB may find itself with little additional room for maneuver.

The purpose of this briefing note is to explain why the ECB has made the changes it did, what are the prospects for the success of its new strategy, and what are the alternatives if European macroeconomic performance continues to stagnate. The brief has four sections. The first sets out the policy dilemma both in terms of macroeconomic performance and in terms of policy leverage. The second looks at how the ECB hopes to stimulate new activity. The third explains the ECB's new approach to communicating with the markets. The fourth explains how these two sides of the strategy work together and why they may not have the desired effect.

High Unemployment, Falling Prices, and a Broken Monetary Transmission Mechanism

The aggregate data for European macroeconomic performance in spring 2014 was stark. Unemployment in May was 11.6 percent of labor force in the 18 countries that have adopted the euro (the 'euro area', or EA18) and 10.3 percent across the 28 countries of the European Union (the EU or EU28).[1] Meanwhile, the annualized growth in output was just 0.2 to 0.3 percent in the first quarter of 2014;[2] industrial production fell by 1.1 percent between April and May, even if it was up marginally over the previous year;[3] and aggregate inflation has remained roughly constant at 0.5 percent in the euro area and a slightly higher 0.6 to 0.7 percent across the EU28.[4] The picture looks worse as you delve into the aggregate measures. To begin with, the high rates of unemployment occur against a backdrop of sluggish employment growth and rising vacancy rates. European unemployment has been mired in the double-digits all year; employment increased by just 0.1 to 0.2 percent in the first quarter of 2014;[5] and the job vacancy rate increased from 1.6 to 1.7 percent over the same period.[6] European employers are looking for more workers and European workers are available for employment – but the jobs and the workers are not in the same places. Hence, some countries like Germany show a high percentage of job vacancies (2.9 percent in the first quarter of 2014) and very low levels of unemployment (just 5.1 percent in May 2014). Other countries like Spain have very low vacancy rates (0.6 percent), and very high levels of unemployment (25.1 percent). Both countries have roughly the same quarter-on-quarter growth in employment. Germany is able to create more jobs on an annualized basis, and yet there is little evidence that Germany is able to benefit from access to

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Spanish labor or that Spaniards are able to relocate to Germany in sufficient numbers to bring the two economies more closely together.

This divergence in economic performance between Germany and Spain is another dimension of the European macroeconomic dilemma. On the surface it means that the two countries need to focus on different problems. Germany needs to find more skilled labor and perhaps needs to start worrying about the impact of rising wages on price levels; Spain needs to stimulate more investment even as it needs to worry about how firms and households are going to repay their debts. On a somewhat deeper level, the two countries need to think about how their economies will interact and whether German growth is going to be enough to pull Spain out of its recession or whether the sluggishness of Spanish economic performance will sap the energy from Germany's economic recovery. Such dilemmas are hardly unique to European countries or even to those European countries that share the same currency. The United States has a similar relationship with Europe, just as Europe and the United States have a broader relationship with China. The challenge of managing economic interdependence is a common feature in today's integrated world economy and it has been around for far longer than Europe's economic and monetary union, the European Union, or European integration, for that matter.

What is unique in the European context is how the instruments of monetary policy operate across big cross-national divergences like those seen between Germany and Spain. Normally a central bank lowers interest rates to encourage investment when economic performance weakens and raises interest rates to slow down the pace of investment as economic performance starts to overheat. These policy changes operate through a market mechanism that starts with banks borrowing from the central bank or from one another at the very short term end of the maturity spectrum and then works through different patterns of interbank lending until it begins to have an impact on the cost of credit that banks offer to non-financial firms that are looking to invest. The central bank has the greatest influence on very short term interest rates that it charges directly to banks or banks charge to one-another, but the impact on economic performance is strongest where banks finance investment at the long-term end of the maturity spectrum.

The problem in Europe is that the stark divergence in economic performance between countries like Germany and Spain has broken the monetary policy transmission mechanism that connects decisions taken by the Governing Council of the ECB to economic activity in the non-financial sectors of the economy in two places. On the one hand, banks in countries like Germany that are doing well economically are reluctant to lend to banks in countries like Spain that are struggling economically. On the other hand, banks in countries like Spain are reluctant to lend money to finance investments in the non-financial sectors of the Spanish economy even as Spanish firms are more eager to pay down existing debts than to take out new lending that they might not be able to repay. Hence when the Governing Council of the ECB lowers interest rates in the very short-term market where banks borrow from each other and from central banks, the effect is felt more strongly among German banks than among Spanish banks and the benefits are even slower to find their way in terms new lending to Spanish firms for new investment. In other words, the sharp divergence in economic performance between countries like Germany and countries like Spain not only pulls down the European aggregates – and so makes it look like the whole European economy is suffering – but also makes it very hard for the ECB do have an impact on macroeconomic performance using conventional monetary policy instruments.

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European monetary policy makers are well aware of the dilemma they face and have been complaining about their situation at least since Mario Draghi became President of the ECB in November 2011, and arguably since the onset of the financial crisis in 2007.[7] The reason is that the monetary transmission mechanism broke down in Europe first as a result of a general crisis of confidence in the markets that connect banks to other banks, irrespective of the country in which they are headquartered or located. Moreover, this breakdown in confidence took place only in Europe but also – and more obviously, perhaps – in the United States.[8] Meanwhile, the United States economy experienced regional divergences in economic performance every bit as important, and perhaps even more so, as those found in Europe.[9] The United States was able to restore the functioning of its monetary transmission mechanism in part because it was able to restore confidence in the banking system.[10] The initial crisis was deeper in the United States than in Europe, but it was also shorter.[11]

Europe has had greater difficulty restoring the functioning of its monetary transmission mechanism because European banks are too big for national governments to bailout or restructure effectively and because the crisis in the European banking system soon spread to sovereign debt markets. Governments that tried to bailout their domestic banks soon found themselves unable to borrow at low costs and a few – like Greece, Ireland, and Portugal – even found themselves pushed outside private capital markets. As the crisis ground on, the close financial relationship between European banks and national governments even began to threaten the single currency. It was at that point – in the summer of 2012 – that the fractures in the European monetary transmission mechanisms hardened along geographic lines. The tight integration of European financial markets that was the hallmark of the 21st Century was more than offset by the disintegration to took place as a result of the crisis.[12]

The European Council responded by launching its program to create a European banking union that would restore confidence in banks wherever they may be located by severing the financial relationship between national banking systems and national governments.[13] ECB President Mario Draghi lent his support by promising to do 'whatever it takes' to safeguard the euro as a single currency. And yet while the immediate signs of the crisis abated the ECB could not restore the smooth functioning of its monetary policy transmission mechanism. During the two years that followed Europe's dramatic efforts to bring an end to the financial crisis, European macroeconomic performance continued to stagnate.[14]

Confidence, Liquidity, and Targeted Lending

Some of this stagnation was due to efforts by the ECB to restore confidence to the banking system. As part of the new European banking union, the ECB has to take up a role as the single supervisory mechanism (SSM) for systemically important banks within the euro area. From November 2014, the ECB will have direct supervisory responsibility for just over 130 banks and it will work closely with national supervisors to monitor the 6000+ other financial institutions that operate in European markets. In order to begin work, the ECB needs to undertake a three-stage evaluation of the main European banks. That evaluation began in late autumn 2013 with the development of common rules and accounting standards, progressed in early 2014 with a review of banking asset quality based on data reported as of 31 December 2013, and continues in the form of a stress test on European bank balances that builds on the results of the asset quality

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review and more recent balance sheet data. The whole exercise should culminate on 17 October 2014 in a 'comprehensive assessment' of how Europe's banks are doing both individually and as a sector. In turn, this assessment should lay the foundations for the new supervisory regime and greater confidence between banks. However, in the meantime – during the year running from November 2013 to October 2014 – Europe's banks have a strong incentive to offload non-performing assets and to build up capital rather than embarking on new lending. As counter-intuitive as it sounds, Europeans would have to recover from the great recession without the benefit of new bank credit.

The Governing Council was well aware of the difficulties that it faced and even at the start of the process, in January 2014, Draghi cautioned that the European economy would struggle to grow without new credit.[15] The challenge was to figure out what the ECB could do to support the recovery. In conventional terms, the Governing Council had already used up much of its room for maneuver. The ECB was paying no interest on deposits made by commercial banks into the European System of Central Banks and it was charging just 0.25 percent for banks to borrow through its main refinancing operations. In other words, the ECB was very close to the 'zero bound' for short-term interest rates. Some economists were pressuring the ECB to follow the example of the U.S. Federal Reserve and buy assets in international capital markets – thus releasing more cash into the European economy. This policy is called 'quantitative easing' because it works more on the quantity of money that is in circulation than on the price of borrowing (or interest rate). And it has been used successfully by the Bank of England as well as the U.S. Fed. Nevertheless, the Governing Council of the ECB did not seem eager to move in this direction.

The ECB faced a three-fold problem in trying to copy the policies of the Fed. To begin with, many of the participants on the ECB's Governing Council are central bank governors from countries – like Germany – that did not need more liquidity. These central bank governors do not like the idea of adding even more liquidity into the European banking system because they do not see how doing so would either encourage lending to banks in more distressed countries (like Spain) or – if it did – how it would encourage those banks in distressed countries to lend to non-financial firms.

The second problem is that the only relatively risk free assets circulating in European capital markets are sovereign debt instruments. This is problematic because Europe has just come through a sovereign debt crisis that demonstrated that not all sovereign debt is equally risk free, the ECB and its member central banks should not take on the kind of market risk associated with holding distressed sovereign debt unnecessarily, and yet the sovereign debt instruments with the highest credit ratings are also those being issued by governments where financial markets are already flush with liquidity. To be successful in quantitative easing, the ECB would have to take on a lot of risk; to avoid taking on risk, the ECB would likely hamper the success of the policy. Worse, it is unclear just how much sovereign debt the ECB can purchase without violating its legal prohibition against financing governments. Many in Germany argue that the ECB should only purchase sovereign debt instruments in the context of conventional open market operations, it should do so against a promise to return those instruments to the market at some future point, and it should not hold sovereign debt instruments on its balance sheet outright. The German Constitutional Court has already received a number of complaints about the ECB's prior

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securities markets policy (SMP) and about its commitment to buy debt from distressed countries in outright monetary transactions (OMT); the case against OMT is still ongoing; and while the German Constitutional Court has accepted that only European Courts can have the final say in interpreting European Treaty obligations, there is considerable suspicion that an explicit policy of quantitative easing would push the German Court too far.[16]

The third problem in seeing the ECB follow the Fed's practice of quantitative easing is that the purchase of sovereign debt instruments would not ensure that lending ever found its way to the non-financial sectors of the economy. Unlike in the United States, most European firms are bank dependent – which is to say, they do not borrow with corporate bonds floating on the stock exchange; they take out loans from banks instead. This means that there is not a large stock of corporate bonds that the ECB could buy to encourage firms to borrow. Moreover, European banks do not package their loans in 'asset backed securities' the way U.S. banks do either. This means that there is very little market-traded paper that corresponds to lending in the non-financial sector of the European economy. Before the ECB could follow the Fed with quantitative easing, therefore, it would first have to find a way to build up the volume of European asset backed securities connected to lending to the non-financial sector. This is no easy task given the many different regulatory obstacles involved. Yet without doing so, any additional liquidity that the ECB would inject into European markets would be unlikely to result in new lending for investment.

During his 6 March 2014 press conference, ECB President Draghi made it clear that he was considering what to do if the policies already implemented proved to be ineffective: "We are monitoring developments on money markets closely and are ready to consider all instruments available to us. Overall, we remain firmly determined to maintain the high degree of monetary accommodation and to take further decisive action if required."[17] The question this raised was only what would be required for further action to be taken. The response was a sustained decline in medium-term expectations for price inflation. Draghi made the same point in April and again in May. Meanwhile the data continued to accumulate that the European economy was in stagnation.

By 5 June, Draghi and his Governing Council felt they had sufficient justification to act. They decided to introduce a raft of measures to repair the monetary transmission mechanism by restarting lending to non-financial firms in distressed economies. This collection of measures included some symbolic elements like a commitment to allow banks to borrow as much as they need at the main refinancing rate in the ECB's regular liquidity auctions at least through December 2016. It also included a suspension of efforts to pull the liquidity out of the market that the ECB created through its purchase of sovereign debt instruments under the securities markets program that ran from May 2010 to September 2012. Together, these measures signaled the ECB's commitment 'to maintain the high degree of monetary accommodation' for the next thirty months. But these were less important than the two main features of the new strategy.

The ECB decided to introduce a 'negative deposit rate', which is to say it decided to charge commercial banks 0.10 percent (or 10 'basis points) for holding their money at a euro area central bank. At the same time, the ECB reduced the cost of borrowing money at the main refinancing rate to just 0.15 percent. For banks in countries that have surplus liquidity, like

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Germany, this meant that commercial banks would have to find something to do with their money or pay the change for depositing that money in the European system of central banks. The ECB's plan is to encourage those banks to lend their money to banks in distressed countries like Spain or Italy. If it worked, the 10 basis point charge on central bank deposits could help repair the cross-border damage to the monetary transmission mechanism by creating an incentive for banks in one set of countries to lend money to banks in another.

The next step is to encourage the banks that borrow money from other banks or from the ECB to use that money to make loans that firms in the non-financial sector can use to finance investments. Here the ECB introduced a new sequence of 'targeted' long-term refinancing operations to start in September 2014. In essence, it offered banks four-year loans at very low fixed rates of interest. The banks could borrow from the ECB as a proportion of their previous new lending to firms in the non-financial sector and they could hold onto the money so long as they used as least some of it to finance new loans to the non-financial sector; if they used the money for other purposes and so did not increase lending for investment, the banks only penalty was a requirement for early repayment of the borrowing they took out from the ECB. If they did use the money to create new lending, then starting in March 2015 they would become eligible to borrow even more money at low, fixed rates from the ECB so that they could continue to finance the increase in new lending.[18] The details of the program are complicated and yet the incentives it creates are not. The only question is how the banks will respond to the new environment. Should Europe's banks use money from the ECB to restart lending for investment in the real economy, that could go a long way to repairing the other gap in the monetary transmission mechanism – the one between banks and non-financial firms.

Credibility, Transparency, and the Management of Expectations

The ECB's new monetary strategy relies on unconventional policy instruments. A negative deposit rate has never been used by a such a large central banks and 'targeted' central bank credit has never been deployed in such a challenging and diverse financial environment. The Governing Council is engaged in a massive experiment, in that sense. Worse, the main actors in this experiment – European bankers – know that they are being used as guinea pigs. Hence it is important for the ECB to create an atmosphere of trust between monetary authorities and the banks they seek to influence.

On 3 July, Draghi announced two major changes to how the ECB will communicate its monetary decisions to the financial community (and the world as a whole).[19] One change is that the Governing Council will slow down the pace of its monetary decision-making by moving from a policy meeting once every four weeks to one held once every six weeks starting in January 2015. The other change is that the ECB will publish an 'account' of the Governing Council's deliberations some three-to-four weeks after the monetary policy meetings are held.

The slow-down in the pace of meetings is important because it gives more time for the Governing Council to accumulate data and so change is policy stance. To explain why this is important, it is necessary only to note that the change in strategy described above unfolded between March and June. In that time, the Governing Council could had two meetings where it could have announced a policy change. Indeed, most of the main lines of the new strategy were already agreed. Moreover, there was no dramatic change between March and April, April and

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May, or May and June sufficient to explain why June was somehow better than May as a moment to introduce the new strategy. Hence each meeting was preceded by speculation that a change was imminent; only those who focused on the June meeting were rewarded.

Such frequent speculation is not useful for relations between the ECB and market participants. It would be better if the pace of policy announcements were slower and the signals about why the policy needs to change and what are the triggers for action could be more transparent. This is part and parcel of the move among central bankers toward 'forward guidance' in their communications strategies. Such guidance is used in the United States and Great Britain to greater or lesser effect. By lengthening the time between policy meetings, the ECB hopes to have more success with its own form of guidance. The six week period is consistent with practice in the United States and Britain as well.

At the same time, market participants would like to have a better sense of how monetary policy is debated within the Governing Council. Both the Federal Open Market Committee in the United States and the Monetary Policy Committee in Britain publish minutes of their policy meetings. Traditionally, the Governing Council has relied on the monthly press conferences hosted by the President of the ECB. The two types of communication have different strengths and weaknesses. One the one hand, minutes show how members of the policymaking community resolve their differences of opinion while a press conference tends to reveal only the consensus view that emerges at the end. On the other hand, minutes tend to be published with a delay and emerge as a static document; a press conference is both more immediate and more interactive.

The Governing Council has additional constraints to consider because it is comprised primarily of national representatives who are supposed to be insulated from political influence. If the great strength of minutes is that they show the diversity of opinion in the Governing Council, the great weakness from the ECB's standpoint is that they make it all too easy for national politicians to identify how their national central bank governor (or co-national member of the ECB executive board) weighed in on debates over the appropriate direction of monetary policy. Hence, the challenge for the ECB is to develop and account of the Governing Council's meetings that can reveal the diversity of intellectual arguments without revealing the identity of the various participants.

The ECB Executive Board has been looking at various 'dry runs' of the Governing Council's deliberations in written form and come up with an account they believe offers the advantages of 'minutes' without jeopardizing the ECB's political independence. This account should help market participants understand what the Governing Council views as an important development and so anticipate when the Governing Council is likely to change its policy response. Moreover, the longer gap between policy meetings will give market participants more time to digest information about the Governing Council's deliberations even as it gives the Governing Council more time to gather new data from one meeting to the next.

Future Prospects

In theory, the two sides of the ECB's new strategy work well together. A stronger communication platform should help build greater understanding within the markets around the ECB's use of unconventional monetary policy instruments and so should also build confidence

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that these instruments will work. In turn, that confidence should feed into the very success that it anticipates. So long as Europe's banks feel that there is going to be recovery in lending across countries and to the non-financial sector, then they are more likely to embrace the incentives to participate in that new lending in the first place. The fact that the ECB is converging on patterns of practice used in other major economies or parts of Europe is another positive indicator. Market participants are likely to embrace change that looks somehow familiar, particular coming out of a major financial crisis.

In practice, the success of the new strategy remains to be seen. The macroeconomic challenges Europe faces are daunting and repairing the damage of such high levels of unemployment and correspondingly low levels of investment (or high levels of capital consumption) is a time-consuming process. It will be difficult for the ECB to bolster market confidence long enough for the new lending to find its way into new activity and employment.

Should Europe's economy suffer a major shock in the meantime, the ECB's new strategy could be found wanting. Economists and politicians will call again for the Governing Council to embrace quantitative easing and so follow in the footsteps of the United States. Indeed, the ECB has already begun efforts to rebuild the supply European asset backed securities to be used in case it proves necessary. The challenge will be to build consensus around quantitative easing within the Governing Council. That challenge will be complicated by the need to provide an account of the Governing Council's proceedings. The ECB may have purchased greater confidence among market participants in the present at the price of less room for maneuver should this new strategy not work out.

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Notes

[1] http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-01072014-AP/EN/3-01072014-AP-EN.PDF
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[8] See Timothy Geithner, *Stress Test: Reflections on Financial Crises* (New York: Random House, 2014).
[9] See, for example, Atif Mian and Amir Sufi, *House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent It from Happening Again* (Chicago: University of Chicago Press, 2014).
[10] See Paul Krugman's review of Geithner: Paul Krugman, 'Does He Pass the Test?' *The New York Review of Books* 61:12 (July 10 – August 13, 2014) pp. 6-10.
[11] http://europe.unc.edu/wp-content/uploads/2013/08/Brief0904-econ-crisis.pdf
[12] http://www.ecb.europa.eu/press/pr/date/2014/html/pr140428.en.html
[13] http://europe.unc.edu/wp-content/uploads/2013/12/Brief1312-bankingunion.pdf
[14] See Erik Jones, *The Year the European Crisis Ended* (Basingstoke: Palgrave-Pivot, 2014).
[15] http://www.ecb.europa.eu/press/pressconf/2014/html/is140109.en.html
[16] http://www.bruegel.org/publications/publication-detail/publication/840-did-the-german-court-do-europe-a-favour/
[17] http://www.ecb.europa.eu/press/pressconf/2014/html/is140306.en.html
[18] http://www.ecb.europa.eu/press/pr/date/2014/html/pr140605_2.en.html. For details of the targeted long-term refinancing operations, see: http://www.ecb.europa.eu/press/pr/date/2014/html/pr140703_2.en.html
[19] http://www.ecb.europa.eu/press/pr/date/2014/html/pr140703_1.en.html

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