Guest lecture

The eurocrisis: the role of the European Central Bank

Eurocrisis
A crisis consists of a multiplicity of economic shocks. The crisis started in 2007 as a global financial crisis, not necessarily in the euro zone. Individual households held loans which they never could repay. Hereby the banks were in trouble and also the banks who carried the risk by having a stake in the mortgages. The banks suffered from a huge loss on the loans, also the euro banks. The public finances of the governments had to save the banks.
The euro crisis, or better said the euro debt crisis, was the result of the macroeconomic imbalance. The crises caused low growth and low inflation, which we are dealing with right now.

When founding the European Union (EU) the individual interest rates each country had disappeared. Before the EU, each country had his own currency with different policies and a different interest rate. When the EU was founded, the interest rates at which the government borrowed was lower than the interest companies had to pay on its debt.

With the convergence of interest rates of the countries in 1999 the borrowing costs started to decline. The costs were now the same for every country, namely 4%. Because of the low interest rate, it became attractive to borrow which resulted in high private debts. The credit growth of the private sector increased to 15% per year so consumption went up. This was good for the housing market because of more spending. The house prices also increased.
The governments of the countries of the EU could also easily borrow because of the low interest rates so they got more revenues. By this the governments could spend more what supported economic growth. These positive economic developments feed the idea that you could easily repay your debt so the demand on credit increased even more.

The core countries of the EU, like Germany, The Netherlands and Italy, were running a balance of payments surplus. Which means that the governments were earning more than they spend. But the poor countries, also called the periphery, were running a balance deficit. This actually wasn't a bad situation because the periphery had to catch up with the core so that they were not running a balance deficit anymore. The poor countries borrowed money to stimulate economic growth but unfortunately the money did go in non-productive sectors, like the housing sector. The housing sector is not productive at all because a house is not a mobile asset, you can't repay your foreign debt with these assets. So the investment of the periphery was poorly chosen and they didn't catch up with the core at all.

Around 2008 the interest rates of the different countries diverged again. If you enjoyed a low interest rate while borrowing much, and now the interest rate goes up, you can't effort the costs of our debt anymore. The main country that was experiencing this was Greece. Around that time the EU found out that Greece committed fraud with statistics. This was a huge shock to the financial market. Greece had a higher public debt than they claimed so the EU countries stopped lending to Greece. Greece really needed the financial support to overcome its balance deficit but the countries didn't want to lend anymore. Finally the loans were granted but in return for that, Greece had to adjust its economy by cutting back on spending. This had a negative effect on the economic growth.
When the interest rate also in Ireland increased, Ireland entered a crisis in the housing market on the mortgages. Banks were in trouble and had to be rescued by the government, which caused problems for the government.
Portugal and Italy suffered from a loss of competiveness because of an increase in wages. Export became too expensive, so with this financial crisis there was no demand anymore for these countries.
These examples are multiplicity imbalances in the economy of the EU which has an impact on the economic growth which caused a recession and eventually the crisis.

Today, the worst of the crisis is over, we can say we are not in a crisis anymore. The euro area is recovering really slow though. We are almost back at the GDP rate we had before the crisis, which means 7 lost years. But we are not having the same welfare back. We have to give it another 2 years and we will back at the old welfare rate. This means 10 years of no increase in welfare.
The US on the other hand recovered quickly. It only had to recover from the bank crisis. But the US is also dealing with low inflation, close to 0%. This is caused by:

- Low commodity prices globally
  The oil prices collapsed because of supply and demand factors.
- Globalization
  By trading internationally countries produce where it's the cheapest. The EU and the US have a weak negotiation position because of higher wages. Because of this, there is no wage growth what results in low inflation.
- Weak economic activity in the EU

The role of the central bank
The Eurosystem is responsible for monetary policy in the entire euro area. The Eurpsystem consists of the ECB (European Central Bank) and NCBs of 19 countries. The decisions are taken by the Governing Council. The Governing Council consists of 6 ECB board members + 19 NCB presidents (Klaas Knot is one of them). They meet twice a month and discussing monetary policy during a meeting once in the 6 weeks.
The main objective of the European central bank is **to maintain price stability in the euro area**. This is defined in low inflation, close to 2%. I hear you say that 0% is much better, but that is not true:

- 2% instead of 0% provides a safe margin before inflation turns into deflation (when inflation is below 0)
- Measuring inflation statistics can't measure quality. The price of an iPad for example increased over time, but you can't call it inflation because obviously the quality of an iPad increased. Sequaciously, the price increases.
- Different products are taken together in a so-called basket. These basket are fixed which means you can't measure changes in the basket.

Price stability is the main objective because this is crucial to foster economic welfare. It is also an efficient allocation of resources, the price signals are important. Stable prices contributes to higher levels of economic activity and means maximizing economic growth and welfare.

The second objective of the European central bank is to maximize economic growth and welfare, and minimize unemployment.
In the US the objectives are equal, they have the luxury to choose what the EU has not. The EU only pays attention to the second objective if they can maintain the first one.

Interest rate as policy instrument
Determining the interest rate is an instrument particularly used in the short run. The ECB can increase or decrease the supply of money and so the value/price of money. If the ECB is setting a monetary transmission policy it lowers the interest rate, so it is cheap to borrow. This will increase spending and investment what increases aggregate demand. Also the prices will go up which means more employment so that the labor market gets tighter. Higher wages will be the result and so higher supply costs. This will cause higher prices.
The ECB influences not directly the prices, but through determining the interest rate.

How can the ECB steer interest rates?

- The Governing Council determines the official interest rate
  This is the interest rate at which banks loan by the ECB, so the price banks has to pay for their debts by the ECB.
- This affects the funding costs of banks
  A high interest rate contributes to high opportunity costs of holding money. Households will put their money on a savings account at which the bank pays interest on. Banks have to pay higher interest so they will increase the interest rate at which they lend.

- Which in turn affects other interest rates (as above), to varying degrees …and thereby the real economy

The floor of the interest rate is determined by the bank reserves. The ceiling of the interest rate is determined by the loans of the banks. So the interest rate can't go higher than 4%.

The ECB set a monetary policy in response on the crisis. It lowered the interest rate until it could not go lower because of reaching the zero lower band. This means the interest rate cannot go (much) below zero. This would have a counter effect.
The 3 policies set by the ECB

- Unconventional 1: forward guidance
  The ECB promises to keeping all short run interest rates low so that they set a low long term interest rate. With reducing the long term interest rate the yield curve becomes flatter so the interest rate of borrowing in real life is also lower.
- Unconventional 2: asset purchases
  Expansion of monetary policy via asset purchases to influence the economic activity, called quantitative easing. The ECB purchases financial assets, mostly government bonds from individuals, so getting cash which the ECB can spend. Now there is more liquidity directly in the economy. This stimulates spending, just like lowering the interest rate.
- Unconventional 3: longer term loans
  In crisis banks need more funding security, they need cheap loans and longer maturities. From max. 3 months up to 4 years. This increases the availability of loans. The banks can now do more lending to the real economy.

The policies called above have been successful. The supply of credit is positive again for the EU as a whole. Unfortunately for The Netherlands the credit growth is still negative. But the credit is becoming less and less negative (the second derivative is positive, saying it in mathematical terms). The credit is getting to flow again.
The policies are well intended of course, it is legitimate to get the inflation back to where it started. But such policies carry risks. Extremely low interest rates was the cause of the economic recession, and what is the ECB doing? Exactly, lowering the interest rate. Keeping interest rates too low for too long could result in excessive debt accumulation and a new crisis.
Firms, banks and governments have to be confident in loaning again, but they only need to use the money for productive investment. With a low interest rate, close to 0%, every investment in the economy is productive. They look profitable, but when the interest rate goes up these investments turn out not as profitable as thought before. This causes the misallocation of resources in the economy which means the future welfare and growth will be lower. This is the price to pay in the long run for short run policies.