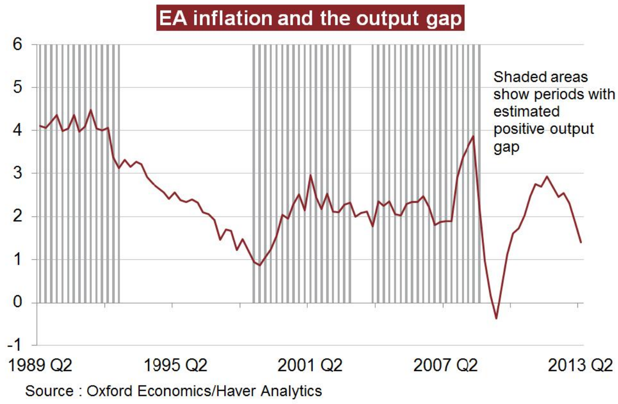
The ECB's next steps

- **The rate cut was good, but not enough to avert deflation**
- **The ECB's inactivity in the face of weak M3 growth is puzzling**
- **Expect negative interest rates and a policy of talking down the euro**

The ECB repo rate cut on 7th November was good news. But it is unlikely to be enough to avert the danger of deflation in the euro area. Why have disinflationary/deflationary pressures gone so far? And, what, therefore, can and will the ECB do next?

The slowing inflation has many causes, but the main ones are years of below-trend growth and consequent large negative output gaps.

Both the IMF and Oxford Economics estimate that the EA negative output gap is about the same size in 2013 as it was in 2009, when the level of consumer prices fell for five consecutive months (the OE estimate is that the negative output gap is slightly larger now than four years ago).[1] Output growth for next year is at best likely to be trend – and that is only because the EA trend growth rate only is around 1%. Hence, the negative output gap will remain throughout 2014 and for some years beyond. Since what matters with output gaps is their level, not their rate of change, disinflationary/deflationary pressures will persist.



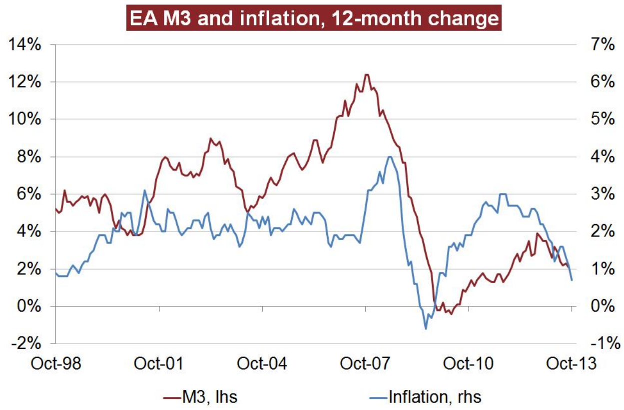
Milton Friedman said "Inflation over any sustained period of time is always and everywhere a monetary phenomenon." The unstated corollary to this is "And so is deflation." The weaker consumer – and producer – price developments were preceded by slowing broad money growth. In the year to September, EA M3 grew by 2.1%, the lowest number since January 2012. Perhaps significantly, the last time broad money growth was as weak as this was in 2009, when the M3 growth rate had slumped from 12.4% in November 2007, to 3.9% in May 2009 (and ultimately to -0.4% in April 2010).

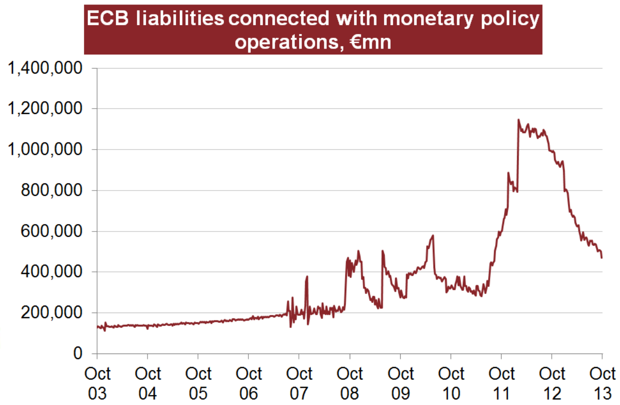
---

[1] I am a Special Advisor to Oxford Economics.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

The M3 numbers point to a deteriorating outlook for the EA in 2014. Hence, the ECB's relative inactivity in the face of the weak broad money is puzzling. This is at least ostensibly a monetarist central bank. At every post-Governing Council meeting press conference, reference is made to broad money developments as one of the two 'pillars' underpinning the ECB's analysis. Of course, the ECB has slashed interest rates, in common with most other central banks. But, when broad money growth has remained anaemic, it has not been prepared to attempt to spur it.





Why is the ECB seemingly so loath to act to accelerate M3 growth? Partly, it is because of the difficulty in boosting broad money growth. Even in countries which have implemented substantial bouts of quantitative easing – the US, the UK and Japan – the impact on broad money, as opposed to on the monetary base, has been much less than anticipated.[2] That is partly because policies aimed at boosting credit growth (instead of directly boosting broad money growth) by filling the banking system with cash, run up against the problem of unwillingness among indebted households and companies to acquire more debt. This could be circumvented by buying assets directly from the non-bank public instead, as the Bank of England did in its asset purchase program.

But that is doable in a single country. In the euro area, that approach would be problematical. First, because any reflationary policy would be met by German opposition, in spite of the fact that German inflation now also is skirting deflation. Second, the issue of what to buy. Whatever the theoretical attractions of other assets, the only realistic asset the ECB could buy would be sovereign debt. But, on what basis? Only triple-A rated would narrow the choice substantially and lead to wider spreads between the core and the periphery. Weighted by size of GDP would overcome the (relatively) limited choice, but

[2] Broad money is generally the broadest available measure of liquidity. Its main component is deposits held by the non-bank domestic private sector; as well as cash. The monetary base consists of cash and of banks' deposits with the central bank. The relationship with output growth and inflation is stronger for broad money than for the monetary base.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

would mean proportionately fewer bonds from the smaller crisis-hit countries, again possibly leading to spreads widening. Weighted by the stock of outstanding debt would mean loading up on Italian debt and would be opposed by Germany. One possibility is buying debt weighted by shareholding in the ECB (a combination of population and GDP) but that could also mean buying non-EA country debt, since all EU countries are shareholders in the ECB (non-EA countries have not paid up their full capital). That would certainly be resisted by everyone concerned (it could be circumvented by recalculating the weighting formula, of course).Weighted by credit rating also encounters problems.

There may be other reasons why the ECB has let broad money growth slide. But, for whatever reason, the euro area is looking ever more likely to face a renewed period of falling prices. It is not (yet) headed for a Japanese-style prolonged deflation; but neither can that be ruled out.

Deflation would be particularly bad in the euro area, which still suffers from substantial debt overhangs. Deflation dampens nominal growth; which means that the debt burden is not reduced (and, in fact, could rise relative to GDP even if debt is being paid down, although that would be an extreme case). Lower nominal GDP growth also means that governments cannot raise the revenues they had expected, meaning that budget deficits do not narrow to the intended degree. In the current EA political climate, the governments concerned might be inclined to abandon or at least ease austerity; but the pressure from the creditor countries would rather be to tighten more, which would crush domestic demand even further, leading to a vicious circle.

There is also the possible risk that experiencing a bout of deflation eventually would cause an opposite reaction, ie, induce greater acceptance of higher inflation than the 2% that is generally perceived to be equivalent to de facto stable prices in most countries. As the experience of the 1970s and 1980s show, that would be equally bad.

So what can – and more importantly will – the ECB do to ward off the risk of deflation? Even without a policy of boosting broad money growth, the Bank does have some weapons it could deploy.

- The repo rate could be cut to zero. This was discussed at the November meeting. The impact of this would probably be limited. It is highly unlikely that the current level of interest rates deters anyone from borrowing, be it a household or a company. Nevertheless, in conjunction with other measures, it would be helpful.

- The ECB could also, as it has already discussed, introduce negative interest rates on banks' deposits with the central bank. But, unless the negative interest rates are high enough, banks may yet find that, for reasons of safety and for lack of credit demand, they would take the loss involved and keep the money where it is. Nevertheless, in theory this could have a substantial impact. Although banks' reserves with the ECB have come down since peaking in the wake of the two three-year LTROs in 2011 and 2012, they still amount to close to €470 billion. Pre-crisis, the sum was about €200 billion. If the entire excess could be shifted towards credit, the stock of broad money (since credit is usually the most important counterpart to broad money) would see a

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

once-off rise of about 1.7%. Moreover, the ECB's latest bank lending survey shows banks planning to ease their lending standards and the demand for loans actually rising in the current quarter, both for the first time in years, meaning there should be scope for some credit growth. The likelihood is that the ECB will introduce negative interest rates on deposits in the near future.

- A further possibility is to attempt to talk down the euro. This has already begun, with recent comments by the Italian Finance Minister Fabrizio Saccomanni. A lower euro would push up import prices (and would also further help the euro area's export performance), to some extent off-setting the impact of the negative output gap.

All these measures are helpful. But, ultimately, the ECB will only escape the risk of deflation when activity has been strong enough for the negative output gap to close. That does not seem to be on the cards for some years yet. Deflation may be averted; but, until growth takes off, it will remain a threat.

Gabriel Stein 2013-11-11
gabriel.stein@steinbrothers.co.uk