European Central Bank

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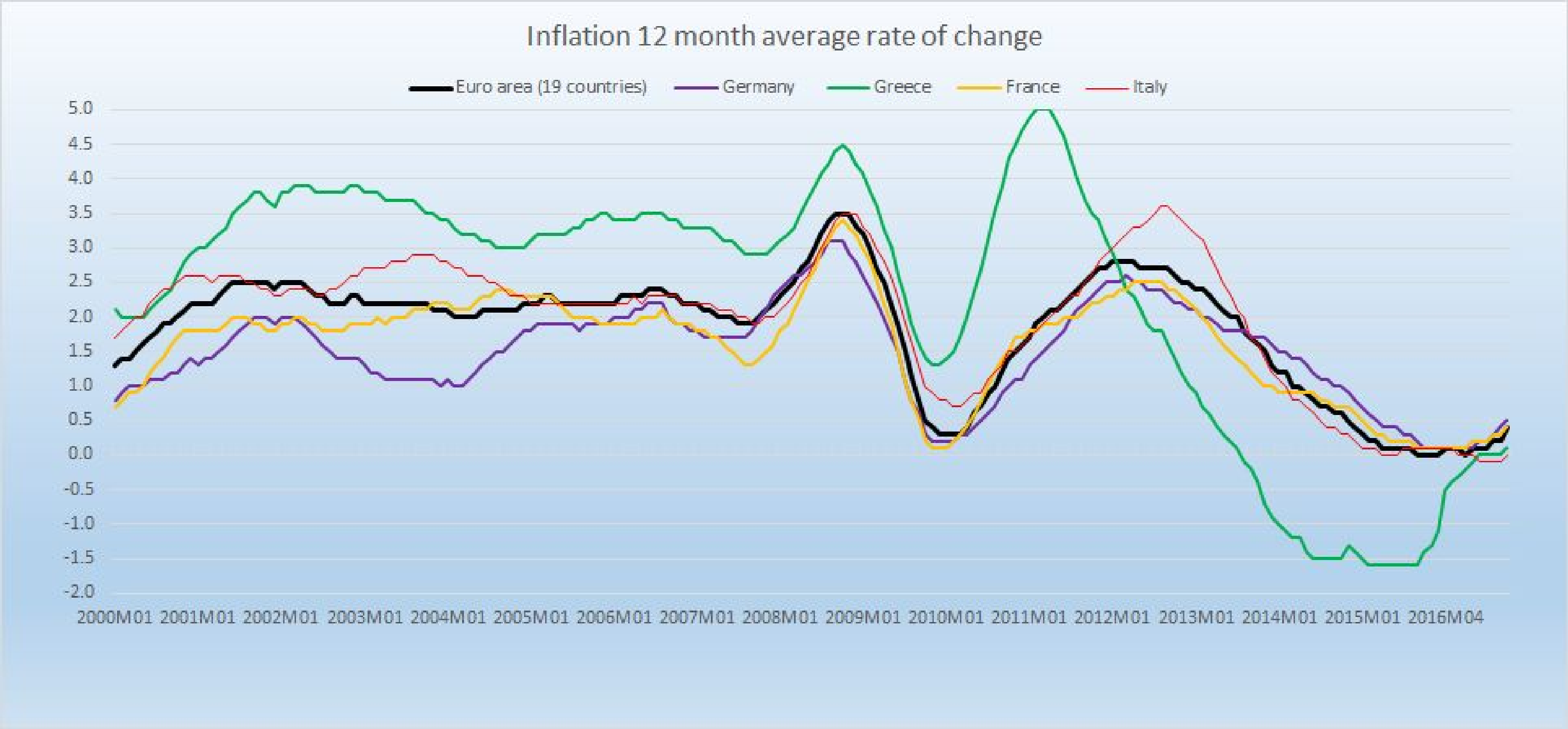
ECON 110BH, Winter 2017
Milena, Colleen, Carolyn, Yuan, Yaochen

About ECB

The ECB is an official EU institution at the heart of the Eurosystem and the Single Supervisory Mechanism, which comprises the ECB and the national supervisory authorities (Central Banks) of the participating countries.

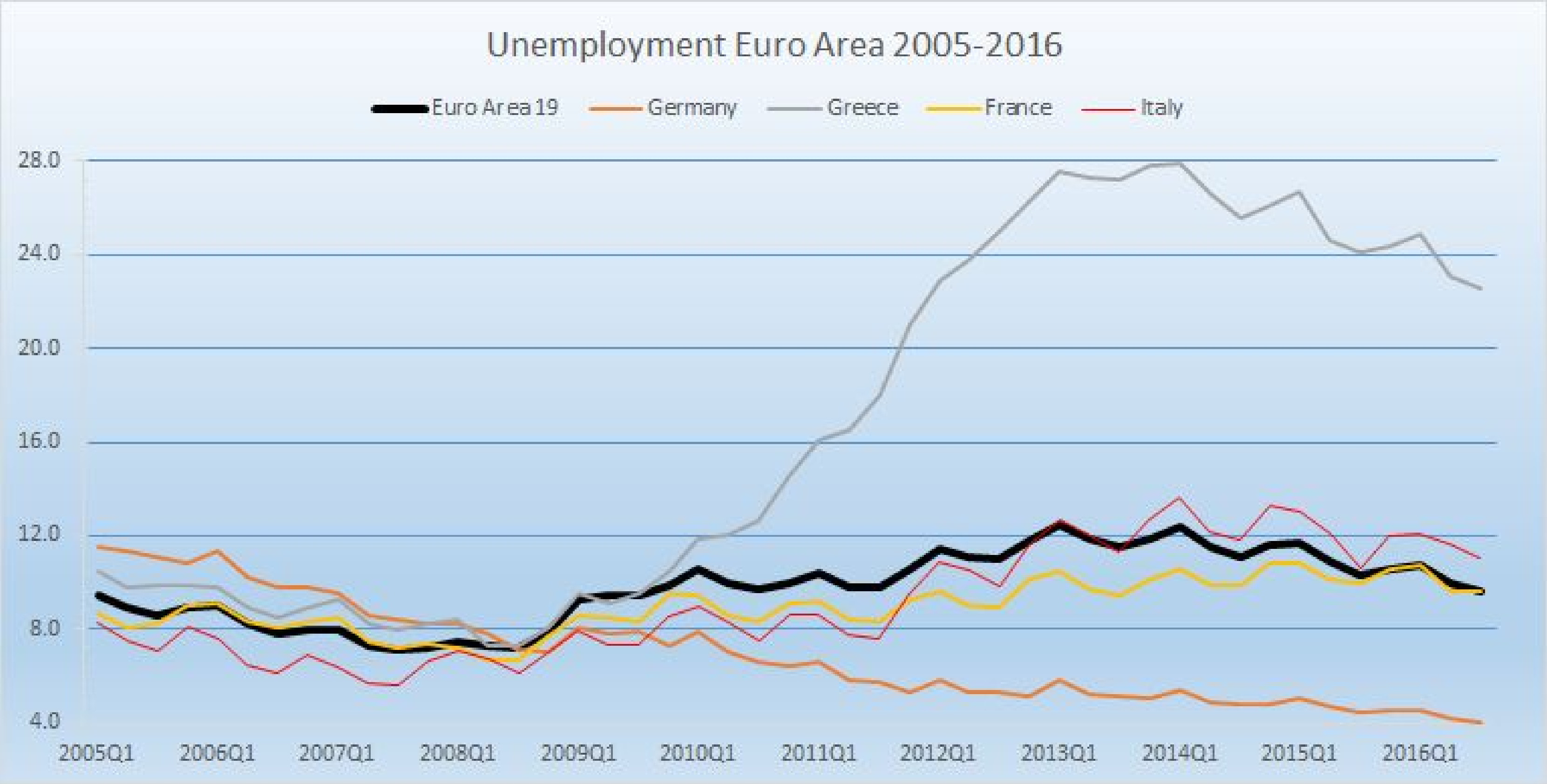
19 countries are under the ECB monetary policy, while other European countries have their own currencies and central banks, like Norway and Sweden.

Current Economic Outlook



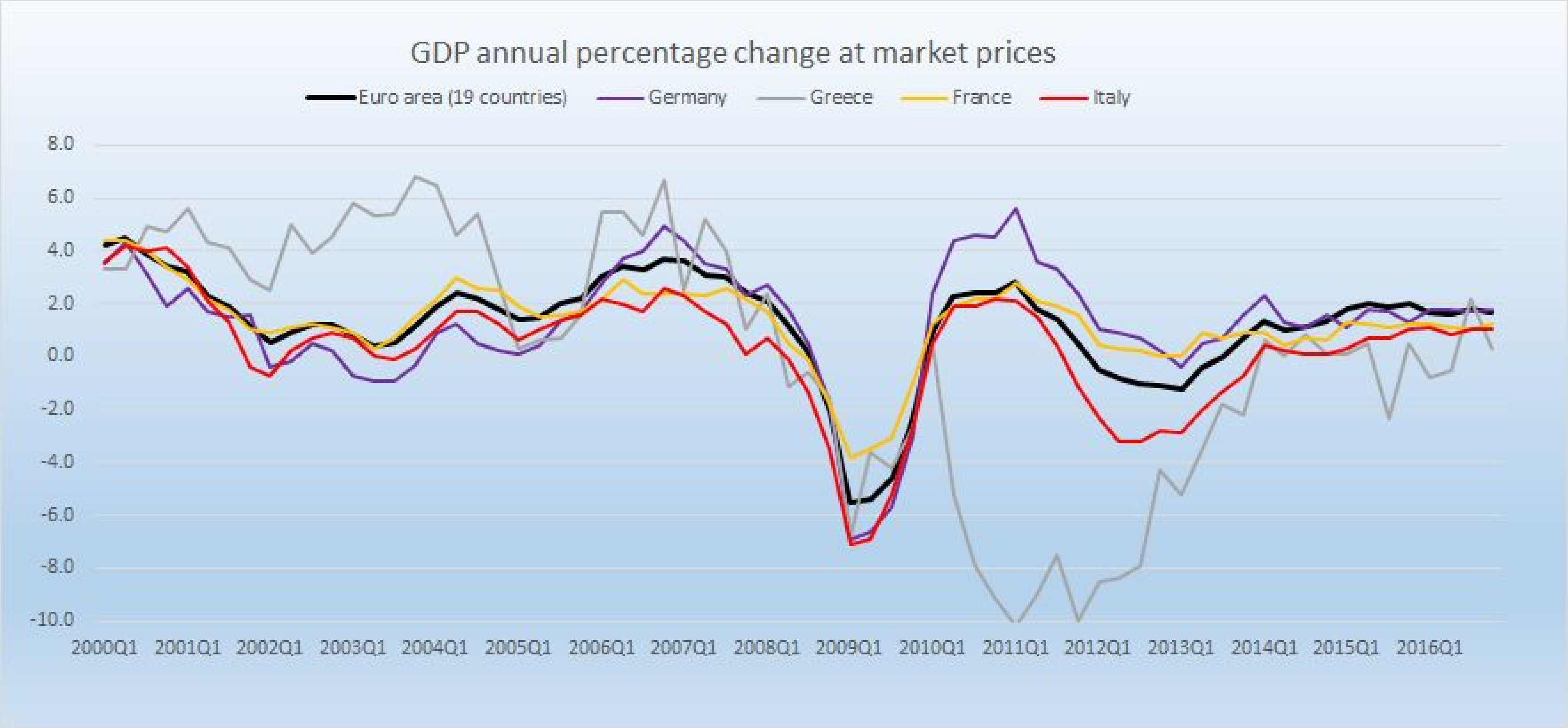
Data: Eurostat

Current Economic Outlook



Data: Eurostat

Current Economic Outlook



Data: Eurostat

Negative Interest Rate

Traditionally, the ECB would set two interest rates:

1)A deposit interest rate that the ECB pays to banks on excess reserves held overnight in the banks' account with ECB

2)A marginal lending rate at which bank can borrow overnight from the ECB

Deposity facility rate
Marginal lending facility rate
7
6
5
4
3
2
1
0
-1
2000-02-04
2001-02-04
2002-02-04
2003-02-04
2004-02-04
2005-02-04
2006-02-04
2007-02-04
2008-02-04
2009-02-04
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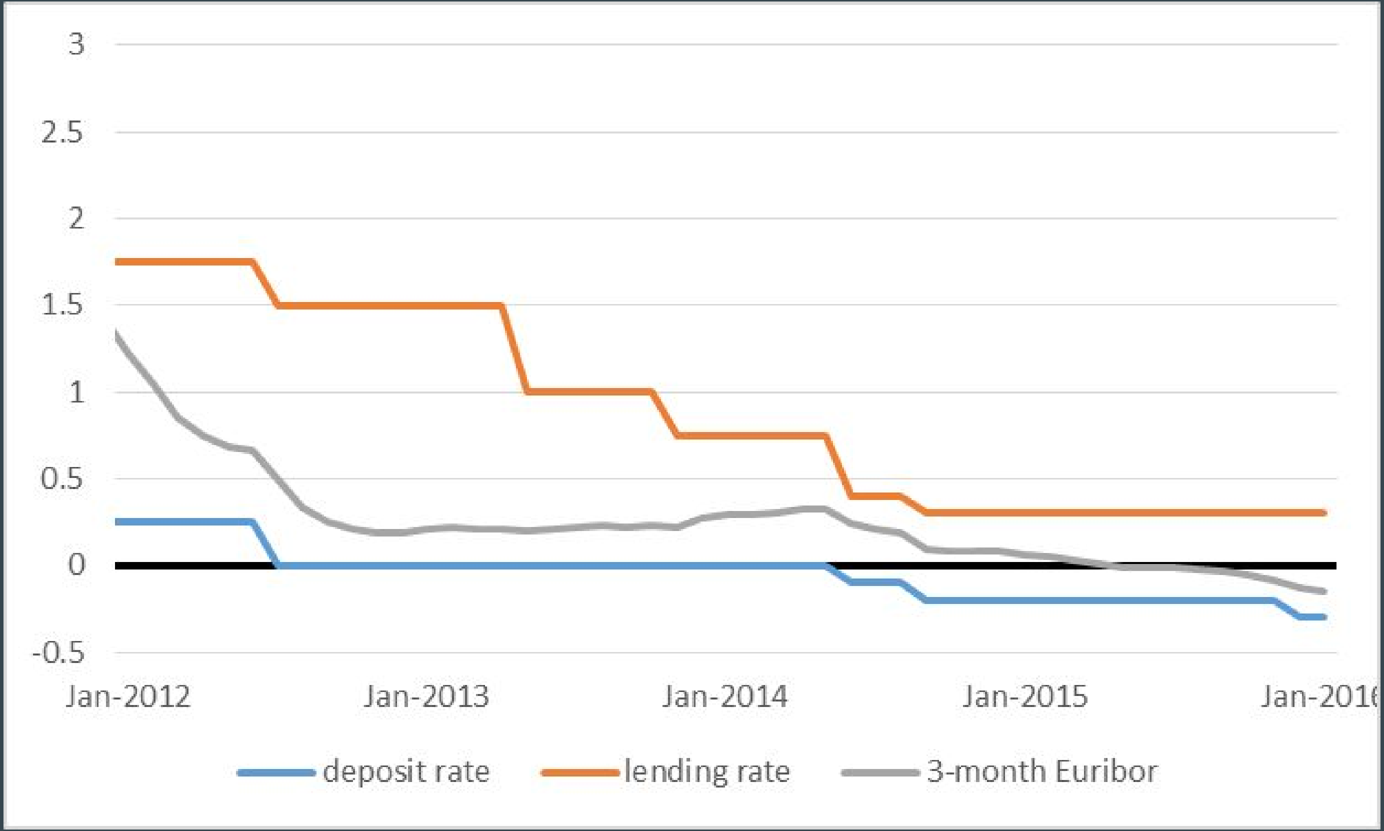
2011-02-04
2012-02-04
2013-02-04
2014-02-04
2015-02-04
2016-02-04

Data: ECB



Average interest rate over the month on 3-month interbank loans (in gray) and end-of-month values for ECB deposit rate (in blue) and lending rate (in orange), January 2012 to January 2016.

Source: http://econbrowser.com/archives/2016/02/negative-interest-rates-2

Negative Interest Rates impact

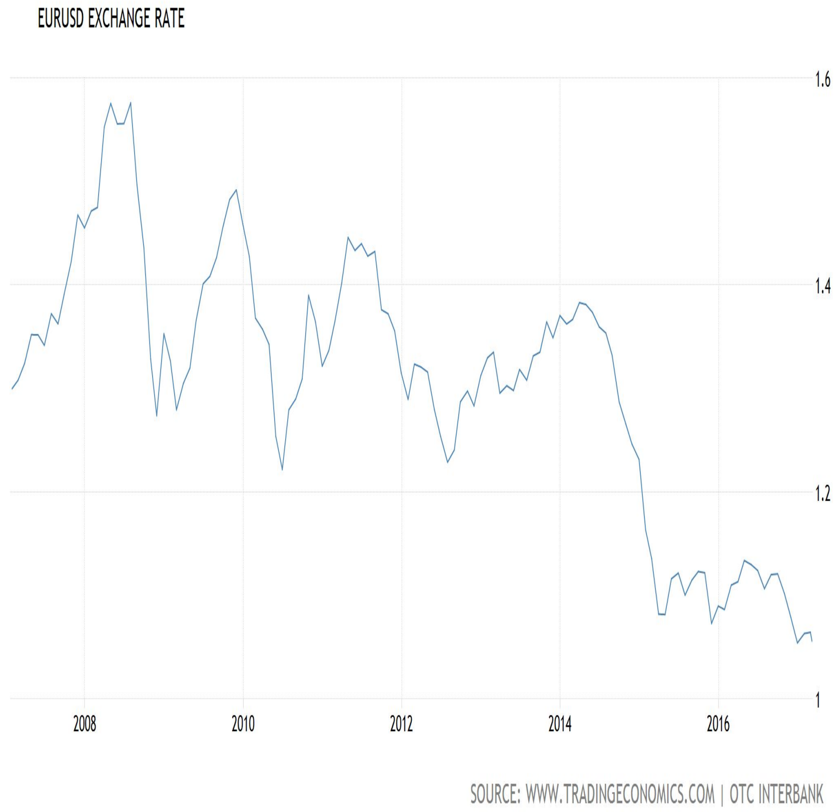
How do the negative interest rates are correlated with inflation... (What about government bonds?)

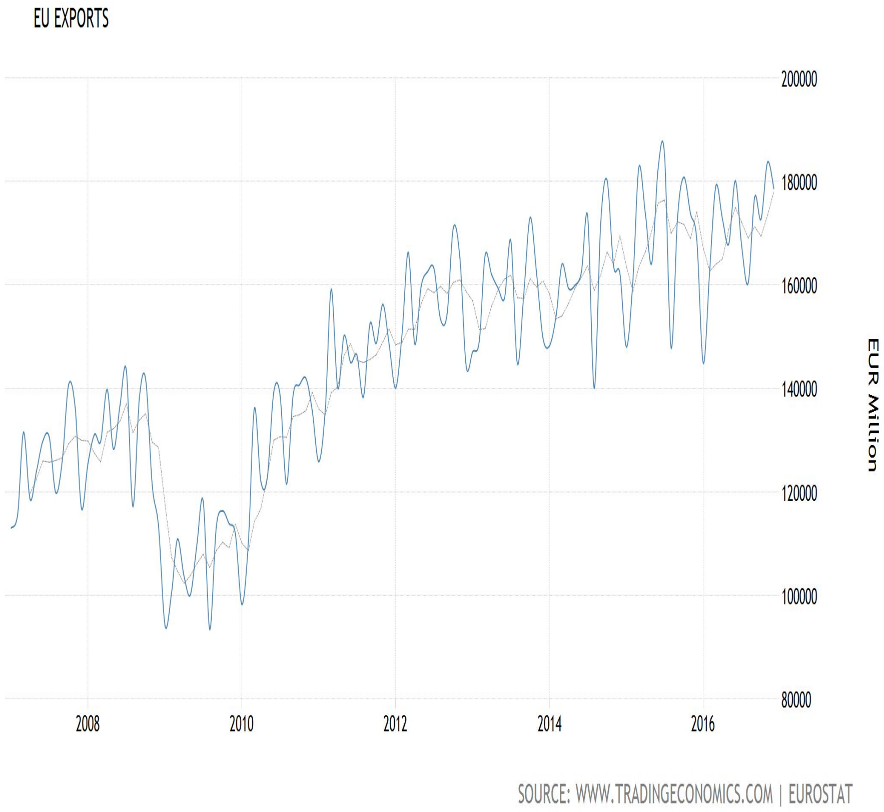
The negative interest rate supposed to bring up inflation

Euro depreciation stimulates export

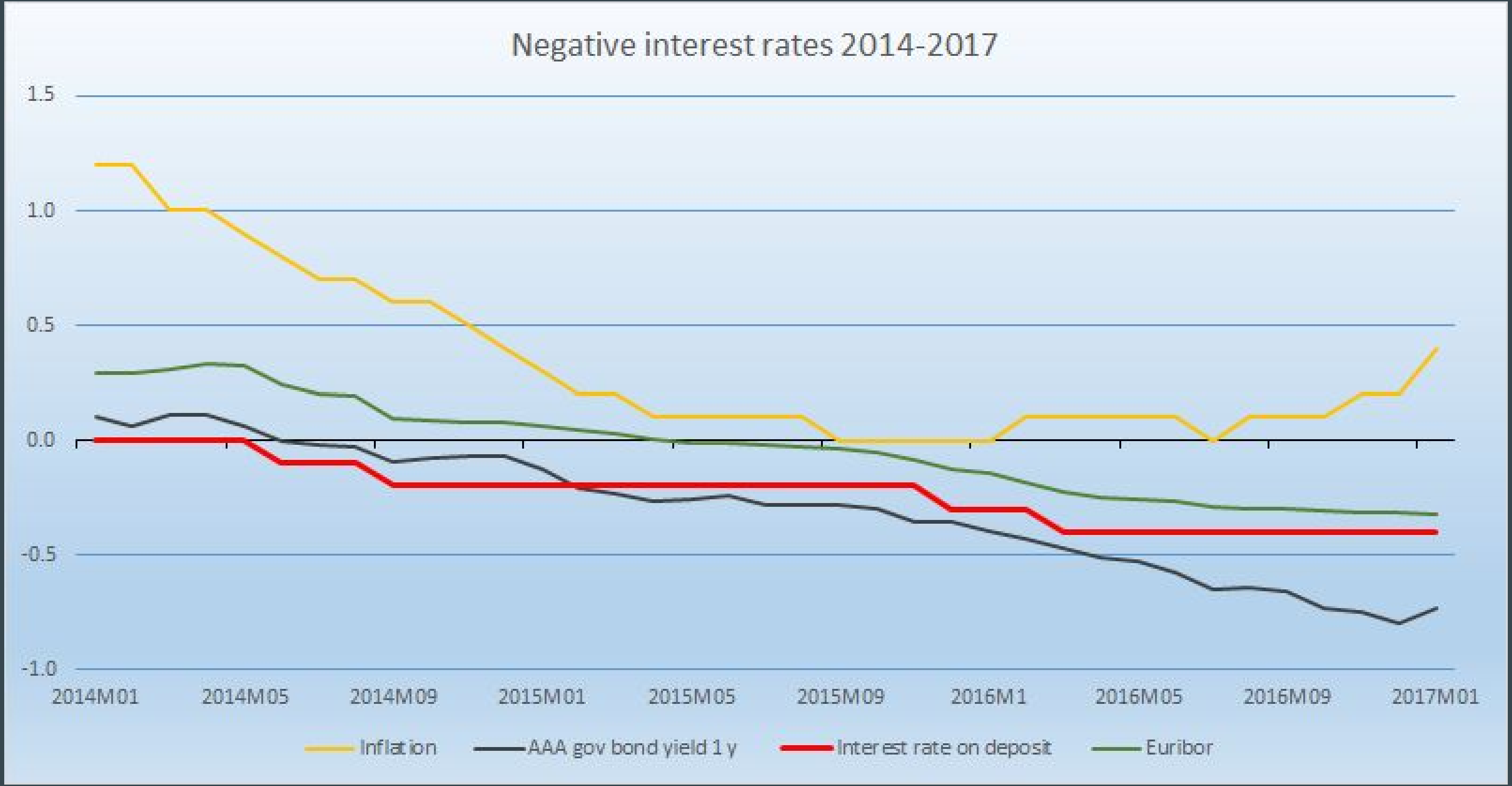
Keep lending cost low, encourage more borrowing.

Bring Gov bond yield down.

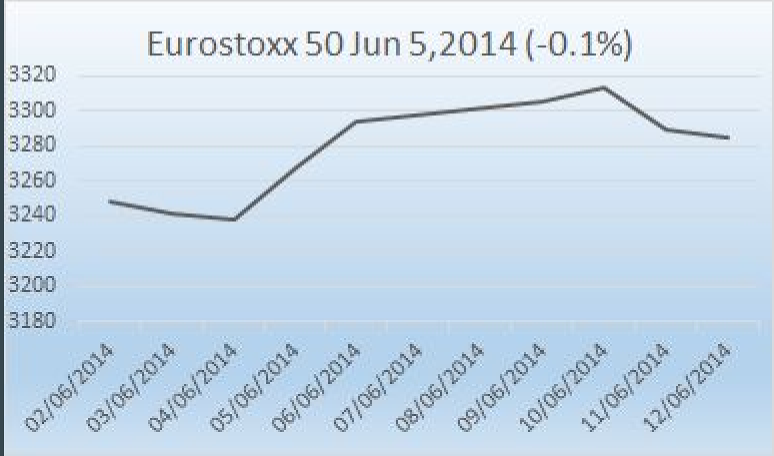

EURUSD EXCHANGE RATE
1.6
1.4
1.2
1
2008
2010
2012
2014
2016
SOURCE: WWW.TRADINGECONOMICS.COM | OTC INTERBANK

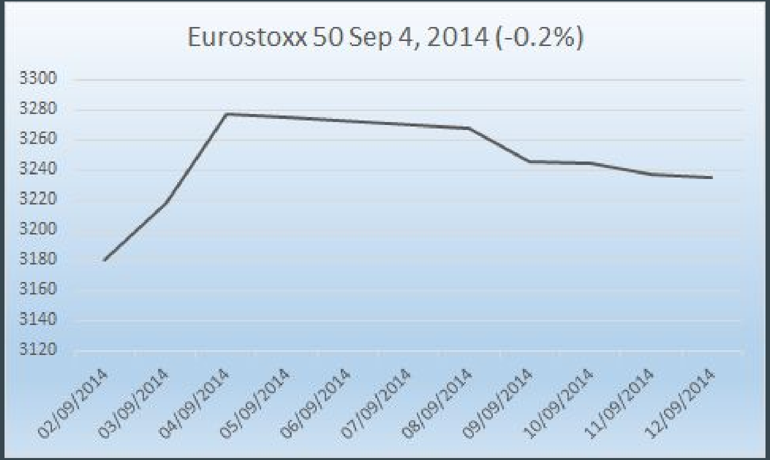

EU EXPORTS
200000
180000
160000
140000
120000
100000
80000
EUR Million
2008
2010
2012
2014
2016
SOURCE: WWW.TRADINGECONOMICS.COM | EUROSTAT

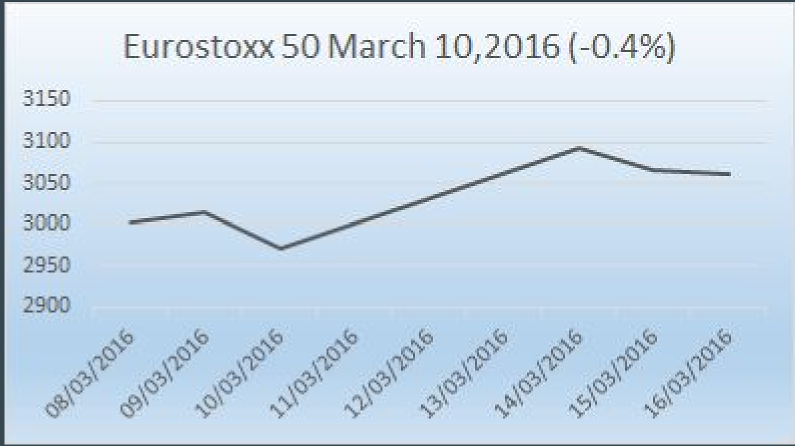
Negative Interest rates



Data: Eurostat







Source Yahoo Finance

European Debt Crisis

- Spurred by slow global economic growth that began in 2008, resulting in several European countries unable to repay or refinance its debts
- In 2010, investors demanded higher yields on these countries's bonds (sovereign debt) because of greater risk
  - Raises the cost of the debt
- Led to several bailouts by the EU and the ECB
  - In exchange for austerity measures (increase in taxes, decrease in spending)
  - Has led to political instability and slower economic growth

European Debt Crisis

- Currently, there is greater investor comfort in investing in the region's bond markets, resulting in low yields
- Slow economic growth and risk that Europe will sink to deflation
  - Response: negative interest rates, quantitative easing program
- Economic recovery uncertain after Brexit and speculations of other countries leaving the EU
  - Have described EU as a "sinking ship", referring unrecoverable economy and unfair pressure on economically-stable countries to bail out countries in crisis

Quantitative Easing (QE)

Why? To stimulate the economy by massive bond buying programme

The ECB “took the unprecedented step because previous stimulus measures -- including record low interest rates and buying other assets -- had failed to boost inflation expectations.”

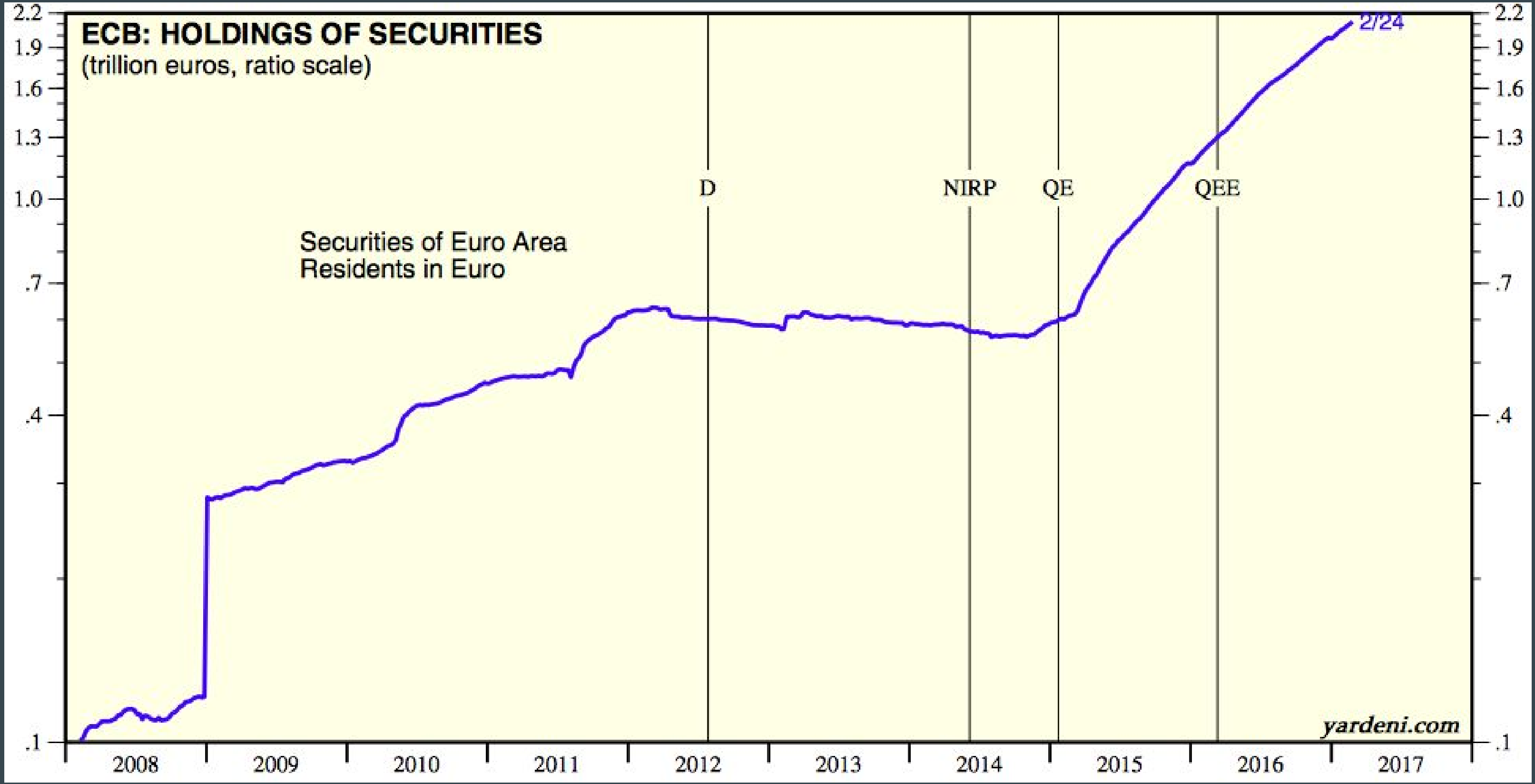
When?

Program started in Jan 2015; initially planned to last until Sep 2016;

extended at least til the end of 2017 (why extended? Continue “until we (ECB) see a continued adjustment in the path of inflation”--President of ECB)

How much? Around €60 billion per month

What happened to ECB's balance sheet?

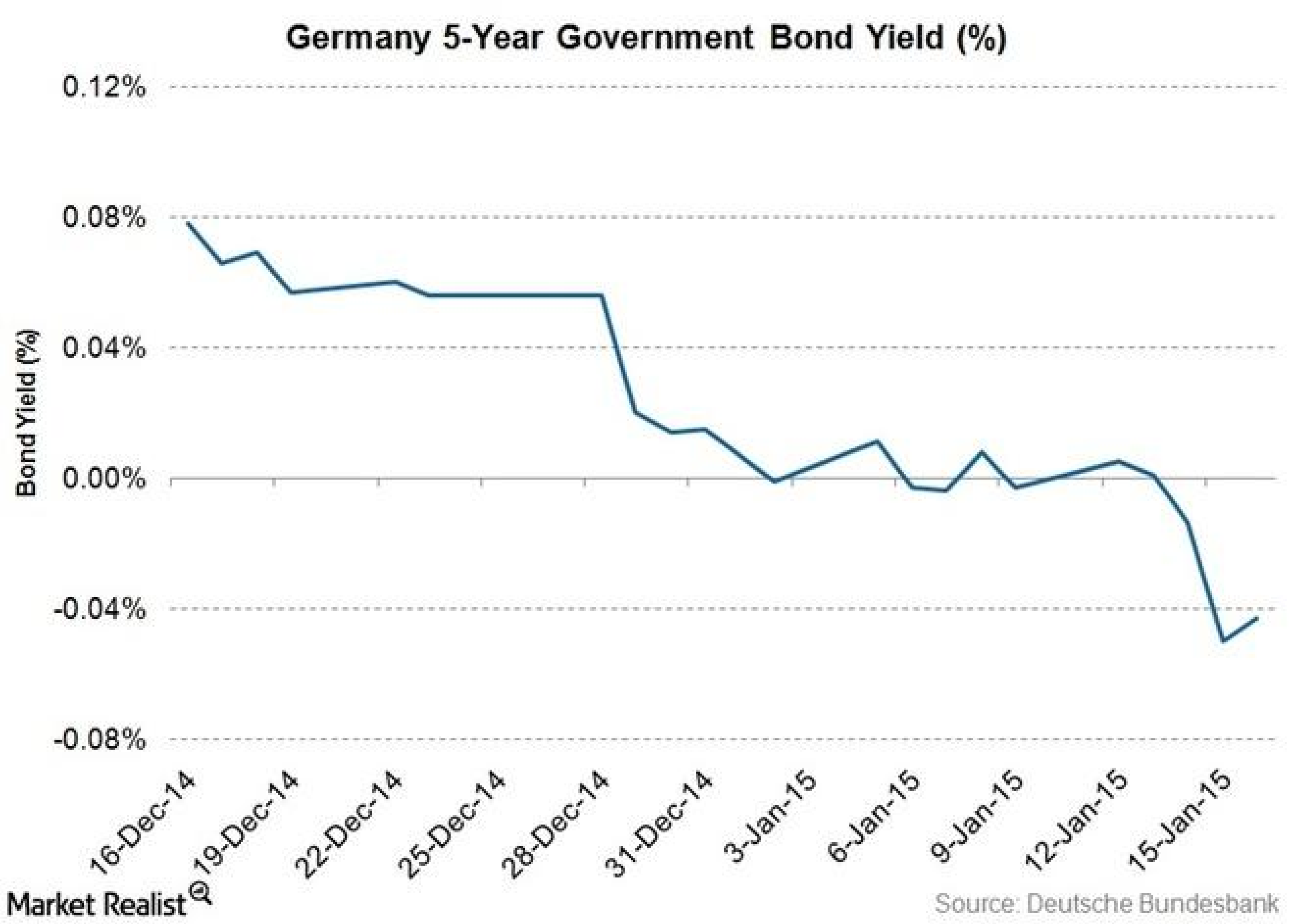


Source: Yardeni Research, Inc. http://www.yardeni.com/pub/peacockfedecbassets.pdf

Does QE work?

Yes. At least in the short run.

- Long-term bonds interest rates decrease immediately
  - Yields on five-year German bonds have even dipped into negative territory
- The currency has slumped 10% against the dollar in 2015 to trade at an 11-year low of $1.09 upon announcement
  - **Interpretation:** Euro weakened; exports cheaper; inflation goes higher as imports become expensive
- Cheap money is also pushing investors into stock markets in search of better returns.
  - European market surged in 2015


Germany 5-Year Government Bond Yield (%)
0.12%
0.08%
0.04%
0.00%
-0.04%
-0.08%
Bond Yield (%)
16-Dec-14
19-Dec-14
22-Dec-14
25-Dec-14
28-Dec-14
31-Dec-14
3-Jan-15
6-Jan-15
9-Jan-15
12-Jan-15
15-Jan-15
Market Realist
Source: Deutsche Bundesbank


European Note Yields Drop to Records
Two-year yields from Finland, France and Germany sink
German Government Bonds 2 Yr BKO
Finland Government Bond Generic 2 Year
France Govt Oats Btan 2 Yr Btan
0.050
0.000
-0.050
-0.100
-0.150
-0.200
-0.250
-0.300
-0.350
Oct ...
Dec
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
2014
2015
Source: Bloomberg
Bloomberg

Despite the short-run economic impact...

The overall effect is uncertain.

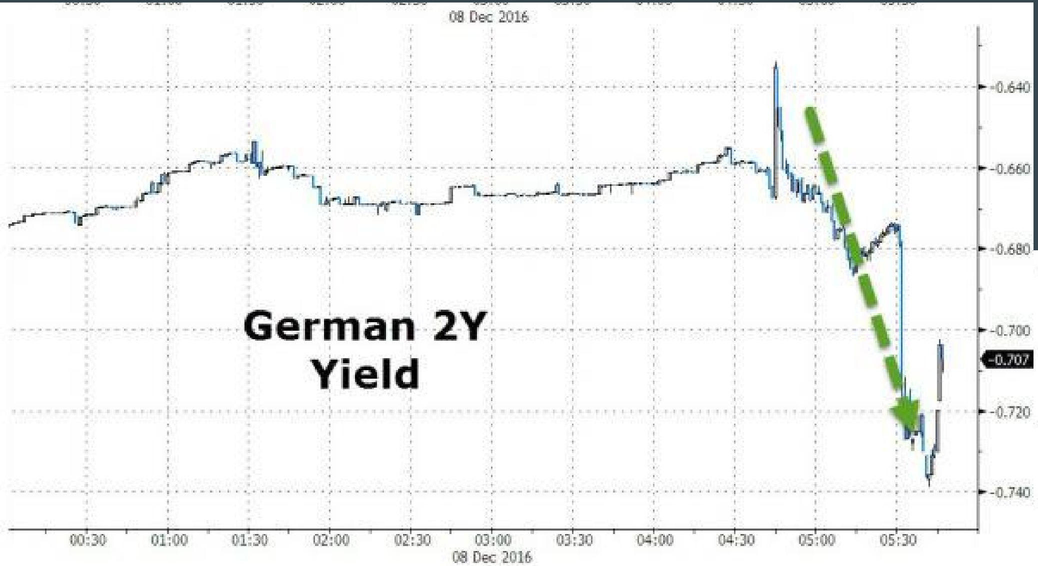
Yields on short and long term bonds both fluctuate.

For example, there was an announcement in Dec 2016

ECB will "conduct an extra nine months of quantitative easing, but cuts bond purchases from €80bn to €60bn per month"

(It sent a clear signal that there would be a limit to how far the ECB's QE can run and how high the ECB's balance sheet can grow beyond 2017.)

What happened? (by extending QE; cutting purchase amount)

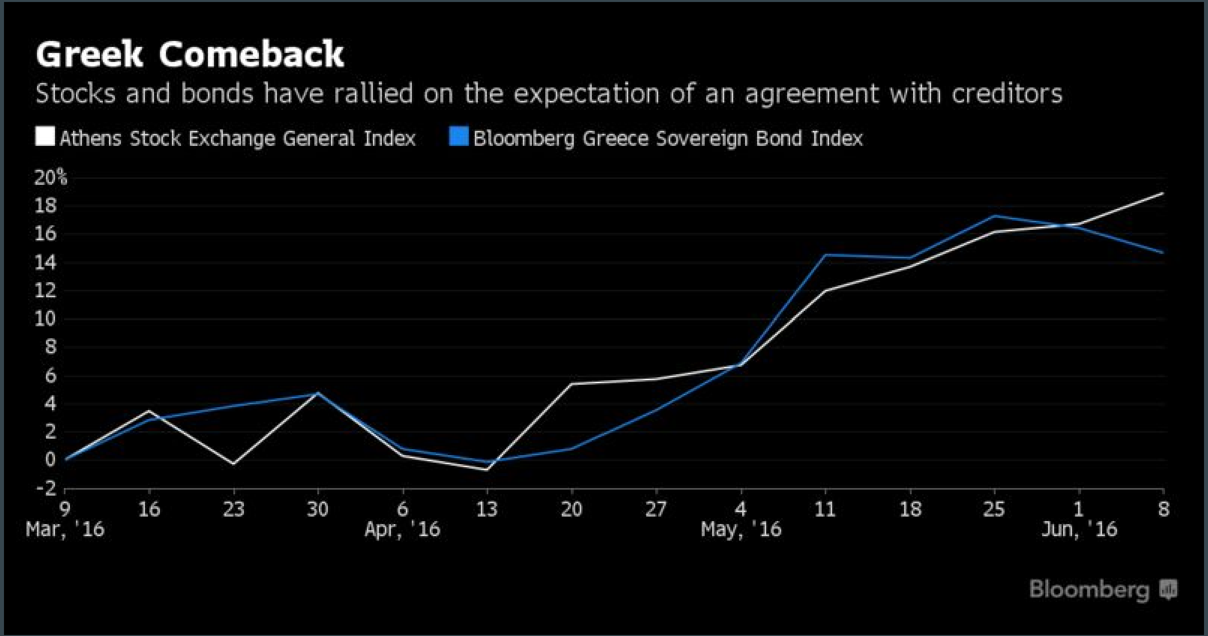


Source: http://www.zerohedge.com/news/2016-12-08/european-yield-curve-surges-steepest-29-months-after-ecb-eases-qe-rules

By the way...Does Greece benefit from QE?

At first, no...The purchases were NOT supposed to take place for countries still receiving bailout funds from the EU

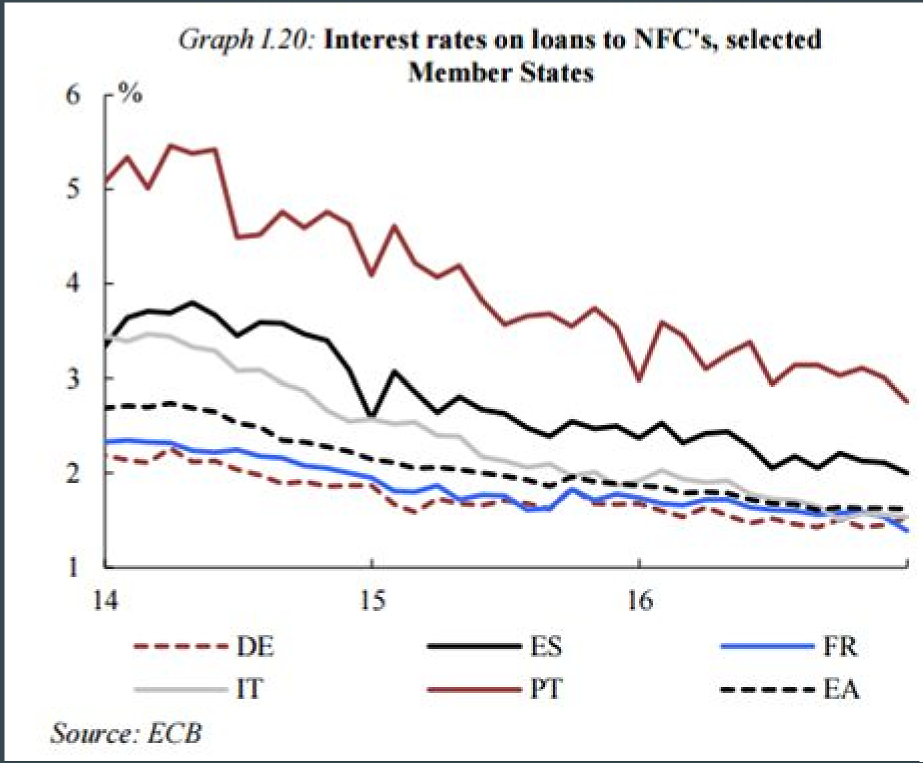
- As a bail-out country, Greece was barred from the ECB's government bond-buying scheme
- **In April 2016**, ECB has finally begun hoovering up bail-out bonds held by Greek banks

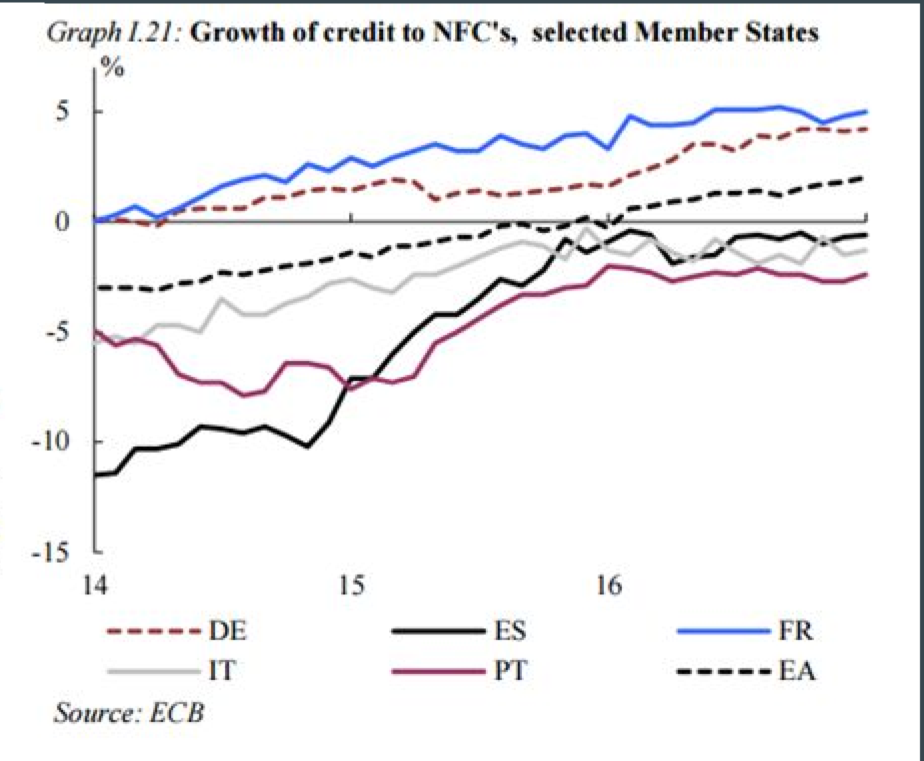


Main goals of QE and negative interest rates

Economic kick-start: "Euro area banks have been further lowering interest rates to non-financial corporations (NFCs) and households over the past year. Specifically, for the whole euro area, the annual growth rate of monetary financial institution (MFI) loans (adjusted for loan sales and securitisation) increased further to 2.3% in December 2016 for NFCs and to 2.0% for households. This suggests that the transmission of the ECB's accommodative monetary policy has been efficient at the overall level of the euro area." - European Economic Forecast, Winter 2017

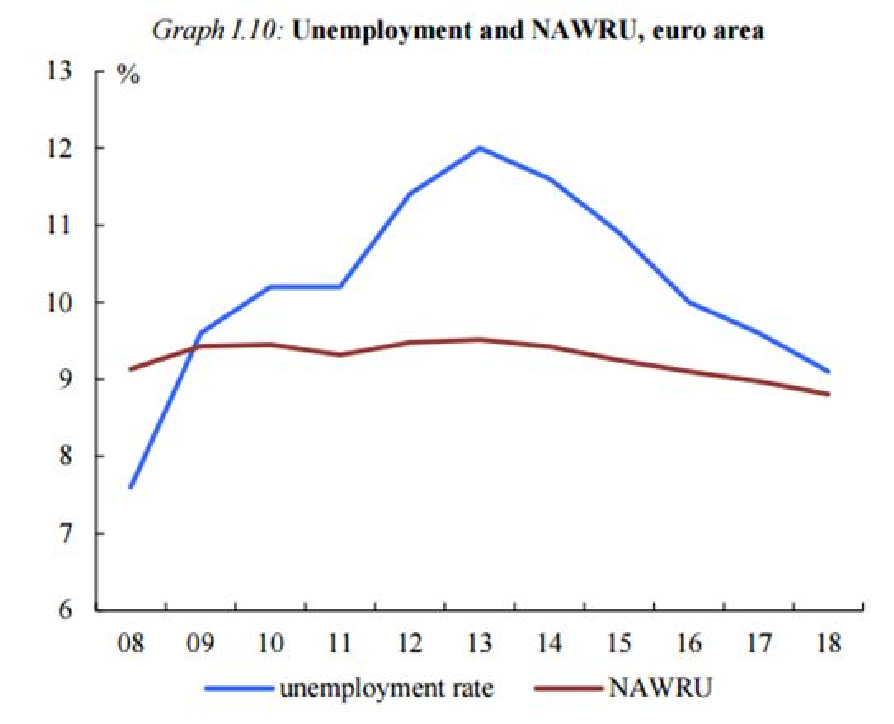
Interest rates on loans and growth of credit





Natural rate of unemployment NAWRU

"In December 2016, the unemployment rate reached 9.6% of the labour force in the euro area, its lowest level since May 2009. However, there is a risk of elevated long-term/structural unemployment that could be detrimental to the further improvement of the labour market and potential growth. The euro-area unemployment gap in 2016 is estimated at 0.9 pps., down from 2.5 pps. in 2012."



https://ec.europa.eu/info/publications/european-economic-forecast-winter-2017_en

Recommendations

Are negative interest rates doing their jobs (in terms of unemployment , GDP, and growth of credit to NFCs)?

Yes, it might be worse without them.

What can we suggest?

In the long run, we should aim to get interest rates above 0. Quantitative easing will help inflation return to the target level of 2% (projected by end of 2017). Once the target, the QE can gradually decrease and the ECB can set interest rates back to normal.

Recommendations

Fiscal policies are really different among member states and they should need different monetary policy (Germany would need higher interest rates while other countries are doing better with negative interest rates in term of their inflation and short run output)

Should the Euro area have a unique government debt and Euro-bonds?