

Is the ECB impotent?

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In June 2014, the ECB announced a set of new measures (a detailed description of which is provided in a special study entitled, "[How can the fragmentation of the euro zone banking system be fought?](#)", Revue de l'OFCE, No. 136, in French) in order to halt the lowering of inflation and sustain growth. Mario Draghi then clarified the objectives of the ECB's monetary policy by indicating that the Bank wanted to expand its balance sheet by a trillion euros to return to a level close to that seen in the summer of 2012. Among the measures taken, much was expected from the new targeted long-term refinancing operation (TLTRO), which gives banks in the euro zone access to ECB refinancing with a maturity of 4 years in return for providing credit to the private sector (excluding mortgages). However, after the first two allocations (24 September 2014 and 11 December 2014), the picture has become rather complicated, with the amounts allocated well below expectations. This reflects the difficulty the ECB is having in fighting effectively against the risk of deflation.

Indeed, having allotted 82.6 billion euros in September (versus anticipations of between 130 and 150 billion), the ECB granted "only" 130 billion on December 11, *i.e.* once again a lower amount than had been anticipated. So we are a long way from the maximum amount of 400 billion euros that had been evoked by Mario Draghi in June 2014 for these two operations. Moreover, these first two allotments were clearly insufficient to boost the ECB's balance sheet significantly (Figure 1), and all the more so as banks are continuing to reimburse the three-year loans that they received in late 2011 and early 2012 in the very long-term refinancing operation (VLTRO) [\[1\]](#). What explains the banks' reluctance to make use of this operation, even though it allows them to refinance the loans

granted at a very low rate for a 4 year term?

The first is that the banks already have very broad and very advantageous access to ECB liquidity through the monetary policy operations already implemented by the ECB^[2]. These operations actually offer a lower interest rate than does the TLTRO (0.05% against 0.15%). Similarly, a TLTRO is not more attractive than some long-term market financing, especially since many banks do not have financing constraints. TLTRO is thus of marginal interest, due to the maturity of the operation, and more restrictive because it is conditioned on the distribution of credit. For the first two operations conducted in September and December 2014, the allotment could not exceed 7% of outstanding loans to the non-financial private sector in the euro zone, excluding loans for housing, as of 30 April 2014. A new series of TLTRO will be conducted between March 2015 and June 2016, on a quarterly basis. This time the maximum amount that can be allocated to the banks will depend on the growth in outstanding loans to the non-financial private sector in the euro zone, excluding loans for housing, between 30 April 2014 and the date of the operation in question.

The second explanation is that the weakness of credit in the euro zone is not simply the result of supply factors but also demand factors. Sluggish activity and private agents' efforts to shed debt are holding back lending.

Third, beyond banks' ability to find refinancing, it is also possible that they are trying to reduce their exposure to risk. The problem is thus related to their assets. However, non-performing loans are still at a very high level, especially in Spain and Italy (Figure 2). In addition, although the Asset Quality Review (AQR) conducted by the ECB has revealed that insolvency risks are limited in the euro zone, the report also points out that some banks are highly leveraged and that they have mainly used the available liquidity to buy government bonds in order to meet their

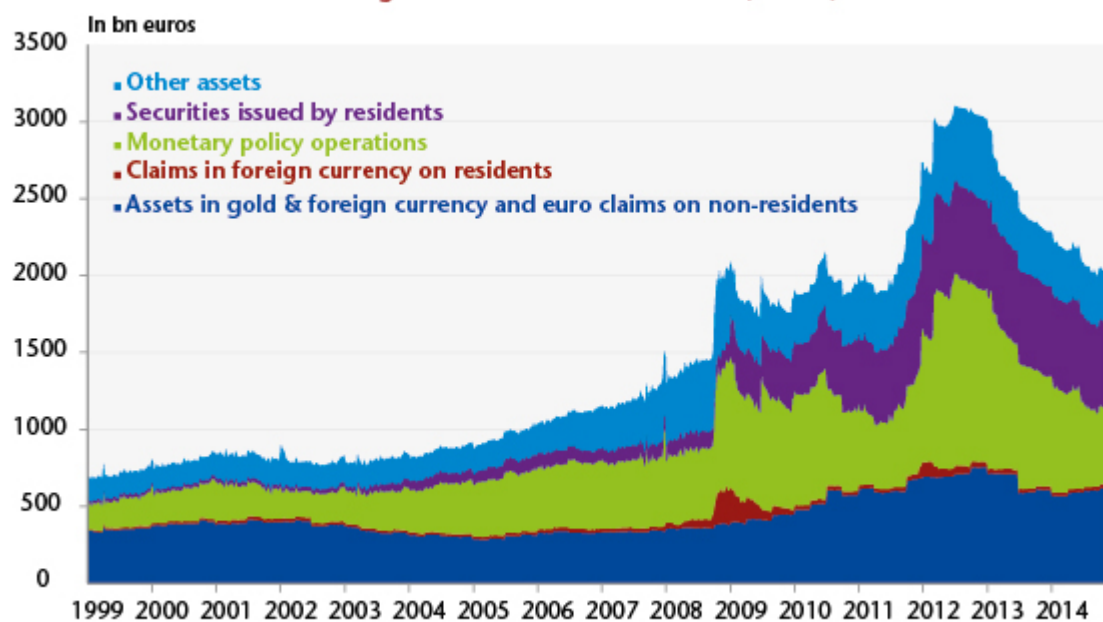
capital requirements. They are then reducing their balance sheet risk by limiting loans to the private sector.

Finally, two uncertainties are also reducing the banks' participation in the TLTRO. The first concerns the stigma attached to the conditionality of the TLTRO and to the fact that banks that do not meet their commitments on the distribution of credit will be required to repay the financing obtained from the ECB after two years. So banks facing uncertainty about their ability to increase their lending may very well wish to avoid the prospect of having to repay the funds sooner. The second factor concerns uncertainties about the programs for purchasing ABS and covered bonds^[3]. The banks could also turn to these programs to get cash in exchange for the sale of assets that they would like to get rid of.

Has monetary policy become totally ineffective? The answer is certainly no, since by giving banks a guarantee that they can refinance their activity through various programs (TLTRO, ABS, covered bonds, etc.), the ECB is reducing the risk that credit will be rationed due to the deteriorated state of some banks' liabilities. Monetary policy is thus helping to free up the credit channel. But its effects are nevertheless limited, as is suggested by [Bech, Gambacorta and Kharroubi \(2012\)](#), who show that monetary policy is less effective in periods of recovery following a financial crisis. Can we get out of this impasse? This observation on the effectiveness of monetary policy shows that the ECB should not be viewed as the be-all and end-all. It is still essential to complement its support for activity through an expansionary fiscal policy across the euro zone. This point was also reiterated by the President of the ECB during this summer's [conference at Jackson Hole](#): "Demand side policies are not only justified by the significant cyclical component in unemployment. They are also relevant because, given prevailing uncertainty, they help insure against the risk that a weak economy is contributing to

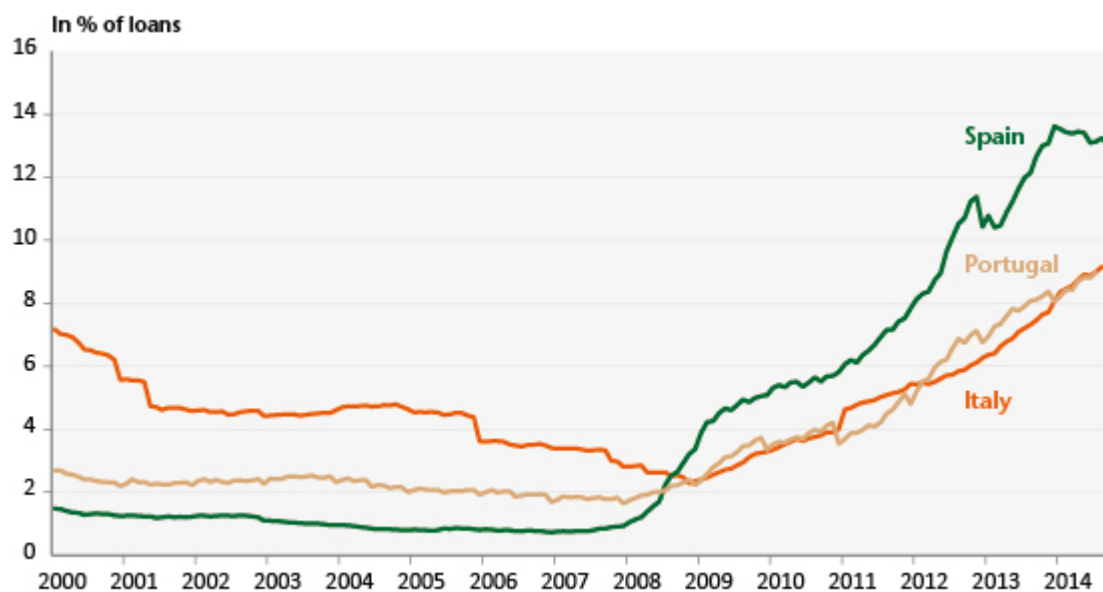
hysteresis effects.”

Figure 1. ECB balance sheet (assets)



Source: ECB.

Figure 2. Bad debt



Source: National central banks.

[1] See the special study in the *Revue de l'OFCE* no. 136, "[Comment lutter contre la fragmentation du système bancaire de la zone euro?](#)" for an examination of the various monetary policy measures taken by the ECB since the onset of the financial crisis and an estimate of their impact on the real economy.

[2] This includes standard monetary policy operations as well as the VLTRO operation through which the ECB provided liquidity for an exceptional term of 3 years in December 2011 and February 2012.

[3] This involves programs for the purchase of securities in the market and not cash distributed directly to the banks. The covered bonds and ABS are securities pledged on assets whose remuneration depends on that of the underlying asset, which is by necessity a mortgage in the case of covered bonds and which in the case of ABS may include other types of loans (credit cards, cash loans to businesses, etc.).

The ECB – or how to become less conventional

By [Jérôme Creel](#) and [Paul Hubert](#)

The gloomy economic situation in the euro zone and the deflationary risks it is facing are leading the members of the European Central Bank (ECB) to consider a new round of quantitative easing, as can be seen in [recent statements by German, Slovakian and European central bankers](#). What might this involve, and could these measures be effective in

boosting the euro zone economy?

Quantitative easing (QE) includes several different types of unconventional monetary policy. To define them, it is necessary to start by characterizing conventional monetary policy.

Conventional monetary policy involves changing the key interest rate (the rate for so-called medium-term refinancing operations) by what are called open market operations so as to influence financing conditions. These operations can change the size of the central bank's balance sheet, including by means of money creation. So there is a stumbling block in distinguishing between conventional and unconventional policy: increasing the size of the central bank's balance sheet is not sufficient in itself to characterize an unconventional policy.

In contrast, strictly speaking an unconventional quantitative easing policy gives rise to an increase in the size of the central bank's balance sheet but without any immediate additional money creation: the extra liquidity provided by the central bank to the commercial banks serves to increase their reserves with the central bank, so long as these reserves are ultimately used for the subsequent acquisition of securities or to grant loans. These reserves, which are the commercial banks' safe assets, help to consolidate their balance sheets: risky assets decrease in proportion, while safe assets increase.

Another type of unconventional monetary policy, qualitative easing, consists of modifying the structure of the central bank's balance sheet, usually on the assets side, but without changing the size of the balance sheet. This may mean that the central bank purchases riskier securities (not AAA rated) to the detriment of safer securities (AAA). In doing this, the central bank reduces the amount of risk on the balance sheets of the banks from which it has acquired these higher-risk securities.

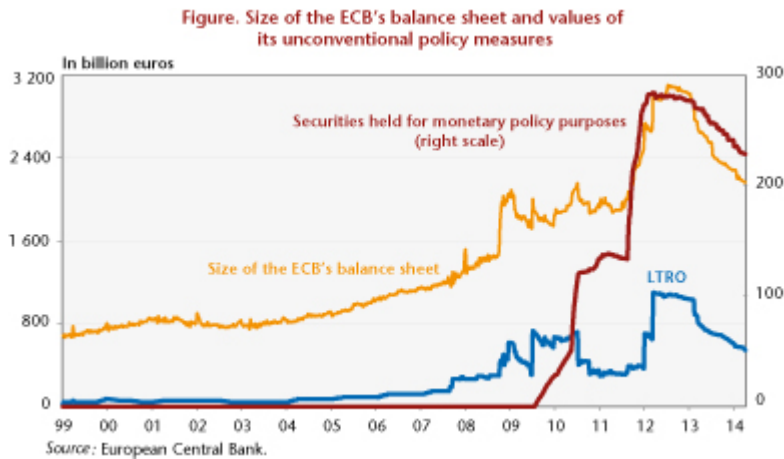
A final type of unconventional monetary policy involves conducting an easing policy that is both qualitative and quantitative: credit easing, *i.e.*, the size of the balance sheet of the central bank and the resulting risk increase in concert.

Unconventional monetary policies that are often attributed to the ECB include operations to provide long-term liquidity (3 years) at low interest rates, as was done in November 2011 and February 2012, and which were described as very long-term refinancing operations (VLTRO). But were these really unconventional large-scale operations? On the one hand, these operations involved not trillions of euros but an amount closer to 500 billion, which is not negligible after correcting for bank repayments to the ECB. On the other, the LTRO operations are part of the ECB's conventional policy arsenal. Finally, these operations were partially sterilized: the loans granted by the ECB to the commercial banks were offset by sales of securities by the ECB, thereby altering the structure of its assets. So we can conclude that the VLTRO operations were in part "conventional" and in part "unconventional".

The situation is different for the Securities Market Programme mechanism, which consisted, on the part of the ECB, of purchasing government debt on the secondary markets during the sovereign debt crisis. This mechanism led to increasing the size of the ECB's balance sheet, but also the risk involved: the policy of credit easing has indeed been an unconventional policy.

Given the different definitions of unconventional policy in current use, it is helpful to recall that the ECB explicitly indicates the amounts it has agreed within the framework that it sets for its unconventional policies, which are called Securities held for monetary policy purposes. These amounts are graphed in the figure below. They show the frequency and magnitude of the monetary activities that the ECB itself

defines as unconventional.



The three different measures shown in the figure (size of the ECB's balance sheet, LTRO amounts, and amounts of Securities held for monetary policy purposes) are expressed in billions of euros. The first two went up in the fourth quarter of 2008 after the bankruptcy of Lehman Brothers, whereas the third measure of unconventional policy started only in June 2009. We then see a new joint deepening of these measures at end 2011. Following this episode, the amount of LTRO operations came to 1090 billion euros, which represented about 50% of euro zone GDP (2,300 billion euros), i.e., about one-third of the ECB's balance sheet, while the amount of Securities held for monetary policy purposes was only 280 billion euros, or 13% of euro zone GDP, about a quarter of the LTRO operations. It is interesting to note that the ECB's monetary policy, which depends on the banks' demand for liquidity, changed in 2013. One can interpret the reduction in the balance sheet size as a sign of a less expansionary policy or as a reduction in the demand for liquidity from the banks. In the first case, this would indicate that the strategy for ending the monetary easing policy probably came too early in terms of the European economy – hence the recently evoked recourse to new unconventional measures.

Until then, these measures had been formally introduced to restore the channels for transmitting the ECB's monetary policy to the real economy, channels that in some euro zone

countries have been scrambled by the financial crisis and the euro zone crisis. The way to restore these channels was to inject liquidity into the economy and to increase the reserves of the banking sector in order to encourage banks to start lending again. Another objective of these policies was to send a signal to investors about the central bank's ability to ensure the stability and sustainability of the euro zone, as reflected in Mario Draghi's famous "whatever it takes" [\[1\]](#) statement on 26 July 2012.

In a recent working paper with Mathilde Viennot, we consider the effectiveness of conventional and unconventional policies during the financial crisis. We estimate how much the conventional instrument and the purchases of securities held for monetary policy purposes under the ECB's unconventional policies have affected interest rates and the volumes of new loans granted in various markets: loans to non-financial corporations, to households and on the sovereign debt market, the money market and the deposit market.

We show that unconventional policies have helped to reduce interest rates on the money market, on the government securities market and on loans to non-financial companies. These policies have not, however, affected the volume of loans granted. At the same time, it turns out that the conventional instrument, whose lack of effectiveness was one of the justifications for implementing unconventional measures, had the expected impact on almost all the markets surveyed, and more so in the southern euro zone countries than in the northern ones on the market for 6-month sovereign debt and for real estate loans to consumers.

So it seems that unconventional policies have had a direct impact on the sovereign debt market as well as indirect effects, helping to restore the effectiveness of the conventional instrument on other markets. One of the reasons that helps to explain the weak impact of both instruments on the volumes of loans granted is the need facing the commercial

banks [2] to shed debt and reduce the size of their balance sheets by adjusting their portfolio of risk-weighted assets, which has pushed them to increase their reserves rather than to play their intermediation role and to demand relatively higher compensation for each exposure taken.

Though legitimate, this behaviour is affecting the transmission of monetary policy: interest rates fall but lending doesn't restart. It thus seems important that monetary policy is not based exclusively on the banking sector. If there is a new round of unconventional operations, it should be focused directly on the acquisition of sovereign or corporate debt in order to bypass the banking sector. This workaround would undoubtedly lead to amplifying the transmission of monetary policy to the real economy. And it would be welcomed for helping to avoid the risk of deflation in the euro zone.[\[3\]](#)

[\[1\]](#) "The ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

[\[2\]](#) The reasoning behind unloading debt also applies to their customers: the non-financial agents.

[\[3\]](#) See the [post](#) by Christophe Blot on this subject as well as the recent [Council of Economic Analysis \(CAE\) report](#) by Agnès Bénassy-Quéré, Pierre-Olivier Gourinchas, Philippe Martin and Guillaume Plantin.