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Zero Interest Rate Policy and the Stability of the Banking Sector in the Eurozone

Symposium The Banking Union: The Interim Balance of an Ambitious Project

TU Berlin
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Volume of Central Bank Balance Sheets

Source: IMF.
Content

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1. The Origin of the Crisis

Global Context
- Asymmetric monetary policy since the late 1980s.
- With zero interest rates, unconventional monetary policies.
- Japan front-running euro area by 15 years.

Monetary Policy in a Heterogenous Monetary Union
- Since 2001 interest rate cuts in response to the bursting dotcom bubble.
- Germany: Hartz-Reforms to comply with Maastricht criteria, which boost savings and depress investment.
- One-sided capital flows from Germany to the southern euro area trigger overinvestment, speculation and consumption booms as represented by growing current account deficits and rising international debt.
Divergence from Taylor-Rule Benchmark in Eurozone

Source: ECB, Oxford Economics, OECD.

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Public Expenditure Paths after Euro Introduction

Source: Oxford Economics.

Index: 1999=100

Deutschland
Griechenland
Italien
Irland
Portugal
Spanien
Eurozone

Source: Oxford Economics.

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Real Estate Prices in a Dysfunctional Monetary Union

Source: Oxford Economics.

Spain, l.h.s.

Germany, r.h.s.

Index: 1980 = 100

Source: Oxford Economics.
Stock Indices: Germany and Spain

Source: Thompson Reuters.
2. Lessons from Japan

The Bubble Economy
• Interest rate cuts in response to post-Plaza yen appreciation triggered speculation in stock and real estate markets (1985-1989).
• The bursting of the bubble tempted the Bank of Japan to interest rate cuts to zero and unconventional monetary policy.
• Since 2013, under the so-called Abenomics (アベノミクス) the central bank balance sheet inflated to ~100% of GDP.

Monetary Transmission Disturbed
• Carry trades cause new bad loans (vulnerable to international financial cycle).
• Paralyzed money market.
• Damaged commercial banks:
  – bad loans (only cleared from 1998),
  – shrinking margins (e.g. credit-deposit spread),
  – declining credit demand, growing deposit-loan ratios.
• Concentration process sets in (convoy approach).
Japan: Interest Rate, Credit Growth and Real Growth

Source: Bank of Japan, 3-year moving averages.
Japan: Margins in Bank Business

Source: IMF.
Japan: Number of Banks

Source: Japanese Bankers Association (日本銀行協会).

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3. European Crisis Response

Conventional Monetary Policy
• Interest rate cuts to zero (main refinancing rate).

Unconventional Monetary Policy
• Full allotment at eased collateral requirements (T(LRO)).
• Negative interest rates on deposits at central bank.
• Forward guidance: ”whatever it takes”.
• Purchases of government and corporate bonds.

Regional Monetary Policy
• Discretionary rescue schemes: ELA, EFSF, EFSM, ESM, etc.
• TARGET2,
• ANFA,
• (T)LTROs.

Tightened Regulation
• Basle III,
• ECB Banking Supervision (SSM, 130 largest banks).
Money Market Rates Germany/Eurozone and Japan

Source: Deutsche Bundesbank, Bank of Japan.
(T)LTROs as Rescue Measures for Banks

(T)LTRO Operations

- LTRO (12/2011 und 02/2012): €529 + €489 bill. (1%)
- TLTRO I (2014): 399 Mrd. (-0,4% - 0%, depending on use)
- TLTRO IIa,b,c,d (06/2016- 03/2017): (€399 bill. + €45 bill. + €62 bill. + €216 bill.)

Rescue Measures for Weak Southern Eurozone Banks

- Loss of deposits in southern euro area banks would have been to be compensated by costly credit raised on money markets.
- With long-term refinancing operations the banks can sell credit to the central bank to raise liquidity.
- Credit to enterprises can be prolonged or new credit can be provided at the same interest rate like the stronger banks.
- (T)LTROs support weaker banks, which are clustered in the southern eurozone (Spain 25%, Italy 33%, France 16%).
- Consolidation process postponed.
Commercial Bank Credit and TARGET2 Balances of Spain

Source: Banco de España, Deutsche Bundesbank.
4. The Impact on the Banking Sector Compared to US

Conventional Monetary Policy
• US: key interest rate at zero by 2009, increasing since 2016.
• EA: key interest rate at zero by 2012, zero since then.

Unconventional Monetary Policy
• Heterogenous European monetary union, i.e. idiosyncratic intra-EMU business cycles require an implicit regional redistribution mechanism.
• US: Fed balance sheet expanded to 24% of GDP by 2014, contracting since then.
• EA: Balance sheet expanded to 44% of GDP by 2019.
• US: 50% of asset purchases risky securitized loans.
• US: Trouble Asset Relief Program (TARP) removes bad assets from banks’ balance sheets ($475 bill.)
• EA: Asset purchase programs (~€3000 bill.) rescuing more indebted governments than banks.
Remuneration of Reserves and Supervision

Remuneration of Reserves at Central Bank
- US: positive, increasing to 2.4%: $95 billion to US banks
- EA: negative, falling to -0.4%: €20 bill. from German banks to ECB.
- Net interest earnings of German banks decline (€66 bill. to €20 bill).

Bank Supervision
- US & EA: supervision and reporting requirements tightened.
- US: Proprietary trading remains possible via money market funds.
- EA: Proprietary trading strongly restricted.
- US: 541 insolvent financial institutions closed.
- EA: Bank failures rare.
- US: Bad assets removed from banks’ balance sheets.
- EA: Large amounts of bad assets remain in banks (Deutsche Bank).
- US: Bad loans: 2%
- EA: Bad loans: GR: 45% CY: 28%, IT 10%, ES: 4%, PT: 12%, DE: 2%.
- EA: Risks ignored (BBVA, Carige, Monte dei Paschi, Dexia).
Outstanding Debt of German Non-financial Corporations

Source: Datastream Financial Equity Indices.
Failed E(M)U Macroeconomic Management

Germany
• The combination of low interest rates and (still) relatively tight fiscal and wage policies keep net capital outflows high (current account surplus redirected to US).
• This weakens the purchasing power of consumers and government (investment deadlock) and therefore domestic enterprises and banks.

Southern Euro Area
• The „Six Pack“ imposes fiscal austerity, which accelerates capital outflows (=capital flight).
• The capital outflows have been partially compensated by TARGET2 inflows (ECB government bond purchases).
• This weakens domestic enterprises and banks.

US
• Tax cuts and successful financial stabilization measures attract capital inflows,
• which stabilizes via the domestic business activity domestic banks.
Stock Prices of Financial Institutions

Source: Datastream Financial Equity Indices.
5. The Impact on the Real Economy

Link between Banks and the Real Economy
- Banks don’t create value added, they ensure the efficient allocation of capital.
- With the extensive monetary policy rescue measures, the capital allocation efficiency in the euro area is disturbed.

Declining Productivity (Increases) (Schnabl 2015)
- Structural distortions are conserved by benign liquidity conditions (Schumpeter 1911, Hayek 1929, Hoffmann und Schnabl 2016).
- Forbearance lending (Sekine, Kobayashi und Saita 2003).
- Zombie lending (Caballero, Hoshi und Kashyab 2008).
- Evergreening (Peek und Rosengreen 2005).
- Soft budget constraints (Kornai 1986).
Soft Budget Constrains and Zombification
Productivity Gains in Europe

Source: OECD, IMF.

Germany - UK - France - Italy - Spain - Greece

Percent


Source: OECD, IMF.
IEP Index on Political Polarization in EU28

Source: Institute for Economic Policy, University of Leipzig.
Thank you very much for your attention!

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