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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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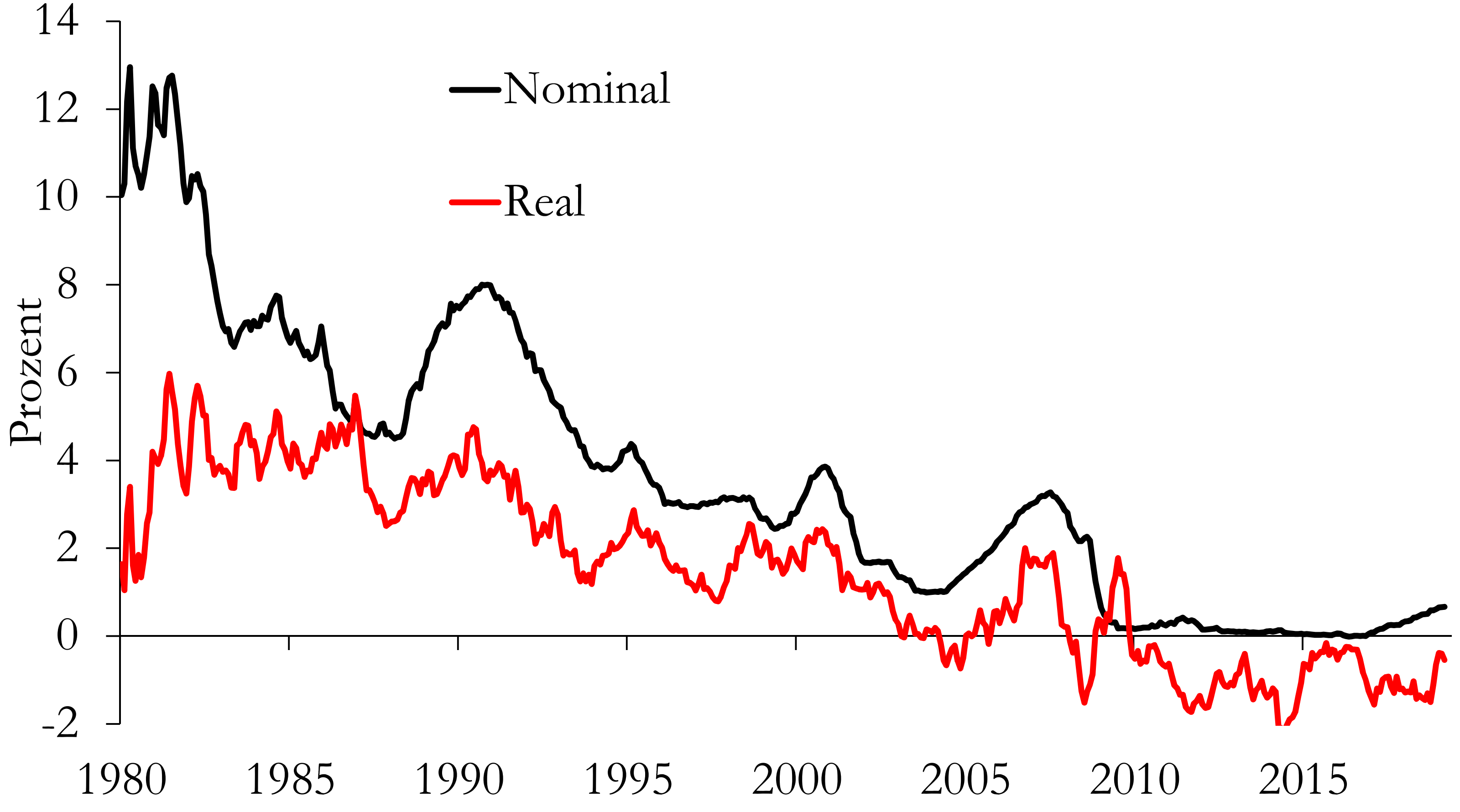
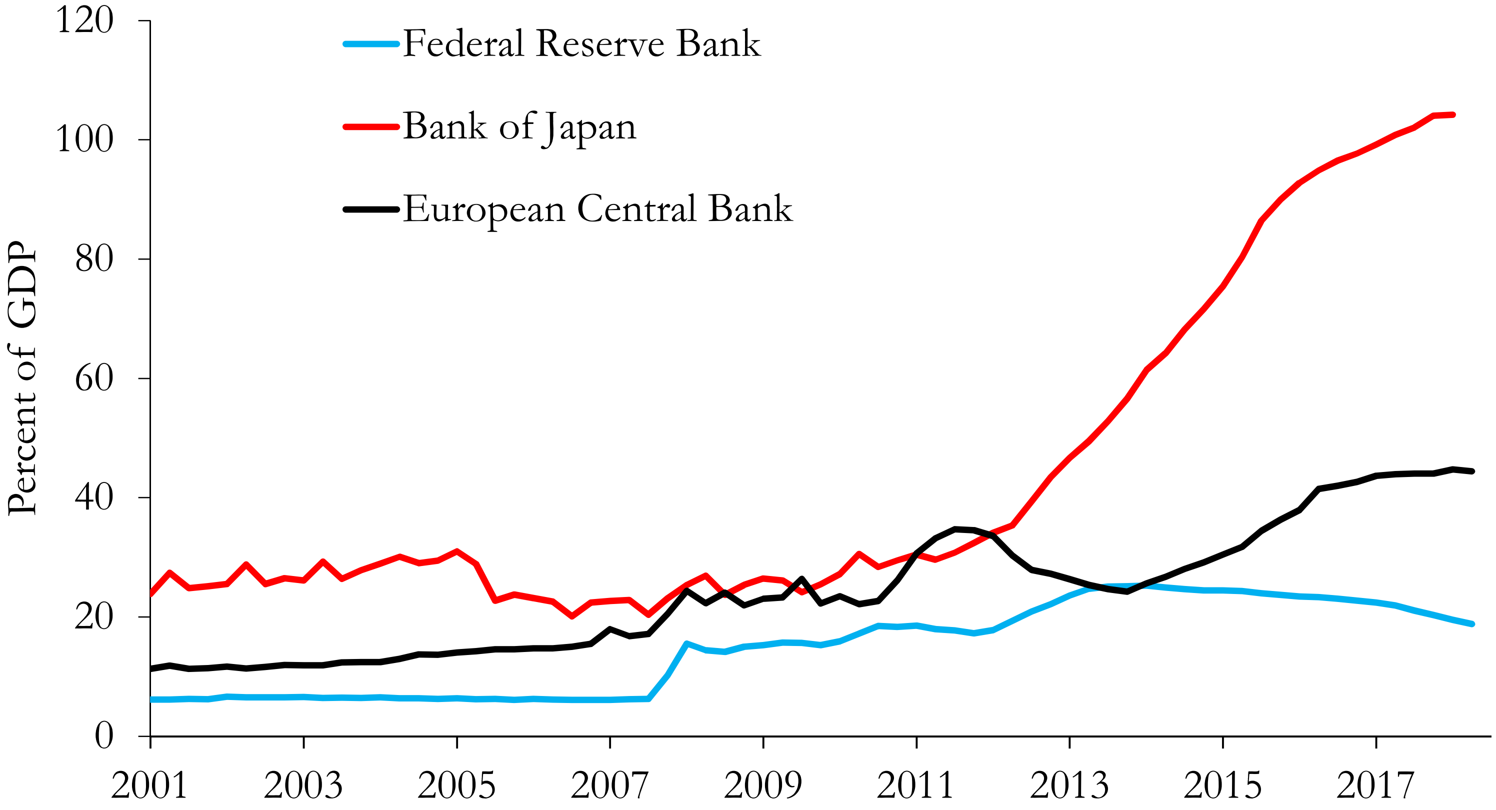
The Global Context: G3 Money Market Rates



Source: IWF: IFS, Arithmetic Averages.

Volume of Central Bank Balance Sheets



Source: IMF.

Content

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2. Lessons from Japan
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4. The Impact on the Banking Sector Compared to the US
5. Policy Implications

Gerstenberger, Juliane / Schnabl, Gunther 2017: The Impact of Japanese Monetary Policy Crisis Management on the Japanese Banking Sector. *CESifo Working Paper 6440*.

Hoffmann, Andreas / Schnabl, Gunther 2016: The Adverse Effects of Unconventional Monetary Policy. *Cato Journal 36, 3*, 449-484.

Schnabl, Gunther / Stratmann, Thomas 2019: Unlike the Fed the ECB Leaves Euro Area Banks Unprepared for the Downswing. Blog "*Think Markets*", 25.2.2019

Schnabl, Gunther 2018: Exit Strategies from Monetary Expansion and Financial Repression. *Cato Journal 38, 2*, 447-466.

1. The Origin of the Crisis

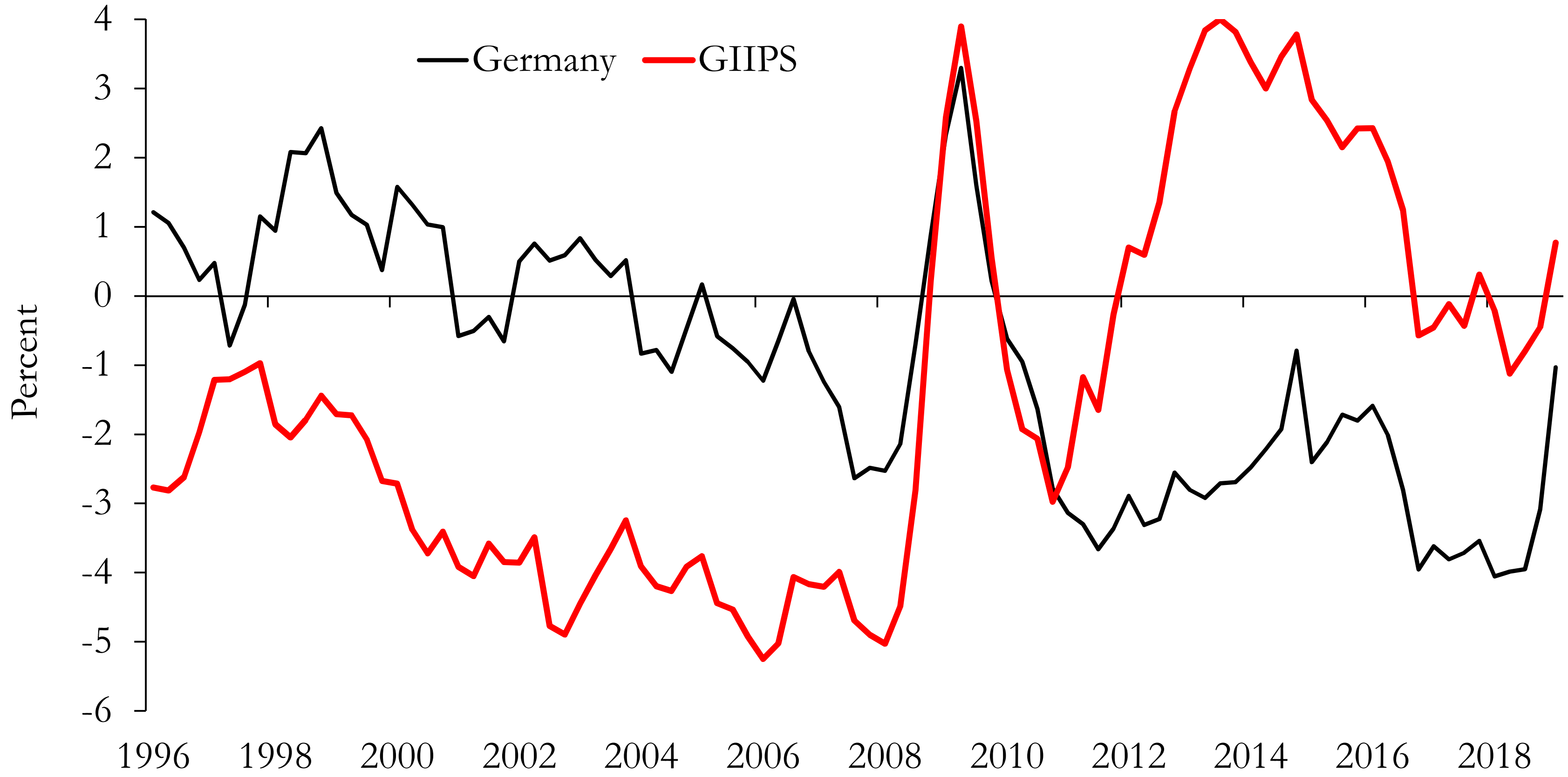
Global Context

- 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

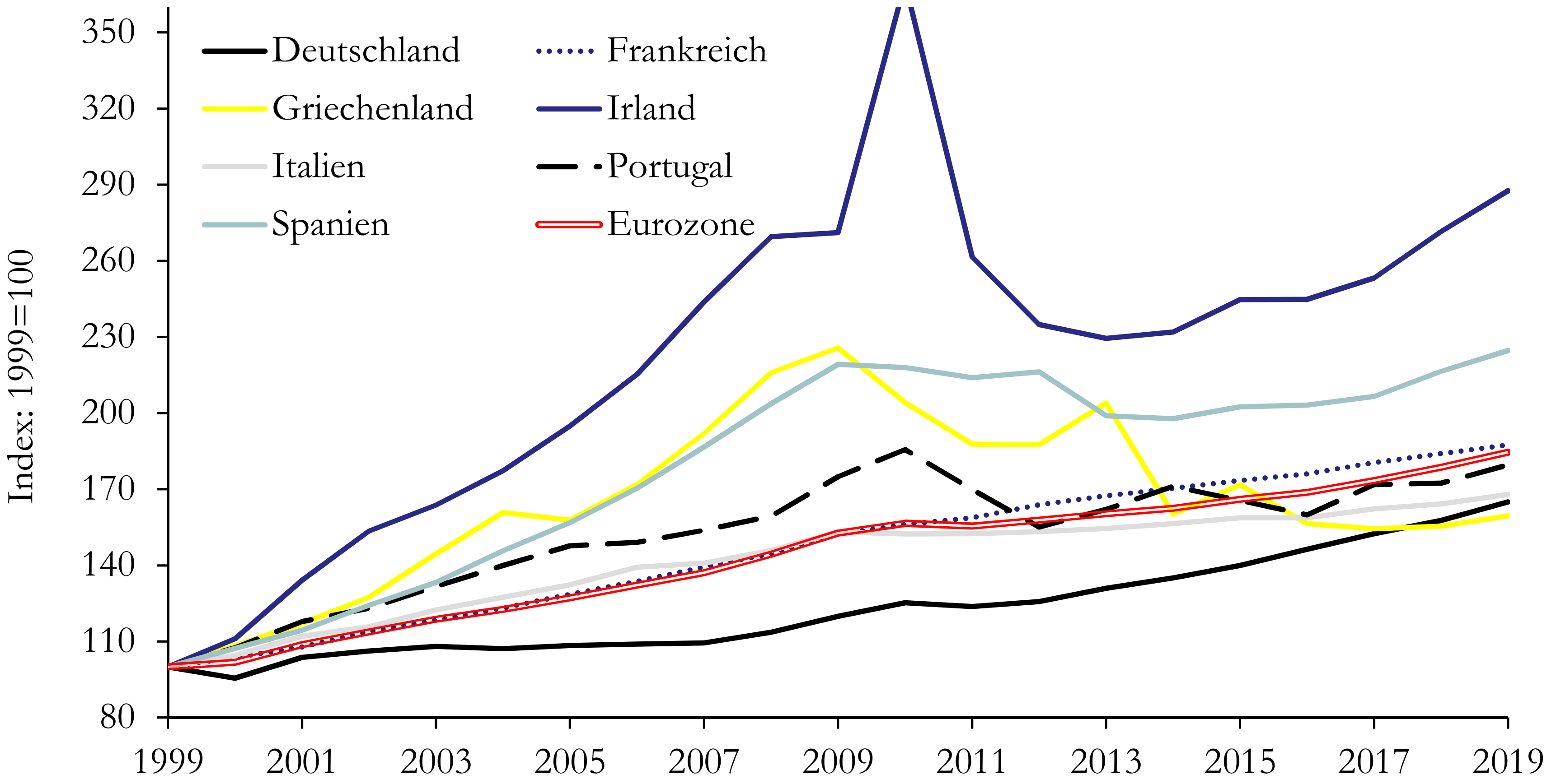
- Since 2001 interest rate cuts in response to the bursting dotcom bubble.
- Germany: Hartz-Reforms to comply with Maastricht criteria,
- which boost savings and depress investment.
- One-sided capital flows from Germany to the southern euro area
- trigger overinvestment, speculation and consumption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

Divergence from Taylor-Rule Benchmark in Eurozone



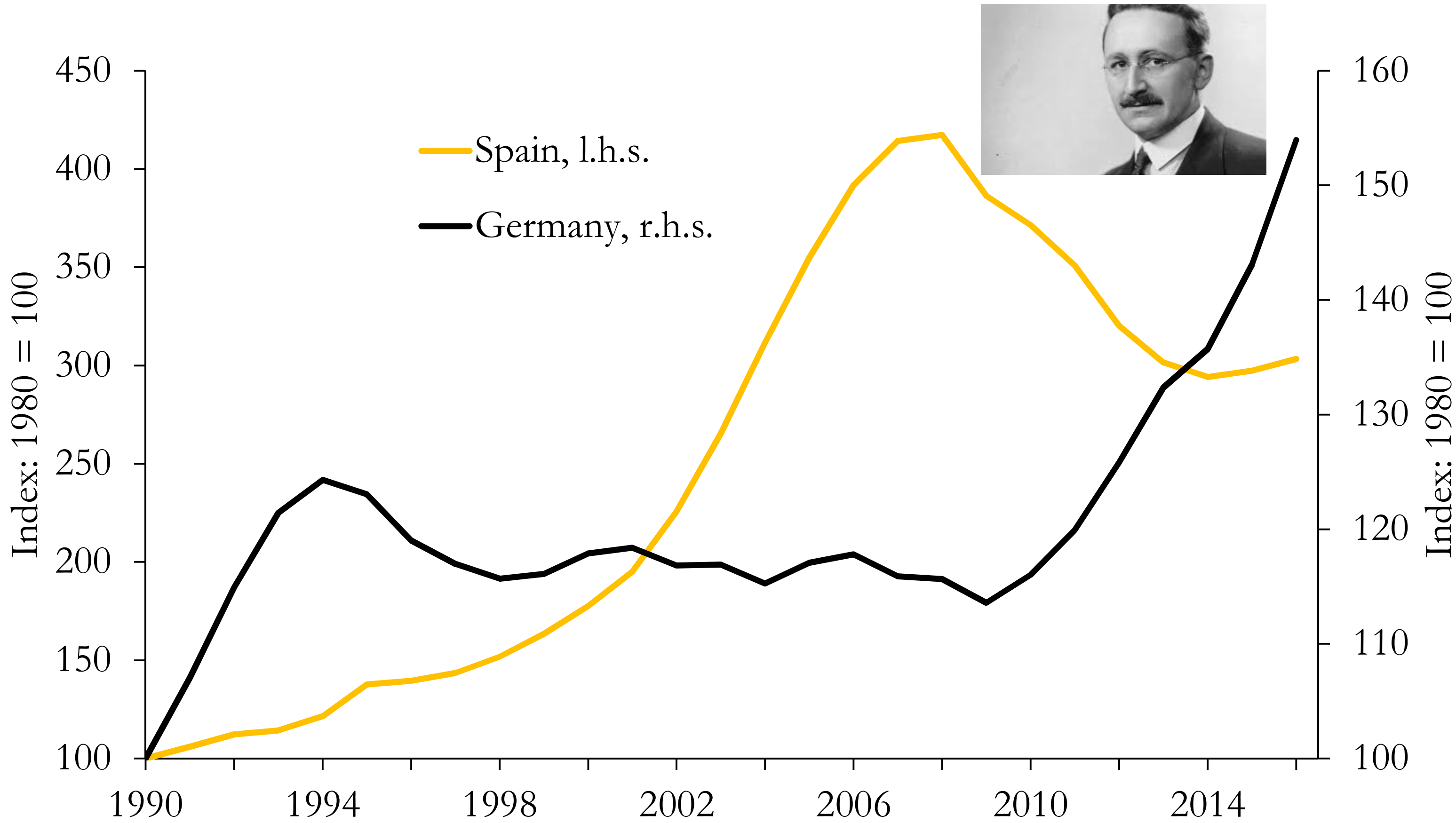
Source: ECB, Oxford Economics, OECD.

Public Expenditure Paths after Euro Introduction



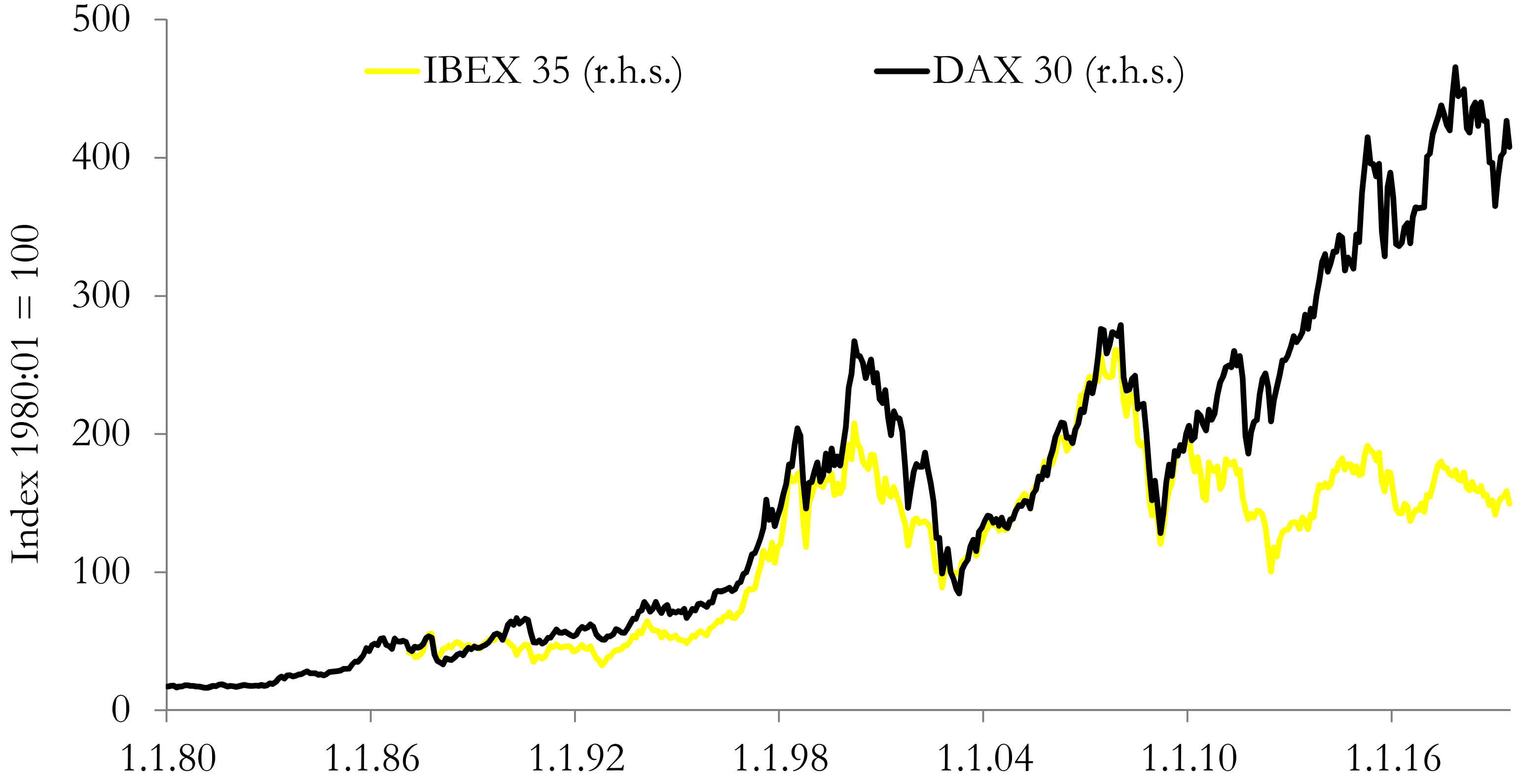
Source: Oxford Economics.

Real Estate Prices in a Dysfunctional Monetary Union



Source: Oxford Economics.

Stock Indices: Germany and Spain



Source: Thompson Reuters.

2. Lessons from Japan

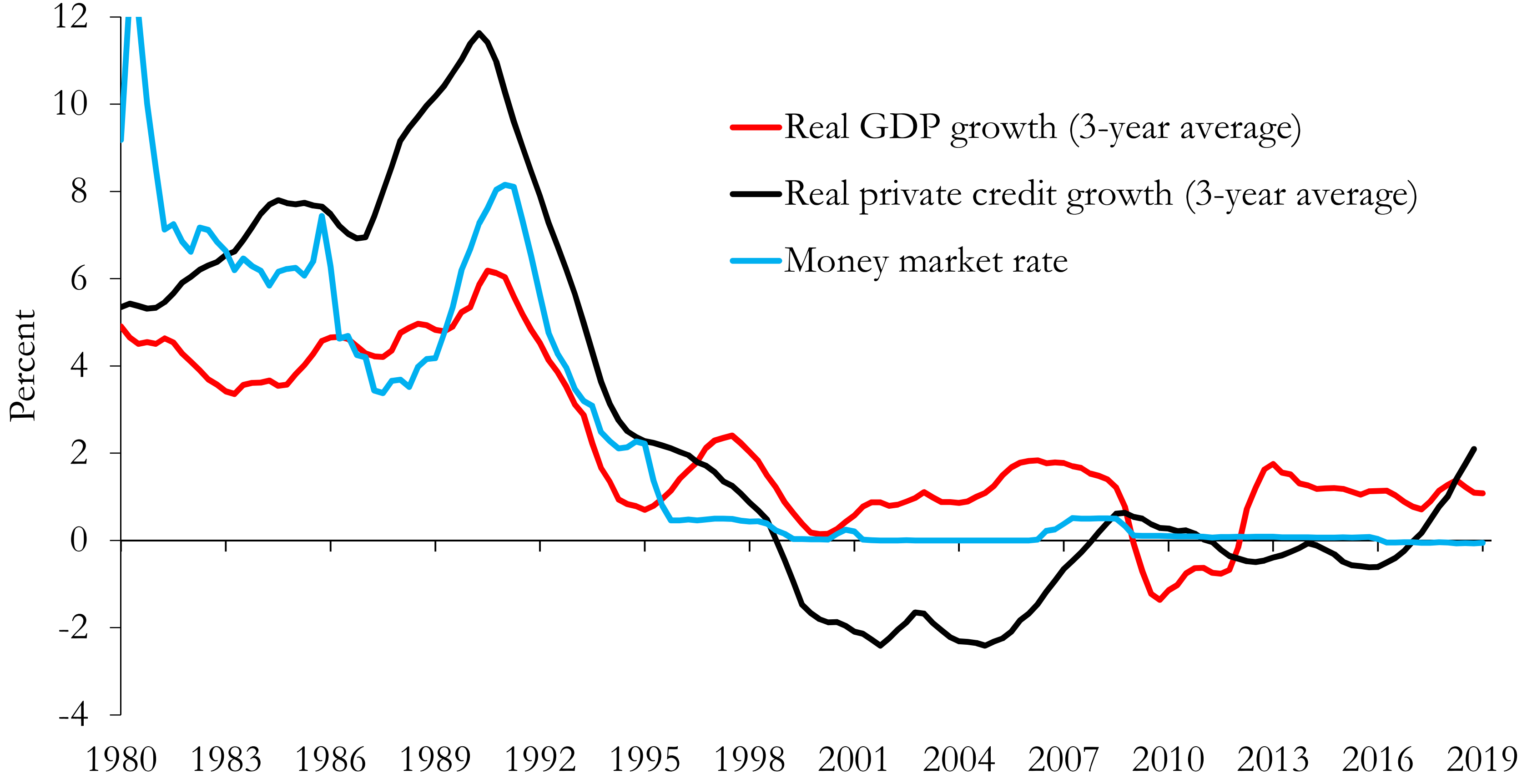
The Bubble Economy

- 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

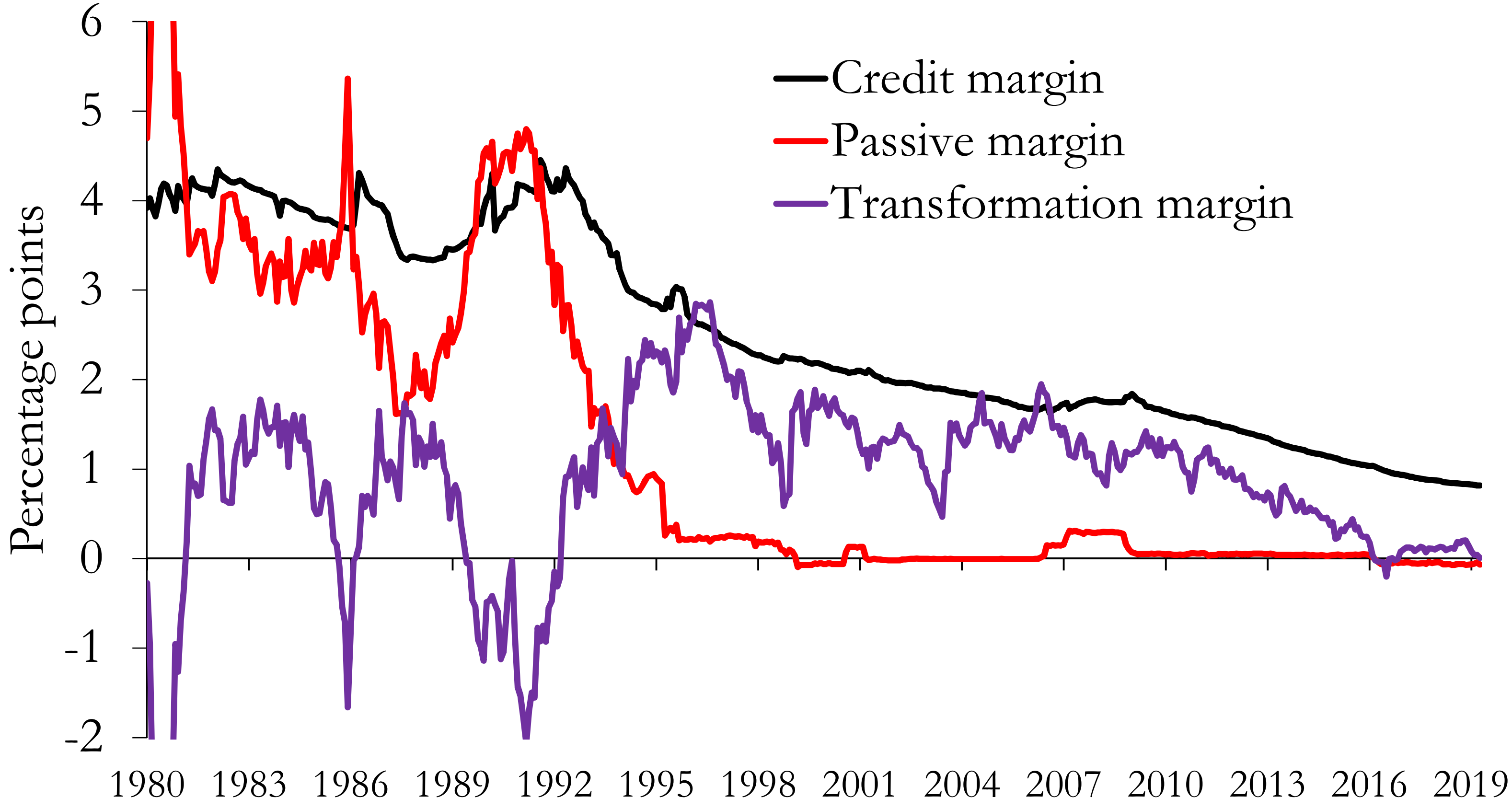
- Carry trades cause new bad loans (vulnerable to international financial cycle).
- Paralyzed money market.
- Damaged commercial banks:
  - bad loans (only cleared from 1998),
  - shrinking margins (e.g. credit-deposit spread),
  - declining credit demand, growing deposit-loan ratios.
- Concentration process sets in (convoy approach).

Japan: Interest Rate, Credit Growth and Real Growth



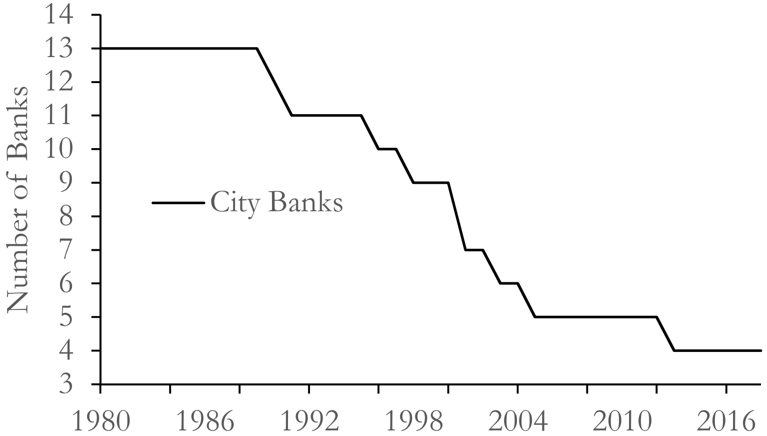
Source: Bank of Japan, 3-year moving averages.

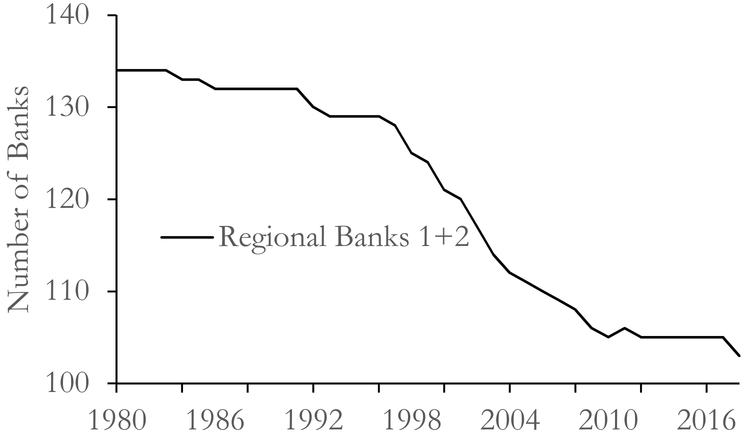
Japan: Margins in Bank Business

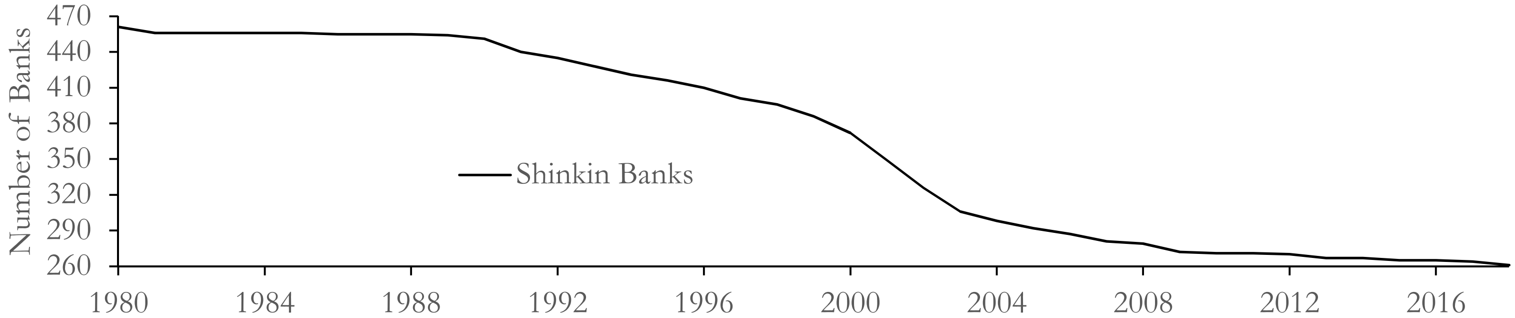


Source: IMF.

Japan: Number of Banks







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

3. European Crisis Response

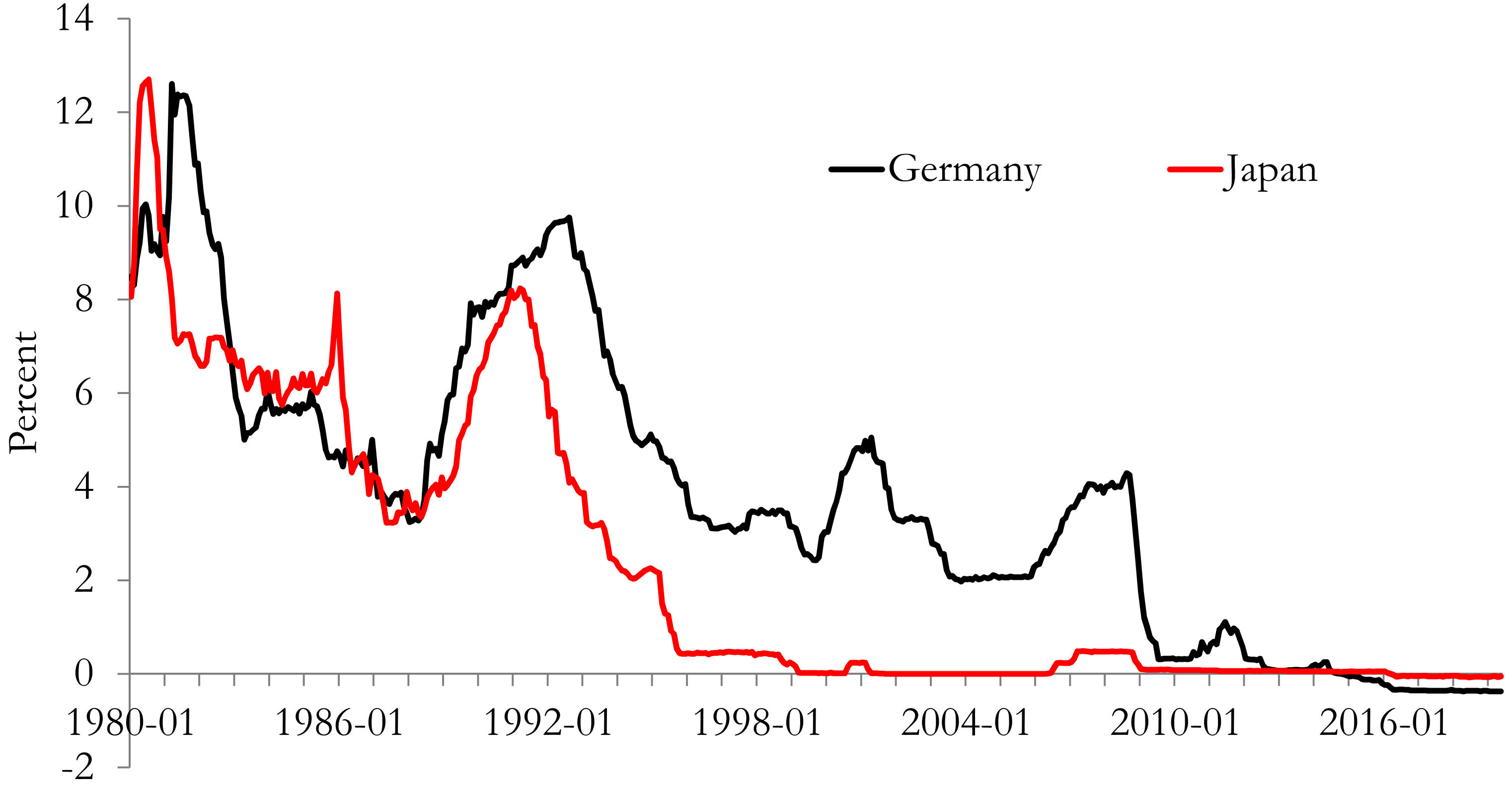
Conventional Monetary Policy
- Interest rate cuts to zero (main refinancing rate).

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



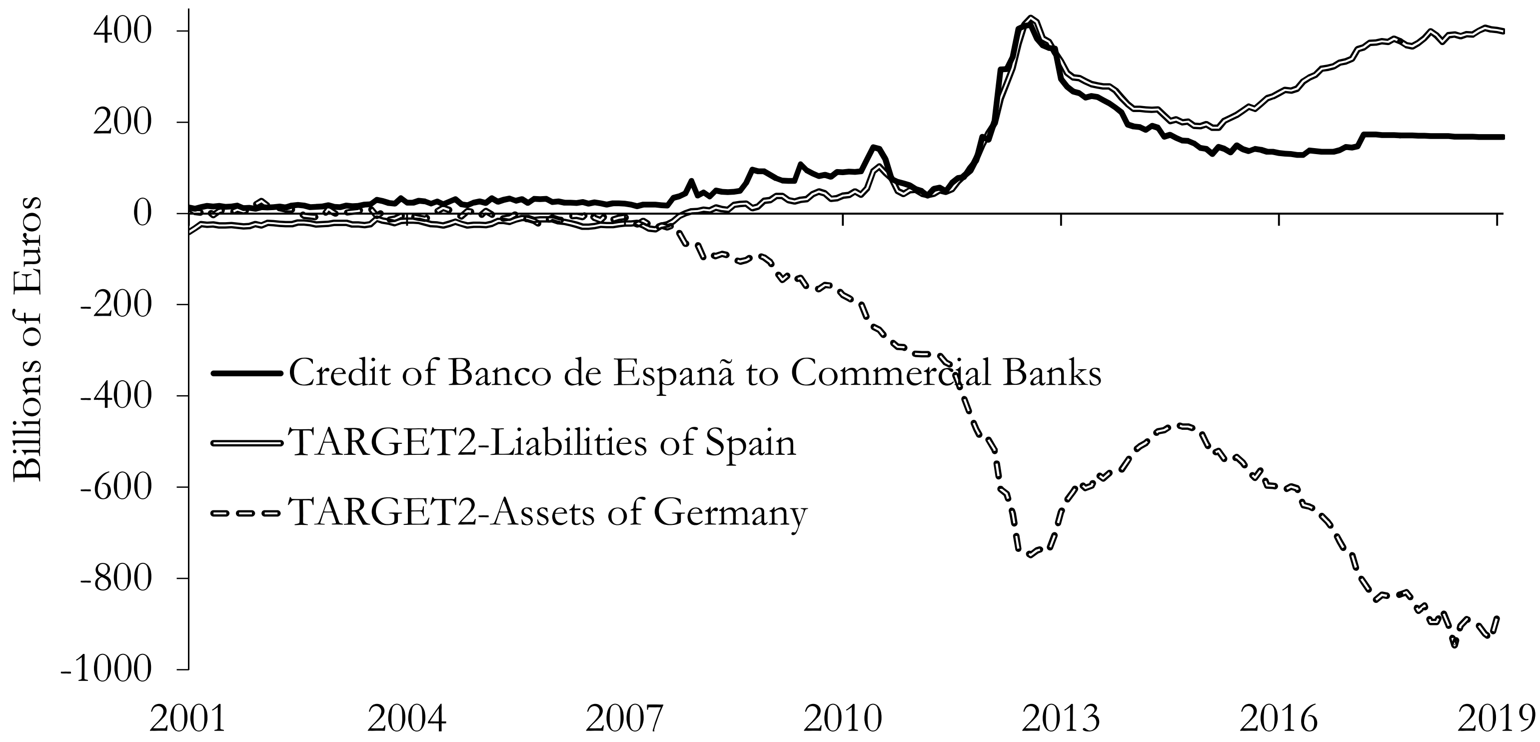
Source: Deutsche Bundesbank, Bank of Japan.

(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.)
- TLTRO III (announced March 2019): €720 bill. from Sept. 2019.

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

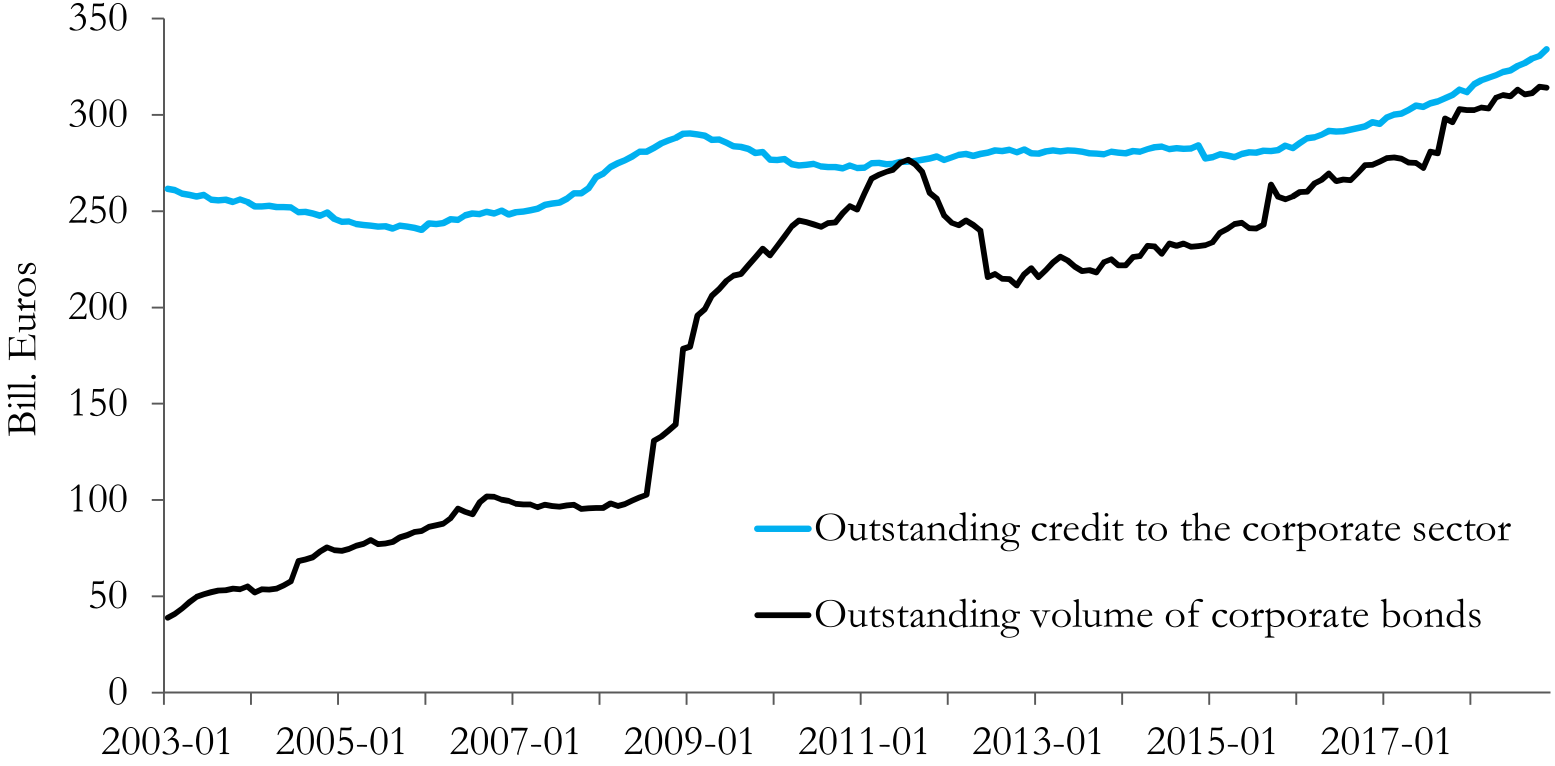
Remuneration of Reserves at Central Bank

- 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 Mangement

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.

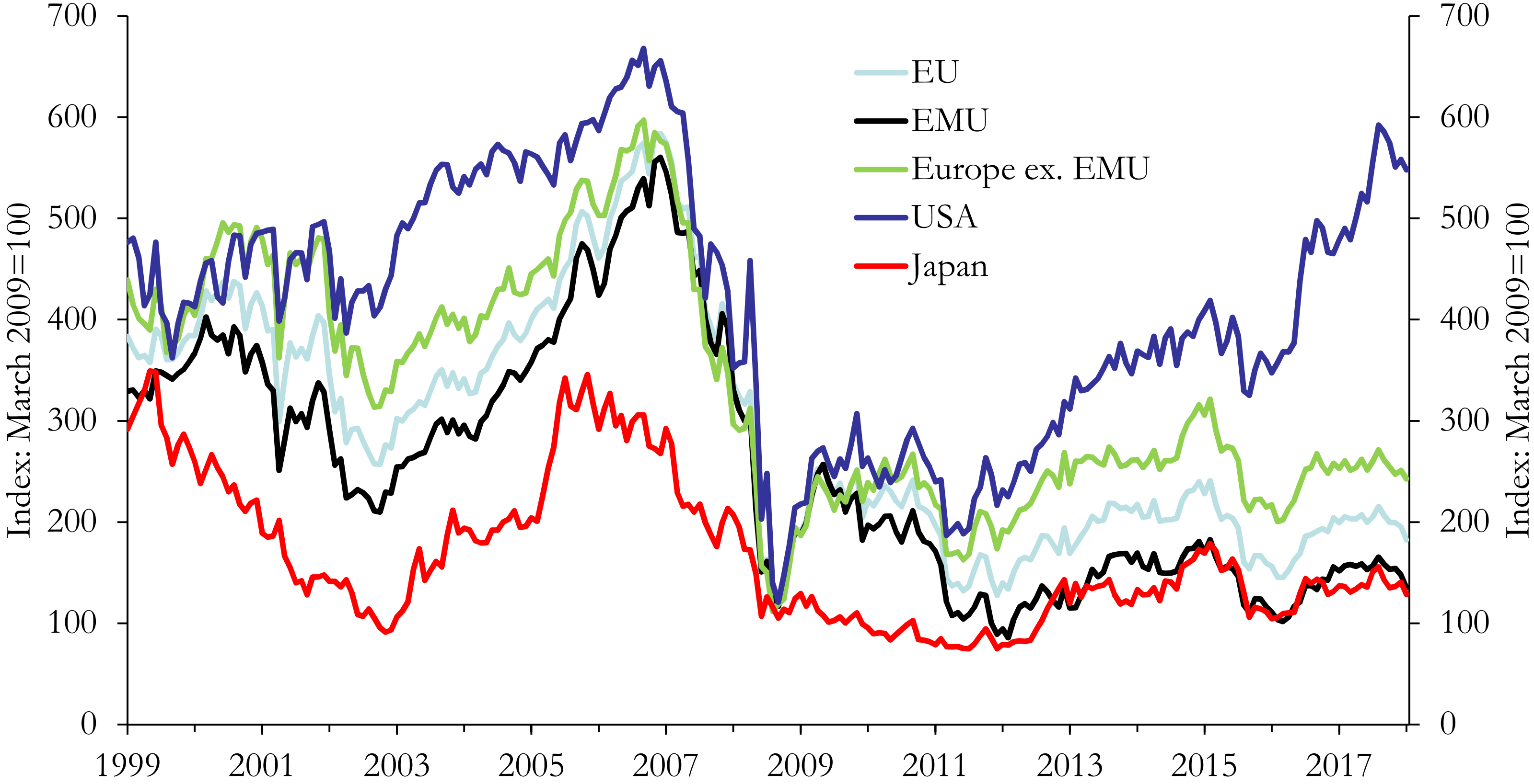
Southern Euro Area

- 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 measueres 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

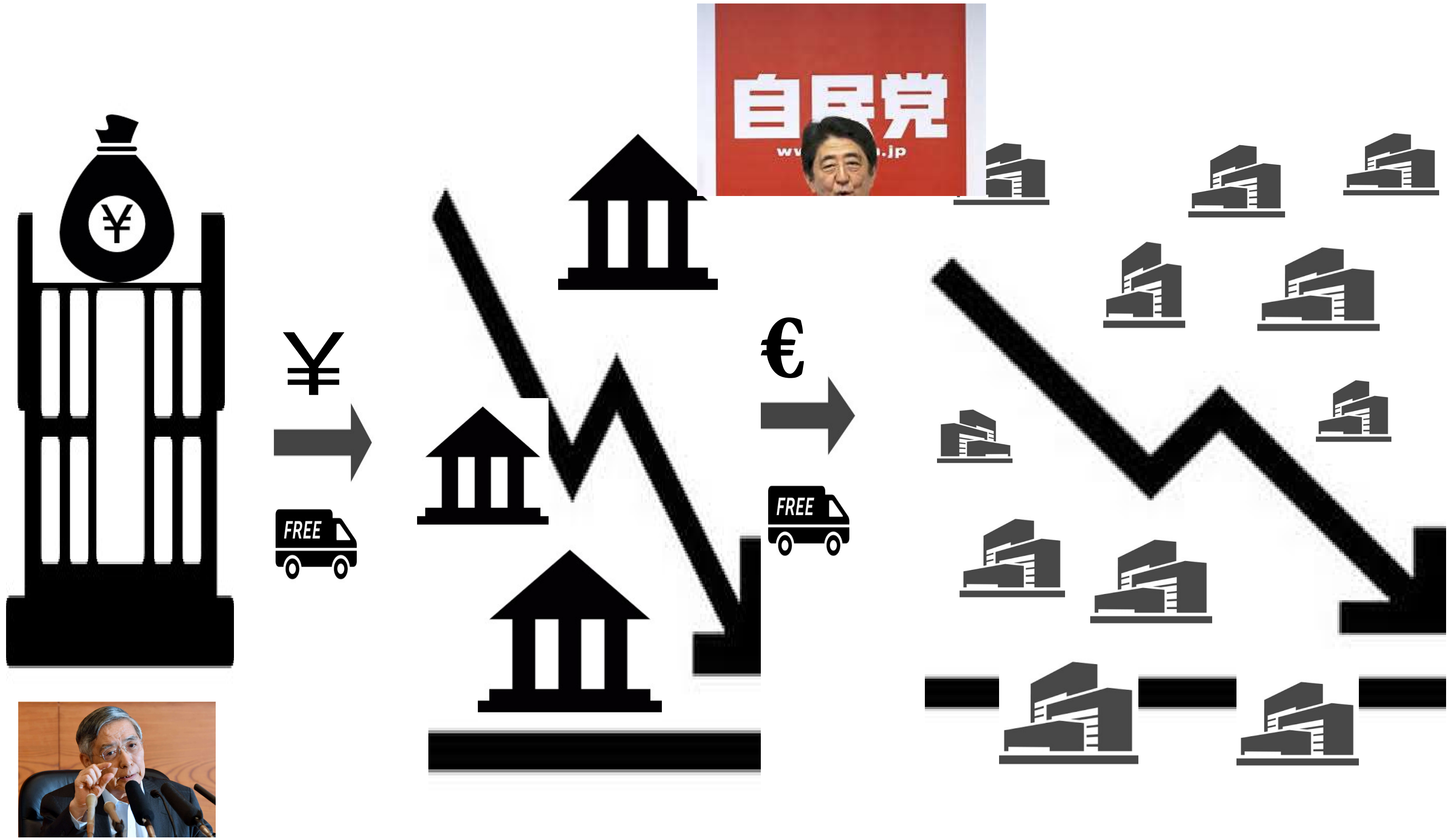
Link between Banks and the Real Economy

- 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.

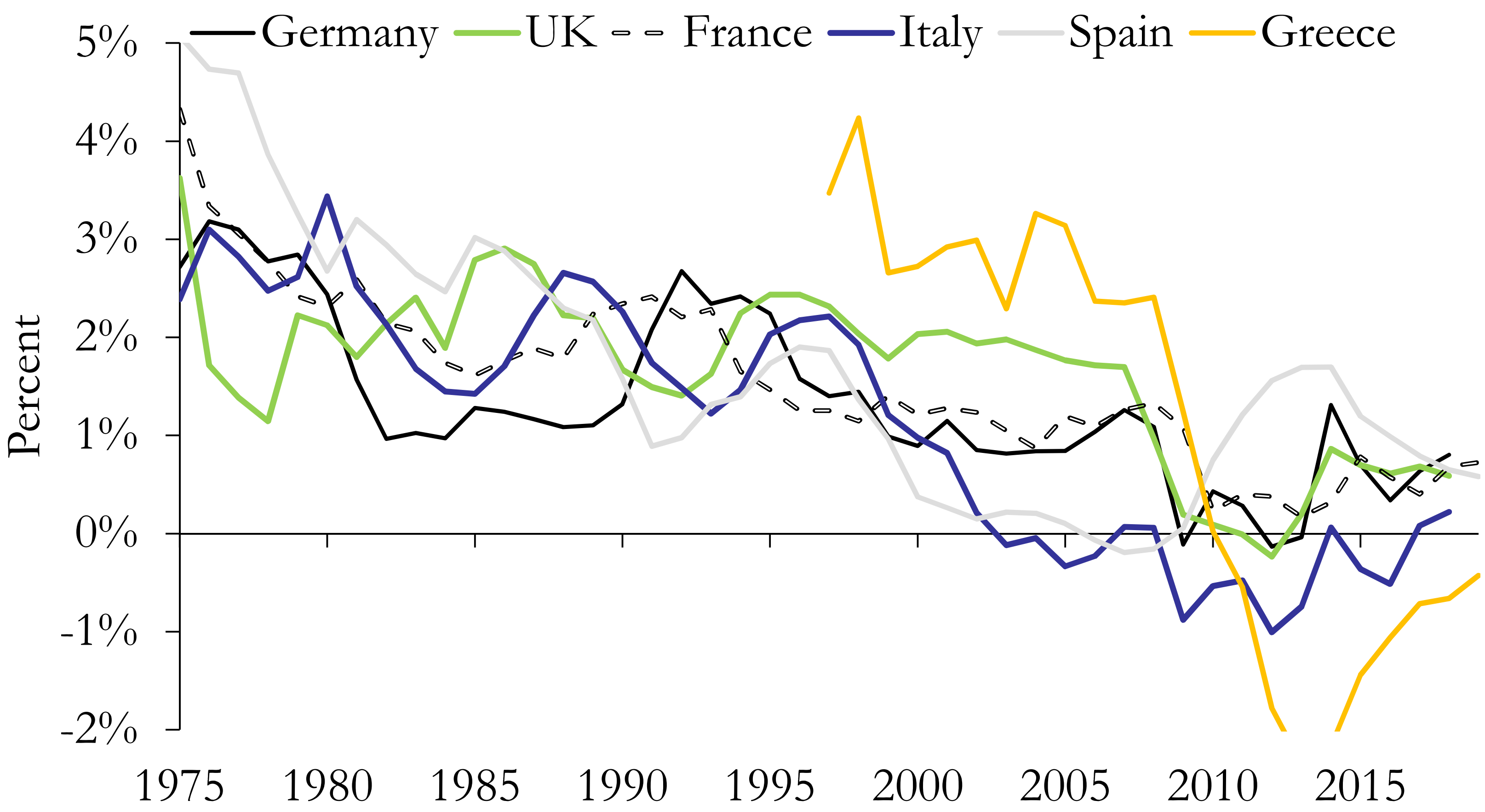
Declining Productivity (Increases) (Schnabl 2015)

- 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)*.
- *Walking dead* (McGowan, Andrews and Millot 2017)
- *Soft budget constraints* (Kornai 1986).

Soft Budget Constrains and Zombification

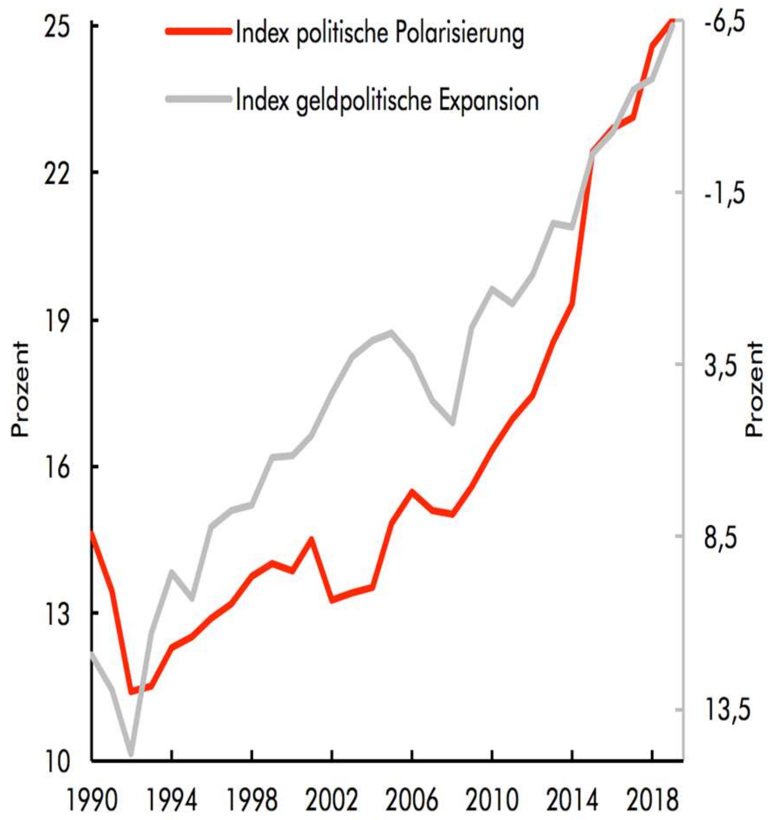


Productivity Gains in Europe



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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