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IW Monetary Outlook December 2015

Weak Credit Growth Hinders Eurozone Inflation to Increase

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Content

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Executive Summary

While the ECB still struggles with an impaired bank lending channel of monetary transmission, the Fed successfully fought the labor market slack that was caused by the great recession of 2008. Due to the improved labor market, the Fed can now start its gradual interest rate lift-off. The ECB will increase its stance of policy accommodation instead, since low interest rates still do not translate into higher inflation. On the contrary, inflation and interest rates are decreasing in tandem. The reason for the impaired monetary transmission channel was originally the banking and sovereign debt crisis in the Eurozone, but the impairment of monetary transmission is now caused by banks' reduction in risk-weighted assets, which are an effect of the implementation of the new Basel III capital ratios. Instead of lending to businesses and households banks increased their exposure to sovereigns. This effect is due to the preferential treatment of sovereign debt in bank regulation and is exacerbated by the low interest rate environment. As long as credit growth does not contribute to the growth of money, reducing interest rates even further will not bring inflation back to its target value. It seems more and more that banks' capital regulation hinders the credit channel of monetary transmission to function, on which the ECB has to react by further increasing policy accommodation. It seems doubtful that further policy rate cuts into the negative territory will increase bank lending as long as bank lending is restricted by a lack of equity capital. For inflation to return to normal, banks' capital regulation has to be adjusted in such a way that the credit channel of monetary transmission is working properly again. For achieving this, the abatement of the preferential treatment of sovereign debt in bank regulation is highly necessary. Based on our analysis, we expect the ECB to cut its main refinancing rate into negative territory and the deposit rate further into negative territory. Moreover, we expect the ECB to enlarge its asset purchase program for one additional year. For the Fed we expect a gradual adjustment of the Federal Funds Rate corridor by 0.25 percentage points at each of the subsequent open market committee meetings.

Table 1: IW Monetary Outlook December 2015

Interest rates, in percent

	October 2014	**October 2015**	**Forecast for Dec. 2015**	**Forecast for Jan. 2015**
ECB Main Refinancing Rate	0.05	0.05	-0.05	-0.05
Federal Funds Rate Target	0.00 – 0.25	0.00 – 0.25	0.25 – 0.50	0.50 – 0.75

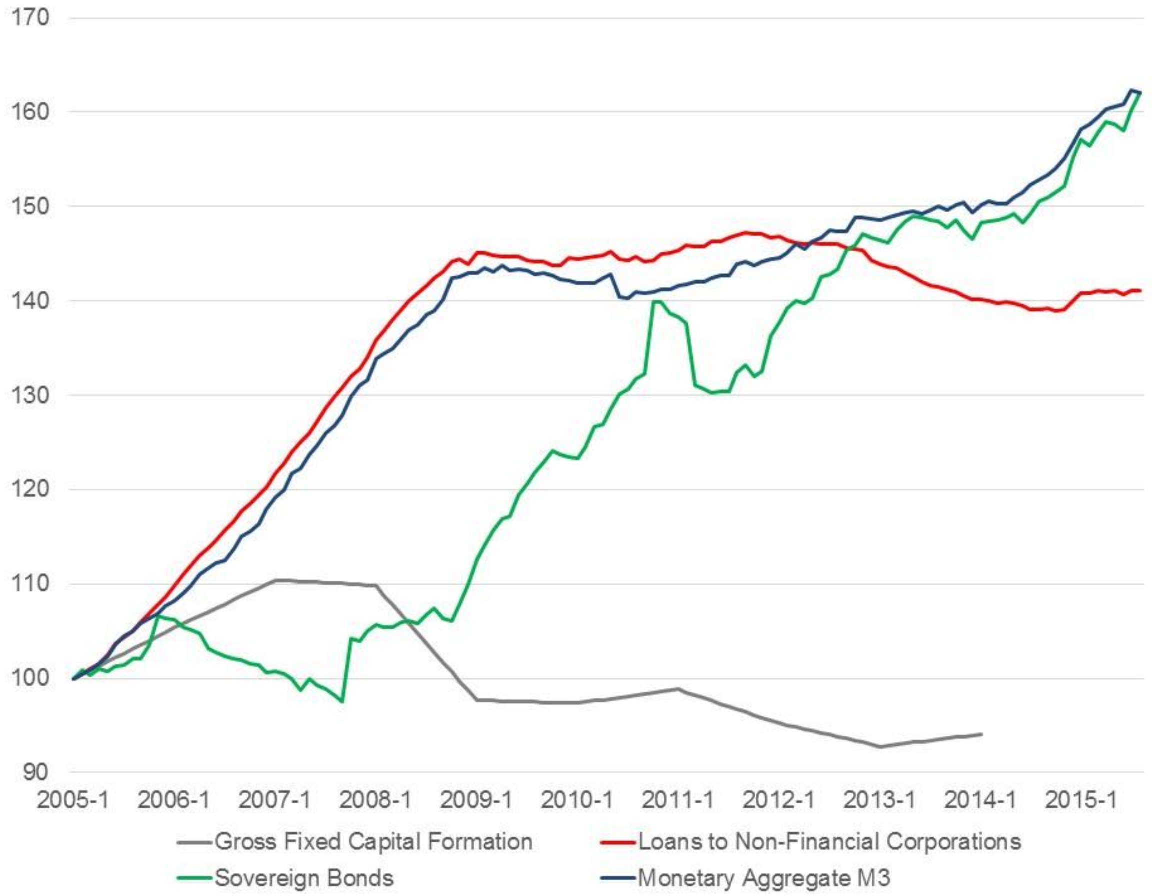
Sources: European Central Bank, Federal Reserve Bank of St. Louis, Cologne Institute for Economic Research

1. Low Investment Demand and Low Credit Growth

On December 3, 2015 the Governing Council of the European Central Bank (ECB) will meet for the last time this year, while the Federal Reserve Bank's (Fed's) Federal Open Market Committee (FOMC) last meeting is on December 15 and December 16. Based on recent central bank communication, the Fed is expected to start its gradual exit from low interest rates, while the ECB is will likely intensify its accommodative monetary policy stance. The difference in the policy moves of both central banks is related to the different credit dynamics in the US and the Eurozone. While money and credit are both growing in the US, credit and money are diverging in the Eurozone indicating a still disturbed bank lending channel of monetary transmission. This impaired transmission channel hinders the ECB to reach its policy objective of a medium term inflation rate of below but near 2 percent.

Figure 1: Money and Credit in the Eurozone

Index: 2005-1 = 100

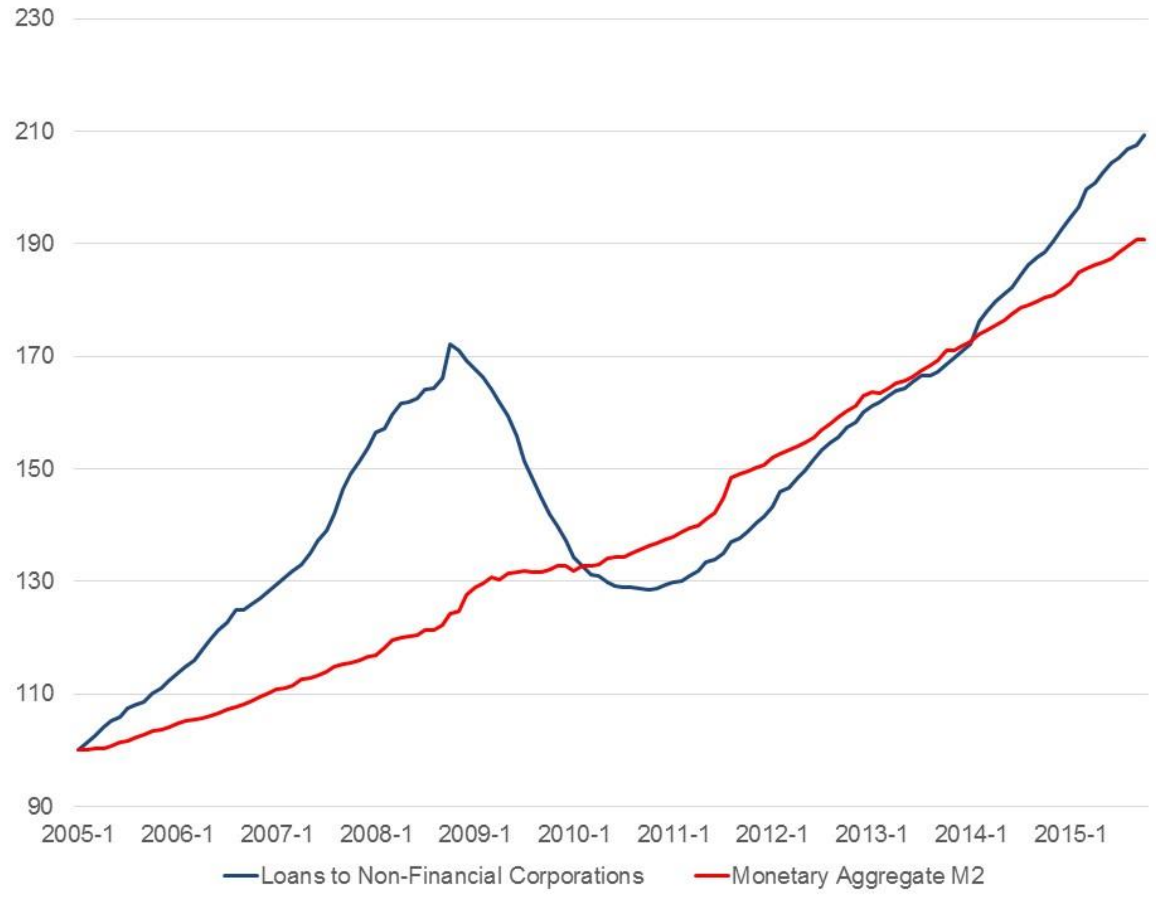


Source: European Central Bank, Cologne Institute for Economic Research

The dynamics of the monetary aggregate M3 in the Eurozone is predominantly driven by banks' exposures to sovereign debt, while money seems to be decoupled from the dynamics of credit (figure 1). While the monetary aggregate M3 and loans to non-financial companies have moved in tandem in the past, both time series seem to diverge now. Part of the stagnating credit growth is related to stagnating investment dynamics. But from the declining investment series cannot necessarily be concluded that the weak credit dynamics are only caused by the weak investment dynamics, since both time series are the result of the intersection of the demand for loans and the supply of loans. While part of the weak investment dynamics is due to companies' investment inattention, the other part is due to banks' restrictive loan supply. In addition to that, also credit is determined by the intersection of loan demand and loan supply. While loan demand can be weak due to companies' investment inattention, loan supply can be weak because of banks' restrictive credit policies.

Figure 2: Money and Credit in the US

Index: 2005-1 = 100



Source: European Central Bank, Cologne Institute for Economic Research

A juxtaposition of figure 1 with figure 2 indicates, that the problem of weak credit growth is more special to the Eurozone and does not apply to the US. While the ECB is still confronted with an impaired bank lending channel, the Fed was merely confronted with a labor market slack which was caused by the great recession of 2008 and which could be well tackled with quantitative easing. In contrast to this, the ECB's quantitative easing might not be successful in achieving inflation and growth as long as the bank lending channel in impaired. Since purchasing sovereign debt from banks does not free equity capital which can be used for lending to non-financial corporations, bank regulation might hinder monetary transmission.

That banks deleveraging and de-risking are a dominant driver of banks' loan dynamics can be inferred from the results of the IW-Bank Monitor (Demary, 2015). Regression analyses from a panel of the 80 largest Eurozone banks show that banks have reduced their loan supply in order to meet the higher Basel III capital requirements. Banks normally have three options to increase capital ratios: they can issue equity capital in financial markets, they can retain earnings or they can reduce risk-weighted assets. Since issuing equity capital can be prohibitively expensive in times of market stress, while retaining profits might be not possible for most banks, since most of these banks did not returned to being profitable, banks dominant way to increase their capital ratios was to reduce lending to non-financial corporations. Profitable and well capitalized banks maintained lending, but this was only the case for eight of 80 banks in the sample. In addition to reducing risk-weighted assets, banks switched from financing non-financial corporations to financing sovereigns. This result is due to the preferential treatment of sovereign debt in bank capital regulation, which allows banks to purchase sovereign debt without issuing equity capital. Moreover, the negative effects of the preferential treatment of sovereign debt on bank lending are accelerated through the low interest rate environment as the results show. These results indicate that bank regulation might have a negative effect on the bank lending channel of monetary transmission and might be one reason why the ECB still has difficulties in achieving its objective of maintaining inflation near its inflation target of below but close to 2 percent in the medium term.

2. ECB Is Likely to Intensify Policy Accommodation

In comparison to the last IW Monetary Outlook (Hüther/Demary, 2015), Eurozone inflation improved only slightly from -0.1 percent in September 2015 to 0.1 percent in October 2015. Although the low headline inflation is due to declining energy prices, core inflation, i.e. inflation without the dynamics of energy and unprocessed food prices, is still at a too low level. It improved slightly in October to 1.0 percent from 0.9 percent in September. Compared to its October 2014 level, it is now 0.3 percentage points higher. An additional threat to price stability are the still unanchored inflation expectations. The survey of professional forecasters reveals that the surveyed experts expect consumer prices in 2016 to increase on average only with a rate of 1.0 percent. In order to bring inflation expectations back to the ECB's inflation target, either energy prices have to increase in beginning of 2016 or the ECB has to conduct a more accommodative monetary policy. While inflation expectations did not improve sufficiently, the growth rate of M3 improved in October. The money growth stock grew at a rate of 5.3 percent compared to the previous year. In September it increased by 4.8 percent compared to its previous year level. Deflationary pressures, however, come from the still negative Eurozone output gap. However, some improvements can be seen. The growth rate of real GDP increased from 0.8 percent in the third quarter of last year to 1.6 percent in the third quarter of this year. Moreover, the labour market improved slightly in October 2015 with the Eurozone unemployment rate declining to 10.8 percent from 11.5 percent in October 2014. Although the Eurozone indicators show some signs of improvement, the monetary outlook does not indicate any room for the ECB to halt policy accommodation. On the contrary, the slow improvement of key indicators might be a reason for the ECB to remain highly accommodative.

Table 2: Key Eurozone Indicators

In percent, percentage change from previous year

	Previous Year	**Latest Data**
Consumer Price Inflation Rate	0.4	0.1
Core Inflation Rate	0.7	1.0
Inflation Expectations for Next Year	1.0	1.0
Output-Gap	-3.3	-2.7
GDP Volume Growth Rate	0.8	1.6
Monetary Aggregate M3 Growth	2.5	5.3
Unemployment Rate	11.5	10.8

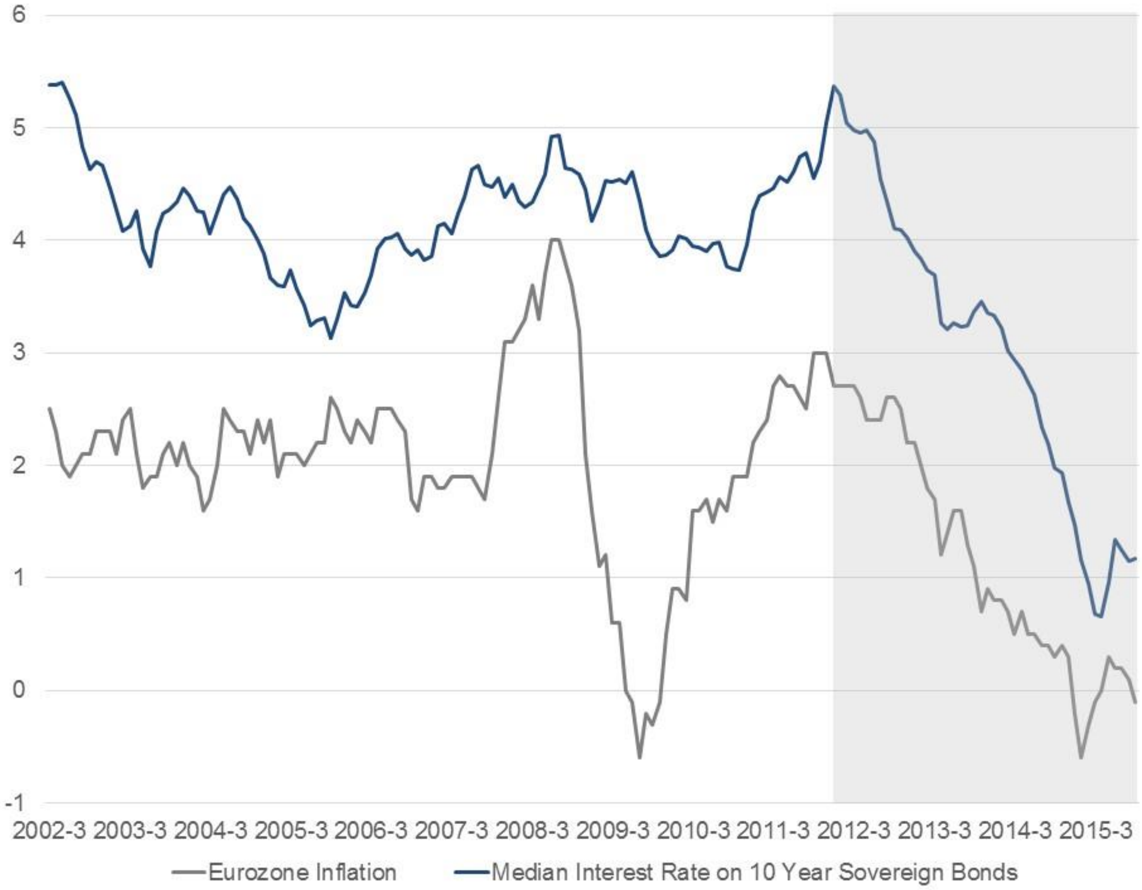
Sources: ECB, Eurostat, OECD, Cologne Institute for Economic Research

Figure 3 strengthens our view that the ECB will stay highly accommodative for a while. In December 2011 the ECB announced its first round of balance sheet expansion with the two long-term refinancing operation tenders. Since this time the interest rates in the Eurozone are trending downwards on average. The median interest rate on sovereign bonds with a maturity of 10 years decreased from around 5 percent to approximately 1 percent. However, these lower interest rates did not prevent inflation from trending downward in tandem with interest rates.

From the downward co-movement of interest rates and inflation one should not deduce causation from interest rates to inflation, since inflation was hit by a negative aggregate demand shock during the Eurozone recession and most recently by a positive aggregate supply shock trough declining energy prices. The problem why the ECB's balance sheet expansion and its recent quantitative easing program did not lead to rising inflation rates up to now is caused by a low investment demand and at the same time by banks restrictive loan supply which was first due to their deleveraging and now to their adaption to the new Basel III capital requirements. Hence, weak credit is not caused by a shortage of central bank liquidity, but by a shortage of equity capital. The results suggest that the new bank capital requirements might hinder monetary transmission and thereby force the ECB to be highly accommodative.

Figure 3: Eurozone Inflation and Median Yield on 10 Year Eurozone Member Country Sovereign Bonds

In percent



Sources: European Central Bank, Eurostat, Cologne Institute for Economic Research

Based on the monetary developments, the weak investment demand and banks reduction in their risk-weighted assets, we expect inflation to stay below the ECB's inflation target in the following months and therefore we expect the ECB to stay highly accommodative. It seems possible that the ECB tries to bring inflation expectations back to their target level by expanding its large-scale asset purchase program for one additional year. Moreover, the ECB might try to increase the banks' loan supply by reducing the risk-free interest rate even more, such that banks will invest in projects with a very low net present value. Since the risk-free interest rate is already close to zero, we expect the ECB to cut its main refinancing rate and the deposit rate by 0.1 percentage point, such that the main refinancing rate will be -0.05 percent and the deposit rate be at -0.3 percent.

3. Fed Is Likely to Start Gradual Exit from Low Interest Rates

The monetary outlook for the US looks more favourable compared to the Eurozone's outlook. Under these conditions, the Fed can stay accommodative for a while even under an increasing path for the Federal Funds Rate corridor. Although consumer price inflation was only at 0.2 percent in October 2015 compared to 1.4 percent in October 2014 and core inflation is only 1.3 percent, the US labour market improved in such a way that inflationary pressures might arise in the distant future. The unemployment rate improved to 5.0 percent in October 2015 compared to 5.7 percent in October 2014. With reaching full employment, robust growth of real GDP and anchored inflation expectations at 2.0 percent for 2015, the Fed can start its gradual exit from low interest rates without risking economic growth.

Table 3: Key US Indicators
In percent

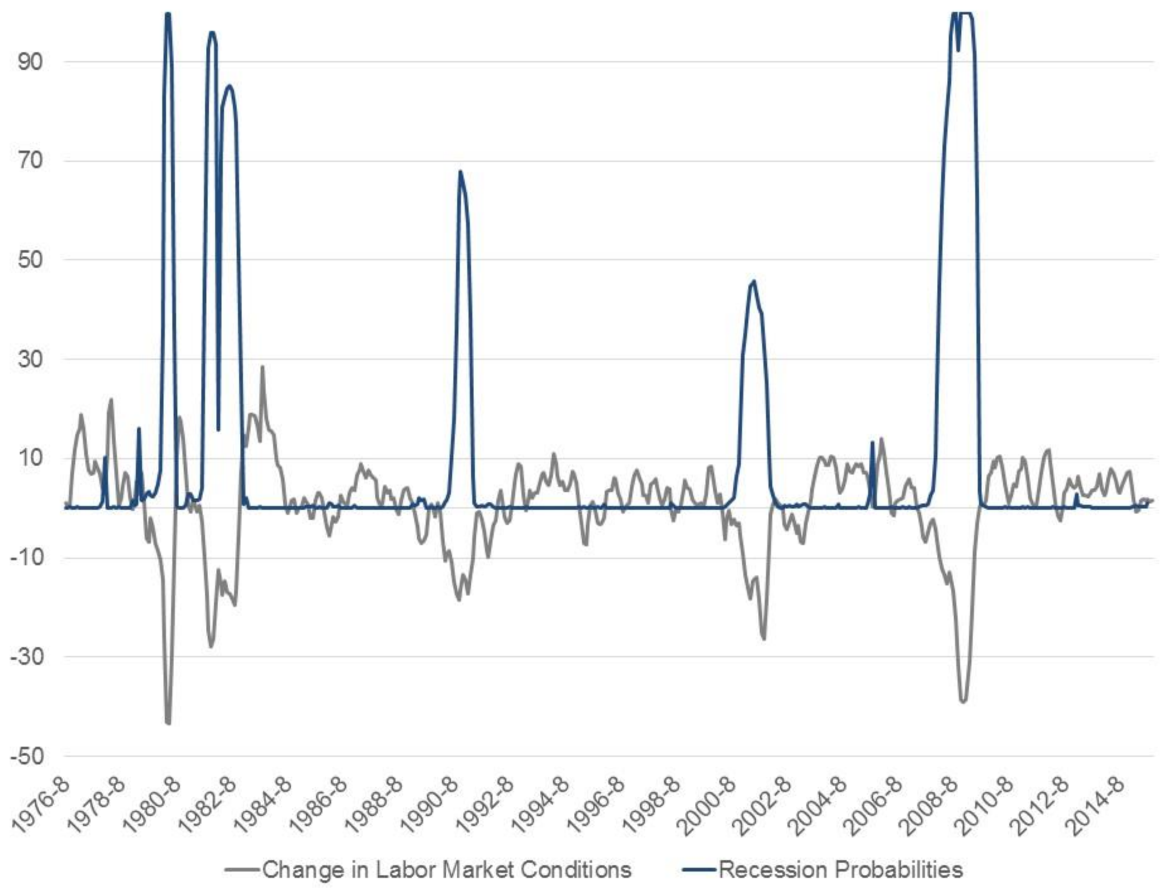
	Previous Year	Latest Data
Consumer Price Inflation	1.4	0.2
Core Inflation Rate	1.5	1.3
Inflation Expectations for Next Year	1.9	2.0
Output-Gap	-2.8	-2.0
GDP Volume Growth Rate	2.9	2.2
Monetary Aggregate M2 Growth	5.5	5.7
Unemployment Rate	5.7	5.0

Sources: Federal Reserve Bank of St. Louis, Federal Reserve Bank of Philadelphia, Bureau of Labor Statistics, OECD, Cologne Institute for Economic Research

Figure 4 confirms our assessment that the US is on a stable growth path, so that the Fed can safely start a gradual return to higher interest rates. The labour market conditions index and the recession probabilities indicate no dangers for the growth of the US economy. Therefore, we expect the Fed to increase the corridor for the Federal Funds Rate to 0.25 – 0.50 percent at its December 2015 meeting and to 0.50 – 0.75 percent at its January meeting.

Figure 4: US Recession Probabilities and Change in Labour Market Conditions

Index points



Source: Federal Reserve Bank of St. Louis

4. Conclusion and Policy Recommendations

While the Fed has successfully fought the labour market slack which was caused by the great recession of 2008, the ECB is still struggling with an impaired monetary transmission channel. As a consequence of the improved labour market the Fed can now start its policy lift-off, while the ECB is still combatting deflationary pressures which are the result of a weak investment demand and an impaired bank lending channel of monetary transmission. These developments force the ECB to expand its large-scale asset purchase program and the ECB might drive interest rates further into negative territory or order to stimulate bank lending.

It seems that the credit channel of monetary transmission is still not working such that the ECB's expansionary policy measures translate into higher inflation rates. One reason for this might be the low investment demand, the other is that the implementation of the higher Basel III capital ratios hinders the credit channel to function. Behind this background, further research should elaborate on this, because either higher capital ratios do not fit to an inflation target of near, but below 2 percent or the Basel III capital ratios are too high for the credit channel of monetary policy to function properly. An adjustment of either banks' capital requirements of the ECB's policy objective would be necessary when the inflation target of close to 2 percent is only reachable with extremely accommodative monetary policy measures. Although it can be possible that this effect is only due to the implementation phase of Basel III and it will phase out when implemented, one nevertheless has to ask if bank regulation and monetary policy collide. Since the accommodative monetary policy, including large-scale asset purchases as well as negative interest rates, show already tremendous side effects to financial stability, for savings and for old age provisions, policy makers might have to reconsider bank regulation.

Behind the background that a lack of equity capital is the limiting factor to bank lending and not a lack of central bank liquidity, the ECB's decision to impose negative interest rates on banks' deposits at the ECB seems to be counterproductive. In times, in which banks have to increase their capital buffers it might be better to foster banks to return to profitability instead of introducing measures which increase their interest rate costs.

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