Monetary policy: trapped by the mountain of debt

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Investors in the financial markets were very worried about excessive monetary policy tightening by the Federal Reserve (Fed) at the end of 2018. The Fed has, however, shown itself to be more flexible now. It will not dogmatically maintain its previous forward guidance, but instead base interest-rate policy on current economic and inflation estimates (data dependency).

Concerns about declining liquidity – due to the reduction in the Fed's balance sheet as the bonds acquired during Quantitative Easing (QE) now begin to mature – also appear exaggerated. The central bank balance sheet has already decreased from around US-Dollar 4.5 to 4 trillion. The Fed is currently allowing a maximum of US-Dollar 50 billion in bonds to mature per month without reinvesting this amount in new bonds. If it maintains this rate, its balance sheet will decline to US-Dollar 3.5 trillion by the end of 2019, which corresponds to the general magnitude of the balance sheet reduction expected. Fed Chair Powell has already signalled that he is flexible with respect to the announced monthly reduction in liquidity after the recent warning signals sent by the markets.

More than one or two federal funds rate increases – if any at all – should only be expected if the US economy continues to boom unabated at its current strength in 2019. The economy can live with a federal funds rate of 2.5 to 3 per cent, which would once again give the Fed enough space to manoeuvre in the event of an economic downswing.

The European Central Bank (ECB) instead no longer has room to manoeuvre. The minimum reserve ratio has been just one per cent for a long time, allowing banks to issue an almost unlimited amount of loans, the money for which they receive at zero cost. Safe German Bunds are yielding less than zero per cent up to a maturity of eight years, which is ruining the interest-rate margins of banks. The ECB is therefore hoping to slowly exit from its low interest-rate policy, but this is scarcely possible as more and more debtors become dependent on low interest rates. This applies in particular to Italy, which has a mountain of government debt equal to more than 130 per cent of GDP. The yield on 10-year Italian government bonds rose to an alarming high of 3.8 per cent in October 2018 due to the quarrels about the Italian budget.

The spread over German Bunds was greater than three percentage points for a short time, a level requiring banks to hold more capital to cover their positions. Fears of another banking crisis caused the Italian government to back down in its budget dispute with the EU, and the spread subsequently fell again below the three percentage point mark. Yields will likely rise significantly again if there are signs that a weak economy and expensive bank rescues could raise the Italian budget deficit considerably above the 2.04 per cent target. This is even more so since Italy will have to find more than Euro 400 billion in capital market funding for maturing bonds and new debt in 2019.

ECB: goodbye QE; hello TLTRO

Higher yields on Italian government bonds are therefore not just a potential problem for the debtor (the state), but also a serious problem for many creditors (banks). A banking crisis could cause a massive outflow of deposits that could put their liquidity at risk. It would therefore not be surprising if the ECB used unconventional measures to loosen its monetary policy again in 2019, instead of tightening it as would be generally expected. It may, in fact, even be forced to do so, since the so-called "TLTRO" loans to banks will mature soon. These "targeted, long-term" loans were granted to banks in 2016 and 2017 with maturities of four years and interest rates between zero and -0.4 per cent.

Although TLTROs do not protect banks against insolvency, they do stabilise the income and liquidity of weaker institutions in particular. Banks that are afraid that concerned clients might withdraw their money are in no position to issue loans if they cannot obtain long-term refinancing. Since this would be impossible in the capital markets, or only possible at very high interest rates, the TLTROs offer a lifeline that provides predictable loan refinancing at very low rates, thereby also improving their liquidity ratio ("net stable funding ratio"). For this, however, the TLTROs must have a remaining maturity of more than one year. The tranches maturing in the summer of 2020 would therefore have to be renewed in the summer of 2019 at the latest.

The ECB's TLTRO programme has a total volume of Euro 717 billion. Euro 239 billion of this went to Italian banks, 167 billion to Spanish banks, 114 billion to French banks and 88 billion to German banks. On average, one can say the following: the weaker the bank, the more dependent it is to receive the ECB's attractive long-term loans. There are some particularly glaring examples in Italy. Banca Carige, for example, which recently encountered financial difficulties, used Euro 3.5 billion in TLTRO II loans from the ECB to cover 16.6 per cent of its funding. Banca Iccrea, which used EUR 13.8 billion to cover 40 per cent of its funding, is an even more blatant example. Given the widespread weakness of bank balance sheets, however, it is questionable whether TLTROs can keep all the banks alive. Banca Carige, for example, has net bad loans of Euro 2.3 billion, and only Euro 2.0 billion of equity capital. Account and savings deposits are around Euro 10 billion, while the Italian deposit protection fund only has around Euro 1 billion available. That should give pause to even the most fervent proponents of an EU banking union.

The TLTRO example illustrates how fine the line is between bank and state financing. Although expansive fiscal policy – i.e. rapidly rising government expenditures – may violate EU stability criteria, it cannot be sanctioned. When the ECB makes promises to rescue the euro that imply an unconditional readiness to provide funding for cash-strapped governments and banks, the corrective force of the bond market, which normally penalises excessive deficits with higher interest rates, is circumvented. Populism therefore leads not only to a more expansive fiscal policy and rising debt, but also increases the pressure on the central bank to keep interest rates extremely low so that the mountain of debt is "repayable".

The ECB has to prevent three things: a slide into a deep recession, another banking crisis and a collapse of the euro – with all three of these risks affecting each other. We are assuming that the ECB – like the other major central banks – wants to avoid major structural breakdowns. If risks like an economic slowdown become more probable, the ECB will not sit on the sidelines watching, but will instead use unconventional measures such as the TLTROs described above, new bond purchases or previously unused methods like helicopter money.

Higher inflation rates are not only desirable, they are necessary. The high debt ratios can only be reduced by inflation if major haircuts or an economic depression are to be avoided. For this to happen, the nominal interest rate must remain significantly below the rate of inflation for a long period of time, as occurred during the US financial repression in the 1940s and 1950s. This policy of negative real interest rates is already a reality in the eurozone, although only at a homeopathic dose so far.