

Comment on “The European Economy: Out of Crisis, Finally?”

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1. Deflation and Macro-economic Policy

1. The sovereign QE was successful in reducing the long-term interest rates and raising equity prices, promoting the tendency to depreciate the euro rate. However, I have three questions.

2. First question: Whether the massive purchase of government/private bonds by the ECB aimed at achieving the goal of euro 3 trillion size of balance sheet is consistent with the negative rate (- 0.2%) for deposit facility and excess reserves on the ECB's account?

1. Deflation and Macro-economic Policy

- Private banks may be induced to repay the accumulated lending from the ECB to save interest payments and avoid receiving negative return on deposit account and excess reserves.
- In addition, private banks, notably in Germany, may have no incentive to sell government bonds to the ECB, given the fact that they get, in return, negative rate for on deposit facility and excess reserves, unless the government bond price rises sharply (which implies sizable negative yields). The purchase of bond with negative yields may result in loss incurred by national central banks.

1. Deflation and Macro-economic Policy

- The loss was incurred already in the case of the Bank of Japan.
- Furthermore, it is not likely for the Bank of Japan to introduce the negative interest on excess reserves, because it makes difficult to attain the level of monetary base target.

1. Deflation and Macro-economic Policy

- More generally speaking, is it sustainable to maintain the negative yields of government bonds of all the maturities, given the existence of cash as an alternative asset with the zero interest rate?
- It seems to me that only sensible solution may be the introduction of the “Gesell money”, although it may not be feasible in practice.

1. Deflation and Macro-economic Policy

3. Second question: The major responsibility (80%) to bear risks arising from the implementation of sovereign QE is assigned to national central banks.

- The division of risk bearing among national banks will work to raise the risk premium of low-rated government bonds and tend to fragment the government bond market in the Euro area and thus limiting the effectiveness of transmission mechanism of monetary policy.
- On the other hand, the adverse spillover effect from the Grexit on financial market can be more easily contained, although there remains the channel through the Target 2.

1. Deflation and Macro-economic Policy

4. Third question: Is the sovereign QE strong enough to erase the deflation risks in the absence of fiscal stimulus?
- Given the lesson from Abenomics, promising approach may be the combination of infrastructure investment at the European level combined with the sovereign QE.
 - The increase in infrastructure investment (for instance “Investment Plan for Europe” by the EU) is needed to mitigate the risk of secular stagnation and provide the euro bonds to the market to facilitate the implementation of massive purchase of public bonds by the ECB.
5. There may be a room for amending the austerity policy regime by implementing macro-economic adjustment in a more coordinated way.

2. Debt Crisis in Greece

1. The Greek government requested the Troika to provide the bridge loans for six months, thereby cancelling (not extending) the existing support program.
 - The Finance Minister Varoufakis proposed to replace the existing debt by the GDP-linked bonds (debt owed to the EU) and the perpetual bonds with the interest payment linked to nominal GDP (debt held by the ECB).
 - These proposals seem not nonsensical, given the past examples of other emerging economies, under the assumption of availability of reliable statistics. Do they really contradict the EU law to prohibit money financing, if they entail a risk of haircut?

2. Debt Crisis in Greece

2. To my surprise, the ECB removed the waiver to use the Greek government bond as collateral for monetary policy operation by the ECB on 11 February, pointing to the fact that it is not possible to assume a successful conclusion of the program review scheduled at the end of February.

- This implies that Greek banks must rely on the “Emergency Liquidity Assistance” program with higher interest rate(1.5%)to secure funding. But the ELA can be provided only under the conditions of solvency and soundness of borrowing banks.

2. Debt Crisis in Greece

- After Asset Quality Review, the three Greek banks with large size of non-performing assets were requested to augment the capital, because they fell short of adequate capital in a stress test. Further, the deposit drain from Greek banks amounted to Euro 15-20 billion in January and accelerated in February .
- On 12 February, the ECB increased the total amount of ELA by 5 billion to 65 billion.

2. Debt Crisis in Greece

- If the ECB makes the judgment that major Greek banks are insolvent or the deposit drain leads to bank run, then the ELA is likely to be suspended. Then what will happen?

3. Financial Stability

1. The establishment of Single Supervisor Mechanism is an important step towards banking union among a fourfold union. However, the banking resolution and the common deposit insurance scheme are not yet established.

2. How will the ECB as a single supervisor act if the Greek banks face the risk of insolvency?

- Will the collaboration with the national resolution fund and the ESM solve the issue by facilitating the recapitalization of Greek ?

3. Financial Stability

3. Now, the ECB has two jobs on monetary policy and prudential policy.

- The sovereign QE intends to promote the risk taking by banking sector to induce the increase of bank credit, while the banking sector under capital shortage is requested to intensify the deleveraging from the standpoint of maintaining financial stability.
- As a result, the QE's effect on bank credit will be significantly eroded.

4. Implications for Exchange Rates

1. The euro rate will depreciate further in part due to the sovereign QE by the ECB and the deepening debt crisis in Greece with the increased risk of Grexit.
2. The sharp appreciation of dollar coupled with low oil prices will make it difficult for the Fed to achieve the 2% inflation target, while the further depreciation of the yen rate vis-à-vis dollar will be prevented by the flight to safe asset.

4. Implications for Exchange Rates

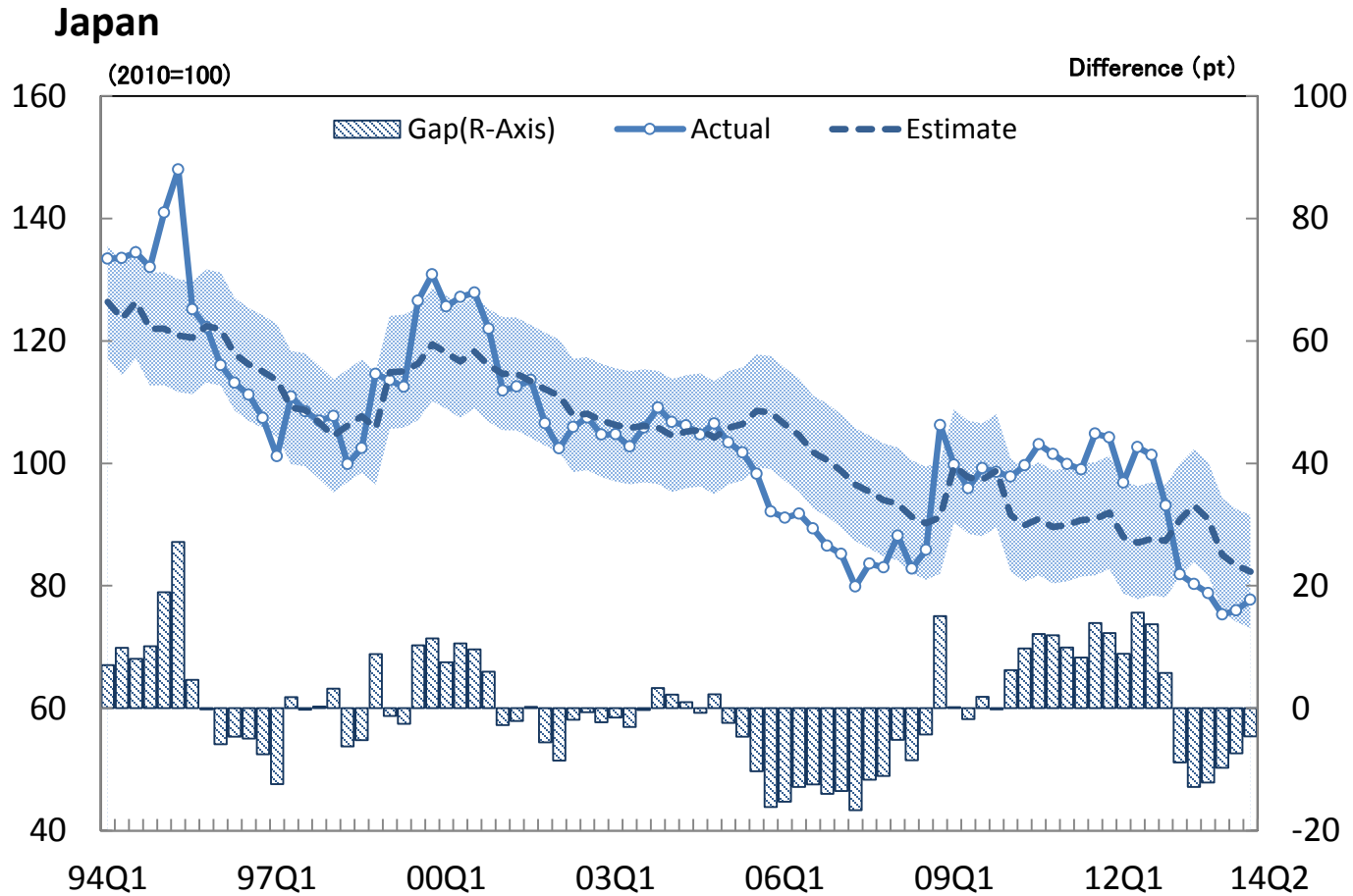
3. The real effective exchange rate of US dollar reached the historical average in the 45 past years. To what extent the US authority tolerate the appreciation of dollar?

- Notably, is it possible that the debate at the Congress on the TPP with respect to the introduction of currency clause, advocated by the Economic Policy Institute and the Peterson Institute, can influence the tolerable limit? The EPI explicitly mentioned Japan as a currency manipulating country.

4. Implications for Exchange Rates

4. The real effective exchange rate of Japanese yen remains both below the fundamental rate based on the BEER and the historical average.
5. While some economists point to the risk of currency wars under the circumstance of cutting interest rates and expansion of balance sheets of central banks among a number of countries, current depreciation of the euro rate is not inconsistent with the long-term real effective euro rate, except for Germany.

Fig.1 Divergence from Behavioral Equilibrium Exchange Rates



(Sources) Bank for International Settlements, Japan Center for Economic Research's Estimates

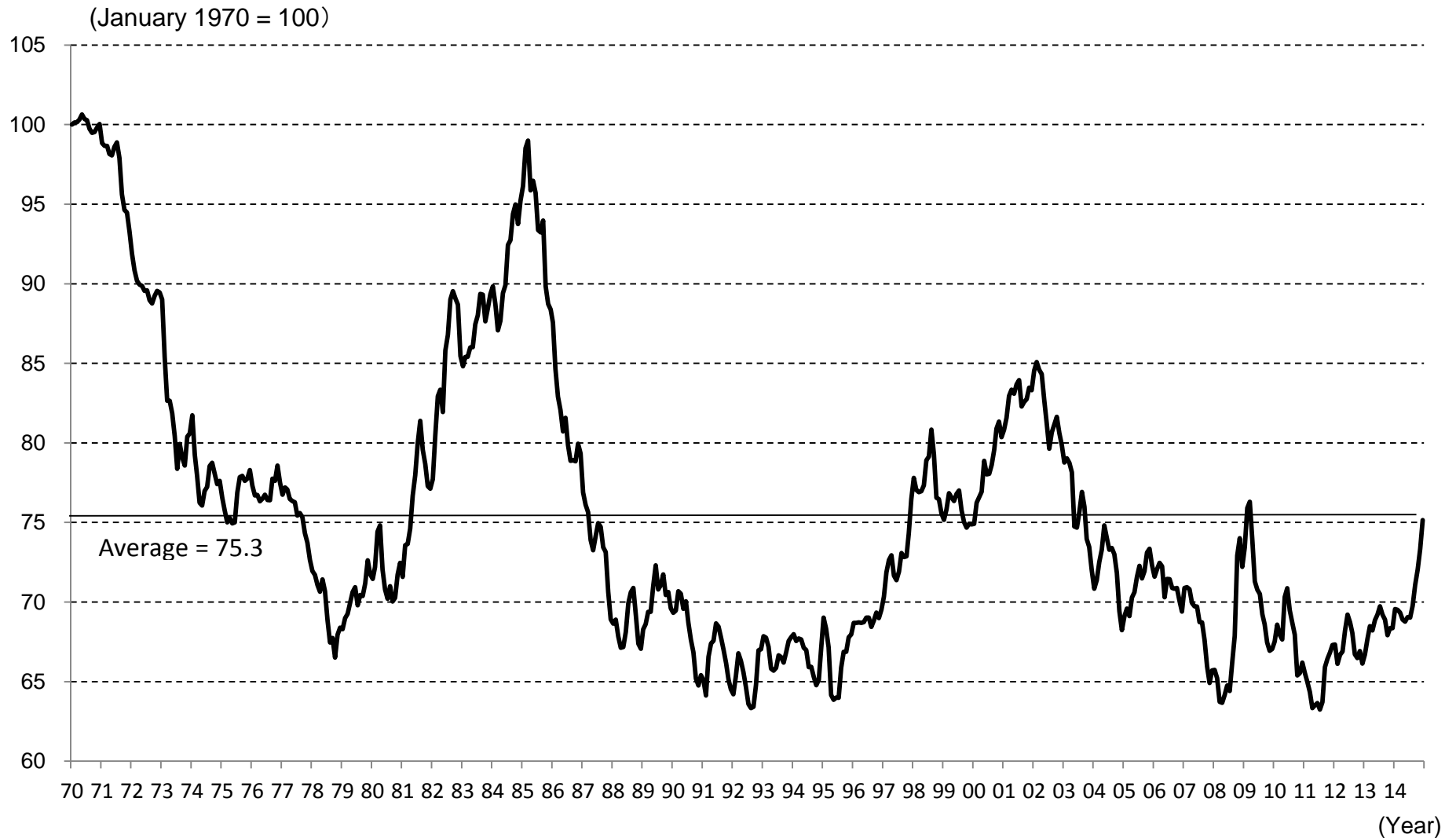
Fig.2 Real Effective Exchange Rate of Japanese Yen



(Source) Bank for International Settlements, *The BIS Effective Exchange Rate Indices*

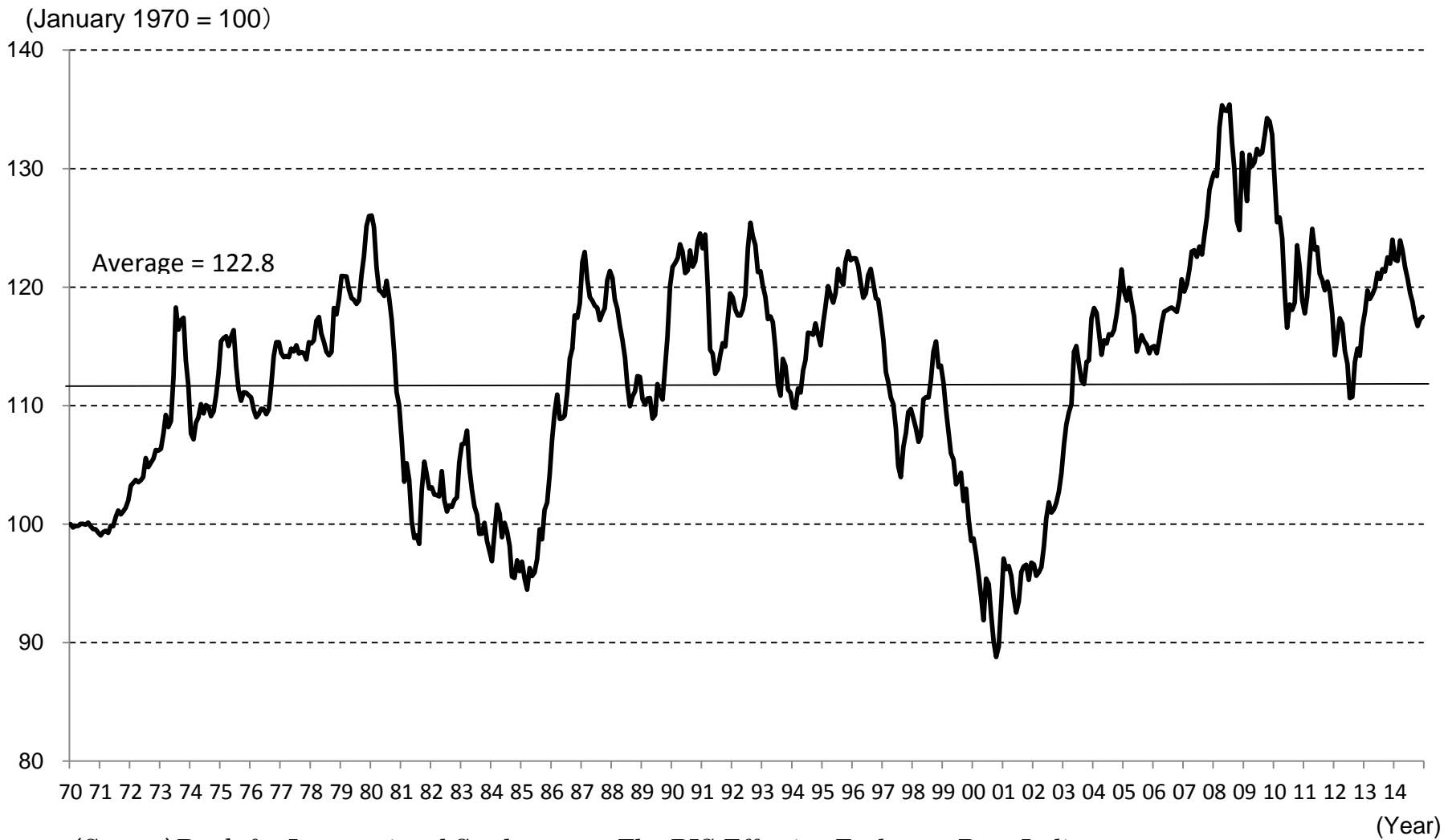
(Year)

Fig.3 Real Effective Exchange Rate of US Dollar



(Source) Bank for International Settlements, *The BIS Effective Exchange Rate Indices*

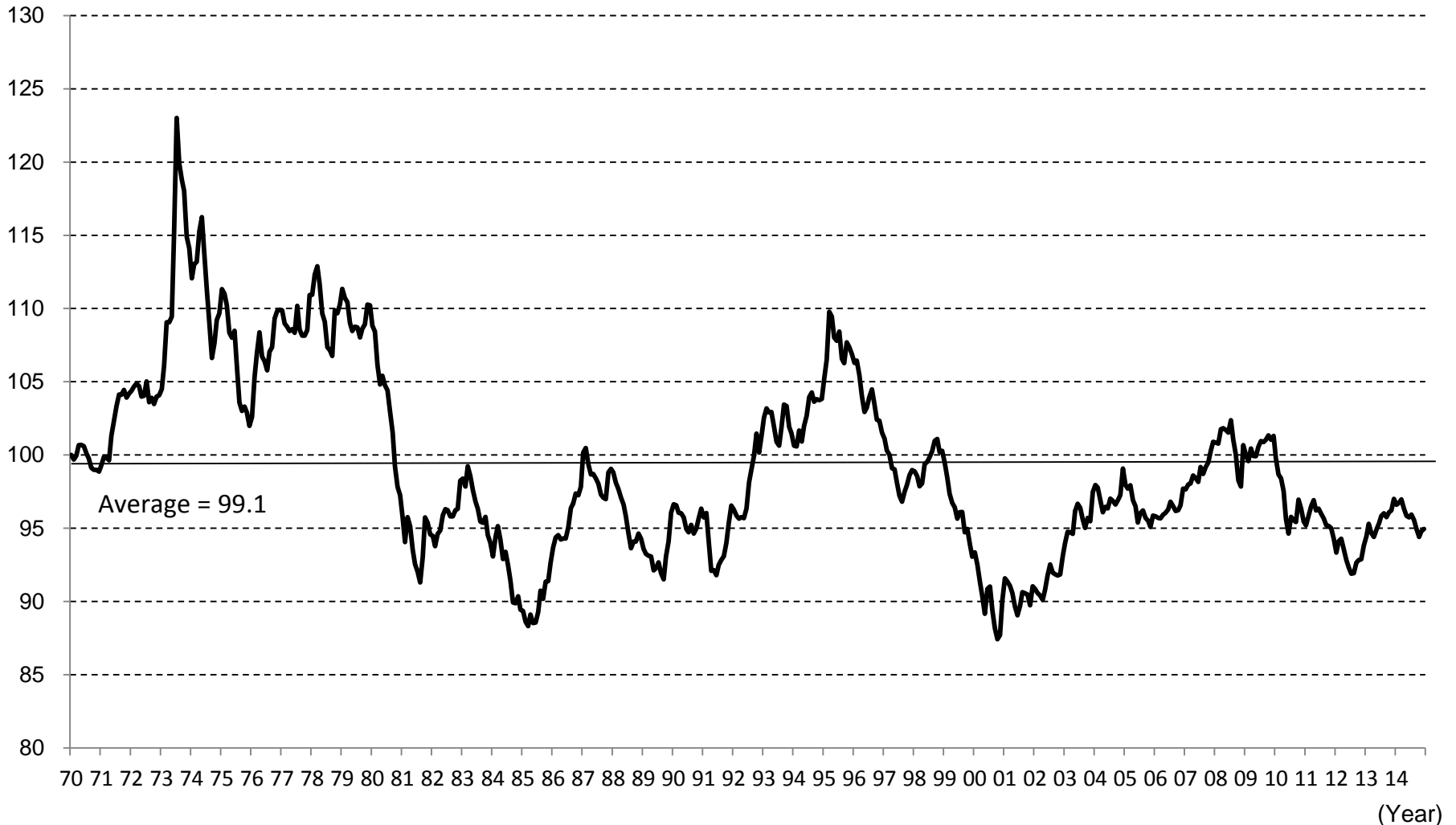
Fig.4 Real Effective Exchange Rate of the Euro



(Source) Bank for International Settlements, *The BIS Effective Exchange Rate Indices*

Fig.5 Real Effective Exchange Rate of Deutsche Mark/the Euro(Germany)

(January 1970 = 100)



(Source) Bank for International Settlements, *The BIS Effective Exchange Rate Indices*

(Year)