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The Euro-Crisis: A To-Do-List for the ECB

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1. Executive Summary

So far, the ECB has responded to the European twin crises of bust banking systems and sovereign debt crises using traditional central banking tools: interest rate reductions, combined with discretionary bond purchases. In addition, the ECB moved to take inter-bank funding away from the open market and transfer it to a direct loan relationship with the ECB (the LTRO of 8 December 2012). We welcome the last step, but warned that it will not be sufficient to solve the crises.

To do that, further European centralisation and transfer of sovereignty to Brussels or Frankfurt are not necessary. Indeed, such a policy gain fails to address the fundamental problem, which has been ignored by all crisis measures so far: to get out of the debt spiral and vicious and self-reinforcing circle of shrinking demand leading to weaker government finance and shakier banking systems, we need a policy to trigger an expansion in domestic demand in the affected economies. None of the policies suggested by the European leaders do however boost domestic demand.

Our research has demonstrated that domestic demand is a function of credit creation. It is currently shrinking, because credit creation is shrinking. Thus what is required is a new strategy, which can be implemented by the ECB with cooperation of national governments, and which aims squarely at increasing credit creation and generating sustainable growth and employment.

The policy centres on an ECB package of measures to solve the bad debt problem in the banking system in exchange for banks' cooperation in a regime of guided bank credit. The list of policies is can be found on pages 5 and 6 of this report.

This paper is a reproduction of a note issued by Professor Werner in his role as member of the ECB Shadow Council. The views expressed are his own and may differ from those of other members of the Shadow Council.[1]

[1] The Early Editor's Club, Newsroom, Shadow ECB Council, The Euro-Crisis: A To-Do List for the ECB, Contribution of 27 June 2012 by Richard A. Werner

The Eurocrisis: A To-Do list for the ECB

As the ECB gathers for its Council meeting many wonder whether interest rates should be cut further.

Further rate cuts are neither necessary nor sufficient to stimulate growth in the eurozone. To the contrary, they are likely to be counterproductive. Indeed, I would not have cut rates as much as they have been cut, due to the negative impact on savers. This is also recognised as a problem in the UK, where pension fund returns have been affected by the Bank of England's policies.

As I said in Japan in the early 1990s, in a recession that occurs after an asset bubble, we are faced with an impaired and increasingly risk-averse banking system. I thought I was dramatic when I said at a time when interest rates were above 4% in Japan that in this situation interest rates can be lowered to zero, and it would not have any positive impact on the economy. Little did I know that the Bank of Japan wanted to prove me right.

The assumption that moving prices will be helpful – in this case the price of money, also known as the interest rate – is based on standard economic models where demand is supposed to equal supply, and thanks to price movements we obtain equilibrium. The assumptions on which such equilibrium models and their outcomes are based (perfect information, no transaction costs, complete markets, etc.) are so extreme that we know they do not hold in our world. Hence markets are not in equilibrium. This means we can be quite sure that all markets are usually rationed. Then the short-side principle applies: whichever quantity of supply and demand is smaller will be transacted.

So if we think that lack of loan demand is the problem (as bankers and central bankers will inevitably argue) then lowering the price of money should stimulate the demand for it – and hence boost borrowing by firms and households, boost bank lending, and hence expand demand. Thus Japanese banks and the Bank of Japan have argued for over a decade that the shrinking bank credit growth, and later zero bank credit growth, and finally contracting bank credit, were due to lack of loan demand, and hence lower interest rates would solve the problem. After over a dozen interest rate reductions from over 7% at the beginning of the 1990s to 0.0001% over a decade later, bank credit growth had not recovered.

Today, UK banks are saying the same thing: shrinking bank credit growth is not due to them – they would like to lend – but there is simply no demand for loans. This is true only in a very narrow sense, and hence overall this statement is misleading: the banks have raised their hurdle of who qualifies as being credit-worthy, and only the top borrowers, mainly large firms, now qualify. And it is true that these large firms usually do not need to borrow from banks, as they either use cash flow or capital market funding. But it is the small firms not able to use other channels of fund-raising that would like to borrow from banks – but the banks are not interested in them, even less so than they had been before.

Likewise in Japan: in aggregate the problem was not weak loan demand, but the lack of credit supplied by the banks. Banks were burdened with high and rising amounts of bad debts – partly due to the excessive bank credit boom that created the asset bubble of the 1980s, which in turn was the result of the Bank of Japan's window guidance, and partly due to the misguided Bank of Japan policy of the 1990s, which kept repeating that the problem was lack of loan demand and hence interest rate reductions would fix it.

True Quantitative Easing

So what did I suggest to fix Japan's recession and banking problem? It is indeed the same policy that I am now advocating for the eurozone. I argued that a new type of monetary policy was necessary that did not focus on the price of money, but on its quantity. That quantity is credit creation.

Since I did not want to be confused with monetarist proposals - and in fact warned that boosting bank reserves or high powered money, for instance via open market purchases from the banks was also doomed to fail - I needed a new expression for this, especially since in the Japanese language the expression 'credit creation' used to be little understood. I thus added the word 'quantitative' to the standard expression of stimulatory monetary policy ('monetary easing'), short **'quantitative easing'**.[2]

Having denied that my proposal to expand credit creation would work, the Bank of Japan then switched from its failed interest policy to the older, and also failed monetarist policy of expanding bank reserves - but had the nerve to call this 'quantitative easing'.

Here is the list of policies that make up true 'quantitative easing', as I proposed in the 1990s in Japan, adapted as policy advice for the ECB. I have put forward the following list of policies in my discussions at the ECB Shadow Council.[3]

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[2] Richard A. Werner (1995). How to create a recovery through 'Quantitative Monetary Easing'. *The Nihon Keizai Shinbun (Nikkei)*, 2 September 1995 (morning edition), p.26 (in Japanese). English Translation available at http://eprints.soton.ac.uk/340476/ .

[3] The Early Editor's Club, Newsroom, Shadow ECB Council, The Euro-Crisis: A To-Do List for the ECB, Contribution of 27 June 2012 by Richard A. Werner

The ECB's To-Do List:

1. The ECB should purchase all non-performing assets from all Eurozone banks at face value, in exchange for banks agreeing to comply with a new 'credit guidance regime' run by the ECB.

2. The ECB should introduce and operate this new 'credit guidance', whereby the ECB via its national central banks (NCBs) requires banks to meet monthly and quarterly quotas concerning the growth of total credit outstanding AND the credit outstanding in each of the sub-categories of credit, on which banks have to report on a monthly basis as well, namely:

   A. bank credit for GDP transactions, divided into
   - mortgage credit to households
   - consumer credit
   - other credit to individuals
   - credit to the manufacturing industry (divided into further specific industries, though no sub-targets set)
   - credit to the construction sector
   - credit to the non-financial service sector (divided further into specific industries)
   - R&D, education
   - other categories

   B. bank credit for non-GDP transactions, divided into
   - credit to other banks
   - credit to non-bank financial institutions
   - credit to financial or property holding companies
   - other categories

   whereby the ECB via its NCBs restricts credit to type B sectors and sets positive year-on-year percentage growth targets for credit of type A.

3. The ECB should institute a loan guarantee scheme for the most desirable types of loans, i.e. to the manufacturing sector implementing new technology, environmentally enhancing and sustainable energy producing sector, as well as in R&D and education. Loans are guaranteed by the ECB.

4. The ECB should immediately re-introduce the Bundesbank's bill rediscounting operations, expanded to all NCBs and extended to firms in type A sectors, but Eurozone-wide, via the NCBs.

5. Until above scheme has got traction, the ECB, via its NCBs introduces a new direct lending facility whereby the NCBs extend credit to type A sector borrowers.

6. The ECB should introduce a new scheme, whereby the ECB and NCBs meet with the national finance/treasury ministries and debt management offices in order to end the issuance of government bonds in the markets and instead fund all public sector borrowing requirements (that must meet unchanged Brussels budgetary requirements) through direct loan contracts from the national banks. This reduces borrowing costs sharply, as the prime rate is lower, helps banks as their business expands without further capital adequacy requirements (risk weights are zero), while the loans do not need to be marked to market, but can be used for ECB refinancing. (The Werner-Siekmann proposal).

7. The ECB should meet with national bank regulators, the European Banking Authority and the Basel Committee on Banking Supervision (BCBS) in order to negotiate release of eurozone banks from the Basel capital adequacy standards for the coming three years, until bank credit growth and hence nominal GDP growth is back to full employment levels.

Further Reading:

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Werner R. A. (2002), 'How to Get Growth in Japan', *Central Banking*, vol. XIII, no. 2, November 2002, pp. 48-54

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