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The ECB's Ad hoc Monetary Policy: Will its Lack of Forward Guidance Finally Burst the Eurozone?

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Most experts agree that central banks need to provide “forward guidance” for monetary policy to be effective. But exactly what forward guidance is the ECB giving by its current interventions, real and oral? Apart from the rhetoric of interest rates to remain low for a long time, the ECB offers only paltry information about the use of its instruments and their effectiveness. The ECB’s “ad hoc” monetary policy rather leaves the future development of monetary aggregates, interest rates, prices and public finances unpredictable let alone uncontrollable. Its series of discretionary interventions distort market signals and exacerbate price fluctuations, effectively undermining stable economic expectations. On current trend, ECB policy may make a Eurozone break up less distant as it prevents investment as well as regulatory and economic convergence between Eurozone countries.

In the EMU’s present political practice, neither fiscal nor monetary policymakers follow the policy rules their architects once designed. National governments have always treated the Stability and Growth Pact (SGP) as a set of unwelcome fiscal guidelines rather than a hard budget constraint imposed by European law. Since its establishment in 1997, the aversion of national governments to the fiscal framework has never really changed. A two-year period of strong political symbolism in favour of tighter rules emerged only temporary after capital market discipline constrained government refinancing operations by the end of 2010. After the ECB’s promise to “do whatever it takes to preserve the euro”, fiscal rules have become less respected. From 2010 to 2013, public debt in the European Monetary Union (EMU) has risen by 13 per cent, now amounting to 93 per cent of the Eurozone’s Gross Domestic Product (GDP).

The primary objective of ECB policy, to maintain price stability, was for many years the operative norm as well as the outcome. The ECB provided households, corporations and investors with guidance about future interest rates and prices. Today, however, the ECB jumps from one “extraordinary” policy to another in order to support financial markets with liquidity. Measures are justified as necessary to fight the risk of deflation or to secure private sector credit supply. Yet ad hoc policies such as purchasing asset backed securities or bonds undermine forward guidance.

European households and corporations face extreme uncertainty about the future path of asset and consumer prices. Nor is current policy providing them with forward guidance of the development of public spending let alone how and when member states will finally initiate structural reforms to spur business and raise their potential growth. Moreover, consumer, business and investor confidence is permanently exposed to the risk of further extraordinary measures, which have several adverse implications that go along with uncontrollable feedback effects.

First, the ECB interventions again raise bail-out expectations. The ECB is implicitly acquiescing to repeated demands that troubled assets, public or private, should be written down. It effectively cleans bank balance sheets in order to relieve private sector financial institutions, their shareholders and creditors from the possibility of bail-ins or even bankruptcy. Most banks have only partly written off their bad assets and these banks will certainly not transfer any good quality assets to the ECB. As a result, far too many non-performing assets have already been transferred to the ECB. Like other central banks, the ECB can always cope with non-performers on its own balance sheet – but at the risk of medium-term inflation pressures and moral hazard in the financial system.

Second, ECB actions effectively take away the pressure on governments to reform and thereby preserve the comparative regulatory disadvantages between member states. Governments that easily can issue their government bonds because markets expect the ECB, if needed, to ride to their rescue, have no real external pressure to reform their economies. Moreover, due to the uncertainty about its impact on prices, ad hoc monetary policy measures do

not constitute an economic environment that encourages investment planning and business expansion. These measures do not encourage trade creation and innovation either. Thus, much needed economic convergence in the EMU is significantly thwarted.

Lowering entry barriers to labour and product markets promotes business creation and investment, which is what EMU governments and the ECB officially seek. However, the ECB rather spreads the fear of a lost decade for Europe. This fear is backed by the weak argument that Japan's economy suffered seriously from a long period of deflation after the beginning of the 1990s, which is taken as a paragon calling for extraordinary liquidity provision measures in the Eurozone. The lessons from Japan are alarming though. Japan's central bank cut interest rates aggressively in 1991, thereby providing excess liquidity to the economy for a long time. As a result, domestic banks hesitated to clean up bank balance sheets and the Japanese government continued to accumulate huge amounts of public debt. Equally worrisome: Japanese commercial banks, generously funded by the Bank of Japan, provided easy credit to bad corporate debtors. What is broadly known as "zombie lending" further depressed Japanese firms' competitiveness as well as investment and employment growth. Zombie lending also retarded the Japanese government's efforts to undertake much needed institutional reforms.

Third, a substantially weaker euro undermines Europe's long-term global competitiveness. The ECB's current policy measures put pressure on the external value of the euro, particularly against those currencies whose central banks have already indicated hikes in interest rates in 2015. Since its peak in May 2014, the euro depreciated by 11 per cent relative to the USD. The euro also lost in value against the currencies of Europe's major trading partners (except the Russian ruble). Needless to say, the ECB and some national governments highly welcome the inflation of nominal prices in a way that the euro depreciates against other currencies. The temporary gain in price competitiveness, however, not only reduces the pressure on European firms to bring about product and process innovations. A weaker euro also reduces governments' incentive to improve domestic business regulations.

Fourth, the ECB's ad hoc policies deter investment and consumption. The impact of higher asset prices on aggregate demand will be marginal since asset holders must always fear the ECB's decision to stop excessive liquidity provision, be it abrupt or gradual. More recently, the sharp outflow of hot money from many emerging market economies has shown how nervously investors reacted after the U.S. Federal Reserve's decision to "only carefully" withdraw from its extraordinary asset purchases. Distorted asset prices today do not contribute to stable expectations about asset prices in the future and therefore delay investment and consumption. In addition, liquidity-driven asset acquisitions are not the kind of productive investment that is needed in the Eurozone for creating jobs and economic growth.

Fifth, the ECB's ad hoc measures are likely to deflagrate, while a Eurozone breakup continues to levitate over the Eurozone. After Mario Draghi announced that the "ECB is ready to do whatever it takes to preserve the euro", European stock prices went up for a long time while sovereign bond yields went down. Financial markets, however, are already getting reluctant to celebrate new liquidity measures. European stock prices heavily fluctuated after the ECB's announcement to provide additional liquidity in the range of another 700 to 1.000 billion EUR. Government bond yields are also on the rise again. Financial market participants are losing faith in European policymakers actual capacity to timely enforce far-reaching institutional reforms leading to increased business activity. In addition, the sword of "exiting the euro" is still hovering over many countries of the Eurozone, preventing foreign investors to engage in these countries. Additional liquidity provision measures will not eliminate the internal foreign exchange risk that is still an implicit feature of the Eurozone.

To sum it up, the ECB's path of policy discretion has resulted in a de facto loss of forward guidance, which has uncontrollable feedback effects. It undermines structural reforms and does not eliminate the internal foreign exchange risk in the Eurozone. The ECB neglects that only a predictable economic order will productively unveil the "particular knowledge of time and space" in EMU member states. If the ECB continues to follow its ad hoc decision making policy, it undermines much needed labour and product market reforms and delays productive investment. Progress with the liberalisation and harmonisation of country-specific market regulations would really stimulate business expansion in the Eurozone. The discussion about too much austerity, too much deflation and too less credit supply naively ignores where business activity and jobs, respectively, come from. Failure to deal with the EMU's internal regulatory barriers in order to achieve real economic convergence seriously threatens the cohesion of the Eurozone. Enforcing such reforms, however, is not a competence of the ECB.