

Economics in Brief



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ECB monetary policy: Currently no risk of inflation

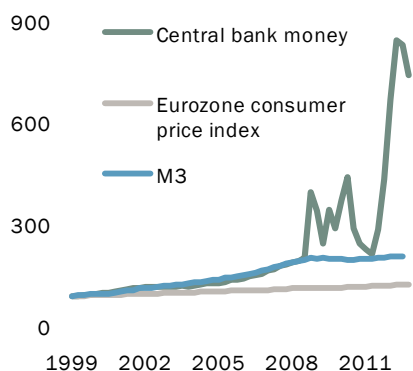
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The ECB has taken a number of steps to stabilise the financial and banking markets. In addition to reduced key interest rates and qualitative measures (loosening the criteria for ECB-eligible collateral, broadening the range of maturities of tender transactions), it has also injected considerable liquidity into the European banking system. This also included the SMP, and it would include purchases of government bonds through OMT as well. This liquidity creation has produced EUR 775 billion in central bank money (deposits from credit institutions at the ECB).

No automatic link

The high volume of central bank money is often associated with the threat of higher future inflation rates. These fears are based on the notion that higher growth in money supply leads to higher inflation. However, central bank money and money supply are not the same thing. There is no automatic link between the two, as the current situation shows (Chart 1).

Chart 1: Central bank money, M3 and price index (Q1/1999 = 100)



Source: Bloomberg, Feri

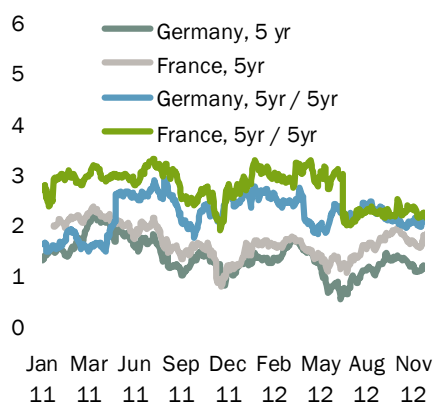
Banks currently demand central bank money not for their lending operations but for security. Bilateral unsecured money market transactions continue to be under heavy stress, and they are possible only for banks with the highest credit rating in the first place.

No inflationary climate at present

Thus, the real economy is not the reason for the high volume of central bank money. The Eurozone is in recession, and the momentum of Germany's economy has slowed significantly in the second half of 2012 as well. Demand for credit in the Eurozone is falling as a result, and in Germany credit demand has now also weakened. Even if the economic situation in the Eurozone and Germany improves again in 2013, this does not create a climate for very strong price increases based on the real economy. Accordingly, inflation expectations are currently stable (Chart 2).

There is no inflationary pressure from wages either. Increases in hourly wages in the Eurozone have remained

Chart 2: Inflation expectations (in per cent)



Source: Bloomberg

stable at around two per cent for over a year. But this level has been primarily determined by Germany (between 2 and 3%). In Italy, wage increases are around 1½%, in Spain they have fallen drastically to below 1%.

The ECB has plenty of instruments

In the short to medium term, no change is to be expected with regard to the inflationary factors mentioned above. If changes do occur, the ECB must reduce the available volume of central bank money (excess reserves) in due time to prevent inflation. To achieve this, it has the appropriate instruments:

- Suspension of refinancing operations: the suspension of periodic tender operations would gradually reduce central bank money holdings. A noticeable effect, however, would not set in until the two three-year operations mature, that is, in around two years.
- Deposits / bonds: The ECB can absorb excess liquidity through (revolving) deposit transactions or by issuing its own bonds at attractive interest rates.
- Increasing minimum reserves: A higher MR rate can limit the "leverage effect" of the reserves on lending business.

Conclusion

In the current economic climate, inflationary concerns are unjustified. Economic and lending dynamics are weak. If this changes, the ECB has the instruments to neutralise excess reserves. Only if it deliberately refuses to use them will it attract (and deserve) valid criticism. ■