# An ECB dead end

Oliver Hartwich | The New Zealand Initiative | 07 April 2016

If you are a born optimist, you may have concluded by now that the euro crisis is over. Indeed, we have not heard much about it lately. No bailouts, no bank runs, no Greek elections. It almost feels like financial stability.

If you are a realist, however, you would be looking at two figures and know that we are right in the middle of the euro crisis. One of them is very small, the other one very big.

The first figure is -0.4 per cent. That is the penalty interest rate the European Central Bank now charges banks wishing to deposit their money. Under normal circumstances, this rate would be positive. That it is not shows how desperate the ECB has become to kick money back into circulation.

The second figure is €605,006,288. This is the German Bundesbank's net position under the TARGET 2 system. Forget about the technicalities - what it signifies is the capital flight from the euro periphery to the euro centre. And forget about the absolute sum (which is gargantuan anyway) but just realise that it is 18% higher than last year. Oh, and keep in mind that under normal circumstances the TARGET 2 balance would be around zero.

Seven years after the beginning of the euro crisis and Greece's admission of fiscal irregularities, we are nowhere near monetary business-as-usual in Europe. If anything, we are further from it than ever.

The euro crisis has become chronic - but that does not mean that it cannot become acute anytime. Quite the contrary, the state of the eurozone is so bad now that even outrageous ideas for future monetary policy can no longer shock us.

A case in point - when ECB President Mario Draghi was asked what he made of "helicopter money", he did not dismiss it out of hand. Instead, he effectively told journalists that the idea of just crediting people with newly created central bank money had to be watched. In central banking speak, this basically means that it is the next logical step.

But it is also an admission that the ECB has exhausted all its conventional and unconventional policy options. What remains in their toolkit are those policies that are plainly untested, untried and unworkable.

How bad must the state of an economy be when even zero interest and negative deposit rates do not trigger any inflation response? How bad when not even quantitative easing can revive economic activity? And, indeed, how bad when the very survival of the banking system depends on such trickery?

Let there be no doubt about it. Europe has manoeuvred itself into a dead end. Or more to the point, the ECB has.

The problem with the ECB's policies is not so much that they may be technically illegal and certainly run counter to the spirit of the treaties under which the Bank was set up. The problem is that they entrench the eurozone's reliance on ECB support to the point that it can no longer be withdrawn without causing widespread damage.

Let's put it this way... If the ECB decided tomorrow, next year or in 10 years' time that now was the time to return to more normal monetary circumstances, it could no longer do so. That is because it has already administered so much of its monetary medicines that withdrawal symptoms could well kill the patient.

On the back of the ECB's ultra-loose monetary policy, we have seen several bubbles blow up in bonds, in equities and in real estate. Little wonder! All the freshly created euros had to find a new home and wherever they did, they blew up prices. Since it cannot be in anyone's interest to risk a rapid deterioration in prices anywhere, expect pressure on the ECB to remain high to continue providing even greater support in the future.

It is not just these markets that are kept alive by the ECB. It is governments as well. As about half of European government bonds now trade in negative interest territory, there is no pressing need any more to consolidate public finance or reform Europe's economies. It was the ECB that effectively did the finance ministers' jobs and helped balance the books.

Unfortunately, as a collateral damage, the appetite to reform has deteriorated across the continent. It was just too simple, pleasant and easy to rely on the ECB instead.

Finally, the ECB has also helped to keep banks alive which under more normal circumstances would have disappeared ages ago. In a development reminiscent of Japan's zombie banks in the 1990s, the ECB's policies are keeping struggling eurozone periphery banks going which should have been liquidated. However, as long as these banks can get fresh money from the ECB at zero cost, or once they will even get paid to borrow, these banks will continue to operate. And they will still be able to purchase their own governments' bonds, which is contributing to the problem of government reliance on the ECB as described above. But maybe that is the intention?

With its policies, the ECB has made itself indispensable. It is the ECB and the ECB alone that can keep the great illusion of European Monetary Union alive.

Unfortunately, in doing so, the ECB is also the guarantee that the euro crisis will be permanent. The solution to the crisis is the ECB which in turn is now also the cause of the crisis. In this way, the ECB will keep itself busy with fighting the fires which it has laid itself.

We no longer need any visible symptoms and acute reminders of the euro crisis. The euro crisis has become a permanent institution. It's called the ECB.

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