ECB keeps monetary policy on hold as tensions grow

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The European Central Bank (ECB) has kept its interest rate and quantitative easing policy on hold at the meeting of its governing council held in Frankfurt on Thursday. This was widely interpreted as a sign that it did not see any immediate rise in risks as a result of the Brexit referendum in the United Kingdom to leave the European Union (EU).

This week the level of bond purchases by the ECB passed the €1 trillion mark, under a program announced last year. In the lead-up to the meeting there had been conjecture that the bank would announce an extension of the program beyond the present cut-off date of March 2017 and widen it because the supply of bonds it is able to buy is drying up.

In his press conference, ECB president Mario Draghi instead maintained his standard response that the asset purchasing program "is intended to run until the end of March 2017, or beyond if necessary, and in any case until the governing council sees a sustained adjustment in the path of inflation consistent with its inflation aim."

Lifting the inflation rate is a central ECB objective because it eases the debt burden on banks and other financial institutions.

Keeping the present base interest rate at its present level of minus 0.4 percent, Draghi said he expected interest rates to remain "at present or lower rates for an extended period of time" and well beyond the ending of the asset purchasing program.

Draghi said the available evidence so far suggested "resilience of the euro area economy" in the face of continued global economic and policy uncertainty, but that the outlook was subject to "downside risks."

In reality, the data provided by the ECB itself, as well as other information, indicate that the bank's policies—negative interest rates and asset purchases of government and corporate bonds—are having little or no impact in achieving its stated aims of lifting inflation to around 2 percent and boosting economic growth.

According to the latest estimate from Eurostat, the annual inflation rate for August was just 0.2 percent, unchanged from the level in July. This indicates that the ECB has little chance of meeting its target in the foreseeable future.

Data from other sources show the situation is getting worse. The percentage of goods and services prices rising at less than 1 percent has risen to 58 percent, higher than when the ECB started its asset purchasing program last year. In Italy, which is experiencing virtually no growth, the figure is 67 percent.

Economic growth likewise shows no sign of improvement. While the ECB revised its estimate for growth in 2016 slightly upwards to 1.7 percent for 2016, it revised down its estimates for the following two years.

The ECB's decision not to change its existing policy sparked concern in sections of the financial press. The economics commentator for the British *Daily Telegraph*, Ambrose Evans-Pritchard, noted that large areas of the euro zone were slipping "deeper into a deflationary trap," despite negative rates and €1 trillion worth of quantitative easing "leaving the currency bloc with no safety buffer when the next global recession hits."

Evans-Pritchard warned: "The ECB is close to exhausting its ammunition and appears increasingly powerless to do more under the legal constraints of its mandate."

The chief obstacle to extending the quantitative easing measures is opposition from Germany, led by its finance minister, Wolfgang Schäuble, and backed by leaders of the country's major banks who claim that the low interest rate regime is destroying their business model.

In an editorial comment on the decision, the *Financial Times* pointed to the tensions within the ECB. It said the meeting of the governing council was notable not so much for what it did not do, but for what it did not say. While the decision to keep the policy on hold was reasonable for now, “Draghi’s inability to expand on what action to take if further stimulus is needed in the coming months is worrying.”

The extension of quantitative easing would involve reducing the current restrictions on what assets the bank can purchase, as it is running out of bonds to buy within the current guidelines. The FT noted that such relaxation would meet with “strong political opposition,” particularly from Germany, because rule changes could expose the ECB to losses or “skew purchase towards the bonds of the most indebted countries.”

The FT wrote that while Draghi “clearly would like to have said more,” he confined himself to saying that there was no question of the “ECB’s will, capacity and ability to act.” It warned: “Such assertions may serve the immediate need, but they will not be tenable for long unless the ECB is also able to spell out what its next step would be.” The editorial declared the “rearguard action” being fought by Germany against Draghi was “deeply misguided.”

Some of the tensions came to the surface during the question-and-answer session of the press conference. In his opening remarks, Draghi said governments had to take action to raise productivity and improve the business environment, in part through launching infrastructure projects to increase investment and boost job creation.

In answer to a question on this issue, he cited the September 5 communique from the G20 summit which pointed to the importance of fiscal strategies to improve growth, emphasising in an answer to a later question that this was a statement not of central bankers but of governments and finance ministers—a thinly-veiled jibe at Germany.

Draghi was more explicit after being asked if he was referring to Germany when he had said some countries have margins (a reference to budget and balance of trade surpluses) to make investments. “Countries that have that fiscal space should use it,” he said. “Germany has fiscal space.”

In conditions where the ECB’s own figures indicate that no major increase in economic growth is on the horizon and deflationary pressures continue, the tensions within the ECB are set to increase in the coming period.