How ECB Policy Could Stir Spending in the Private Sector

By Antonio Fatas , INSEAD Professor of Economics

ECB President Mario Draghi says the central bank's policy changes will support lending to the real economy. But is it that easy?

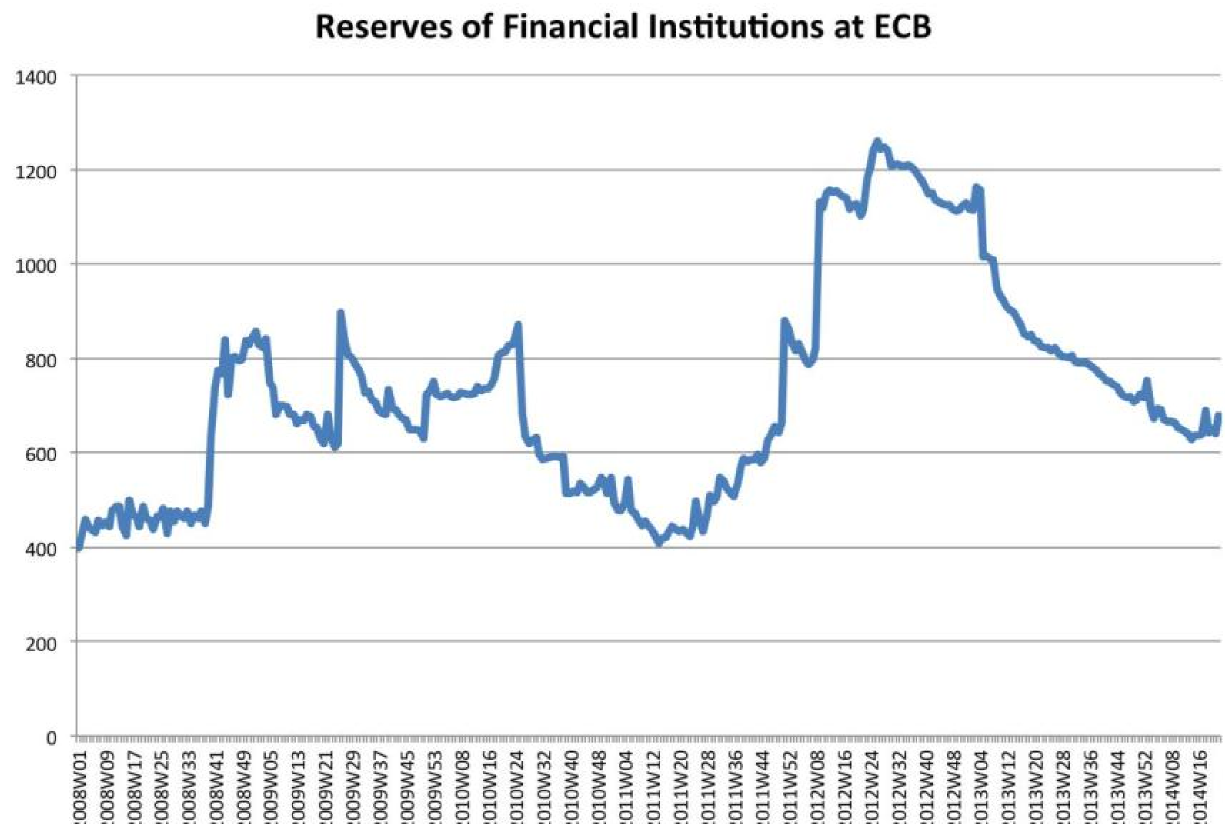
Last week the European Central Bank (ECB) announced new monetary policy actions to help restore growth in the Euro area and bring inflation closer to its 2 percent target. Interest rates were reduced and further provisions of loans to commercial banks were announced. In addition, there is a plan to implement purchases of asset based securities.

The effectiveness of recent monetary policy actions by central banks has been met with some scepticism because of their failure to deliver the necessary increase in lending to the private sector. Although liquidity is introduced, it seems to get stuck in accounts that the commercial banks hold at the central bank (reserves). Because of this, both the Bank of England and now the ECB are implementing injections of liquidity that are linked to increased lending to the private sector by the financial institutions that are borrowing that liquidity.

The role that reserves play in the recent monetary policy actions by the ECB leads sometimes to confusion. Some seem to think that the high level of reserves that banks hold is a measure of the failure of central banks to generate additional loans to the private sector. The logic being that reserves stay high because of the lack of willingness to lend. This is the wrong view of reserves: they cannot simply be seen as resources that are waiting to be provided as loans to the private sector.

Reserves are a liability in the central bank balance sheet which are created when the central bank decides to allocate more loans to commercial banks or when it decides to buy securities. If a commercial bank decides to give a loan to one of its customers (household or business), **the reserves do not disappear**. Once that customer uses its loan for a purchase, these reserves are transferred from one commercial bank to another, but the level of reserves remains constant.

How can reserves go down? In the case of the ECB, most of the injections in liquidity have been done via loans to commercial banks. Reserves will only go down **when commercial banks pay back their loans with the central bank** (or when the central bank decides to reduce the amount of loans it provides as some of the outstanding ones are repaid). So any increase in the provision of loans by the ECB will lead to an increase in reserves. Below are the two series: loans to commercial banks (an asset for the ECB) and reserves of commercial banks at the ECB (a liability at the ECB). Both series are in billions of euros (Source: ECB).



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