What Now For the European Central Bank?

By Antonio Fatas , INSEAD Professor of Economics

The European Central Bank seems to have hit the limit of what it can do to stimulate growth.

Last Thursday the European Central Bank (ECB) announced a further reduction in interest rates, extended its quantitative easing programme by increasing the rate at which it buys assets, beefed up its targeted long-term refinancing operations (TLTRO) programme and extended its horizon. On the whole the actions seemed positive: a good news story and on the whole expected. However, while the markets immediate response was very positive, they took a backward turn after a press conference falling to levels significantly below pre-announcement.

It is always hard to comment on why markets react in a certain way to statements on monetary policy but watching the press conference I felt a state of desperation and possibly confusion at the ECB, which was not very reassuring.

It’s hard to blame the bank entirely. When central banks hit the zero lower bound on interest rates, there is very little they can do. And the available tools are not easy to communicate to markets and the general public. An extra €20 billion spent on quantitative easing - including corporate bonds and loans to banks that have an interest rate contingent on the amount of net lending - are all policies that are much harder to understand and calibrate (even for economists) than a reduction in interest rates.

When central banks can't help

So what did we learn on Thursday? That the ECB wants to do more but that there is no magical tool that will get the Euro area out of its current state. The fact that the ECB seems willing to do more, despite some internal resistance, is good news. But the message (explicit and implicit) that they have clearly reached their limit is bad news. From the press conference it was clear that interest rates cannot go down any further. When it comes to quantitative easing there is always room for enlarging the set of assets that are included in the programme, although the Bank of Japan has been trying that with limited success.

In summary, the zero lower bound trap is a real one. In the absence of aggressive fiscal policy or a sudden and large improvement in the world economy, the ECB is going to have a hard time reaching its inflation target or helping the Eurozone economy return to normal growth rates.

Whatever it takes to fix this does not seem part of the tools that the ECB has at its disposal. With this in mind, I don't want to think about what future ECB press conferences are going to look like.

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