THE NORMALIZATION OF THE EUROPEAN CENTRAL BANK'S MONETARY POLICY FROM AN AUSTRIAN PERSPECTIVE

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I
NORMALIZATION OF THE ECB'S MONETARY POLICY

After several years of historically low interest rates and quantitative easing, the European Central Bank (ECB) has finally started wind-ing down its ultra-accommodative monetary policy in late 2018. Among the first steps tapering its asset purchase programme (APP), which foresees monthly purchases of up to €30bn per month until September 2018 — «or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of infla-tion consistent with its inflation aim» (ECB, 2018a). By then, pur-chases of euro area fixed income securities on behalf of the ECB will have mounted to as much as €2,550bn or almost 90% of euro area GDP (€2,834bn in market prices in Q4 2017, the latest date for which data were available (ECB, 2018b)). Further, according to market esti-mates, the first hike of the main refinancing rate, which was slashed to 0% in March 2016, could emerge in Q1 2019, thereby following a tightening of the monetary policy the US Federal Reserve (FED) had already started in December 2015 (FED, 2015).

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II
TOO LITTLE, TOO LATE?

According to Hayek's 1920 business cycle theory (ABCT), economic boom and bust cycles are mostly attributed to central bank mis-takes (Oppers 2002). The latter usually lead to a number of ampli-fication mechanisms and, ultimately, peak in significant reductions in economic activity. The resulting welfare declines are often sharp and persistent (Brunnermeier and Oemke 2013).

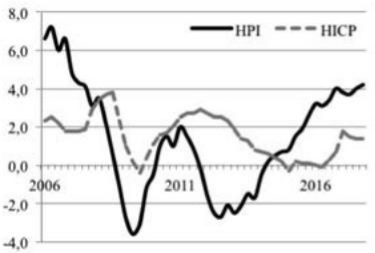
During an economic upswing, the central bank keeps interest rates too low, which, in turn, leads to investment projects with comparatively low marginal efficiency being realized. To a large extent, these projects are financed by the creation of credit on behalf of the banking sector. Rising corporate profits paired with low deposit rates trigger an increase in share prices. As long as the labour market features idle capacities, however, employees' wages will fail to meaningfully rise. Yet, with unemployment falling in line with the economic upswing, wages are set to increase, leading the corporate sector to gradually adjust prices upwards in line with the theory of mark-up pricing. Inflation will start gaining momentum. As soon as the central bank reacts to these develop-ments in an attempt to contain inflationary pressures, those invest-ments featuring a comparatively low marginal efficiency need to be unwound. Eventually, the ensuing economic downturn could turn into a full-blown recession — to which, according to the ABCT, the central bank will (unintentionally) contribute by keep-ing interest rates too high for too long (Belke and Polleit 2015).

More precisely, Hayek claimed that the creation of credit on behalf of monetary authorities pushed investment beyond socie-ty's long-term willingness to save. As illustrated above, this inevi-tably triggers a mismatch between supply and demand, which would ultimately lead to a recession. Considering that the rapid growth of credit throughout the economic upswing has led to a misallocation of resources, any monetary policy aimed at avoiding (i.e. postponing) a potential recession could only intensify the ensuing correction (Oppers 2002). What is more, an expansionary monetary policy during a period of economic weakness will merely postpone necessary structural reforms, thereby making

the subsequent and inevitable adjustment become even more severe (Dierks 2018).

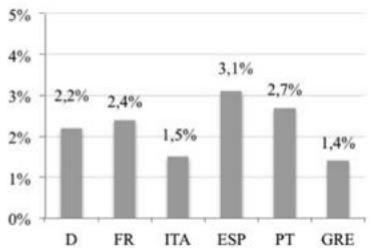
As emphasised by Hayek (1931), central banks tend to keep inter-est rates too low during economic upswings, thereby unconsciously contributing to the development of economic booms. More recently, however, and in contrast to Hayek (1931), central banks were fast to cut interest rates during a crisis in an attempt to avoid recessions. Further, the (ultra) accommodative monetary policies adopted became visible in rising asset (e.g. property, among others) prices (HPI) — rather than consumer prices (HICP) (fig. 1).

Figure 1
HOUSE VS. CONSUMER PRICE INFLATION



Source: ECB, Eurostat, 2018

Figure 2
REAL Y/Y GDP GROWTH EUROZONE



Note: 2017 data. Source: Eurostat, 2018

In other words, as could be observed in recent months and years, interest rates might well converge towards nil and central banks' balance sheets could be inflated without the need for infla-tion targeting forcing central banks to tighten their respective monetary policies (Schnabl 2016).

III
INTEREST RATES COORDINATE INTERTEMPORAL ALLOCATION

Capital restructuring is both costly and time consuming as the demand mismatch outlined above cannot be immediately

corrected. Yet, in a market economy, prices, i.e. interest rates, are *the* coordination mechanism for any intertemporal allocation. More precisely, Austrians understand an unconstrained market, without policy interference, to be the only mechanism allowing for an effective intertemporal allocation of resources (Oppers 2002).

The relevance of interest rates as a coordination mechanism can be illustrated by a sudden change in consumer preferences, i.e. con-sidering the impact of a decision to increase today's savings (at the expense of postponing consumption). Any such development would increase the supply of loanable funds, inevitably lowering its price, i.e. the interest rate, which, in turn, would lower the (opportunity) cost of investment. This prompts an increase in investment spend-ing; thus expanding the capital base. A larger stock of capital allows for enhancing production with the future supply of consumer goods set to increase. This satisfies consumers' original spending plans as they had consciously postponed consumption before.

IV
DISRUPTING THE EFFICIENT INTERTEMPORAL ALLOCATION

According to the Austrian perspective, considering the interest rate's critical role in coordinating intertemporal consumption and invest-ment decisions, attempts on behalf of the central bank to manipulate the interest rate will affect the market for loanable funds. In conse-quence, any such intervention will inevitably make the plans of con-sumers and producers intertemporally inconsistent (Oppers 2002).

The ECB's adoption of its (ultra) accommodative monetary pol-icy, i.e. the increase in the amount of money, (typically created through bank credit expansion), has seen market rates drop to below the natural rate in several euro area economies. As a conse-quence of the low interest rate environment, consumers ceteris paribus are tempted to increase consumption (at the expense of today's savings). Producers, in contrast, will seek to enhance pro-duction and thus increase investments spending. The inconsist-ency becomes obvious: as a result of the producers' increasing investments expenditures, future output is set to increase.

Consumers, in contrast, have moved their consumption forwards, i.e. they are likely to consume *less* in the future, not more. Credit-fi-nanced investment thus does not match the consumers' (question-able) willingness to postpone their consumption. Instead of observing an intertemporal transfer between consumers (saving) and producers (investing), the easy availability of loanable funds will trigger a competition over resources between these two par-ties, which can only be partly offset by an increase in output (Oppers 2002). As capacity constraints become evident, however, this competition over resources is typically biased towards invest-ment. In other words: from an Austrian perspective, the improved availability of loanable funds, which results from the central bank's quantitative easing (QE), mainly benefits producers. Investment is set to further increase and to the extent that consumers are not able to spend any more, they will become subject to a so-called 'forced saving' (Hayek 1931).

In the long run, any such credit-induced economic boom is unsustainable. Intertemporal inconsistencies will inevitably materi-alise, as changes in consumption and production patterns were not triggered by a sudden change in preferences — but by the central bank's intervention. From an Austrian perspective, this has not only led to an *over*investment but also provoked a *mal*investment. QE, i.e. the overabundance of cheap funding induced by the central bank, has sent a wrong price, i.e. interest rate signal. Producers, investing today with the aim to enhance future output, will find themselves unable to satisfy consumers' currently elevated demand.

The excess demand will lead to an increase in prices of those con-sumer goods, which are readily available relative to future con-sumption goods; in principle implying little else but an interest rate hike. In consequence, this development will require producers to re-assess their investment decisions as several of these are based on the considerably lower interest rate. Higher carrying costs would yield these investments unprofitable. Owing to this development producers' profits would fall, labour demand would drop and ulti-mately household (i.e. consumers') income would decline. A reces-sion will inevitably ensue and economic activity will not (fully) recover until producers have succeeded in adjusting their capital stock to meet intertemporal consumer demand again (Oppers 2002).

V
SEEKING TO AVOID THE UNAVOIDABLE

At first glance, the developments ultimately leading to the afore-mentioned recession do not appear to be unavoidable. As long as the central bank succeeds in preventing the (market) interest rate from rising, producers will not face higher refinancing costs and economic activity ceteris paribus remains unaffected. In an attempt to firmly anchor the interest rate at its low level, however, yet another increase in the liquidity (credit) provided is compul-sory. This renewed QE would trigger the same effects outlined above, eventually, however, (attributed to the intertemporal mis-match between consumption and production), leading to upward pressure on the (market) interest rate again. Put differently: a reces-sion can only be avoided at the expense of ever more credit provi-sion — a situation, which clearly is unsustainable. Owing to the ever-increasing rate of credit creation, the central bank will become concerned about mounting inflationary pressures. At some point, the central bank will start tightening its monetary policy. The interest rate will rise, investments will become unprofitable and the recession described above will ensue.

According to the Austrian perspective, an expansionary mone-tary policy designed to avoid an adjustment of the capital stock can only postpone a recession, not avoid it, once a malinvestment has occurred. Instead, expansionary monetary policies would merely delay necessary adjustments and might well intensify the intertem-poral mismatch between consumption and production as the inter-est rate's coordinating role continues to be distorted (Oppers 2002).

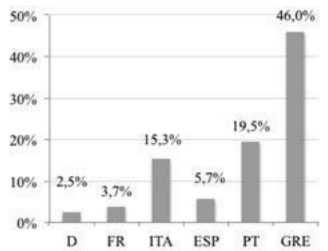
VI
ECB'S MONETARY POLICY 'BEHIND THE CURVE'

Provided no unforeseen events occur and inflation expectations do not surprise on the downside, the ECB's extraordinary mone-tary stimulus will likely be withdrawn over the course of the next few months. As laid out in the ABCT, gradually rising interest rates will render a growing number of investment projects

unprofitable. All other things being equal, the non-performing loan (NPL) ratio is set to rise (fig. 3). Further, higher interest rates, i.e. higher refinancing rates and thus opportunity costs, will typi-cally trigger a moderation of economic activity. This might be a welcome scenario for euro area member states such as Germany, whose current GDP growth exceeds its potential growth (featur-ing a *positive* output gap) , i.e. whose economic activity has started featuring signals of an overheating. For others, in contrast, most notably some of the Mediterranean Rim economies, the end of the ECB's ultra-accomodative monetary policy might still come too early — as their GDPs still remain below pre-crisis levels, respec-tively (fig. 4).

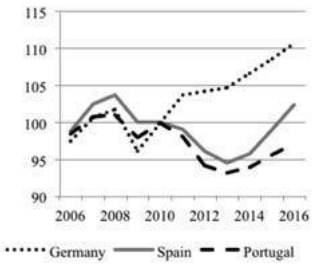
On a more general level, starting in 2012, economic growth in the eurozone has started experiencing a sound recovery with econ-omies such as Spain featuring a GDP growth of as much as 3.1% y/y in Q4 2017 (fig. 4), the latest date for which data were available (EUROSTAT 2018).

Figure 3
2017 NPL RATIOS



Source: Eurostat, 2017

Figure 4
GDP LEVELS (2010 = 100)



Source: Eurostat, 2018

Inevitably, in light of the rationale outlined above, recent eco-nomic developments triggers the question whether the normaliza-tion does not simply come too late. Further, the likely very modest pace of any tightening of the ECB's monetary policy might well add to potential woes. Clearly, this raises concerns whether the ECB's move towards a potential rate-hike cycle in 2019 is not con-siderably «behind the curve« already — or, in other words, to what

extent the ECB merely reacts to market developments — as opposed to leading them.

VII
INEVITABLE ADJUSTMENT PROCESSES

In light of the above, it is hardly worth negating that the ECB has started embarking on a tightening course too late. However, from an Austrian perspective, the debate should not focus on timing issues. Instead the question is to what extent a market intervention on behalf of a central bank cannot be primarily considered as the root cause of the distortions: it is an inadequate monetary policy, which ultimately causes and determines magnitude and duration of a boom and bust cycle (Dierks and Polleit 2015).

Scholars of Austrian Economics consider central banking and its basic feature, i.e. the creation of fiat money as well as, most nota-bly, involuntary or 'forced savings', to be the root cause of financial and economic crises (Huerta de Soto 2009). Consequently, as out-lined above, monetary policy is unable to solve the problems it has caused in the first place. On the contrary, in their attempt to fight financial crises by lowering interest rates and expanding both credit and money supply, central banks not only prevent the eco-nomic system from restoring itself back to equilibrium. They also provide incentives for malinvestments, thereby paving the way for the inevitable future crisis (Dierks and Polleit 2015).

Within the scope of a normalization of its monetary policy the ECB aims at pursuing an interest rate policy consistent with bring-ing the economy onto a path of economic stability paired with an inflation rate of «below, but close to, 2% over the medium term». Market interest rates (and eventually, the ECB's main refinancing rate) will be guided towards their natural level, i.e. an interest rate, which is believed to be consistent with price stability amid bal-anced economic growth.

Factors underlying business cycles typically have a variety of origins; including both demand and supply related causes (Dierks 2018). Among these and in light of increasingly mobile capital flows, Austrian factors may have become more important,

especially as, driven by ultra-accommodative monetary policies, herd behaviour and bubbles could encourage malinvestment — such as the one envisaged by Hayek. Thus, as has been noted ear-lier (Oppers 2002), a complete rejection of the ABCT in recent years goes too far.

Scholars of Austrian Economics understand any normalization of the ECB's monetary policy to inevitably trigger adjustment pro-cesses. In other words, even a *gradual* tightening as envisaged by the ECB cannot avoid a subsequent economic contraction. It would simply affect some investments first and spill over onto others as time elapses. Finally, bank (fractional reserve) lending will be directly affected, in turn adversely affecting economic growth. From an Austrian perspective, this contraction (i.e. recession) is lit-tle else but the unavoidable result of a multitude of economic activ-ities suddenly grinding to a halt. Typically, this type of activity, which is directly related to a loose monetary policy, is poised to end as soon as market distortions disappear, as they are crucially dependent on cheap central bank funding. Thus, a gradual tight-ening of the monetary policy would merely delay restoring an effective intertemporal allocation of resources.

According to the ABCT, the expansionary phase of the business cycle will come to an end as soon as the central bank reacts to an increase in consumer price inflation by restricting its expansion of bank reserves. Credit markets will tighten and the risk-adjusted, i.e. market interest rate rises toward its natural level, thereby con-stricting investment to the limits imposed by voluntary saving (Salerno 2012). Despite euro area consumer price inflation remain-ing modest at the time of writing, the pending normalisation of the ECB's monetary policy in the months ahead might, to the extent that this has not yet happened, trigger a re-adjustment of the monetary union's credit markets.

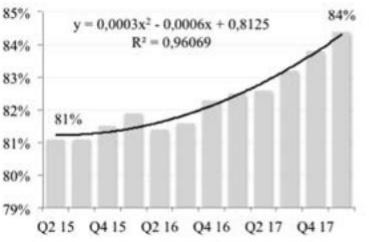
Higher interest rates will bring the investment boom to a halt and corporates producing capital (as opposed to consumer) goods will experience an unanticipated drop in spending on their output and, in consequence, falling prices and profits. At the same time spending on consumer goods will continue to increase (temporar-ily) as the new money already paid out in wages and rents by pro-ducers of capital goods are transformed into spending on consumer

goods with a time lag. Consequently, the price of labour will con-tinue to be driven up by producers of consumer goods. Confronted with rising labour and credit costs, producers of capital goods will no longer be able to profitably sustain production at current levels. Variable costs will be reduced, leading to idle production capaci-ties, as firms downsize — or even go out of business. Unemploy-ment rises and, ultimately, the recession sets in (Salerno 2012).

During any recession, spending on capital goods declines rela-tive to spending on consumer goods, thereby reversing the relative spending streams that characterized the economic boom phase. This reversal will initiate an adjustment process, which, in turn, re-establishes intertemporal consumption preferences and thus the voluntary savings of market participants. The production of consumer goods available for immediate use will increase at the expense of those available in future periods.

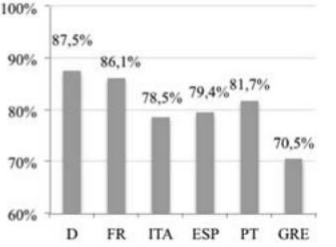
Among the sectors (economies) potentially affected hardest by the adjustments described are those, which currently operate at (or even above) capacity (fig. 5). Among these, inter alia, is the con-struction sector (across the euro area), which will likely see more moderate activities in the years ahead (fig. 6).

Figure 5
EURO AREA CAPACITY UTILIZATION



Source: European Commission, 2018

Figure 6
REGIONAL CAPACITY UTILIZATION



Note: Data refers to manufacturing sec-tor in Q1 2018. Source: Eurostat, 2018

An optimal policy response to an economic downturn will thus always vary according to the underlying causes.

VIII
CONCLUSION

Considered pragmatically, the ECB's reaction to the financial crisis should not be fully condemned. Nonetheless, a very valid (and dif-ficult to enfeeble) point of criticism is that the ECB's ultra-accom-modative monetary policy has prevailed for far too long. Thus, from an Austrian perspective, the normalization, i.e. the tighten-ing of the ECB's monetary policy is not only a step long overdue — but, perhaps even more so, a crucially necessary means to return to a monetary policy, which, in terms of distorting intertemporal allocation, is less harmful than what the euro area had witnessed over the course of the past few years.

Ceasing a predominantly dovish monetary policy will inevita-bly lead to some (more) unintended consequences (Dierks 2018). If not conducted carefully and in very modest steps, the likelihood of a pronounced dip in economic activity, i.e. a recession, is set to abruptly increase. Perhaps this somewhat resembles a fatalistic view, as it most certainly is too late to adopt countermeasures now. Ideally, at an earlier stage, the central bank had not intervened to this extent — but had instead placed more emphasis on the mar-ket's self-healing capacities. In an attempt to moderate the perils of yet another boom and bust cycle, the normalisation, i.e. the tight-ening of the ECB's monetary policy should have started long ago. Yet, ever since its inception, the European Monetary Union fea-tured considerable conceptual flaws. These, however, despite being well known, only started attracting attention once the finan-cial crisis started gaining momentum; ultimately leaving its mark on euro area money and capital markets. It thus has to be empha-sised (again) that, within its current framework, the European Monetary Union cannot prevail in the long-term. Profound reforms need to be urgently adopted.

Challenges are plenty and the long-term impact of the ECB's monetary policy remains as unclear as before. Eventually, as time will tell, the recent monetary policy has already sown the seeds for yet another crisis.

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