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Broken transmission

The European Central Bank has lost control of interest rates in Spain and Italy

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WHEN interest rates are high savers are happy, but borrowers are not. When they fall, savers' pain is debtors' gain. It is a natural trade-off. But in the euro zone these days rates hurt everyone: they are low for depositors and high for borrowers. This is especially so in Italy and Spain, where the rates small firms pay to borrow are far above those set by the European Central Bank (ECB) and those paid to depositors. The link between the ECB's "policy" rate and borrowing in the real economy is broken.

The ECB had an easy start. It was able to rely on just one tool, its short-term interest rate. When the ECB lowered its rate by half a percentage point in 2003, firms' borrowing rates fell by the same amount. When it tightened policy between 2005 and 2007, the pattern was the same. As the ECB rate went from 2% to 4%, firms' borrowing rates rose from 4% to 6% (see left-hand chart). This predictable wedge between policy and market interest rates meant the ECB knew how its decisions would feed through to the interest rates that influence output and inflation.

It also had a fair idea why its policies influenced economic activity as they did. The precise "transmission mechanism" had not always been clear: the Federal Reserve and Bank of England had been using short-term interest rates as a policy tool for years, and economists noticed that the timing and size of interest-rate influence could not be pinned solely on consumption, investment or exchange rates. The mysterious missing link was what Ben Bernanke, then of Princeton University and now the Fed's chairman, and Mark Gertler of New York University called a "black box" in a 1995 paper*. Economists generally assume that higher prices reduce demand but raise supply. Messrs Bernanke and Gertler observed that when rates rise, credit supply might fall. One "channel" through which this happens is the supply of bank lending.

The bank-lending channel works as follows. When a central bank raises interest rates, the return on government bonds rises. Banks lose deposits as customers buy bonds. To plug the gap banks switch to another source of funding—borrowing in wholesale markets—that is more costly. As their own costs rise, banks' loans become scarcer, dearer or both. This slows the economy by raising financing costs for bank-dependent borrowers. The whole process works in reverse when central banks cut rates.

The bank-lending channel would not hold in all cases, Messrs Bernanke and Gertler pointed out. Since it works because banks' funding costs rise as they take on more wholesale debt, it is only relevant for banks that have a shortfall of customer deposits. Asian banks, which have more deposits

than loans, are poor candidates. And it will be important only in countries where firms are dependent on bank borrowing. If firms can get financing via the capital markets the channel will be much weaker.

Those conditions describe the euro area perfectly. Its banks make more loans than the cash they collect as deposits. The resulting gaps are filled by wholesale funding. A recent IMF analysis shows the gaps are large, around 40% of the total funding for peripheral countries. It is also an economic area in which small and medium-sized enterprises (SMEs) are crucial. They account for between 60% and 80% of employment, according to a recent study by the OECD, an intergovernmental think-tank. The euro zone is bank-dependent and its banks are reliant on market funding. Finance in Britain works in a similar way.

That explains why central banks' normal tools are so powerful. But it also explains why they can fail to work at all. In 2008, as the euro zone started to contract, the ECB slashed its main rate from 4.25% to 1%. But because investors were worried about the state of the banks, the returns that banks had to offer on their own bonds rose. This offset the ECB's easing, so that firms' borrowing rates fell by less than normal.

When the euro crisis intensified in 2010, the ECB's influence on interest rates in Spain and Italy waned even further. Banks' bond yields rose in line with their governments' cost of borrowing. As predicted by the bank-lending channel, but now as a result of a change that the ECB did not control, the supply of loans contracted. The amount of borrowing in Italy and Spain has started to fall again (see right-hand chart). Some of this may be due to weak demand. But a 2011 study by the ECB suggested that tight credit conditions could take two percentage points off annual growth in the currency area. Recent studies by the IMF and the Bank of Italy concur: credit supply is a big problem.

Channel tunnel

Britain's experience is so similar that it provides ideas the ECB can use. The Bank of England's policy rate has been 0.5% since 2009, yet SME borrowing costs have been high and business lending has contracted. Since studies showed that tight loan supply was partly to blame, a new tool, the Funding for Lending scheme (FLS), was created in 2012. Banks first swap their assets, including bundles of SME loans, with the central bank. In return they get ultra-safe treasury bills. Banks can then offer this good collateral as security when they borrow. Because the bank's creditor gets the safe assets if the bank defaults, this form of funding is cheap.

Since SME lending attracts higher capital charges than mortgage lending, there is a risk that cheap funding will flow to home buyers but not firms. To ensure that its assistance hits the right spot, the FLS scheme was tweaked in April to target funding support to banks that increase net SME lending. The ECB was expected to cut interest rates again at its meeting on May 2nd, after *The Economist* had gone to press. If it went further and followed the FLS example, it would be controlling the bank-lending channel at both ends: directly setting banks' wholesale-funding costs and influencing where

credit flows. Such measures are extraordinary, but they may be needed to make interest rates work again.

Sources

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