Yves Mersch: Monetary policy in an environment of low growth and interest rates

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Nordea 3rd Annual Nordic AAA Seminar, Copenhagen, 13 June 2013.

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Ladies and Gentlemen,

It's a great pleasure to speak to you at this 3rd Annual Nordic AAA Seminar.

Today's seminar will examine the AAA fixed-income market, considering both the investor and the issuer perspective. It is clear that we as central bankers are closely watching these markets as they are of crucial importance.

Take, for instance, the working of monetary policy transmission. The impact of central bank action on the term structure of 'risk-free' rates is the backbone for the wider transmission of our monetary policy stance to a broad range of asset prices, to real activity and eventually to price developments. The price level is the ultimate objective of our mandate defined by the Treaty on the Union level which therefore can only be challenged by the European Court of Justice or a Treaty change.

Moreover, high-rated sovereign debt also plays a key role in our collateral framework and for the implementation of monetary policy. And finally, the yields on AAA-rated sovereign bonds provide central bankers with a rich set of information about the market's outlook for inflation or future interest rates.

The recent years of crisis have provided two important lessons on sovereign debt markets. First, for sovereign issuers, an AAA rating is not working like an automatic life-time subscription. It must rather be interpreted as an award that requires healthy public finances and sound economic fundamentals in order to keep it. And second, both financial stability and monetary policy transmission could be at risk if the smooth functioning of sovereign debt markets is hampered.

In my remarks, I will address three issues from a euro area perspective:

- First, I will give you a summary of the current economic environment in the euro area and the outlook for economic activity and inflation.
- Second, I will elaborate on our latest monetary policy decisions.
- And third, I will address some of the specific questions for our monetary policy. That is on the one hand, the challenges close to the zero lower bound in an environment of slowly receding financial sector fragmentation and very low interest rates. And on the other hand, the challenges arising from keeping interest rates low for too long. But be aware that there is no forward guidance in any of my remarks that would provoke undue volatility.

The currently low inflation environment certainly warrants an accommodative monetary policy stance to improve credit conditions in the economy. But we are not the only player in this game. Engineering a broad based recovery and returning to sustained growth in the euro area can only be based on the appropriate structural policy efforts.

Subdued price pressure over the medium term, economic activity expected to stabilise slowly

Let me start with the current economic conditions in the euro area which show a combination of subdued underlying price pressure, a shallow recovery of economic activity and weak credit dynamics.

In the euro area, the output has continued to shrink in the first quarter of the year, so that we have now witnessed a decrease in gross domestic product (GDP) output for the sixth quarter in a row. Confirming this bleak picture, the unemployment rate has stayed in double digit territory.

On a somewhat more positive note, economic sentiment appears to be slowly picking up from low levels. Looking ahead until the end of next year, the Governing Council expects euro area export growth to benefit from the recovery in global demand.

Turning to price developments, euro area headline inflation stood at 1.4 percent in May. Our definition of price stability is a positive inflation rate below 2 percent. As capacity utilisation is low and the economic recovery is expected to be slow, we expect price pressure to remain subdued. Inflation expectations are well anchored.

Finally, the dynamics of loans to the private sector is still very feeble in the euro area.

The weakness in current and expected economic activity is certainly an important factor in depressing loan dynamics to the private sector in the euro area economy. The need for deleveraging for several banks, corporations and households is further dragging on growth dynamics. On top of that some borrowers are still facing elevated costs of financing, which also differ strongly across the euro area. While fragmentation on the funding side has receded, this cannot be said of lending activity to the real economy.

Focusing on euro area banks' lending policies – the supply side of loans – credit risk and macroeconomic uncertainty remain their main concerns, according to the last wave of our Bank Lending Survey in April. In addition, the need for further balance sheet adjustment across sectors has certainly contributed to the slow pace in the provision of loans.

Euro area monetary policy remains accommodative

What I just described was a sketch of the situation which we saw in the ECB's Governing Council last Thursday: On this basis, we decided that our monetary policy stance should remain accommodative as long as necessary and we kept interest rates unchanged.

Beyond this decision on rates, there is an on-going debate on further measures the ECB could take, if necessary, to provide additional accommodation or improve funding conditions, although, as I mentioned, fragmentation on the funding side is of lesser concern than on the lending side.

This debate has taken a broad scope, including for instance: measures to revitalise the market for Asset Backed Securities; additional long-term refinancing operations; enhancing the framework for additional credit claims; and broader or targeted changes in collateral policies. All these limited measures are under study or theoretically available on the shelf.

It is in this context, that also the issue of setting a negative rate on the deposit facility has come up. Speaking here in Denmark today, I would like to say a few more words on our decision on the level of that deposit facility rate.

Some commentators wondered whether we would consider taking this rate to negative territory, and many of those drew comparisons to the Danish case, where the central bank had decreased the rate on certificates of deposits to minus 20 basis points in July 2012.

The possibly negative deposit rate is one facet of the so-called "Zero Lower Bound" debate. While this concept enjoyed some prominence in the academic literature for several years, it seems to have now spread into something routinely discussed in taxi-drive small talks.

At first sight, the term "Zero Lower Bound" seems to provide for an unambiguous metric: once the relevant monetary policy rate is zero, it cannot fall any further.

One reasoning behind this is that any type of nominal interest rate cannot fall below zero. Anybody holding an asset with such negative remuneration would simply switch to cash. Then he would ‘at least’ earn a nominal return of zero.

However, this reasoning may be incomplete. One example is the case of negative deposit certificate rates at the Danish central bank that I already mentioned.

So obviously, under certain circumstances, some assets provide particular services that make market participants willing to hold these assets although they display negative interest rates.

To understand the nature of the question on possible negative deposit rates in the euro area, let me quickly recall that the ECB operates a corridor system consisting of three rates.

First, the main refinancing rate is the interest the ECB charges in the main refinancing operations with its counterparties. It usually provides the mid-point of the corridor system. Second, the marginal lending rate is the interest charged on overnight lending from the Eurosystem to banks. It constitutes the ceiling of the corridor system. Third, the deposit facility rate governs the remuneration for excess reserves that our counterparties hold with the Eurosystem as overnight deposits. It constitutes the floor to the corridor system. Moreover, it also provides the floor on interbank market rates as banks have no incentive to lend funds below this rate in the market.

Setting the deposit rate to a value below zero would imply that the remuneration for excess reserves in the euro area is negative. In other words, banks are charged for making overnight deposits with the ECB.

From a technical point of view, we are ready to implement a negative deposit facility rate. And, in general, there are constellations conceivable where the Eurosystem could deploy such a negative rate, if it is deemed required by our mandate to safeguard price stability.

So what are the pros and cons?

Theoretically, a negative deposit rate may provide additional accommodation. In the current environment of excess liquidity, the relevant overnight interest rates have shifted close to the deposit rate. In this situation, reductions in the deposit rate could push down overnight interest rates further.

At the same time, possible caveats and unintended side effects of this move have to be kept in mind. In particular, crossing the zero line can set off actions in the market that may run counter to the central bank’s policy easing intentions. For example, there can be a substitution by private actors towards cash which becomes the highest yielding short-term asset. Similarly, the money-holding sector may promote financial innovations that could emulate currency and allow tax avoidance. These actions may undermine the underlying purpose of the move towards negative deposit rates.

Overall, the consequences are subject to considerable margins of uncertainty as such a move has never been observed in the Eurosystem or in any other major currency area in the world.

How do these considerations differ from those underlying the move by Denmark’s or the Swiss central bank?

Both countries apply a fixed exchange rate policy vis-à-vis the euro area. In contrast, the ECB does not consider the euro exchange rate as a policy target. This adds an additional complexity to the monetary policy objective function.

What could be the effects of introducing a negative deposit facility rate on the euro exchange rate? One can in principle single out three factors that would be at work. First, the traditional interest rate differential channel could exert a downward pressure on the euro. Second, a signalling effect may amplify this downward pressure, as market participants would see a realisation of a completely new scenario, which they had previously priced in as a mere possibility. At the same time, an improvement of macroeconomic prospects – the very intention of that policy move in the first place – would possibly exert upward pressure on the exchange rate.

Overall, also for the exchange rate, any gauge of the impact of a move to a negative deposit facility rate might be subject to considerable uncertainty. Also the historical experience is of limited help: the few instances of such policy movements happened under different economic constellations and for central banks that worked under different monetary policy paradigms.

So, in conclusion, we are in a situation of a professional golfer who has a huge set of specialised clubs at his disposal – and he is in principle able to master them all. He will then draw the most suitable one depending on the position of the ball and the landscape he is facing. That is, negative rates are in our bag of tools, but may or may not be deployed depending on the economic landscape. This applies to all other tools and measures that I mentioned before as well.

In this context, our monetary policy strategy provides the necessary flexibility to react to different economic and market constellations. This flexibility derives from our medium-term policy horizon and the definition of price stability. It is defined not as a point target but as a range of permissible inflation outcomes. These two elements of flexibility ensure that we do not have to mechanically react to temporary shifts of prices. Instead, we can adopt a steady hand approach. This avoids policy-induced volatility.

Challenges to monetary policy in an environment of fragmentation and the implications of protractedly low interest rates

This brings me to my third and last part: where do we stand and what are the challenges that we are facing in the euro area?

Since the outset of the financial crisis in 2007, we had to adjust and expand our toolkit in order to be optimally equipped in serving our objective of price stability amid evolving challenges.

The biggest challenge that we saw during the last year, I would summarize that with the term ‘fragmentation’.

What is behind this? Recall that our objective is to safeguard price stability for the euro area as a whole. However, fragmentation in financing conditions means that for two firms with the same credit risk, the financing conditions would depend on the area of residence. The same holds for private households. As a result, our monetary policy stance is not transmitted homogeneously in all parts of the euro area. In other words, before the crisis, an interest rate cut of 25 basis points was passed through to bond yields, bank deposit rates and lending rates in a similar fashion throughout the euro area. Now, this pass-through has become smaller on average and its effect very disparate across jurisdictions.

One of the main factors contributing to fragmentation was the increasingly perceived risk that the euro area might break up and some countries would return to a domestic currency – the so-called redenomination risk. Such fears manifested themselves as undue and sizeable spread surcharges in sovereign bond yields. But it also affected all sorts of other financial asset prices, such as corporate bond yields and other financing rates, through various contagion channels.

So if ‘fragmentation’ is the one word characterizing the main threat to our stability-oriented monetary policy, one of our most successful answers to it can be summarized in only three letters: OMT. This stands for the programme of Outright Monetary Transactions. OMT keeps up all motivation of the respective countries for consolidation and the necessary structural reforms. This ‘incentive-preserving’ feature of OMT results from the implied conditionality as well as from the fact that after the removal of the excessive ‘panic’ component of bond yield spreads, capital markets can exert their disciplining function via sovereign debt pricing.

Finally, although not a single Euro has been spent on OMT yet, the programme has been highly successful already. Let me give you a few examples, where the OMT announcement has certainly contributed to positive developments, while – of course – it cannot be singled out as the sole responsible factor:

Sovereign bond spreads for stressed jurisdictions came down from the excessive levels observed in summer 2012; sovereign bond yields in core countries also normalised by moving upwards reflecting a reversal of previously extreme flight-to-safety flows; bank deposits have been slowly flowing into peripheral countries; banks' recourse to Eurosystem financing has decreased; corporate bond spreads and financial market volatility has come down; and TARGET balances – the aggregate gross claims of national central banks against the Eurosystem – have also decreased.

While this improvement is certainly welcome, we are facing two challenges: first, significant fragmentation – while mitigated – remains. Second, we must be wary of the potential side effects of our monetary policy.

In fact, the partial relaxation in financial markets, which I mentioned, has already induced some commentators to ventilate the idea that we may face renewed exaggerations – not unlike the underpricing of risk that we have seen before the crisis in some market segments. Some even assert that the protracted period of low interest rates could by itself be a factor to trigger such distortions.

In fact, a low-interest-rate environment may in principle spur an underpricing of certain risks, support the emergence of asset price bubbles, or provide incentives to delay certain adjustments in bank balance sheets with the risk of zombie-banking and evergreening.

However, in the euro area we do not see evidence of broad-based mis-alignments in asset prices. As a case in point, common valuation metrics of major stock price valuation levels are near their historical averages – rather than exaggerated as was the case in earlier low-rate periods.

At the same time, there is no reason for complacency, and a future build-up of imbalances in certain market segments cannot be excluded. But this is exactly the field where macroprudential authorities have to be alert and intervene with market-specific instruments. So, let me repeat in this context my appreciation for the micro- and macroprudential policies at EU and national level that are underway.

Regarding the required balance sheet adjustments the benign market environment should rather be a supportive factor for that. Decent stock market valuation levels, for instance, tend to decrease the cost of capital. That's helpful for re-capitalisation. Moreover, banks' balance sheets will be scrutinized upon transition to the Single Supervisory Mechanism – once the required backstop for possible recapitalisation needs will be in place.

In any case, the level of our policy rate has to be always understood as reflecting our best attempt of safeguarding price stability in the euro area as a whole. I think, in this respect, the single objective is a very important guide post to anchor inflation expectations, but also to make transparent and traceable the trajectory of our rate setting.

Conclusion and outlook

Let me conclude. Almost six years after the outbreak of the financial crisis in summer 2007 the economic situation in the euro area is far from back to normal. Unemployment is high in several member states, growth is expected to return only gradually and credit to the real economy is reaching the real economy fairly reluctantly overall and at different speed levels across euro area countries. Following its objective of safeguarding price stability, the ECB had to activate a variety of non-standard measures to improve the transmission of its accommodative monetary policy stance. However, we are still operating in a difficult environment and fragmentation of financing conditions across the euro area is one of the most prevalent problems.

So let me finish with some key messages that, I think, characterise the policy landscape in the time to come:

1. Monetary policy has helped to prevent economic outcomes to be even worse than what we see today. Monetary policy accommodation is needed to keep prices in line with the ECB's definition of price stability.
2. The ECB has not run out of ammunition. We can employ more tools and measures whenever they will be needed.
3. But monetary policy has limits: it is not effective when it comes to structural issues and we should keep in mind the challenges that arise from keeping interest rates too low for too long. Therefore we should not forget about the responsibilities of other policy areas:
    1. A properly designed banking union is essential to restore financial integration and to support a new steady state where bank balance sheets will be fit for lending
    2. Fiscal consolidation is required to spur and maintain confidence of consumers and investors
    3. Structural reforms are key to bring euro area economies back on a sustainable growth path.

For the ECB, the different crisis modes required various modifications in our tool box of monetary policy instruments. But our objective of price stability remained time-invariant. It has served as an anchor of stability in the euro area during the crisis; it is helping the transition to a new steady state of a better-integrated euro area economy; and it will certainly remain our guiding principle in the future.

Thank you for your attention.