Peter Praet: Long-run saving and monetary policy

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Parliamentary evening on "Challenges for long term savings products in the context of the zero-interest rate policy", Brussels, 14 November 2016.

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Accompanying slides

The European Central Bank (ECB) has carried out a number of unconventional monetary policy measures since the crisis to bring about a return of inflation to our objective. These measures include targeted long-term repos, negative deposit facility rates since 2014 and large-scale asset purchases. We have received criticism of these unconventional policies from some quarters surrounding their potential negative consequences. In the light of that criticism, I wanted to answer three crucial questions tonight relating to our unconventional measures: Why have we implemented them? Have they been successful in their aims? And, finally, have they had unduly large negative side effects on the distribution of wealth and income?

The determination of long-run interest rates

First of all, I would like to spend a few moments discussing the determination of interest rates and what has happened to long-run interest rates over the past three decades. These two things have significant bearing on the rest of my remarks.

Put most simply, saving is the decision to forgo consumption today, in return for higher consumption in the future. Since people are by nature impatient, they require compensation for delaying consumption, compensation usually in the form of interest payments. That compensation is paid for by those seeking to spend more today than their current income, such as people buying houses, or firms investing in new capital, who in return will not consume all their income in the future to repay the debt. There are two parts to interest payments – the real component which is the extra amount of goods and services you can buy in the future relative to today and the inflation component which compensates for the changes in the prices of goods and services in the future.

Long-run nominal interest rates have been falling across major advanced economies for more than three decades. In major part, this is due to the success of central banks in taming inflation. The expected inflation rate and the inflation risk premium incorporated into long-run interest rates have fallen. Yet changes in expected future inflation that are in turn realised are benign for savers – it is changes to the amount of goods and services that can be purchased in the future that matter, not changes in nominal prices.

But it is not just long-term *nominal* interest rates which have been declining; long-term *real* interest rates have also fallen. Factors beyond monetary policy have played a role in driving real rates lower, which are less benign. There has been a secular decline in productivity growth rates in advanced countries, and increased pessimism about future growth. With lower expected return on capital, firms are more reluctant to invest.

There has also been a savings-investment imbalance beyond that explained by the fall in productivity growth, often referred to as a “global savings glut”. In part, this is explained by the ageing populations of advanced countries, driving up the demand for safe assets at a time when they have become increasingly scarce.

This falling real rate is bad news for savers since it means lower future returns in terms of consumption of additional goods and services. And in the long run it is the concept of the natural rate that determines the return to saving, not short-term movements in monetary policy.

This concept of a natural rate of interest represents the real rate consistent with saving and investment being in balance, output being at its potential and neither upward nor downward pressure on inflation. While the natural rate may change over time, it is unobserved and can only be estimated. Such estimation is relatively imprecise, with different models giving a range of estimates making it uncertain as to the true level of the natural rate.[1] Nonetheless, the natural rate does appear to be lower than in the past.[2]

Why unconventional measures have been necessary

Developments in the natural rate matter for the conduct of monetary policy in the euro area. To stimulate the economy, central banks steer short-term real interest rates below the natural rate to encourage the public to bring forward spending, be it in the form of consumption or investment. As the natural rate falls, so does the rate that stimulates the economy. With the natural rate now lower in the euro area, and the significant downward shock to output and inflation from the crisis, negative rates, and our other policy measures, have been necessary to stimulate demand and drive inflation towards our objective.

There is a limit to how low short-term rates can go. Since the return on cash is zero, at some point the public will switch to using cash and disintermediate the banking sector. Of course, there are costs involved in holding large quantities in cash, so the crossover point lies a little way below zero.

Given that there is a limit to how low interest rates can go, other unconventional measures have to come into play. There is not just one short-term interest rate that matters for saving and borrowing decisions. Our asset purchase and targeted long-term repo programmes seek to influence the entire constellation of rates that affect economic conditions. We have provided guidance that we will not withdraw stimulus until output and inflation are on sustainable paths. But let me emphasise once more, these measures were necessary given the size of the crisis and the already low natural rate.

Effectiveness of the unconventional measures

That brings me to my second question, have the unconventional measures been successful? The short answer is yes. The euro area economy is recovering steadily. Unemployment is falling, reaching 10% in the third quarter. Youth unemployment fell to 20.6% in the third quarter and continues to decline more rapidly than the overall unemployment rate. Bank lending to households and companies is growing, while demand for loans is rising.

ECB simulations showed that euro area GDP would be cumulatively at least 1.5% lower between 2015 and 2018 without the expansionary policy measures, with worse outcomes for inflation. And more than that: by acting timely and decisively we preserved future growth prospects. There is a growing awareness of the potential permanent negative effects of prolonged downturns, a process termed hysteresis.

There are a number of channels through which hysteresis works. Unemployed people lose valuable human capital and skills that may take time to recover. They may also become permanently discouraged from working, reducing long-run participation in the labour force. The distressingly high rates of youth unemployment witnessed in many euro area economies are likely to cause some labour market “scarring”.

Prolonged downturns may also cause businesses to become increasingly uncertain about future prospects, causing them to delay investment. This has the dual effect of depressing current economic activity, which reinforces the downturn, and reducing the amount of capital available for future production. Lower future growth translates directly into lower natural rates today, something I shall return to shortly.

Other potential consequences of unconventional measures

While our measures have been successful in their aim of stabilising output and inflation, they also carry risks in terms of allocation of resources and distribution of wealth and income. Potential risks include blunting the creative destruction of the crisis by allowing unproductive, zombie firms to remain in business and permitting the inflation of asset bubbles. Some have also raised concerns that low interest rates have reduced incentives for governments to carry out difficult fiscal and structural reforms.

These topics are complex and deserve a greater depth of comment than I have time to cover today. Given the audience here tonight, I wanted to focus on two particular potential consequences of our unconventional measures: the impact on the distribution of wealth and income, and the impact on bank profitability.

To an extent, monetary policy always works through a redistribution of activity. Lowering interest rates encourages households to bring forward to today some consumption planned for the future. Some have argued that negative rates have the perverse effect of forcing savers, such as those with a fixed savings target for retirement, to save more.

But such an argument is not borne out by the data. Since the introduction of the negative rate on our deposit facility, saving rates across the euro area have remained broadly stable, or have fallen. The only major country to have some rise is Germany. However, the profile of the German saving rate also reflects the ongoing recovery in the residential investment sector.

But before I analyse more deeply the distributional impact of monetary policy action by the ECB, let me first consider the distributional impact of monetary policy *inaction*. These effects are clear. Economic activity would have been lower and unemployment – particularly youth unemployment – higher. This would have had a disproportionately higher impact on the incomes of the poor and the young. At the same time, inflation would have been lower, which research shows transfers wealth from younger households to older households, who are more likely to be savers.[3]

So the ECB not acting also carried distributional implications. Further, the deeper and more prolonged recession would likely bring about greater hysteresis, depressing future growth and hence returns for savers. Overall, households would have been worse off had the ECB not acted.

Counterfactual discussions aside, how have households fared across the euro area? To gauge the effect on different euro area households, we can draw upon results from the Eurosystem’s Household Finance and Consumption Survey (HCFS), conducted in 2010 and 2014. Even though these surveys do not cover the period since the introduction of the negative deposit facility rate, they do coincide with declines of 2-year euro area benchmark bond yields by 130 basis points and 10-year bonds by 110 basis points.

Euro area net financial income as a fraction of total household income fell slightly. When looking more closely at households grouped by wealth quintiles, we find that households with the lowest net wealth, whose debt payments are higher than their financial income, had an unchanged position. Households with the highest net wealth, whose financial income is much higher than their debt, had the most marked fall in income.

But while net financial income has fallen for the wealthiest households, the same is not true for wealth. Wealthier households tend to have a greater amount of housing wealth and house prices have risen since the introduction of negative interest rates. Extrapolating the HFCS forward using changes in equity, bond and house price data shows increases in the net wealth for every wealth quintile.

The ECB's policy measures have been unambiguously positive for euro-area governments. Germany alone saved approximately 28 billion euro in 2015 in lower than expected interest payments. Such payments would ultimately have been financed from lower spending or higher taxes. Broadly speaking, the lower income the household sector has received from income payments from government bonds, either directly or intermediated through the banking sector needs to be offset against lower tax liabilities now or in the future.

Indeed, research by Deutsche Bank[4] shows that the impact of low and negative interest rates on the returns of German household financial assets has been limited so far. This was in part due to revaluation gains on the back of the ECB's asset purchase programme as well as interest income from investment funds and insurance and pension products. It is still possible for savers to gain positive real returns by holding a diversified portfolio of assets. Bank deposits may currently be giving a negative real return, but as research by the Bundesbank also shows, negative real returns on bank deposits is the norm, not the exception in Germany.[5]

But savers are not the only sector potentially affected by negative rates. Low and negative rates depress net interest margins for banks since lending rates fall, but there is a floor to deposit rates caused by the effective lower bound. To date, ECB staff estimates show the impact of our policy measures has been net positive for banks.[6]

Net interest margins have certainly been compressed, but that has been offset by a greater flow of lending as economic activity is higher, lower incidence of non-performing loans, again due to lower servicing costs and greater levels of activity, and revaluations of fixed income portfolios.

Over time, the revaluation effects will fade and the squeeze on net interest margins may intensify. Future expected profitability may also suffer if banks react to lower overall returns by extending riskier loans, which in turn may sour. Overall, potential negative side effects from low rates on banking sector profitability are likely to intensify the longer they are used, which is precisely why they are envisaged as short-term measures.

But our unconventional measures are not the only headwind for financial sector profitability in the euro area.[7] The overhang of non-performing loans from the financial and sovereign debt crises continue to weigh on banks' profits. At the same time, a number of jurisdictions are marked by overcapacity in banking and have average cost to income ratios markedly above those seen elsewhere in Europe and other advanced economies. Finally, banks are under increasing competition from non-banks and the FinTech sector. It is certainly a challenging time on many fronts for euro area banks, and many will have to consider carefully their business models.

Such efforts need to go hand-in-hand with further steps towards closer cross-border integration: completing banking union is crucial to allow banks to compete internationally as euro area banks and not only as national champions. We need a single euro area regulatory approach that will facilitate cross-border mergers, acquisitions and investment, thereby enhancing diversification, risk-sharing and efficiency. Only by completing what we started can we reap the full benefits of banking union.

Changes are also likely needed from savings products frequently used in the past. I believe that the really important question to debate tonight is not quite the published title, but instead: what are the challenges for long-term saving products in the presence of a low natural rate.

Conclusion

Let me sum up. The ECB's unconventional policy measures over recent years have been necessary to react to the severe negative shock arising from the crisis. They differ from conventional policy measures taken before the crisis in part because of impairments to the transmission mechanism caused by the crisis. But in major part the measures are a result of the

ECB adapting to the secular downward shift in equilibrium interest rates over the past three decades.

The measures have been successful in stabilising output, helping to reduce unemployment and have begun to help steer inflation back towards our objective. We will keep the measures in place until output growth and inflation are back on sustainable paths. While some redistribution between households is inevitable with monetary policy actions, it is clear that to date there has not been an inequitable redistribution in the euro area. Indeed, the distributional consequences of policy inaction would have been worse.

The ECB will continue to use appropriate measures available in our mandate to achieve our inflation objective. This includes the temporary use of the unconventional measures introduced since the crisis until growth and inflation are once more self-sustaining. In enhancing macroeconomic stability and inhibiting the short-term effects of the crisis from weighing on long-term economic prospects, monetary policy is providing its best possible support to long-run saving.

And it is important to view the contribution of monetary policy in the wider context of macroeconomic policy. Fiscal policy can play a greater role in stimulating demand, reducing the burden on monetary policy. Public investment as a share of GDP has declined for a number of years. It is vital that fiscal authorities re-balance towards more growth-friendly policies.

Furthermore, the secular decline in rates is not inevitable. Structural reforms are needed to unleash the productive potential of the euro area economy. Such reforms fall beyond the remit of the ECB and are the responsibility of other national and European policymakers. Now is the perfect time for such reforms, since the current accommodative policy of the ECB can help offset any short-term adjustment costs of their implementation. This is a window of opportunity that needs to be seized. Doing so will raise future income in the euro area, supporting an increase in the natural rate and boosting the returns to saving.

[1] See Orphanides, A and J. Williams, (2002), "Robust Monetary Policy Rules with Unknown Natural Rates", *Brookings Papers on Economic Activity*, Vol.2, 63–145, Laubach, T and J. Williams (2003), "Measuring the Natural Rate of Interest", *Review of Economics and Statistics 85*, No4, pp 1063–70, Laubach, T and J. Williams, (2015), "Measuring the real natural interest rate redux", *Federal Reserve Bank of San Francisco Working Paper*, No. 2015–16 and Taylor, J.B, and V. Wieland, (2016), "Finding the Equilibrium Real Interest Rate in a Fog of Policy Deviations", *Economics Working Papers 16109, Hoover Institution, Stanford University*.

[2] Notwithstanding the uncertainty over estimates of the natural rate, key drivers of long-term interest rate in a standard Solow growth model such as productivity and population growth have been slowing for decades in advanced economies, suggesting that the natural interest rate may have indeed declined. See Gordon, R.J., (2016), "The Rise and Fall of American Growth: The U.S. Standard of Living since the Civil War", *Princeton U.P*. and Goodhart C., P. Pardeshi and M. Pradhan, (2015), "Workers vs pensioners: the battle of our time", *Prospect Magazine, December*.

[3] Adam, K and J. Zhu, (2014), "Price level changes and the redistribution of nominal wealth across the euro area", *Journal of the European Economic Association*, 14 : 871–906.

[4] Deutsche Bank Research, Focus Germany – Difficult times for German savers, 4 October 2016.

[5] Bundesbank monthly report October 2015.

[6] Rostagno M., Bindseil, U., Kamps, A., Lemke, W., Sugo, T. and T. Vlassopoulos, Breaking through the zero line – The ECB's Negative Interest Rate Policy, Brookings Institution, Washington DC, 6 June 2016.

[7] For a more detailed discussion of the challenges for euro area banks and the interlinkages with monetary policy see Praet, P. (2016), "Monetary policy and the euro area banking system", Speech at ECMI Annual Conference, Brussels, 9 November 2016.