

Sabine Lautenschläger: Low inflation as a challenge for monetary policy and financial stability?

Speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank, at the Parliamentary Evening, Hamburg, 7 July 2014.

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Summary

Although low interest rates might have side effects with respect to financial stability, they were necessary for the ECB to fulfil its mandate of ensuring price stability, said Sabine Lautenschläger, member of the ECB's Executive Board, in a speech at an event organised by the Deutsche Bundesbank in Hamburg. "The risks of the rate of inflation being too low over a long period are not to be underestimated," she explained. The experience of Japan had proven that an unanchoring of inflation expectations could start a downward spiral – consumers and investors could change their behaviour and defer spending.

The ECB's Governing Council had therefore cut the main refinancing rate and had decided on a package of instruments to encourage banks to lend more to corporations and households. Excessively low inflation rates made it harder for stressed countries to adjust their economies and regain competitiveness. "We [could] soon find ourselves in a vicious circle in the euro area", Lautenschläger warned. It would take some time before the measures adopted took effect, especially the instruments designed to increase liquidity, she explained. "I would expect that to happen next year, rather than this year."

Should inflation rates not increase gradually as expected, the Governing Council was unanimous in its readiness to decide on further unconventional measures to effectively counter the risks related to an excessively long period of low interest rates, said Ms Lautenschläger. A broadly ranging programme of securities purchases was basically an instrument that a central bank could use, Lautenschläger claimed. But the requirement to be met for such a use had to be very high, because of the significant potential side effects, she said. What was also being discussed was a revitalisation of the market for asset-backed securities (ABSs), which Lautenschläger regarded as a worthwhile goal to the extent that transparent and simple securitisations were involved. For such ABSs, a purchase programme would be possible, but the ECB should only take on liquidity risk and no credit risk. Taking on credit risk, for example to encourage lending to small and medium-sized companies, was the responsibility of the governments of Member States, said Lautenschläger.

An easing of monetary policy has side effects on asset prices, said Lautenschläger. That could reduce risk aversion and increase the threat of asset price bubbles. In addition, indebtedness could increase further and the flexibility of monetary policy action could be undermined. Those were risks that should not be addressed by monetary policy to the detriment the central bank's price stability mandate. On the other hand, this did not mean that there could not be any response. Instruments of macro-prudential supervision should be used, said Lautenschläger. For example, higher capital requirements could slow down lending in the event of excesses on regional real estate markets.

President,

Senator Tschentscher,

Ladies and Gentlemen,

The European debt crisis mercilessly uncovered the imbalances in the euro area that had long been hidden.

It has generated huge economic costs.

It has presented major challenges, especially for those of us responsible for monetary policy, not least because we do not act in a vacuum where politics are irrelevant. Sound national budgets and competitive economies are basic requirements for effective monetary policy.

But it also set in motion urgently needed adjustment processes in many countries, as well as deep-reaching institutional reforms, all of which may make for healthier and more robust economic and monetary union if they are followed through to their conclusion consistently.

However, patience, stamina and reliability will be required to get there. The euro area economy is recovering from the deep recession, but only extremely slowly. Growth is currently only moderate and unemployment remains at record levels. Lending is also still extremely subdued in large parts of the euro area.

All this means that wages and prices are rising only marginally and will do so only very moderately in the euro area in the coming years, too. According to Eurostat's estimate, the rate of inflation in June was just 0.5%. And, although the projections show a slow rise in the rate of inflation to 1.5% in the fourth quarter of 2016, this would still fall short of the target.

At its meeting in June the ECB Governing Council was united in its reaction to the risks associated with such a subdued price outlook and approved a package of measures. This package was necessary to fulfil our primary mandate of maintaining price stability, even if it could have unwanted side effects – but more on that later.

(What is our monetary policy geared towards?)

With respect to assessing the June measures and their risks, I would like to start by briefly explaining when I believe monetary policy action is called for.

The mandate, which is clearly formulated in the Treaty on the Functioning of the European Union, forms the basis of any monetary policy action. It states: “The primary objective of the European System of Central Banks is to maintain price stability”.

The ECB Governing Council has given the objective of “price stability” a more specific, quantitative definition. You all know it: it is the famous 2% benchmark or, more precisely, our target of keeping the increase in prices for the euro area at below, but close to, 2%. Many expectations are associated with this target, which are often very different, depending on the traditions and experiences of inflation that prevail in the respective country: some expect the 2% target to be adhered to in every country; some become restless and see an immediate obligation to act if inflation exceeds or falls short of the target for one or two months. Others in turn only see there being a risk if inflation rises above the 2% benchmark; the risks of inflation being low for too long are then considered minor. And there are lots of economists who see inflation being higher than 2% as the solution to the crisis and the difficult adjustment processes faced by national economies.

Of course, it is not about price increases in individual countries: we make monetary policy for the euro area as a whole. And the focus is not on the prices of individual goods or services, but the stability of price levels in general. That is simple.

However, it is more important that price stability should be ensured *in the medium term*. It is therefore not about achieving an inflation rate of below, but close to, 2% every month. This cannot actually be done through monetary policy in an open market economy with free competition. So a central bank should not expose itself every month to pressure to take action, but orient itself towards the projected rate of inflation over a two to three-year horizon and of course inflation expectations. At the same time, however, price stability should not be postponed ad infinitum.

And we should certainly address upward and downward deviations in the rate of inflation from the desired target. After all, the risks of the rate of inflation being too low over a long

period are not to be underestimated. For me, keeping the downward gap to the benchmark within limits is therefore part of the price stability mandate in order to firmly anchor inflation expectations and reduce the risks of deflation.

Despite this more quantitative definition of price stability, monetary policy is not a mechanistic process. The decisions as to what monetary policy measure to take and whether it is the right one depend on the causes of the very weak price developments. For example, is sluggish lending weakening demand? Do the weak price developments reflect necessary adjustment processes in the crisis countries? Or are fluctuating oil and food prices driving the sharp fall in the rate of inflation?

Oil and particularly food prices more recently have indeed played a key role in inflation developments in recent months. And the increases in prices of services are also tending to decline, all in all, even if it is likely that this can mainly be attributed to developments in the crisis countries.

Such price changes are normally only reflected in the inflation rate temporarily. Monetary policy therefore does not normally react to temporary oil or food price developments. The fact that our mandate is geared towards the medium term allows us to look beyond such short-term developments.

So why did we deem it necessary to act? In the current situation, keeping a steady hand on the tiller would have endangered our mandate of maintaining price stability.

After all, the interplay between falling oil prices, an appreciating currency and a very faltering recovery in demand in many parts of the euro area masks the risk of a phase of very low inflation lasting too long. This can lead to market participants adjusting their inflation expectations. They would then no longer be geared to our target of below, but close to, 2%, but perhaps to the prospect of very low rates of inflation. The example of Japan shows that such a decoupling can directly endanger price stability. Falling inflation expectations may become firmly established in lower wage settlements, triggering a spiral of falling prices and expectations that would be difficult to escape. The risk is then that prices fall so sharply that, for example, consumers postpone their purchasing decisions because they expect prices to fall even further, and companies put off investment. This does not just harbour considerable risks for price stability in the euro area; deflation also increases real debt, thereby impeding debt reduction, including the reduction of private debt.

Now many critics of the low interest rate policy point out that low prices are the consequence of the necessary adjustment processes in the crisis countries. And these critics rightly argue that, in a similar way to short-term fluctuations in oil and food prices, such adjustment processes within the euro area seldom require a monetary policy reaction. They are not normally reflected in the average rate of inflation for the euro area in the medium term. Rather, the issue here is relative price changes.

Germany, too, went through this kind of reform process a number of years ago. As a result, wage and prices in Germany were below the euro area average for a long time. Back then, however, Germany was already able to improve its competitiveness thanks to low inflation, while rates of inflation in many other Member States were higher than that specified in our definition of price stability. Overall, though, inflation in the euro area was close to our benchmark.

However, the situation today is different. Even in Germany, inflation is and remains very low – it stood at 0.6% in May and 1% in June. Prices and wages in the crisis countries therefore need to *fall* even more sharply in order to make up competitive disadvantages. This in turn makes economic recovery in these countries more difficult and may therefore exert further downward pressure on prices. Then we soon find ourselves in a vicious circle in the euro area.

Overview of the measures adopted in June: design and necessity

It was these risks – in particular, the danger of a decoupling of inflation expectations – that made the ECB's Governing Council take responsive action in June.

In essence, the decisions of June comprise three elements:

- further interest rate cuts combined with the reaffirmation of our *forward guidance*;
- measures to improve the monetary policy transmission mechanism; and
- the announcement that work to prepare further possible measures in case they become necessary is under way.

The reason why we reduced the official interest rates to historical lows is that the outlook for inflation had declined yet again. According to the latest estimates of Eurosystem economists, the Harmonised Index of Consumer Prices (HICP) for the euro area will rise by only 0.7% this year. Their projections for next year put the rate of inflation at 1.1%, while the rate of inflation in 2016 is expected to be 1.4%. The projections are cautious even for Germany, where economic activity was brisk in the first half of the year and where the labour market is continuing to develop along favourable lines. Consumer prices will probably rise by only 1.1% this year, and by 1.5% next year. This compares with an average increase of 1.8% in prices in Germany over the past ten years

A further easing of our monetary policy was thus appropriate in view of a long-lasting phase of extremely low inflation. What is important in this respect is that the reduction of the main refinancing rate is factored fully into rates on the money markets, in order to enable the monetary policy easing to full effect despite already very low interest rates. The negative interest rate we have put in place for banks' deposits thus ensures that the interest rate corridor, i.e. the spread between the interest rates on deposits, main refinancing operations and marginal refinancing operations, is wide enough to continue to provide incentives for banks to trade actively on the interbank market. In addition, we have stopped the weekly withdrawal of the liquidity that injected into the markets by way of bond purchases under the Securities Markets Programme (SMP). The higher excess liquidity thus created gives the process additional impetus. And together with the negative interest rate on deposits, the package of measures adopted creates incentives for banks to no longer park their excess liquidity at the ECB, but rather to extend credit or to seek other productive investment opportunities.

The further reduction of our key interest rates in June was combined with measures to ensure that the monetary easing actually reaches those who need it most, namely enterprises still suffering from credit terms and conditions that, despite the accommodative monetary policy, remain clearly more restrictive than those for *enterprises with comparable risk profiles* in other euro area countries.

The additional measures are thus aimed at revitalising sluggish lending in the euro area through targeted injections of liquidity. For some time now, we have been observing with concern that the gap between actual lending levels and the lending levels that model-based estimates see as appropriate in the current phase of the business cycle is continuing to widen in many euro area countries.

What exactly does that mean? After a recession, it is normal for lending to only pick up in a later stage of the recovery. Enterprises, for instance, often first use internally generated funds to finance capital expenditure or investment and only take recourse to loans or other external funds after a while. In many countries, the reduction of debt levels in the wake of the severe distortions on the financial and housing markets is moreover curbing demand for credit still further.

Lending is nonetheless stalling even more sharply than in earlier business cycles. Credit growth in the euro area has, for instance, been on the decline since the second half of 2012.

Even though more recent surveys undertaken by the Eurosystem on bank lending show that credit conditions in the crisis countries have largely stabilised in the first half of this year, around 60% of the banks report that the current terms and conditions for loans are more restrictive than those prevailing, on average, over the period since 2003. And if businesses or consumers know that they have to pay more for a loan than their credit standing would justify, they will not even ask for credit.

That is exactly where the second part of our package of measures kicks in.

The two targeted longer-term refinancing operations we have announced for September and December this year will allow banks to borrow, for a period of up to four years, funds in an amount of initially 7% of their euro area non-financial private sector loans outstanding at the end of April. The focus of our endeavours in this respect is clearly on loans to businesses. That is why residential loans to households have been excluded. Between March 2015 and June 2016, all Eurosystem counterparties will be able to borrow additional funds. That additional liquidity will, however, be closely linked to the respective bank's net lending in order to ensure that the money actually goes where it is needed.

But many of you may be asking yourselves whether, given that many banks are already repaying the funds raised through the previous three-year longer-term refinancing operations early, there is really any further need for long-term liquidity.

We are indeed noting that the terms and conditions under which banks can raise funds on the money and credit markets have eased considerably (by around 100 basis points) since July 2012, and that this has slowly reduced their dependence on central bank liquidity. The TARGET balances relating to payment transactions between central banks have fallen by some €540 billion, i.e. have been almost halved. These are favourable signs.

Although financing conditions for banks in the crisis countries have improved dramatically, interest rates on loans to small and medium-sized enterprises (SMEs) in these countries are nonetheless still significantly higher than those in Germany or other core countries. The high lending rates in the crisis countries are, of course, due to the higher credit risk there, as can also be seen from the high risk of default and the proportion of non-performing loans in these countries. Some 25% of all loans extended to SMEs in the crisis countries are currently deemed to be non-performing. And, as a banking supervisor, I am happy that banks are pricing-in the risks inherent to lending. It would be of only short-term benefit to the real economies of Member States if banks were to extend credit without any close and critical look at the associated risk of default. Enterprises, in particular small and medium-sized businesses, require a banking industry that is robust and does not immediately reduce its services whenever there is an even minor downturn in growth. In order to ensure that banks remain fit and able to provide financing also over the medium to long term, the risk for each individual bank needs to be in proportion to the return. Why do I nonetheless regard targeted injections of liquidity, i.e. targeted longer-term refinancing operations (TLTROs), as appropriate? Aside from differences in credit risk, we are observing that the improvements in financing terms and conditions are not being passed on to businesses and consumers, and that this is happening even though assistance programmes have already seen the implementation of far-reaching measures to adjust the balance sheets of, for example, Spanish banks.

The low fixed interest rate on, and the extended maturity of, the new targeted injections of liquidity offer banks a different set of incentives. We are ensuring planning certainty with regard to the cost of refinancing corporate loans and providing major help with respect to maturity transformation between longer-term lending and often short-term refinancing. This could make one or another loan for corporate customers economically viable without our having to assume any credit risks. Allow me to recall here that the interest rates on our earlier three-year longer-term refinancing operations were variable. For banks, the greater uncertainty about the interest rate went hand in hand with greater uncertainty with respect to their own refinancing terms and conditions.

The new longer-term refinancing operations have a different focus and will come to bear in an environment that has changed. Potential side effects will thus have a lesser impact because yield spreads have narrowed considerably, the economic outlook has brightened and – although there are, of course, residual uncertainties – the banks have significantly improved their capital positions. All these factors should help make banks show less restraint in their lending.

And in order to be able to fully benefit from the two refinancing operations of September and December – i.e. for them to make use of the funds raised over the full four years – the banks will need to expand their lending over and beyond our benchmark over the next two years. Otherwise, they will be required to repay the borrowed funds in September 2016.

Our monetary policy measures thereby encourage banks to again increase their lending. But the banks must also be sound enough to enable them to carry out their core business of supplying the real economy with credit for productive investment.

That, too, is a reason why I attach such great importance to the comprehensive assessment exercise, the check-up on the health of banks in the euro area. Only banks that have properly written-off their losses and that are endowed with adequate capital will be able to extend credit at reasonable terms and conditions. In anticipation of the comprehensive assessment, many banks have undertaken additional value adjustments, have sold assets and have stocked up their capital over the past 12 months – in short, they have cleaned up their balance sheets. That has eliminated yet another obstacle to an adequate supply of credit next year.

(The benefits and risks of further monetary policy action)

Let me return to our monetary policy. Yes, we have adopted a comprehensive package of measures. Immediately after the announcement of these measures at the ECB's press conference, we were nonetheless confronted with the question: is that really all? When and on what basis will we consider the adoption of further measures?

Patience is a virtue – that is all I can say on this. It will take a while for all our measures to take effect. Some responses will become visible sooner. In this respect, the re-affirmation of our *forward guidance*, the prolongation of the full allotment of our standard liquidity-providing operations up to the end of 2016, was of particular importance. This form of *forward guidance* underlines the likelihood, as expressed by the Governing Council, that key interest rates in the euro area will, given the same circumstances, remain at the same level for some time to come.

Other measure such as the targeted LTROs will take longer to have an impact – in this respect, I would expect that to happen next year, rather than this year.

Should a gradual improvement of the inflation outlook not materialise, despite the comprehensive decisions taken in June and contrary to our expectations, the Governing Council was unanimous in voicing its intent to also use unconventional measures within the scope of its mandate to effectively counter the risks of too long a period of low inflation.

Does that mean that the Governing Council will run out the whole arsenal of countermeasures if, for example, new economic or geopolitical circumstances cause the rate of inflation not to converge on the desired benchmark more rapidly, as is expected at the moment? I don't think so, even though quite a number of market participants are already hoping for a broadly ranging bond purchase programme. Such a programme is, of course, one instrument in the set that is, in principle, at the disposal of a central bank. However, the preconditions for the use of such a form of monetary policy intervention need to be particularly stringent, given that the side effects are singularly pronounced. Too low yields on government and corporate bonds could create the wrong incentives and thus pose a significant risk. The underlying monetary policy reasoning behind its use must therefore be beyond question, especially in a monetary union comprising 18, and soon 19, sovereign

countries. Such an instrument could only be considered in a true emergency, for example in the case of imminent deflation. Such risks, however, are currently neither discernible nor expected.

What is also being discussed is the revitalisation of the market for securitised loans. That is certainly a worthy goal, given that asset-backed securities (ABSs) have been exceedingly demonised since the outbreak of the financial crisis. They certainly played a role in causing the crisis, but it must be borne in mind that not every case of securitisation is the same. What I am thinking of in this respect are not re-securitisation positions and synthetic securitisation transactions, but rather of very simply and clearly constructed products that are far less risky. The rate of default for European securitisations that are underpinned by SME loans, for instance, stands at around 0.1%. Since the onset of the crisis, the average default rate for Europe as a whole has been between 0.6% and 1.5%. Cause for concern are rather the default rates in the United States, which stood at between 9.3% and 18.4% over the same period.

Against this background, the Governing Council has decided, in cooperation with other relevant institutions, to gradually revitalise the market for ABSs, in particular that for securities backed by loans to SMEs. For me, that means looking once more at the capital requirements for ABS transactions. And in that respect, I am not thinking of endowing this field of business with any unjustified privileges. I am and remain firmly convinced that, in order to create a system of proper incentives for banks' internal business and risk assessment strategies, the capital requirements imposed on banks must be aligned strictly to the risk entailed in the business operations involved. As the cost of capital for ABS-related risks has been raised simplistically without much differentiation in Basel since 2010, it is now time for another look at this field of business.

But what can the ECB still do for the revitalisation of the ABS market? We have already relaxed the requirements for ABSs that are eligible for use as collateral in our refinancing operations. We have lowered the minimum standard of creditworthiness for certain types of ABS, added further classes of ABS to our range of eligible collateral and reduced the valuation haircuts for ABSs.

The market for ABSs could also be revitalised if the ECB were to directly purchase securities that are backed by corporate loans. I have an open mind regarding the assumption of the liquidity risk involved in such a measure. Depending on how these operations are designed, however, the ECB could take on not only the liquidity risk inherent to such paper, but also the credit risk. In this regard, I have my doubts. If there is public interest in market intervention, for example in order to specifically encourage lending to small and medium-sized enterprises, the national governments of Member States should not be left out of the equation or, expressed more precisely, they should not be relieved of their responsibility. For instance, government guarantee programmes implemented via state development banks for the more risky ABS tranches could be a decisive contribution to success.

Micro- and macro-prudential instruments to preserve financial stability

I have now referred often enough to the benefits, but also the medium and long-term risks, of conventional and unconventional measures. Prolonged phases of low interest rate policies and a generous supply of liquidity to banks simply do have a material influence on asset prices and the supply of credit to an economy. They may therefore also endanger financial stability, in particular if:

1. they lead to declining risk aversion and the formation of financial market bubbles;
2. the tendency to over-indebtedness increases;
3. structural problems and productivity losses are not sufficiently tackled;
4. the scope for monetary policy action is restricted.

The more the key interest rates are lowered and the longer the low interest rate phase lasts, the bigger the risk that one of these undesired side effects materialises.

How should we respond to such developments? Should monetary policymakers make compromises on their objective of price stability? I don't think so. And not only because I feel committed to our Treaty basis. A basis that we are not authorised to change. Even if, in choosing its instruments, the ECB's Governing Council cannot ignore the side effects but must precisely analyse the costs and benefits, the monetary policy objective of preserving price stability is always at the forefront; it is always the primary aim.

But that does not mean that we should simply accept these undesired side effects.

Effective macro-prudential oversight, committed to preserving financial sector stability, is a central building block for a stable monetary and economic union. Europe has comprehensively responded to this lesson from the financial crisis and has created the appropriate legal and institutional preconditions, which must now be made a reality by all EU Member States. As our experience shows, it is not enough to gear regulation and supervision exclusively to the stability of individual financial institutions. It is rather the close interaction between macro-prudential oversight and micro-prudential supervision that is one of the essential prerequisites for consistent crisis prevention.

At European and national level, there are various institutions that can counter some, though not all, of the risks of asset bubbles.

One such institution in Germany is the Financial Stability Commission, which is tasked with identifying and evaluating risks and recommending mitigating measures. Recommendations may be addressed primarily to banking supervisors, which have in recent years acquired a broad toolbox of instruments through the various legislative initiatives. For example, banking supervisors can now respond to a regional property bubble by subjecting banks to higher capital requirements in order to make credit more expensive. Thus the ECB, too, through the establishment of the Single Supervisory Mechanism, has macro-prudential powers. While the national authorities remain entitled to use macro-prudential instruments at the national level, they must notify the ECB of their measures in advance. The ECB has the option of tightening national measures. In a sense, this is a protection against a failure to act at national level and hence improves the outlook for a more stable financial system in the euro area.

Nonetheless, in particular with regard to macro-prudential supervision, there is still some conceptual work to be done. Work on a well-equipped toolbox of instruments, for example; instruments that might not only address banks, but also other financial market participants.

Conclusion

Ladies and gentlemen, following this digression, let me be clear on one thing: preserving financial stability is truly a Herculean task. Our aim must be to make the whole financial system stronger and more resilient. So it's a logical step for us to target all the measures at our disposal towards realising this objective.

But the ECB's primary objective is still to maintain price stability in the medium term. Stable prices are the basis for sustainable growth and a stable banking sector. Our most recent monetary policy decisions do justice to this mandate.

As an independent central bank, we are committed to explaining our actions to democratically elected representatives. But I personally find it particularly important to enter directly into dialogue with you. I am therefore delighted to engage in a discussion with you now. Many thanks to the Bundesbank for giving us the opportunity to do so today.