Sabine Lautenschläger: Stormy times – how is the ECB handling them?

Speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank, at the 2015 – General Assembly of the Bavarian Economic Advisory Committee, Munich, 23 November 2015.

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Introduction

State Minister Aigner,

Dr Wiesheu,

Professor Zeitler,

Ladies and gentlemen,

Let me first of all thank you for inviting me to address you, the leading representatives of the Bavarian economy, here in the Bavarian capital Munich. I am very pleased to have this opportunity to speak to you today.

Munich is no stranger to stormy times, if you think back to the many serious storms and other adverse weather conditions that have hit the city over the years. In January 2007 Hurricane "Kyrill" took the roof off the Hofbräuhaus. Only a few months later, in August 2007, storms began brewing on the international financial markets and, with the collapse of Lehman Brothers in autumn 2008, developed into a full blown storm.

What I'd like to talk about today is how the European Central Bank's monetary policy has responded, and continues to respond, to the stormy times we have been experiencing in the euro area and in Germany for more than eight years.

And in Germany in particular, since the beginning of the financial crisis, there has been much discussion about the ECB's monetary policy. No other euro area country has examined each individual monetary policy measure of the ECB as intensively and passionately as Germany. This is particularly true for the people of Bavaria, known for their clear views and plain speaking. Nowhere have the interest rate cuts, purchase programmes and negative (deposit) rates been as widely criticised as here in Bavaria. As I am also fond of plain speaking, I am happy to come here to the "den" of the Bavarian lion to discuss the objectives, risks and side-effects of the ECB's current monetary policy. We are guided by our objective of ensuring price stability. Our actions, and in particular our most recent monetary policy instruments, are not without risk. Now is an opportune moment to reflect on the pros and cons of the asset purchase programme, or "quantitative easing". In December, the Governing Council of the ECB will discuss whether further monetary policy measures are required, such as an expansion of the above-mentioned purchase programme. It is therefore time to consider carefully the costs and benefits of such an exceptional measure. Now is also an opportune moment to recall to mind the need for the national governments of the euro area countries to create in a sustained manner more growth and more jobs through sound budgetary policies and structural reforms – which, as a kind of desirable side-effect, would also facilitate the swift return to a normal monetary policy: something which is particularly close to my heart.

On the ECB's mandate and independence

In order to penetrate the depths of monetary policy, it is important to once again remind ourselves of the ECB's role and what it needs in order to fulfil its mandate. The ECB's task is to keep the value of money stable in the medium and long term. Our Governing Council has set itself the objective of keeping inflation in the euro area just under 2%. The ECB must therefore prevent both excessively high inflation and excessively low inflation or even deflation. But I will come back to that point later on.

To achieve this, the ECB needs to be independent; also independent from political influence. The independence of central banks is a relatively new, but now undisputed, achievement. The Deutsche Bundesbank was the trailblazer in this regard: since 1957 it has been the very model of an independent central bank. Since the 1990s most industrialised countries have adopted this model in one form or another. Indeed, the ECB itself was also modelled on the Bundesbank.

Why does a central bank need to be independent? On a matter as important as money, people justifiably want to see tight controls. History has shown independent central banks to be the most successful in keeping the value of money stable. The underlying principle is that responsibility for maintaining price stability should be in the hands of independent experts, rather than politicians, who are forced to think in terms of legislative periods and who may be tempted to solve problems with the printing press or, at least, to make life slightly easier for themselves through excessively low interest rates. Comparative surveys have indeed shown significant positive effects of a country's central bank being accorded independence, such as macroeconomic stability and, in particular, lower rates of inflation.

To enable a central bank to fulfil its mandate of ensuring price stability, it uses monetary policy instruments in a way that is designed to have the best possible impact on price developments. This cannot happen without side-effects. Effective monetary policy has also always had unavoidable distributional effects. A change in key interest rates, for example, shifts wealth between savers and borrowers: savers get lower interest rates on their deposits with the bank; borrowers can borrow at lower rates and use the borrowed money to invest in their own business. In addition to these direct effects, there are also indirect effects on economic activity and, consequently, on earnings and income from investments. This reallocation concerns not only individuals and generations, but also countries. It is therefore understandable that each group should try to push monetary policy in a direction favourable to them.

This is precisely why independence as a protection against interference is so important. A central bank should be able to act independently of a politically desirable or politically undesirable distributional effect and concentrate solely on maintaining monetary stability. Politicians – our democratically elected representatives – are alone responsible for resolving distributional conflicts; such conflicts should not be resolved, for lack of democratic legitimacy, through the back door by monetary policy. If a central bank were to get involved in such distributional conflicts, it would become a party in a political dispute and, sooner or later, would lose credibility. And every central bank needs credibility to be successful in the long run.

Subjecting powerful institutions to appropriate controls is an essential feature of democracies. With the privilege of independence, a central bank is with good reason exempt from part of the control. But independence also means responsibility for the central bank: an unconditional responsibility to fulfil its mandate while interpreting the limits of that mandate narrowly and respecting them consistently.

We have felt this responsibility very intensely during the storms of recent years, as we have faced the significant challenges posed by the global financial and economic crisis.

The reasons for the low interest rate policy

Ladies and gentlemen, let me now turn to the specific monetary policy decisions; decisions which have sometimes been poorly understood in Germany and have given rise to concern. I will start with our current low interest rate policy.

Let me be clear straight away: low interest rates are not something that I am enthusiastic about – not least because of the associated risks and side-effects. However, the low interest rate at present is both necessary and justified. I understand the concerns of German savers, myself included, who view the yield on their savings book with very little enthusiasm. Higher interest rates would permanently stall economic recovery, and bring about lasting low inflation, a persistent economic slowdown and rising unemployment – and this would curb the ability to save even more extensively. Moreover, interest on savings deposits also depends on the long-term economic outlook. And that is determined by the economic conditions and government policies in the euro area, and not so much by monetary policy.

The low key ECB interest rates reflect the persistently low inflation in the euro area, and also in Germany. The inflation rate in the euro area since mid-2013 has been below 1%, often well below 1%. To give you more precise figures: in October, inflation in the euro area was at 0.1%, and at 0.2% in Germany. That is significantly lower than our target of below, but close to, 2%. Since the beginning of this year, inflation has hovered around zero. This is certainly, in part, due to falling energy prices, which, incidentally, are good for economic growth and can lead us back to rising prices. However, even if the inflation rate is adjusted for the highly volatile energy prices, it has still been around 1% since autumn 2014, including in Germany.

When considering monetary stability, I am not one to focus on short-term inflation trends and fluctuations, but rather I take a medium- and long-term perspective. The inflation outlook for the next few years confirms the low price pressure in the euro area. Our inflation forecast from September puts inflation at 1.1% in 2016 and 1.7% in 2017. We are therefore slowly approaching our target – also on account of the low interest rate policy. But we are approaching that target only very slowly. A reversal of the low interest rate policy is therefore not yet warranted – and there is certainly no question of inflation risk.

The persistently too low inflation is the result of a protracted economic weakness in which the euro area continues to find itself.

Since the 2008 financial crisis the euro area has experienced two recessions, strictly speaking. The deep recession at the turn of year 2008/09 was only partially offset in 2010 and 2011. In 2012 and 2013, the economy dropped back again and recovered only very hesitantly thereafter. Overall, the gross domestic product (GDP) per capita in the euro area is still 1.5% lower than in 2008. There is still a large demand gap and investments are weak.

Many citizens are not particularly worried when inflation is low for a long time. However, the fact that not only high, but also such low, inflation entails costs and risks is sometimes overlooked.

Moderate inflation lubricates the economy by facilitating adjustments in relative prices and, above all, in wages. Price and wage adjustments are among the most important instruments for companies to improve their competitiveness. Studies show, however, that firms lower their wages only very rarely in absolute terms; instead, they do not increase their employees' pay. In times of normal inflation of about 2%, this works quite well, as Germany showed in the first decade of this millennium. However, when inflation is excessively low competition will not allow wages to soar either and the adjustment process is delayed. Low inflation thus holds back the sometimes necessary adjustment in relative wages and prices. Rigid wage structures, higher unemployment and lower economic growth are the result.

It is not only the cyclical factors that currently speak in favour of low interest rates. There are also global trends which affect the euro area and from which we cannot escape. Since the mid-1990s global real interest rates, i.e. inflation-adjusted interest rates, irrespective of the policies of the respective central bank, have been falling. Real interest rates on ten-year government bonds fell from 4% in the mid-1990s to 2% in 2007. To make it clear once again: this decrease occurred before the crisis and has nothing to do with the subsequent cuts in interest rates. The main reasons for the fall in real interest rates are the demographic development in the industrialised countries and the catching-up process in emerging countries such as China. People there, for the first time, are enjoying increasing prosperity and can save for the first time. This leads to high savings and the interest rate falls further as a result of the plentiful supply of savings. All of this has caused us to reduce the key interest rate to close to zero, like the central banks of almost all industrialised countries. Compared with other central banks, we have been relatively cautious in handling this instrument. We left the main refinancing rate, i.e. the key rate, at 1% until the end of 2011 and then, with the start of the recession in 2012, lowered it further. Since the beginning of the initial turbulence in August 2007 and especially since the collapse of Lehman Brothers in October 2008 we have done a lot to supply banks with liquidity; we have not only provided unlimited liquidity in our refinancing operations, but also extended their maturity by up to three years.

Determining the key rate and liquidity for banks are among the standard tasks of monetary policy. Yes, the current rates are exceptionally low and the liquidity for banks exceptionally generous. However, that is justified in view of the economic climate. There can be no doubt, therefore, that with its low interest rate policy the ECB is operating within the framework of its mandate.

The risks and side-effects of the low interest rate policy

Ladies and gentlemen, I briefly mentioned earlier that the low interest rate policy also has risks and side-effects. Nothing is free in life. That applies to monetary policy as well. That's why it's important to keep a close eye on the cost of certain measures and to always weigh them up against the benefits. But what costs or, more precisely, what risks are we are talking about?

Low interest rates create false incentives since they reduce the pressure on the respective governments to make savings and reforms. And reforms are what the euro area needs. The lower interest burden and the possibility of new borrowing at favourable rates make it easier for the euro area Member States to service their debts. This may lead to a relaxation of reform efforts by governments.

The situation becomes more difficult when it's more than a matter of easing the government's debt burden but if the debt level of government budgets continues to grow during the low interest phase. Then, in the worst case, a point can be reached at which the exit from the expansionary monetary policy becomes a problem – that is to say, if the increase in the key rate could lead more or less automatically to a government debt crisis. In such a situation, the central bank might find itself compelled to keep government debt sustainable. Monetary policy would then have been subordinated to budgetary policy and would have lost its freedom of action to maintain price stability.

The euro area now consists of 19 Member States. The sovereign debt crises of recent years show that the ECB comes under pressure to act in such a position. Due to the close national links between government finances and banks, the banks in the crisis countries also came under pressure. Market participants were concerned that a state in financial difficulties might not have the resources to support the banks in its jurisdiction. At the same time, a country with ailing public finances and a faltering economy does not offer the best earnings prospects for the banks operating there. Following this logic, the money and capital markets cut off funding for banks in economically weak countries – although the banks as such might have been sound. In this situation, the Governing Council found itself obliged to offer the above-mentioned long-term refinancing operations in order to support the banks there and continue to ensure the functioning of monetary policy. Not least, the fact that the political decision-making processes in Europe were, and still are, rather cumbersome added to the pressure on the ECB to act.

A second risk and cost factor arising from lower interest rates are possible disincentives and distortions in financial markets, which threaten financial stability. In the low interest rate phase, banks and investors only obtain low margins with their usual business. They are tempted to increase the low returns by building up riskier positions. To that end, they either buy riskier paper or expand their balance sheets. Such an increase in risk appetite can lead to asset price bubbles on the financial markets and excessive borrowing.

All this continues smoothly as long as the interest rates remain low and prices are fuelled by central bank purchases. But an unexpected event can occur at any time, be it a political crisis or surprisingly poor economic data; turbulence on the financial markets are the inevitable outcome. These are all the more intense the more imbalanced and risky the portfolios of investors are. We experienced that before the crisis: for example, in the case of US subprime mortgages. By fuelling the risk appetite of investors, overly expansionary monetary policy can sow the seeds for the next crisis on the financial markets. In a phase of low rates it is therefore particularly important to pay attention to the stability of the financial markets.

Of course, those investors who are obliged to invest long-term and risk-free especially find themselves under pressure. This applies in particular to pension funds and life insurance companies, which need to cover long-term insurance commitments.

This brings me to the third cost factor, the distributional effects of the expansionary monetary policy. In Germany and elsewhere, there are repeated complaints that the low interest rates are at the expense of savers. And it's true that anyone who has his money in his savings book is suffering at present.

But when one talks about the effects of the low interest rate policy, one should not only mention the cost factors. Let us consider some selected side effects, positive ones, that occur. Many home builders directly benefit from the low interest rates – even in Bavaria. And also small, medium-sized and large enterprises, of which fortunately there are many in Bavaria, can borrow cheaply to invest, to increase their market share and create employment. And the low interest rate policy also benefits Bavaria indirectly: let's not forget that Bavaria is one of Europe's most successful regions with its internationally oriented economy. More than half of the exports of Bavaria's industry go to the euro area. Therefore, the low interest rates not only stabilise the economy in the euro area, but also ensure Bavaria's exports and thus also Bavarian jobs.

And on the subject of positive side effects, we should not overlook the advantages that German taxpayers gain from the low interest rate policy; they are the ones paying lower taxes because the German Government can refinance itself at more favourable rates.

All this does not mean, of course, that I wish to play down the difficulties savers face in finding appropriate forms of saving. On the contrary. But I fear that we will for some time have to adapt to low real interest rates, even after the end of the expansionary monetary policy and beyond the control of a central bank. The reasons for this are the aforementioned major global trends, notably the demographic developments and the so-called "savings glut".

Low real interest rates are neither solely the result of the ECB's policy nor are they unusual from a historical perspective. As I have already indicated, the low real interest rates are partly the result of shifts in global savings and investments, i.e. developments beyond the control of the ECB. And there have also been prolonged episodes of negative real interest rates in the past: in Germany, for example, the real returns on savings between 1974 and 1981 and between 1989 and 1994 were almost always negative. Many people were unaware of this because the nominal interest rates were higher – but inflation was even higher.

Let me summarise my comments on the low interest rate policy. For me, the low interest rate policy was and is the appropriate response to the persistently too low inflation rate. I may not like low interest rates, but they are necessary to support economic growth and thereby to achieve the objective of price stability. In the same way, the programmes to supply liquidity to the banking industry were suitable to restore the monetary policy transmission mechanism and to relieve the banking industry. After careful consideration of the risks and benefits, I regard these standard measures as being appropriate. Although the risks associated with them are undeniable, with both monetary policy instruments the benefits currently outweigh the costs.

Quantitative easing

Ladies and gentlemen, I would, of course, not wish to leave Munich without talking about the purchase of assets – in particular government bonds – by the ECB. This purchase programme has caused quite a stir in Germany and attracted a great deal of controversy. A programme which in many countries of this world is regarded as a sensible instrument in the arsenal of a central bank is, for historical, economic, political and legal reasons, the target of fundamental criticisms in Germany. I think we could fill a whole seminar explaining why a large proportion of the German public is so sceptical about this programme. I don't want to do that here, but I would like to put on record that I share the impression of many people both inside and outside of Germany that, with the massive purchase of assets, the ECB has entered into a new era of its existence; in so doing, the ECB has assumed a new form. However, before we get lost in a philosophical discussion about the role of a central bank, let us return to the very real programme of the ECB.

As you know, in 2014 we cut key interest rates further – and, at minus 20 basis points, even took the deposit rate into negative territory. Our measures did not have an immediate impact – which was not to be expected – and both inflation and inflation expectations continued to fall initially. In the light of this, and following intensive discussions, the Governing Council decided in January 2015 to launch an asset purchase programme, also known as "quantitative easing".

The ECB programme currently foresees the purchase of securities to a value of €60 billion per month until at least September 2016. The purchases in the secondary market primarily consist of government bonds, but also include covered bonds and asset-backed securities. So far the Eurosystem has acquired government bonds to a value of €419 billion, covered bonds to a value of €134 billion and asset-backed securities to a value of €14 billion. There is a direct joint European liability for 20% of the purchased assets. The rest of the risk from the purchased securities falls on the respective national central bank.

With the purchases, the Governing Council aims to clearly signal its determination to achieve its goal of price stability. It wants to put further downward pressure on interest rates in the euro area and expects corporations and private households to make use of the favourable interest rate environment to issue bonds or take up loans. It is hoped that this investment and consumption will stimulate the economy. This should restore the inflation rate to close to 2%.

There are doubts among the general public in Germany about whether the benefits of the purchase programmes outweigh the costs. The criticism is often made that, unlike for our interest rate instrument, there are no reliable empirical data on the effect of the purchases. The benefit of quantitative easing is called into question. In fact, we can identify the first positive effects on financing conditions in the euro area. However, there is uncertainty about how large the effects actually are.

It is also pointed out that the potential benefits are also accompanied by risks. Because there is no historical comparison for the effects of such a broad programme in the euro area, these risks are, in part, difficult to assess and almost impossible to quantify. The already mentioned side-effects of the low interest rate policy – wrong incentives for governments, financial market stability and distribution effects – are even more acute in the case of quantitative easing.

Further monetary policy easing?

Ladies and gentlemen, let me briefly summarise what has been said so far: I have explained to you why I consider the low interest rate policy to be necessary and the risks it creates for financial market stability and the sustainability of fiscal policy. One thing, however, is crucial: there are limits to expansive monetary policy. It buys time, but does not heal the structural causes of the sluggish economic recovery in the euro area and the persistently weak inflation trend. Like any medicine, the beneficial effects of monetary policy measures decline with continued use, while the undesirable side-effects increase. And over-use can lead to the result that the patient feels well and no longer works on the causes of the illness. In that case, long-term harm cannot be ruled out.

Even though less than a year has passed since the decision to launch the quantitative easing programme, new measures are being considered, such as the expansion of the programme. Although certain successes of the programme are visible in the financial markets (for example, in the form of lower interest rates for long-term borrowing) the hopes of a rapid normalisation of medium-term inflation expectations have not yet been fulfilled.

However, this raises two questions. Are the inflation and economic outlooks so bad that new measures are needed? And how effective can further monetary policy measures be, in particular an expansion of the programme, in the current situation?

For me, it is clear. At the moment I see no grounds for further monetary policy measures, particularly not for an expansion of the purchase programme. For me, nothing has changed with regard to the imbalance between the benefits and risks of such a measure. This applies in particular because our programme is in full swing and, as with any monetary policy measure, it takes time for the effects to appear in the credit conditions for corporations and households.

Besides, in my view, the economic situation in the euro area has not fundamentally worsened when compared with January. According to the ECB's September forecasts, economic growth in the euro area will increase from 0.9% last year to 1.4% this year. The rate of inflation, which this year is just above 0%, is forecast to rise to 1.1% next year and 1.7% in 2017. And the Survey of Professional Forecasters indicates an expected rate of inflation of 1.9%.

The data of recent weeks suggest that, so far, the economy in the euro area has shown resistance to the uncertainties in the global economy. In addition, there are the effects of low energy prices, which have led to growth in real incomes and consumption. The low cost of financing for corporations and households is being reflected in an expansion of lending.

All of this together is evidence that the euro area is not in a situation in which there is no alternative to further monetary policy easing. With our low interest rate policy, the current scale of the purchase programme and the forward guidance on interest rates, we are already taking sufficient account of the weak economic outlook, including negative structural factors such as demographic trends, public finances and financial sector adjustments. We should give the numerous and, together, powerful monetary policy measures time to take their full effect.

For me, it goes without saying that particular caution must be exercised in connection with unconventional monetary policy measures on such a massive scale; the potential benefits must be even more carefully balanced against the associated risks and costs. In particular, I fear that, with future increases, ever greater resources will be needed to achieve the same effect.

An expansion of the monetary policy stimulus is therefore, in my opinion, overshooting the target. For me, this would only be justified as a last resort to combat an exceptional danger, such as the previously mentioned deflation. However, we are a long way from such dangers.

In the discussion, we should also not forget to ask about the reasons for the current weak growth. Subdued investment – and you know this better than me – is not only due to poor financing conditions. Often, the causes are structural economic conditions and the situation and regulation of the labour market. This is where action is required in order to encourage investment.

Let me therefore talk now about the conditions which are necessary for strong growth and employment and which therefore, incidentally, could contribute to price stability and normality in monetary policy. You can see where I'm going. How can budgetary and structural policy contribute to bringing our difficult monetary policy path to a successful conclusion? I will devote the rest of my speech to this question of appropriate framework conditions.

A framework for the return to normal monetary policy

Ladies and gentlemen, as I have explained, the ECB responds to the overall economic situation in the euro area. The economy is subject to the usual fluctuations. Monetary policy must, of course, respond appropriately to this. However, the euro area is not only suffering from economic weakness, but also has structural problems that are hampering its economic development. I am speaking about inflexible labour markets, complex tax systems, slow insolvency proceedings, unsustainably financed welfare systems and much more. All of this is like lead boots slowing down our economic recovery.

Monetary policy is largely powerless to deal with structural problems. All that we can do in Frankfurt with regard to structural reforms is to buy valuable time. Because the effect of our measures declines over time, politicians must make use of the time bought by the ECB. Only fundamental reforms will lead to a structural economic recovery in the euro area and thus create the basis for a sustainable economic upturn. When this recovery is foreseeable, it will finally be possible for the ECB to end its expansive monetary policy.

Many countries in the euro area have achieved remarkable things in the area of structural reforms in recent years, making huge social sacrifices. Examples such as Ireland, Portugal, Spain and Cyprus show that the reform efforts pay. For example, after three years of recession, the Cypriot economy will grow again this year, and the country's budgetary position is improving more quickly than expected. Ireland, Spain and Portugal are expecting a current account surplus this year – as much as 3% in the case of Ireland. Admittedly, we're not quite out of the woods yet, and we still have a long road ahead, but there are encouraging signs.

However, on the subject of structural reforms, we should not only focus on far flung horizons, but also look closer to home. Germany should lead by example. As a recent OECD study describes, this has not always been the case recently. Germany too has structural problems which need to be addressed. Examples of these include the lack of sustainable funding of the pension system, inadequate investment in transport infrastructure, and a reform of the tax system, to mention but a few. Even Bavaria should not rest on the laurels of the past, but should maintain the ambition to defend its leading position. Decisive reforms will create the basis for growth and better future prospects in the euro area. Rising investment will increase demand for labour, leading to rising wages and, indirectly, rising prices. This will not only bring an end to the low interest rates that are causing many of us such a headache, but we will again have an economically healthy and strong Europe of which we can all be proud.

Many thanks for your patience and your attention!