

Sabine Lautenschläger: Monetary policy in uncertain times – the European Central Bank and the crisis

Speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the Single Supervisory Mechanism, at a Parliamentary evening, Strasbourg, 13 September 2016.

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All beginnings are difficult. It's true of monetary policy as well.

Let's consider for a moment Europe's first central bank. In 1656 Johan Palmstruch founded Stockholm Banco, introduced paper money and triggered an economic crisis. What happened?

At the outset Stockholm Banco conducted normal banking operations: it took deposits and made loans. The deposits at that time mainly consisted of copper coins, and the most common denomination weighed almost 20 kg.

But in 1662 the Swedish state issued new coins which contained less copper. The old coins stored at Stockholm Banco thus became more valuable and the depositors asked for them back. The bank then found itself with a serious liquidity problem because the desired coins had been issued as loans.

Faced with this situation, Johan Palmstruch had an idea – an idea with consequences. Those who asked for their coins back received paper money instead. This paper money was backed by the copper coins, which had not disappeared but had simply been lent out.

The people and the state accepted the paper money; the crisis was averted. At the same time, Stockholm Banco could now make loans in the form of paper money.

It then did that, but somewhat too generously: it produced more paper money than were backed by the coins. The people lost trust in the value of the paper money and Sweden experienced inflation. To control it, Stockholm Banco stopped issuing loans and paper money. This in turn led to an economic crisis.

In 1667 the Swedish state shut down Europe's first central bank.

In the 350 years since, we have gained theoretical knowledge and practical experience. Today any first-year economics undergraduate could warn Stockholm Banco about the dangers of its policy.

While monetary policy was more art than science in the early days, now it is more science than art. But all that experience and all that knowledge cannot prevent monetary policymakers even now suddenly finding themselves in difficult terrain.

For it's not only monetary policy that has a major influence on economic growth and other important factors for the central bank, but also businesses, banks and other market participants as well as governments; thus, they too influence price stability.

Uncertain times

Looking back over the recent past, we see a decade of crisis and uncertainty; we see a whole series of "black swans" – events that could not be foreseen.

We see how the insolvency of an American investment bank triggered a global financial crisis. We see a global economic crisis, a European sovereign debt crisis and we see how the people of the United Kingdom voted to leave the European Union. Brexit was an event that few people had reckoned with, surely; an event that has heightened economic uncertainty and that may damage the economy.

Although it is still too early to draw any definitive conclusions about the effects of Brexit on the economy, our current forecasts are incidentally offering an encouraging picture. The impact seems to be smaller than many had feared. But it is in everyone's interest to pass through this phase of political uncertainty as soon as possible.

Crises now seem to have become part of everyday life and the improbable has become the norm. In such times of uncertainty monetary policy serves as an important anchor of stability.

However, the crises of the last few years have also pushed monetary policy into uncharted territory. To achieve the goal of stable prices, it has followed new paths.

Monetary policy in uncertain times – finding new ways to the old goal

The journey started in a way that is far from new. Following the failure of Lehman Brothers in autumn 2008, banks found themselves to be objects of deep mistrust. They could hardly assess their own risks, let alone the risks of other banks. As a result, they stopped lending to each other and even solvent banks could no longer refinance themselves.

At this point, the ECB jumped in and became the lender of last resort.

Basically, this is not a new role for a central bank, but one of its original tasks. It goes back to 1873 and Walter Bagehot, who wrote that “to stem a financial panic, [...] the central bank should lend freely at a penalty rate to solvent institutions against good collateral”.

The ECB has done that. It has offered the banks unlimited liquidity and extended the maturities of the relevant loans.

At the same time, it has expanded the list of eligible collateral. As a lender of last resort the ECB managed to help the banking system get through the first phase of the crisis.

When the crisis started, the ECB also reduced interest rates. Initially, this wasn't a new path either, but standard practice for monetary policy.

The lower interest rates are, the more attractive it is for companies to invest and for people to consume. Demand goes up and so do prices.

The ECB entered unfamiliar territory in June 2014 when it reduced the deposit rate for banks to below a level previously regarded as a barrier: the “zero lower bound”, as it is called.

A slow economic recovery and persistently low inflation had made that necessary. Banks are therefore now having to pay interest on their deposits at the ECB.

It may seem strange to many people to have to pay someone you're lending money to. And that's exactly what it's all about: the individual bank should have an incentive to lend its money elsewhere, for example to companies. This is one effect of negative interest rates.

The second effect concerns investors' expectations. They now know that short-term interest rates can fall below zero. Knowing this, they adjust downwards their interest rate expectations for the future and long-term interest rates fall. This boosts the desired effect on investment and consumption.

However, it is precisely these negative rates that have triggered a lively debate in Germany. There is much talk of “penalty rates” which are hurting savers and thus undermining monetary policy.

I can make four comments on this.

In the *first* place, the ECB does not set interest rates in an arbitrary fashion. Interest rates always reflect the economic situation – and that is influenced by things other than monetary policy, by labour market policy, tax policy and fiscal policy, for example.

Raising interest rates in the current situation would benefit nobody, ultimately not even savers or banks: the recovery in Europe would slow down, unemployment would rise and

inflation would fall further. This would not only worsen the banks' situation, but also increase the risk of deflation.

The **second** point applies to savers: a 3% interest rate with 3% inflation is exactly the same as a 0% interest rate with 0% inflation, although for many people it might feel different.

It's what remains at the end that matters, and that is the real interest rate. The real interest rate is that part of the interest rate which is not absorbed by inflation. And if we look at real interest rates, the current situation is not that unusual. Real interest rates in Germany between 1974 and 1981 and between 1989 and 1994 were almost always negative – it just felt different because the interest rates on paper were positive.

Third, savers are naturally not very enthusiastic about the return on their savings – I feel the same.

However, we shouldn't overlook all those who should be pleased to have very low interest rates. Anyone who takes out a loan to build a house or to invest in a business idea benefits. With rising interest rates the opposite would be true – savers would gain and borrowers would bear the burden.

Currently, the overall effect is neutral: the average net interest income of households in the euro area has not changed.¹

Fourth, in fact, not only savers, but also banks are affected by the low interest rates – their interest income is coming under pressure. It is argued that this effect could ultimately undermine the effectiveness of monetary policy. When the income accruing to banks falls too sharply, they could have no alternative but to issue fewer loans or demand higher interest rates on loans. That would be the opposite of what monetary policy is trying to achieve.

This brings us to the absolute lower limit for interest rates. This limit is reached once the desired effect of the negative rates goes into reverse – either because lending suffers or because banks and individuals start to hoard cash.

But we don't seem to have reached the absolute lower limit yet. Since mid-2014, borrowing conditions for businesses and households have improved, and loan growth is recovering. At the same time, the money supply is showing no signs of cash hoarding by individuals or banks.²

But should we feel obliged to cut interest rates even more, just because the absolute lower limit has not been reached?

I don't think so.

Conditions on the financial markets have significantly improved and economic growth is back on track – the slight effect of Brexit shows how robust the recovery is. Against this background I have my doubts about the benefits of further interest rate cuts – especially when we compare the benefits with the costs.

Negative interest rates have both a desired effect and undesired side effects. These include not only the burden on savers, banks and insurance companies but also the risk of reducing the pressure to reform on policymakers as well as the risk of creating asset price bubbles. Such measures should only be taken as and when it is really necessary and the cost-benefit analysis is still positive.

To sum up, despite these risks and side effects I still consider negative rates to be justified at the moment. But going beyond that I'm sceptical about further interest rate reductions.

¹ ECB Economic Bulletin, issue 4/2016, Box 3.

² Monetary aggregate M1, which also includes currency, grew more slowly in June 2016 (8.6%) than in the preceding month (9.1%). ECB, "Monetary developments in the euro area", 27 July 2016.

The ECB has been stepping into unfamiliar territory with another instrument – how have things been going in that respect?

When, in the second half of 2014, the medium-term outlook for the economy worsened and inflation expectations fell back, the Governing Council of the ECB decided to purchase bonds – initially government bonds and then also corporate bonds.

This programme is intended to support the other measures by additionally lowering long-term interest rates via various channels and at the same time it gives a signal that monetary policy is committed to its goal of stable prices.

What we are already seeing is that the bond purchases have helped to further improve borrowing conditions for businesses and households. It is however too early to analyse statistically the unfolding effects on growth and inflation. But analyses based on theoretical models have shown that the programme may have an effect – even though the degree of effectiveness is uncertain.³

But here too it's true that strong medicine has side effects. Particularly in Germany many people are understandably worried that the side effects could be greater than the intended effects, especially over the long term.

The critics of the purchase programme are saying that it distorts debt markets, reduces the pressure on governments to reform, blurs the boundary between monetary policy and government financing, and threaten financial stability in the long run.

As I said, we will therefore need to be patient for a while before being able to make a final assessment of the purchase programme. What matters now is to give the measures time to work.

That's why I see no reason at the moment to change the key design elements of the purchase programme.

Concluding remarks

Ladies and gentlemen, the crises of the past few years have thrust monetary policy into unknown territory.

But we are far from the times of Banco Stockholm, when there was no clear objective for monetary policy, no theoretical basis and no experience of such matters. Yes, the crisis has pushed monetary policy into uncharted territory, but we have a clear objective and we know where we are thanks to theory and experience.

However, in recent years we have done a lot for the first time. The key question is whether our package of measures works – and it's only as a package that the effect can be assessed. Have we come nearer to our objective of bringing inflation back to a stable level of close to, but below, 2%?

What we are seeing is that conditions on the financial markets are improving – I mentioned that earlier with regard to the individual measures. And when the conditions on the financial markets improve, the ground is prepared for a return to higher inflation.

So monetary policy is working. We are approaching our goal, albeit by following new paths.

But we must not overlook two things.

First, the individual measures cannot be continued indefinitely – at some point, for example, interest rates will hit their absolute lower limit.

³ Deutsche Bundesbank (2016), Monthly Report, June 2016.

Second, the measures cannot be continued indefinitely – at some point the effect of the measures will get weaker and the risks will predominate.

In my view instead of new and always more extreme measures we need a little patience. We should not forget that returning inflation to just under 2% is a *medium-term* goal. Our current projections see inflation in 2018 back at 1.6%.

Ladies and gentlemen, price stability is a necessary condition for growth and prosperity, and the ECB is doing everything to ensure it. But monetary policy alone cannot build factories or create jobs or balance national budgets. It can only create the right conditions for these things.

Ultimately, it's up to governments. They have to complete the necessary economic reforms, strengthen the institutional foundation of Economic and Monetary Union and bring these times of uncertainty to an end.

Thank you for your attention.