Yves Mersch: Behaving responsibly in a low interest rate environment - a central banker's perspective

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Stiftung Marktwirtschaft: Expertentagung "5th Kadener Gespräch", Alveslohe, 10 February 2017.

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The policy of the European Central Bank (ECB) is often said to be at the root of the current problems in the banking and financial sector. Particularly in Germany, there’s the added accusation of monetary policy “expropriating” savers.

A closer look quickly reveals that such hasty judgements fail to appreciate the complexity of the matter. Today, therefore, I shall examine carefully the underlying reasons for our monetary policy action. By focusing on the reasons for our actions we can understand more easily how to get back to a normalisation of monetary policy.

Low natural interest rates

Why are interest rates so low?

The growth trend has been declining in many mature economies not just since the crisis, but for several decades. This slowdown in growth has led to lower long-term interest rates.

The structural causes of this trend of slowing growth is a subject of controversy among specialists. Demographic and technological developments are mentioned, as are the effects of the financial cycle, which may be out of sync with the business cycles. I do not want to pre-empt this ongoing discussion. Instead, I would like to focus on two issues, which in the current context are very relevant from a monetary policy perspective – regardless of the structural causes underlying the weak economic growth.

First, the slowdown in growth in this environment increased the risk of a self-reinforcing downward spiral. For the weak growth dynamics will not go unnoticed by economic actors: their expectations are worsening. If, for instance, a company expects demand to fall, it will be less inclined to make big investments.

Secondly, ageing societies, which exist in many mature economies, not only have to cope with a shrinking labour force, but they also have to save more. This has led to a savings glut and to a shortage of safe assets. So investments are falling and savings are rising. This weakness of investment is further reinforced when public authorities invest less than is even needed to preserve the capital stock. This is a cause for concern especially where both fiscal space and demand exist.

This dynamic has led to a reduction in the natural interest rate, i.e. the real rate of interest in which savings and investments are in equilibrium in an economy operating at its potential, where there is neither upward nor downward pressure on inflation.

In the current environment, the ECB has brought the market rate below the level of the natural rate. The key rate since March last year has been at zero and the rate on the deposit facility at –0.4%.

Had we not done this, constant nominal interest rates amid falling inflation rates would have led to higher real interest rates and undermined anaemic growth even more. This would have significantly increased the risk of deflation. This is just as harmful as accelerating inflation. As Walter Eucken said: “Deflation distorts the price framework just as much.”[1]

Thus, price stability for the ECB means that we have to protect European citizens not only from inflation rates that are too high, but also from a deflationary spiral. This is reflected in our quantitative definition of price stability: an inflation rate of below, but close to, 2% in the medium term.

We therefore acted in order to abide by this symmetrical mandate on price stability.

But we are aware that we cannot lower our interest rates to an unlimited extent.[2] As from a certain level, it becomes more attractive to keep cash – despite the associated costs – than to pay negative interest rates. And even if this point has not yet been reached, we are bearing in mind that further rate cuts into negative territory may have non-linear effects. The reactions of people *in extremis* cannot be anticipated.

But we can also influence market interest rates in other ways. Thus, for example, with our asset purchases we have pushed the yield curve down. And by offering targeted longer-term refinancing on favourable terms which reward additional lending, we have made it possible for banks to cut their interest rates, a move which has led to increased lending.

All these measures in recent years have contributed to the economic recovery in the euro area.

Thus, both the demand for, and supply of, credit is rising.

In the real economy, too, positive surprises have predominated recently. The growth rate in the fourth quarter of last year rose to 0.5 %. In the euro area, the seasonally adjusted unemployment rate fell to 9.6% in December. In November it was 0.1 percentage point higher and in December of the previous year it was still at 10.5%.

Overall, the prospects for economic growth in the euro area are increasingly positive. However, while the data within the monetary union is pointing to growth risks being more and more in equilibrium, uncertainty and the risk of political shocks outside continental Europe have clearly gone up.

To put it another way: while the economic outlook for the euro area is steadily brightening, dark clouds are building up on the political horizon beyond the continent.

But of course we shall pay particular attention to how prices evolve. The annual rate of inflation rose, according to provisional estimates by Eurostat in January, by 0.7 percentage point to 1.8%. This sharp jump in the rate of inflation is largely attributable to volatile components, namely energy and, to a somewhat lesser extent, food. Core inflation, on the other hand, which excludes food and energy, remained stable at 0.9%.

For us, the overall inflation rate is the key figure because we protect the purchasing power of citizens, albeit in the “medium term”, not on a month-to-month basis. Given the current high variability of energy prices, indicators of the underlying price dynamics say more about future developments than about the overall inflation rate.

We still assume that, because of energy prices, the overall inflation rate will rise until the middle of this year – reaching our “comfort zone”. But one swallow doesn’t make a summer. For in the second half of the year, it is likely to fall again and then reach 1.5% in 2018.

So, subdued inflation will be with us for quite some time, but the spectre of deflation has disappeared from the radar of market participants.

For this recovery to gain traction, we have to keep our word. The adjustments to our asset purchase programme will be implemented as announced in December – because, first, it contributes significantly to the economic recovery and stabilisation on the price front. And second, monetary policy in times of heightened uncertainty must be a guarantor of stability and reliability by being credible.

And yet, at the same time, how much longer can we continue to talk about “even lower rates” as being a monetary policy option? Considering the importance of credibility for a central bank, as mentioned, there should be no delay in making the necessary gradual adjustments to our communication.

But support from the political dimension is needed too. Structural reforms are required in various areas as well as fiscal stimulus where budgetary flexibility exists.

And what sounded like a platitude yesterday risks being forgotten today: political stability, the rule of law and reliability are essential conditions for maintaining our prosperity. And only open markets and free trade make it possible to boost this prosperity. We need to make the cake bigger, instead of squabbling over the existing portions. Protectionism will only lead to a loss of prosperity for all.

Impact of monetary policy on banks

We are aware that our measures have side effects and that these become more pronounced the longer the unconventional measures last. Let me emphasise that these measures are temporary and are not a permanent part of our active toolbox.

To mitigate risks as far as possible, we closely monitor the broader repercussions of our monetary policy. We carefully watch insurance companies, pension funds and, above all, banks, which play a key role in the transmission of our monetary policy.

Let’s first of all take a look at the banks: over the longer term abnormally low or negative interest rates, together with a very flat yield curve and negative term premia, can have adverse effects.[3]

Those banks whose business depends heavily on maturity transformation and on deposit-based refinancing are being hit particularly hard. And as it is difficult to pass negative interest rates onto retail customers and as the introduction of fees provides only limited remedy, some of the banks will have to adapt their business models. Also, consolidation will continue to be necessary to increase efficiency in the long term.

We are now already seeing that concerns about the future profitability of banks are affecting their share prices. The euro area bank index fell by around 40% between August 2015 and August 2016. This decline was driven by, among other things, a worsening outlook for the global economy and growing concern about the effects of the low interest rate environment and non-performing loans. When banks’ share prices fall, their cost of equity increases, which could then reduce the net return on lending. This may cause banks to become more conservative in their lending in future and to raise the cost of lending. Internal calculations have shown that a decline of around 10% in a bank’s share price reduces corporate lending by around 0.5 percentage point.

Allow me, however, to comment on the sometimes severe criticism, especially from Germany, that we face: the German banking sector is one of the largest in the euro area but at the same time it’s the least efficient. German banks have a cost-income ratio of 73%, which is much higher than that of the rest of the euro area. And while other countries have cut the number of banks by almost a quarter following the financial and economic crisis in order to reduce overcapacity, the corresponding figure for Germany was only 10%.[4]

Traditional business models under review

The current low interest rate environment has not just revealed weaknesses among banks, it has also called into question the traditional business models of insurance companies and pension funds.

For many insurers in Germany, guaranteed returns have become an issue. In the current market environment, it is becoming increasingly difficult to achieve the guaranteed interest rates of 4% that were commonplace in contracts concluded in the mid-1990s. The German ministry of finance has reduced the guaranteed interest rate for the current year from 1.25% to 0.9%. Many insurance companies are now increasingly turning to unit-linked products.

In addition, new regulatory requirements are increasing the demand for safe assets. German government bonds alone are yielding negative returns on maturities of up to seven years.

Against this backdrop, discussions are under way as to what can be done to counter this shortage of safe assets. One suggestion is that market participants create a new kind of safe asset, known as European Safe Bonds (ESBies)[5], consisting of the senior tranche of a portfolio of existing bonds from different euro area countries. The advantage here would be that no joint liability would exist, as is the case in other proposals of this kind.

From a purely academic perspective, this is certainly an interesting idea. But it would be difficult to counter the public's assumption that this would be a surreptitious mutualisation of sovereign debt. The political desire to introduce ESBies in the near future is likely to be very limited.

I therefore don't see this proposal as being part of the operational agenda but rather as a subject for long-term study.

Outlook

Let me conclude.

Weakening global growth and a generally lower natural interest rate are demanding very low, sometimes negative, market rates so that investment and consumption become more attractive. In the medium term we are thereby aiming to get inflation back to a level in line with our mandate to ensure price stability of below, but close to, 2%.

Without our measures, the euro area economy would probably have slipped back into recession, with the risk of fully fledged deflation. We had to act and have prevented things from getting worse. Our measures have proved effective.

Our mandate is clear. It says that in the medium term we have to achieve an inflation rate of below, but close to, 2%. This is the only goal that our unconventional measures are also bound by. And price stability is an exclusively internal objective – the ECB does not pursue an exchange rate policy.

Nevertheless, the longer it takes to achieve this goal, the greater the risk that the side effects of our measures become stronger, especially of the negative rates. While we are doing what we can to keep the side effects to a minimum, the financial industry must play its part and adapt as far as possible.

The recovery has started. However, for it to be sustainable, we must first and foremost address the causes of this global low interest rate environment. But monetary policy cannot manage this on its own – not least because our measures are not intended to become a permanent feature of the system.

The economic recovery cannot be sustained by monetary policy alone; it also needs support from politicians. The main objective is to bring about a turnaround in global growth. This involves stepping up fiscal policy measures where there is scope and need. We also require reforms that increase productivity.

But even these political measures won't be effective if the virus of isolationism is rife. Because the plague of protectionism only creates losers.

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[1] Eucken, W. (1990), "Grundsätze der Wirtschaftspolitik", 6th edition, J.C.B. Mohr (Paul Siebeck), Tübingen, p. 257.

[2] See Rostagno, M., Bindseil, U., Kamps, A., Lemke, W., Sugo, T. and Vlassopoulos T., (2016), "Breaking through the zero line: the ECB's negative interest rate policy", Brookings Institution, Washington DC, 6 June. The presentation is available on the website of the Brookings Institution.

[3] Borio, C., Gambacorta, L., Hofmann, B., (2015) "The influence of monetary policy on bank profitability", *BIS Working Paper* October.

[4] Mersch, Y. (2016), "Low interest rate environment – an economic, legal and social analysis", speech at the University of Applied Sciences of the Deutsche Bundesbank, Hachenburg, 27 October.

[5] Brunnermeier, M., Langfield, S., Pagano, M., Reis, R., Van Nieuwerburgh, S., Vayanos, D., (2016), "ESBies: Safety in Tranches", ESRB Working Paper Series, No 21, September.