Benoît Cœuré: Price stability as the basis of a sustained recovery

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the Wirtschaftstag 2014, Berlin, 3 July 2014.

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Summary

Only sustainable growth via enhancing the productive potential in the euro area will lead to an environment that secures fair prices for credit and fair compensation for savers, said Benoît Cœuré, member of the ECB's executive board. Cœuré explained in his speech at the Wirtschaftstag in Berlin the ECB's monetary policy in the current environment of a stagnating economy. "In a stagnating economy savers complain about low returns while borrowers complain about too restrictive credit conditions". Only an economy with sustainable growth and price stability can solve this dilemma.

"The only way to move on from the current low interest rate environment is to reinvigorate the productive potential of the euro are economy", Cœuré said. Like Ludwig Erhard did by establishing the social market economy after the war, euro area countries today need to go on with fiscal, structural and institutional reforms to revive the area's productivity potential. Monetary policy can only facilitate that process but not change the long-term path. "Governments should not view the current period of low interest rates and favourable market sentiment as an invitation to abandon the path of fiscal prudence."

Cœuré said that the measures the ECB's governing council had agreed in June have been warranted because of the low inflation in the euro area as a whole and also in Germany. The fall in German inflation was adding the risk of a race to the bottom for the euro area as a whole, with potentially disruptive economic consequences. "We had to act, otherwise we would not have lived up to our mandate."

On the complaints of German savers he said that, as shown by the Bundesbank, the current low real rate of return is not exceptional historically. In fact, the real rate of return on deposits had been persistently negative during previous decades, but savers had not realised it because of higher inflation.

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Ladies and Gentlemen,

Last year at this event President Draghi quoted Ludwig Erhard, the father of the "Wirtschaftswunder", the German economic miracle.

It was the principles of ordoliberalism that Erhard applied to put this country on the road to recovery after the war. He gave political life to the unconventional yet ultimately successful "social market economy". Following a political battle against interventionists and central planners at the time, Erhard's ideas were finally approved in August 1949, when his party secured an electoral victory. He fulfilled the mandate bestowed on him by revitalizing a ravaged Germany.

The social market economy has become much more than a central tenet of German economic policy. European leaders have committed themselves to it and enshrined it in the Lisbon treaty.[1] For us at the ECB this ordoliberal foundation is most clearly expressed in our steadfast commitment to price stability. Erhard did not shy away from taking bold decisions to

1 Art. 3.3 of the Lisbon Treaty "The Union shall […] work for the sustainable development of Europe based on […] a highly competitive social market economy, aiming at full employment and social progress […]".

fulfil his political mandate, and we do not shy away from taking bold decisions to fulfil our price stability mandate.

Why did we act in June?

Prior to our June decision, the euro area inflation rate had fallen by two-thirds in less than a year. In May and June it reached just about 0.5% – far from our medium-term definition of price stability of below, but close to, 2%.

Even in Germany inflation has declined markedly. It has hovered around 1% in recent months. As Germany plays a benchmark role for peripheral countries in correcting their imbalances, this fall in the country's rate of inflation was adding to risks of a race to the bottom for the euro area economy as a whole, with potentially disruptive economic consequences.

We had to act, otherwise we would not have lived up to our mandate.

Why did we adopt specifically this set of measures?

Our policy deliberations started off from three contingencies that could generate further downside shocks to inflation, and keep it low for a longer period than consistent with our medium-term horizon.

- The *first contingency* was an unwarranted tightening of the effective monetary policy stance originating from an erosion in money market liquidity or adverse spillovers from global financial conditions. Accordingly, we reduced the key ECB interest rates and reaffirmed our forward guidance, indicating that interest rates would stay at present levels for an extended period of time in the euro area, while being aware that they were bound to increase in other regions during this time;
- The *second contingency* was a further weakening in the transmission of our monetary policy stance, originating from an impaired bank lending channel. In fact, this is no longer a contingency, but has become a reality. But can we address this issue by raising incentives to lend? Is it credit *supply* that is a concern, or is it a lack of *demand* for credit, given the economic weakness in parts of the euro area? The answer is: both are intertwined. A restrictive supply of credit can perpetuate weak and falling demand for credit – and vice versa. In a weak economic environment, banks face higher credit risk. They may refrain from passing monetary accommodation on to their customers, hoping that high lending rates make up for potential losses. From the banks' perspective, this may be a perfectly prudent response. But such a response can substantially deepen the economic malaise. Lending rates that are higher than are justified by a borrower's creditworthiness discourage credit demand. This suppresses the productive investment and durable consumption necessary for economic growth. Additionally, higher rates and low growth increase delinquencies in banks' loan books. *Ex post,* this justifies a bank's original decision to tighten credit conditions and even encourages further restraint, creating a vicious circle.
- And the *third contingency* was a pronounced worsening of the medium-term outlook for inflation originating from a derailing of the economic recovery. Accordingly, there was a unanimous commitment by the Governing Council to take additional unconventional measures if further monetary easing were needed. Let me clarify that we are not in that situation at the moment.

Since the start of the sovereign debt crisis we have had to take a number of initiatives within our mandate in order to preserve price stability and the anchoring of inflation expectations. Some of these measures were controversial at the time. Looking back, and considering the current level of inflation and expectations in the euro area, I think it is obvious that the measures were not only legitimate but absolutely necessary to fulfil our mandate. Had we not taken them, we would most certainly have failed in this.

Failing to fulfil its mandate is one thing the ECB, as an independent institution tasked with a narrow mandate, cannot afford. And it is one thing the Governing Council will not resign itself to, as demonstrated by the unanimous support that we gave to the package of measures decided on in June.

Why was credit easing needed?

Rate cuts alone would have been insufficient to break the cycle. While they provide additional accommodation, the impact would be very limited on those parts of the euro area economy in which banks are reluctant to lend.

Our targeted longer-term refinancing operations (TLTROs), the details of which were announced today, represent a crucial complement to the rate cuts. By supporting lending, they aim to improve the transmission of monetary policy to the real economy.

The idea is not simply to offer funding relief to banks, but to offer clear incentives for them to allocate new credit to the real economy. Thus, banks will be granted access to additional borrowing allowances later in the programme if, and only if, their net lending to households and non-financial companies, excluding loans for house purchase, exceeds a certain benchmark. Should they not meet this benchmark, they will be required to pay back their borrowings two years before the maximum maturity of the TLTROs and will thus not benefit from the term funding advantage.

We are confident that euro area banks with strong business models will be able to make full use of the benefits of TLTROs. In particular, given the incentive structure embedded in the TLTROs, the programme is particularly attractive for banks with a dynamic lending performance.

In addition, we have launched preparatory work in the event we make outright purchases of packaged corporate loans (asset-backed securities, or ABS). This initiative is complementary to the ongoing work at the European and global level to create a new class of high-quality securitisation, whose reduced risk and higher transparency could be acknowledged in the regulatory framework. Let me add that providing capital relief is not in the remit of the ECB. The impact of this work can be greater if European governments, individually or jointly, can provide risk mitigation for those categories of borrowers where there is evidence of a market failure. The European Investment Fund already does so for SME loan securitisation.

Is monetary policy enough?

Beyond being necessary to fulfil our price stability mandate, some have expressed concerns that our accommodative policy is contributing to lower nominal interest rates on certain assets, such as bank deposits, or that it is fuelling asset price exuberance.

Let me address those concerns in turn.

First, let me stress that, as shown by the Bundesbank, the current low real rate of return is not exceptional historically. In fact, the real rate of return on deposits had been persistently negative during previous decades, but savers had not realised it because of higher inflation.[2]

Second, real wealth can only increase in an environment of sustained growth and price stability. And the purpose of our measures is to help steer the economy back on to a sustainable, long-term path. This is not only in line with our mandate under the Treaty. It is

[2] See Deutsche Bundesbank: "Nothing new about negative real interest rates on deposits", http://www.bundesbank.de/Redaktion/EN/Topics/2014/2014_06_30_nothing_new_negative_interest_rates.html.

also in the best interest of savers. A stagnating economy does not generate returns for savers.

Indeed, paradoxically, in a stagnating economy, savers complain about low returns, while borrowers complain about too restrictive credit conditions. In a *chronically* stagnant economy, this imbalance between the two sides of the credit market is bound to last and become entrenched.

Only an economy with sustainable growth and price stability can resolve this dilemma: firms will pay a fair price for credit that is commensurate with their capacity to repay and reflects the economic value of their business projects. Savers will receive a fair compensation for their savings, which in real terms will tend to exceed the growth rate of economic potential.

However, monetary policy can only facilitate the return of the economy to a sustainable, long-term path. It cannot change that path, which depends on structural features that only other policies domains can influence.

In fact, the only way to move on from the current low interest rate environment is to reinvigorate the productive potential of the euro area economy. Much like Ludwig Erhard put Germany back on its feet by establishing a social market economy, euro area governments today need to persevere with their fiscal, structural and institutional reform efforts to revive the area's productive potential and, together with the social partners, trigger a virtuous circle in which price stability and economic dynamism reinforce each other.

As for financial asset prices, their current level is high and can only be justified by the prospect of a continuing reduction in public and private debt levels in euro area countries, and sustained reform efforts to lift productivity. A continued rise that was not matched by underlying improvements would be a matter of concern, and should be addressed using the macro-prudential instruments available.

What are the priorities to restore strong and sustainable growth?

Governments should not view the current period of low interest rates and favourable market sentiment as an invitation to abandon the path of fiscal prudence, but rather to accelerate reforms aimed at freeing up growth opportunities.

First, the crisis has shown that fiscal credibility needs to be earned. Delivering on past commitments under the EU framework is essential for this. This means that governments have to continue on their path towards resilient public finances. They should stick to the rules they have agreed under the new EU fiscal framework and not stretch them to the point where the credibility of this framework would be harmed.

In the long term, there is no trade-off between growth and sound public finances. Lower levels of public debt are needed to support a sustainable recovery. There is such a trade-off in the short term but, in order to mitigate negative growth effects, consolidation efforts should focus on those budget items that do not add to, or perhaps even stand in the way of, dynamic and inclusive growth.

Second, structural reforms should focus on those areas that may hinder productive potential. This means overturning excessive regulations that protect vested interests and harm the common good; and creating a stable institutional landscape that enhances productivity and allows private operators to focus on innovation, growth and job creation.

The euro area faces a major investment shortfall, with real capital expenditures being almost 20% lower than their pre-crisis level, and as much as over 50% lower in some euro area countries. Bridging the investment gap is a priority to secure our economic future. Contrary to what is sometimes argued, however, this should not imply spending more taxpayers' money, but prioritising material and immaterial investment in budgetary plans and creating an environment that unleashes entrepreneurship.

Third, the crisis has triggered institutional reforms at the European level that will ensure a more robust union. The banking union is a critical component in this enhanced institutional framework with its Single Supervisory and Single Resolution Mechanisms and new rules for European banks, including bail-in rules that will shield taxpayers from the errors committed by banks. Currently, we are in the middle of our comprehensive assessment of the most important banks in the euro area. Even before we began this exercise, banks started cleaning up their balance sheets and building capital buffers. I am confident that these and further measures will result in a more stable euro area banking sector that is willing and able to extend credit to the private sector for productive investment.

Thank you very much for your attention.