Sabine Lautenschläger: How innovative should central banks be?

Keynote speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank, at the Wirtschaftsgipfel 2014 "Wirtschaft neu denken – die Kraft der Innovation", organised by Süddeutsche Zeitung, Berlin, 29 November 2014.

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Tradition and innovation in monetary policy

More than six years after the start of the global financial crisis, monetary policy in the euro area still faces major challenges:

Monetary policy, the ECB, faces a challenge – perhaps more than ever before.

It faces a challenge because inflation rates are too low. At 0.4% for the whole euro area, the inflation rate is well below our target of nearly 2%. The prospects for economic growth and further price developments in the medium term are subdued. Monetary growth and lending are weak. Geopolitical risks are adding to the uncertainties which are causing investor appetite to continue to fall.

Expectations of the ECB are high, from markets and from politicians. Every month people give us good advice, often referring to actions taken by other central banks. And they do so despite the fact that our monetary policy decisions from June and September haven't yet been able to fully take effect.

So what else can a central bank do in the current situation? How innovative may central banks be? How innovative is an ECB allowed to be, which as a start-up from the year 1999 is in many ways itself an innovation, and as a custodian of a currency without a state can only partly be compared with other central banks. Of course I can only give you today, less than a week before our ECB Governing Council meeting, some general reflections from my personal point of view.

I think we can all readily agree that innovation cannot be an end in itself. The ECB must and will act only in accordance with its mandate. Price stability is the guiding principle of our actions. The definition of our mandate does not allow for innovations. Moreover, in uncertain times of crisis a clear focus is not less, but doubly important. Central banks therefore have a particularly strong understanding of tradition, and for a good reason: monetary policy is all about trust, reliability and consistency.

Innovative measures must therefore be judged against our mandate of maintaining and creating price stability. As with any decision, innovation demands a sober analysis of the costs and benefits, the opportunities and risks. Allow me to slip briefly into legalese: innovative monetary policy measures, too, should be suitable to achieve their objective. Since monetary policy measures also have side effects, a central bank should use the mildest means to achieve the fewest possible side effects.

Low inflation rates and the catalogue of measures

So what does this mean for the current situation? Unanimous monetary policy can and must maintain price stability. No more and no less. We are judged on whether we achieve an average rate of inflation for the euro area as a whole which is in line with our target of below, but close to 2%. The commitment to price stability is symmetrical. That means that the ECB must act exactly the same when the target is undershot for a sustained period as when it is overshot. We take a medium-term view when it comes to achieving our target, because our aim is to ensure price stability over the medium term.

At the moment, with an inflation rate of 0.4% for the whole euro area, we are a long way off our target.

And in the coming years, too, we can only expect a moderate rise in the inflation rate. There are a number of reasons why the challenges of monetary policy will probably continue to occupy us for quite some time to come. Some banks will still have to adjust their balance sheets, and this applies to an even greater extent to public finances, private companies and households in some countries. This has a structurally dampening effect on overall economic demand, and particularly on investments. Furthermore, important long-term determinants of the real interest rate are pointing downwards: demographic trends, namely longer life expectancy and weak population growth worldwide – but particularly pronounced in the euro area – are creating an environment which necessitates low real interest rates and thus low balanced nominal interest rates.

The euro area suffers from a lack of competitiveness and productivity, which of course take different forms in individual Member States. Structural problems and current weak demand lead to unsatisfactory economic growth and unacceptably high unemployment in many countries. Tackling these challenges in the long term is not the job of monetary policy. Crisis management must tackle the root causes for the long term and we, the ECB, will therefore not tire of reminding governments that we can only provide them time for the urgently needed reforms.

Against this backdrop we could ask whether it was appropriate that the ECB took action. I think it was – precisely because of the path of inflation, even if there is room for discussion about the some of the measures and their design. The list of our crisis management measures is long. In June and September this year we lowered key interest rates further. The main refinancing rate is now just 5 basis points. The interest rate channel has thus been exhausted. For the first time in our history we have resorted to a negative deposit rate in an effort to achieve the desired monetary policy accommodation within the tried and tested corridor system. This justified monetary policy step – which favours investment – was not an easy decision for us, not least because of its possible side effects for the financial sector and for savers. At the same time, we have the tool of forward guidance, which we have used and later reaffirmed: with regard to the inflation outlook, based on current data we expect that the central bank interest rates in the euro area will remain at the current level for an extended period.

In addition we have taken a number of targeted unconventional measures which should improve the monetary policy transmission mechanism. One of these is targeted longer-term refinancing operations (TLTROs), with which banks can obtain liquidity for a fixed interest rate for up to four years. We have drafted two purchase programmes, one for covered bonds and one for asset-backed securities (ABS). The purchase programme for covered bonds started in October. So far purchases of around €16 billion have taken place. We started the ABS programme just last week. I anticipate that together the longer-term refinancing operations and both purchase programmes will have a strong impact on the balance sheet of the Eurosystem.

Innovation or imitation

Every month there are fresh calls for further measures. But is it appropriate to contemplate further measures at this moment in time?

Under normal conditions, central banks are in a position to ensure price stability in an environment of positive nominal interest rates by means of conventional interest rate policy. Once interest rates are at zero, a central bank is left with only unconventional measures in order to fulfil its mandate. Central banks all over the world have indeed been anything but idle. In particular they have significantly expanded their balance sheets, and by making changes in their balance sheet structure they have taken various measures to make targeted investments in submarkets affected by liquidity shortfalls, maintain important credit relationships and ensure a functioning monetary policy transmission.

We, too, have turned to innovative measures, to the targeted longer-term refinancing operations and the purchase of covered bonds and asset-backed securities which I mentioned earlier.

For sure, in times such as these we need to be prepared. That is why the ECB's Governing Council agreed at the beginning of November that the appropriateness of the monetary policy stance should be closely observed. In concrete terms, this means that if it should become necessary to further counteract the risks of a prolonged period of low inflation, the Governing Council intends to take additional unconventional measures within its mandate.

Even if it is good to be prepared, one should beware of showing activism.

There is no automatic mechanism to initiate further programmes. The ECB's Governing Council has not decided on a target for the size of the balance sheet; it has rather unanimously expressed an expectation. A kind of mechanical expansion of the ECB's balance sheet cannot be an end in itself. All of our decisions are to be evaluated against the background of current and medium-term inflation expectations.

Consequently, we must continually analyse current price increases to identify the components which comprise the weaknesses in price developments. Short-term developments are not key, especially when they are largely determined by energy and food prices. The underlying trend and the firm anchoring of inflation expectations are decisive, as well as the orientation of the euro area as a whole. Low inflation rates in some Member States – even when negative – are not in themselves a breach of the target. They can be necessary to restore lost competitiveness. One could also argue about whether it is really necessary to consider further measures given that the measures already taken have not yet been able to have an effect. Monetary policy does not take effect immediately, but only with a certain time lag. As a rule we should take this time and wait and see.

Which measures are we talking about here?

The large-scale purchase of securities, including government bonds, is often seen as a panacea. As I said, even for innovative or unconventional measures, the costs and benefits, and the opportunities and risks must be carefully considered.

Some central banks have used quantitative easing to quickly and decisively provide monetary policy impetus, adjusted to the specificities of their environment. It is these particular central banks and their measures to which we are compared. For me, these are idle comparisons. The following saying applies here: those who constantly compare themselves with others might become more like them, but they won't necessarily become any better.

When making a comparison with the measures of other central banks, people often forget that monetary policy measures, including unconventional ones, have to be adapted to the institutional conditions, economic specifics and financing structure which make up a currency area. Measures which are appropriate in one currency area can be ineffective elsewhere. What seems like the first option in one place can be the very last resort elsewhere, without the actual aim of the measures having to differ much from one another.

Instead, we should ask: would such purchases have the desired effect on the rate of inflation? What "quantities" would need to be purchased to have an effect? How long would such effects last?

The euro area is characterised by a bank-based financial system which makes it considerably different from more strongly market-based financial systems, particularly in the United Kingdom and the United States. This explains our focus on refinancing operations, which have enabled the banking system to overcome liquidity bottlenecks, maintain credit relationships and enter new credit arrangements. Our measures from June and September 2014 also serve to support the credit channel. In essence, it is about improving funding conditions for borrowers in the real economy. The same logic can also be applied to the selective purchase programmes for covered bonds and asset-backed securities.

The Eurosystem is currently faced with 18, soon to be 19, issuers of government securities. Should we not take into account during a broad purchase programme of securities the fact that government securities in the euro area are not without credit risk? There are very few shared competencies in fiscal policy. As long as this is the case, the ECB's purchase of government securities is inevitably linked to a serious incentive problem. After all, the required cost-benefit considerations should also take into account the fact that other central banks bought government securities in a different economic environment with considerably higher long-term interest rates. In the euro area, the long-term interest rates on Spanish and Italian government bonds, for example, are already lower than those from the United States or the United Kingdom. It is therefore questionable whether we should "depress" interest rates for the securities class even further.

Moreover, the interest on national government bonds in the euro area doesn't operate as a benchmark for all further refinancing operations, as is the case in the United Kingdom or the United States for example. Besides, the effect of intervening in capital markets in a bank-based financial system is weaker than in a market-based system, as illustrated by wealth effects, for example.

Therefore with regard to the purchase of government bonds, measures which are obvious in one place could be the last resort at best for us – for instance when there is the threat of deflation, but only if the cost-benefit analysis is favourable.

As you see, there are more questions than answers at the moment. In my view, a consideration of the costs and benefits, and the opportunities and risks of a broad purchase programme of government bonds does not give a positive outcome at the current time.

Concluding remarks

Owing to my position, I have limited myself today to talking about innovations in monetary policy. At this point we should look first at the effect of our recent measures and of the asset quality review and the stress test on bank lending.

Innovations in other political areas are also necessary, if not even more so. The reasons for weak growth and funding shortfalls primarily lie elsewhere, not in a lack of central bank liquidity, to say nothing of capital markets. Innovative political approaches are called for when it comes to increasing growth potential in the euro area, strengthening economic adjustment efforts and making budget consolidation compatible with growth and employment.

But let me conclude by returning to the original question: how innovative may the ECB's monetary policy be? As innovative as necessary and as effective as possible. This requires careful consideration. The risks and side effects must always be taken into account. For me, given the current situation, the hurdles for further measures are very high, especially for broad purchase programmes. The interest and spreads for many debt instruments are already very low: the risk of market distortions cannot be dismissed. The deciding factor for all programmes is their effectiveness for the real economy and ultimately for price stability, which is what we – the ECB as the central bank for the whole euro area – must be judged on. Innovation is not therefore a taboo, but neither can it be an end in itself.

I look forward to our discussion.