Sabine Lautenschläger: Interview in Börsen-Zeitung

Interview with 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, in Börsen-Zeitung, conducted by Mr Mark Schrörs and published on 30 September 2016.

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Ms Lautenschläger, Hyun Song Shin, chief economist at the central bank of central banks, the BIS, warned in a recent interview with Börsen-Zeitung that the major central banks, i.e. including the European Central Bank (ECB), have perhaps reached the point where their policies are doing more harm than good. What makes you sure that the benefits of the ECB's policy are currently outweighing the costs?

Our mandate is to ensure price stability in the medium term, and that means a medium-term inflation rate of below, but close to, 2%. We have been a long way off that mark for some time now, so an expansionary monetary policy is warranted at the moment – even if certain instruments are the subject of some debate. The benefits of our monetary policy can be judged on the basis of whether it is reaching the real economy and having a positive effect, which, in terms of the overall package, is definitely still the case: borrowing conditions for firms and households are continuing to improve, low interest rates are encouraging investment and lending is on the rise. If banks were lending less, that would be one of the possible warning signs that the costs and benefits need to be reconsidered. That is not the case, however.

There is nevertheless also the question of adverse side effects, such as price distortions in the financial markets.

Yes, I'll give you that: there has to be the right balance between the costs and benefits of monetary policy measures – and not just in the short term. We are seeing an economic recovery in the euro area that has been driven primarily by the measures taken by the ECB's Governing Council in 2014 and 2015 in the midst of large downside risks. The ground has therefore been prepared for greater and stronger growth, for more jobs and thus ultimately for higher inflation, too. However, first and foremost, the longer we continue to apply certain measures, the other question that undoubtedly needs to be asked is which risks will evolve into side effects.

Which risks are you particularly worried about?

There are a number of risks, but I wouldn't want to rank them in any way. Perverse incentives are one risk that exists for politicians, for instance, when there is less pressure to implement structural reforms. Another risk is that of asset price bubbles. At the moment, for example, there are pockets of inflated real estate prices, but this does not necessarily mean that there is a bubble; furthermore, this can be counteracted using macroprudential instruments. Ultimately, you always have to think about the long-term effects of a very expansionary monetary policy on the financial sector.

With regard to the future stance of the ECB, hasn't another expansion of the asset purchase programme aimed at quantitative easing (QE) long been a foregone conclusion – if only because there is a risk of turmoil when you reduce the purchases in one go, from €80 billion a month in March to zero in April 2017?

At the moment, I do not see any need for any additional stimulus. Nevertheless, any exit must of course be carefully thought out. We will discuss it and decide on it, taking into account the data available at the time. The latest information that we have received shows that, in terms of growth and inflation, we are heading in the direction that we had projected. The economic recovery is moderate, but sound. What's more, up to now, the risks associated with Brexit have not

materialised to the extent that many feared they would.

But surely the ECB can't leave it until March to make a decision on the future of QE?

There are still meetings scheduled between now and then. We will take a decision when required.

If QE is extended, would you then be in favour of simultaneously planning the exit strategy, one example being tapering, i.e. a gradual reduction of purchases?

Once again, I do not see any need for any additional stimulus. We are heading in the direction that we had projected. As for the nature of the exit strategy, we will decide on that in due course.

In the light of this scenario, are the markets not being completely irrational by speculating about the ECB buying stocks or bank bonds?

There is certainly no place for such debates in this scenario. And leaving that aside, I don't think it would be a good idea to buy those kinds of assets. In my opinion, it is not something that should be considered as a monetary policy instrument.

All the more so as, in the case of bank bonds, there is the matter of the ECB also being the supervisor of the [issuing] institutions?

Irrespective of the question as to whether that would be appropriate for a central bank with supervisory responsibilities, I believe it would problematic as it creates perverse incentives for banks.

The ECB's Governing Council has now set the expert committees the task of looking into options to ensure the smooth implementation of the QE programme. Is there a risk of there being a shortage of assets available for purchase before March 2017, or would this risk only arise if the ECB's Governing Council were to expand QE?

It depends on the yield curves of the assets in question, first and foremost because we have decided not to buy any bonds with yields below the deposit facility rate. The expert committees will now look closely into any possibilities for adjustment. We, the Governing Council of the ECB, will then consider the options in due course and discuss the direction in which it could go – whether or not there is a need for action, and if so, what. At the moment, however, I do not see any reason to change the basic direction of the programme.

The debate is focused not least on the distribution of QE purchases among individual countries on the basis of the ECB's capital key. At the ECB, too, there are some who say that it would be more efficient to base it on outstanding debt in the market, for example. Is the capital key something that you would be prepared to discuss or would it fundamentally alter the nature of QE?

Let me reiterate: at the current juncture, I do not believe it would be advisable to change the basic direction of the programme.

And what about a further cut in interest rates? Not least the deposit facility rate, which currently stands at –0.4%?

In my view, this instrument's potential has been exhausted.

But this would mean that the ECB's forward guidance – that is to say, the expectation that the key interest rates will remain at present or even lower levels for an extended period of time – no longer makes sense.

As I said, I do not consider a further interest rate cut to be the right course of action. Quite apart from that, forward guidance does not refer exclusively to the negative deposit facility rate.

The debate surrounding further ECB measures has also stemmed largely from the fact that long-term inflation expectations on the markets are far below 2%. Does the ECB have a credibility problem?

I don't think so. The fact is that monetary policy needs time to take full effect. When a central bank makes a decision, the initial impact is a psychological one – the markets shout "hurrah". Thereafter, however, the adopted measures need to work their way through the financial system and into the real economy. The measures that we implemented back in 2014 and 2015 are now starting to have a tangible effect on borrowing conditions.

However, an economy's potential for growth, and thus its level of inflation, hinge not only on its central bank's capacity to act but also on its government's fiscal and structural policy – and it is clear that more needs to be done in this regard.

Isn't it then fully counterproductive for the ECB to adopt major monetary easing measures on a quarterly basis, as it did in December 2015 and March 2016, thereby implying that it could accomplish something in the short term, only to dash these hopes subsequently? Wouldn't it be preferable to better explain the reasons behind low inflation?

I have long stressed that it will, on this occasion, take some time to return to the 2% objective. The decisive factor here is the medium and long-term perspective rather than the short-term outlook. We do not need to respond to any and every deviation from the inflation objective; instead, we should, among other things, examine the reasons behind it and assess whether it is a long-term trend. Questioning our inflation objective every time we deviate from it would be the point at which we would quite rightly lose our credibility.

In the United States, the issue of whether the inflation objective should be set higher than the widely announced 2% is a topic of debate. Do you think it would be wise to review the ECB's strategy and objective, especially given that the last review took place 13 years ago?

If you look at the literature written and statements made by economists, some say that 2% is too low, while others claim that the objective should be even higher – so perhaps our middle-of-the-road objective is precisely the right one. In all seriousness, though, such a topic should only be debated if it is possible to see, over a long period of time, that the basic conditions have changed. It is still too early to know whether this is the case. Furthermore, I am not convinced that a period of crisis is the time to suddenly back a different horse.

Let's turn to banking supervision: in the wake of fears over a renewed banking crisis in the spring, the situation has calmed. However, the fundamental situation remains all but unchanged, with market concerns about the banks mounting again over the past few days. Is a new storm now brewing?

The markets occasionally react strongly to news and do not always differentiate between institutions. Improvements in the overall picture since 2008 and 2009 are often then forgotten. For example, banks are, on average, much better capitalised nowadays than before the crisis, and there have also been many developments in the field of supervision.

But the problem of persistently low profitability, which was a major driver of the share price slump back in the spring, remains a pernicious one – not least as a result of low interest rates.

It goes without saying that the profitability of banks is a major issue. A number of institutions need to rethink their business models and adapt to the new circumstances. The low-interest-rate environment is not the only challenge in this regard. I find that the debate on this topic is often too one-sided in Germany.

Because the banks also benefit?

Yes, the banks also benefit from low interest rates. This has been very clear to see over the past year: funding costs have fallen and lending volumes have risen, which has had a positive impact on net interest income. Ultimately, it is important to remember that banks mirror the economic environment in which they are operating. Whenever the economy is strengthened by monetary policy, banks' customers – and therefore the banks themselves – benefit from this. A protracted phase of low interest rates also poses problems; income from maturity transformation is difficult to achieve. This is clearly a challenge for some institutions. The question is this: how long will the advantages outweigh the disadvantages? Up to now, the banks have, all things considered, tended to benefit from the low-interest-rate environment. That being said, the longer this persists, the more difficult the situation will become for some institutions.

As regards the issue of maturity transformation, the Bank of Japan has once again proved highly innovative: it has introduced yield curve control. Could this also be a model for the ECB?

I do not wish to pass comment on another central bank's monetary policy stance. Your question is not one that I ask myself, as the path that we are on is our projected one.

However, some observers fear a "Japanification" of the euro area, particularly in view of the risk that the ECB's unlimited liquidity is keeping "zombie banks" artificially alive.

Since 2007 we have done justice to our role as a lender of last resort with our liquidity support for banks. However, there are also significant differences to Japan: in the euro area, there are a great many more banks with very different business models. Also, the structure of the real economy is more mixed. Quite apart from that, Europe's macroeconomic picture differs from Japan's.

Isn't it something of a paradox that it's precisely the business model that proved to be especially resilient in the financial crisis – the deposit-taking business – that is now suffering most from the low interest rate policy?

Deposit taking is not a business model. A bank won't benefit from deposits, as such, if on the other hand it cannot lend sufficiently, as it then only bears the costs created by the deposits but makes no return.

There is concern, not least because of the dependence of many German banks on deposit-taking business, that they could become the problem child for the euro area. Is that concern justified?

It is not right to make generalisations about German or European banks. Institutions have very different business models. And even German banks don't only carry out deposit taking. The viability of a business model does not depend solely on how low or high interest rates are. There are many factors involved: cost structures, sources of income, the level of competition. Competition and earnings capacity were issues long before the financial crisis and the low-interest phase. They were already discussed in detail when interest rates looked quite different. The low interest rate policy is often brought into play to explain problems that are more deep-seated and of a structural nature.

Most notably, Deutsche Bank has provided a lot of headlines recently. The International

Monetary Fund has even said that it "appears to be the most important net contributor to systemic risks" in the global banking sector. There's no end to the rumours about state aid. Is Deutsche Bank also a particular worry for the ECB's supervisory arm?

As supervisor, we don't make any public comments on individual banks.

But there is also the prospect of a USD 14 billion fine by the US authorities because of earlier mortgage deals – that constitutes a further risk for the bank, doesn't it?

As I said, I'm not going to comment on individual banks. It is part of the supervisor's day-to-day business to keep an eye on the legal risks in the institutions. We are kept up to date on this not only by the banks, but also through exchanges with our supervisory colleagues.

Several ECB representatives have recently called for cross-border bank mergers in Europe. Doesn't that conflict with the aim of curbing the too-big-to-fail problem?

As banking supervisors, we don't conduct any structural policies. But we do look closely at the viability of business models. Generally, one observation, in principle it's banal, has proved to be true: in banking systems with fewer institutions, i.e. with a higher concentration, banks earn more. Particularly in the current difficult earnings climate, cross-border mergers may well have their attractions. There are, for instance, better opportunities for risk spreading.

And the problem of banks being too large and complex is of secondary importance?

Such developments don't necessarily mean that the banks become more complex. And why are you only thinking of the really big banks when we talk about mergers? What's more, the legislator has created tools and an institution, in the shape of the Single Resolution Board, which put us in a better position vis-à-vis too-big-to-fail.

The banks are increasingly complaining that regulation is becoming a drag on growth. Is this the usual complaint of those affected or is there an element of truth in this?

Regulation and supervision are undoubtedly more expensive than they were ten years ago. Banks have to hold somewhat more capital for the same transactions. And they have to meet the supervisors' much tougher requirements. Rightly so. We saw in 2008–09 that the banks were far from being well positioned. The fact is, a well-capitalised and well-managed bank can be of much greater benefit to the real economy in the medium and long term than a weak bank.

So are the complaints exaggerated?

We should make sure that the agreed package of demands [placed on the banks] is coherent and serves the goal of creating a more stable banking system for the benefit of the economy and of customers. We should not under any circumstances, however, go to the other extreme and reverse everything. This would be inappropriate in the current situation and we would also be ignoring the lessons of the crisis.

What do you think of Germany's proposal to apply Basel III in Europe only to the big banks, as in the United States?

I have a slight problem with that. In Germany, for example, small institutions are competing with large ones for the same customers. Take, for example, small and medium-sized enterprises. Why should Bank A have to hold less capital for the same business as Bank B, just because their balance sheet is a bit larger? I guess I also have a problem with this proposal because the savings and cooperative banks, in their entirety, are a systemically relevant grouping.