Jens Weidmann: Inflation and interest rates - what goes down, must go up?

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the European Banking Congress, Frankfurt am Main, 18 November 2016.

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1 Introduction

Ladies and gentlemen

What goes up, must come down. Every child knows that whenever it throws a ball in the air; Isaac Newton penned a book about it; and the rock band The Alan Parsons Project even sang a song about it.

Today, I would like to ask whether the opposite also holds true: that what goes down, must go up?

Now, to those of you who are already starting to get worried, I have some relief: I won’t subject you to my thoughts on physics, or metaphysics for that matter. I won’t talk about balls and gravity, but about inflation and interest rates.

These are most unusual times for central bankers. The world seems to have turned upside down. For quite some time now, monetary policymakers in many countries of the world have been fighting for higher, not lower, inflation.

And not just that: interest rates are at exceptionally low levels – sometimes even negative. Many central banks found it necessary to invent new, unconventional instruments in an effort to bring inflation back into line with their definitions of price stability.

These new instruments, and the prospect of a long period of ultra-low interest rates, gave birth to a situation in which monetary policy became the subject of intense political debate. The intensity reached a level that, at the end of the day, could even have a bearing on the very independence of central banks – which I consider a precondition for a stability oriented monetary policy.

At the same time, many people are beginning to wonder: how long will inflation stay so low? Or, to put it more bluntly: has inflation gone for good?

Renowned German banker Hermann Josef Abs once remarked that he had never got an economic prediction wrong, quite simply because he had never made one. So I will heed this advice and be careful with the predictions I make.

Nevertheless, I will try to convince you of two things:

First, that the traditional forces driving inflation aren’t dead. They’re just hidden behind transitional factors.

Second, simply altering the definition of price stability in response to the current challenges is not the answer, either.

2 Inflation

2.1 Forces driving inflation

Ladies and gentlemen

The reasons for today's weak price pressure can be seen as a combination of cyclical and more persistent influences.

Between 2012 and 2014, it was mainly the ailing economy that dampened inflation. In large part, this was the result of governments and private households trying to prevent their sometimes worryingly high debt levels from mounting further.

And many countries have managed to reduce their external funding needs, which is reflected in the elimination of current account deficits. This is also related to those countries becoming more competitive by keeping wage growth in check. This, too, dampened price pressures.

The ECB estimates that domestic factors such as these have lowered core inflation by up to one percentage point relative to the United States.[1]

On top of domestic factors came commodity prices: 2014 saw the beginning of a steep decline in oil prices. From then on, this replaced weak domestic demand as the main factor behind the low inflation. Dwindling commodity prices knocked almost one percentage point off headline inflation.

I should also mention three more secular forces that are sometimes put forward as explanations for the persistently low inflation: globalisation and the ageing populations in many advanced economies.

Some have argued that globalisation has intensified global competition, preventing firms from raising prices. But this is, by no means, a new discussion[2] and I doubt that this matters as much in the future as it has mattered in the past. Take China as an example. China's integration in the world market dampened inflation in developed countries. But this may no longer hold to the same extent if the Chinese workforce begins to demand its share of the welfare-enhancing effect of globalisation in the form of higher wages.[3]

And the potential channel between demography and inflation runs from lower growth prospects to lower inflation.[4] Others argue that older citizens prefer lower inflation because it protects savers.[5] While long-term growth has indeed declined in recent years, I'm not convinced that the currently low level of inflation in the euro area is to a significant degree also due to a downward trend in growth. Moreover, growth is not exogenously determined, but it can be influenced by economic policy-makers – I'll come back to this point in a few minutes.

By contrast, however, Martin Feldstein has argued that digitalisation and the Internet revolution mean that we are underestimating growth because numerous services are now being provided more or less free of charge via the internet.[6] The flipside of this argument is: the official price statistics overestimate the true rate of inflation. This isn't a new topic, too. It was already discussed in the 1990s. And methodological adjustments have been made in the meantime to reduce the errors discussed at the time. But in any case, it's worth mentioning that the Governing Council's definition of price stability already incorporates a buffer for measurement issues.

To sum up, most of the reasons for the current low rate of inflation are only temporary in nature. This is also reflected in survey-based longer-term inflation expectations, which are stable at slightly below 2%.

Take commodity prices, for example. The impact of the strong decline in oil prices is already beginning to be washed out of the inflation rate. Inflation in the euro area might rise to 1 ½% as early as in February next year.

Taking a somewhat longer-term perspective, the ECB staff projected in its September macroeconomic projection exercise, that inflation in the euro area would continue to increase up to rates that are more or less in line with our definition of price stability – that is, a rate of below, but close to, 2% – at the end of the projection horizon.

Although some uncertainty surrounds the time span needed for this increase to take place, the medium-term determinants of inflation are intact. Just as weak domestic demand dragged on inflation, so, too, will a waning output gap drive inflation higher. The Phillips curve is still alive and well.[7]

Looking at Germany, for example, labour markets are already largely cleared and unit labour costs are accordingly expected rising by 1 ½% this year and to go up by just under 2% in the coming years.

So the first conclusion I will make is this: with respect to inflation, what went down, will go up – albeit at a modest pace.

2.2 Inflation target

But it is equally true: we are still in a situation characterised by low inflation and low interest rates. Some even fear that, because long-term interest rates are also low, there might be a secular decline in the long-term real interest rate.

While I'm convinced that long-term real interest rates ultimately will rise – and their latest strong increase shows impressively that they can be set in motion quite quickly – the prospect of low real interest rates in the longer-run would be uncomfortable also for monetary policy because our policy space is essentially the sum of the inflation rate and the real interest rate.

So, some are asking: why not raise the inflation target to increase the monetary policy leeway?

Very generally it holds that the occasional benefit of steering well clear of the zero lower bound would have to be weighed against the permanent cost of higher inflation. Research shows that therefore the "optimal rate of inflation" is not zero, but somehow positive. That's one reason why the Governing Council of the ECB has defined price stability as an inflation rate of below, but close to 2%.

Moreover, changing the definition of price stability could damage the credibility of monetary policy. The public might begin to expect the target to be increased further in the future to create short-term stimulus. This might raise inflation uncertainty and cause inflation expectations to become unanchored.[8] It would also be wrong to lower the inflation target, as some have occasionally called for. At the end of the day, inflation is a monetary phenomenon and there is no evidence of a structural break in the factors driving inflation. It is therefore inflation that has to move, not the target.

Just as in football where you kick the ball towards the goal, rather than move the goalposts towards the ball.

Lower inflation targets would also increase the likelihood of hitting the lower bound of interest rates. Central banks would end up more frequently in a situation where it is difficult to loosen financial conditions any further – at least with their standard toolkit. Then, central banks will have to think about using unconventional measures, if they haven't done so already.

Unconventional measures, however, come with a different risk-reward calculus than standard instruments as they have more harmful side-effects.

These side-effects are being felt by the banking sector, for instance. Most unconventional tools aim at lowering longer-term interest rates and lead to a flattening of the yield curve. This makes borrowing short-term and lending long-term less profitable.

Monetary policy that is geared solely to preserving price stability does not target banks' profitability. But monetary policy cannot turn a blind eye if banks' low profitability causes problems for monetary transmission – because, in the future, this could get central banks into trouble with regard to safeguarding price stability.

In the euro area, some unconventional instruments involve further complications. Take sovereign bond purchases, for example, which blur the lines between monetary and fiscal policy.

The Eurosystem is becoming the largest creditor of governments, and their incentives to embrace consolidation are weakened, even though fiscal buffers are more important in the euro area than elsewhere. Eventually, there might be increasing pressure on the Eurosystem to make high debt sustainable through low interest rates.

Unfortunately, these market forces are the only mechanism left to set incentives for sound public finances as my perception is that the European Commission has basically given up on enforcing the rules of the Stability and Growth Pact.

Ladies and gentlemen

Unconventional measures not only change the risk-reward calculus of monetary policy. They also change its character.

The monetary policy toolkit of the Eurosystem is modelled around the idea of an "open market economy with fair competition". That means, in particular, that while monetary policy needs to be effective, it also has to keep market distortions to a minimum and treat all sectors similarly. That's why the Eurosystem has, for a long time, intervened only at the very short end of the money market. The other interest rates and prices were allowed to move freely.

But most unconventional tools intervene directly in other markets. This makes it more difficult to contain market distortions. Interventions in individual market segments also harbour the risk that additional interventions might have to follow in order to curb their distortional effects. More monetary policy fine-tuning leads to ever more fine-tuning.

To sum up, then, my second conclusion is this: unconventional instruments should be used with extra care – even if they are used only temporarily.

And we shouldn't forget that our concept of price stability is a medium-term concept. So monetary policy doesn't need to respond automatically whenever inflation deviates from levels consistent with the definition of price stability.

And adopting a longer-term perspective to monetary policy allows policymakers to also take into account the less favourable risk-reward calculus of unconventional measures. This is exactly why the monetary pillar of the Eurosystem's monetary policy strategy is so important, because it sheds some light on the longer-term risks to price stability.

But I am well aware that a wait-and-see attitude won't help us regain room for manoeuvre while inflation is low. It will take something else for that to happen: stronger growth and more resilient economies.

3 Fostering growth

An economy that is growing faster can pay investors higher real interest rates. Stronger growth – productivity growth, in particular – would therefore raise the long-term real interest rate.

Currently, long-term interest rates are very low. This is, of course, partly related to our monetary policy, but perspectively there is also much to gain from increasing growth potential.

Contrary to what some believe – or wish – it's not central banks which can put the economy on a higher growth path. It's politicians who hold the key to unlocking economic growth. That's why the Governing Council has been tireless in calling for structural reforms: Such as reforms fostering competition and innovation or making investment more profitable. For instance, by making it easier for new firms to enter the market. As a case in point, just take the creation of a common services market and a single digital market in Europe. That could yield double the growth effects unleashed by the creation of the common market for goods.[9, 10]

Lowering the barriers that prevent enterprises from exiting the market will likewise foster growth. It would facilitate what Joseph Schumpeter called "creative destruction". OECD research suggests that policy-induced exit barriers matter for productivity growth, because fewer exits lead to less scope for productivity spillovers and the misallocation of labour, capital and skills. It concludes, for instance, that insolvency regimes should be streamlined.[11]

And investing more in skills and education promises to deliver rich rewards, too. This would not only boost labour productivity, but also make workers less at risk of losing their jobs. And this in turn would be the most effective antidote to the feeling on the part of many of being fundamentally threatened by globalisation and technological progress.

4 Strengthening resilience

But more can be done than making our economies more growth-friendly. The economy's inherent restorative powers need strengthening, too. Governments ought to make sure that economies can recover more quickly from economic slumps. Because, firstly, long recessions can, in and of themselves, reduce potential growth.[12] And secondly, quicker recoveries assist central banks in moving the economy away from the effective lower bound once it gets there.

Resilience is the watchword here.

And the good news is that there's often a double dividend. Many of the measures that foster growth also make the economy more resilient.

But more can be done to bolster resilience. For instance, by making sure that the financial sector goes into the next downturn with stronger buffers. That's why the timely implementation of Basel III is so important, but the agreement also has to be regionally balanced.

Or by shoring up the shock-absorbing capacity of public finances. Hence the significance of fiscal discipline, and especially compliance with the fiscal rules of the Stability and Growth Pact.

And a properly designed and implemented capital markets union (CMU) can also deliver greater economic and financial stability, especially when it aims at fostering European equity markets. Bringing down national barriers and creating a European venture capital market, for instance, would help fast-growing, fledgling enterprises gain better access to capital. More private risk sharing through integrated capital markets is potentially a much more important shock absorber than public risk sharing.[13]

Resilience will therefore be a major item on Germany's agenda for its forthcoming G20 presidency. Central bank governors and finance ministers will work on principles aimed at ensuring that future upswings are quicker than the current recovery.

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