Yves Mersch: The causes of monetary policy measures and their impact - a review

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Euro Finance Week, FAROS Institutional Investors Forum, Frankfurt am Main, 17 November 2016.

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"The knowledge of causes produces a knowledge of effects." *(Marcus Tullius Cicero: "Cognitionem causarum enim cognitio eventorum facit." Topica 67)*

The financial sector is facing an upheaval. Many of the changes are intentional and positive. But certainly not all of them. And to understand the individual factors and their interactions better, I'll be taking a closer look today at the causes of our monetary policy measures and their effects. For the European Central Bank's policy is often referred to as a cause of the current problems in the banking and financial sector. It will quickly become clear that this assumption has its shortcomings. By focusing on the causes of our actions we can understand more easily how to get back to a normalisation of monetary policy.

Causes: Low Natural Interest Rates

Let us start with the causes. 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. There are many reasons for this, which I won't consider here in detail. The fact is, the slowdown in growth has led to lower long-term interest rates.

In these circumstances, there is a risk of a self-reinforcing downward spiral as these developments do not go unnoticed by economic actors; their expectations are worsening. If a company expects demand to fall, it will be less inclined to make big investments.

Moreover, 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 reluctance to invest is further reinforced when public authorities – with room to manoeuvre as well as existing demand – invest less than is needed even to preserve the capital stock.

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.

The natural rate of interest plays an important role in our monetary policy. If the key interest rate is below the natural rate, monetary policy has a stimulating effect on the economy as it encourages consumption and investment. Conversely, when the key rates are above the natural rate, this dampens demand and thus price rises.

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

We therefore had to act in order to abide by our price stability mandate.

But we cannot lower our interest rates to an unlimited extent. At a certain level, it becomes more attractive for market participants, for example, to keep cash – despite the associated costs – than to pay negative interest rates.

Although this point has not yet been reached, we should bear in mind that reactions to rate cuts further into negative territory do not necessarily follow a linear path. The reactions of people in extreme situations 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 our measures in recent years have contributed to the economic recovery in the euro area, although this has been slower than expected and desired. As I said just now, lending is on the rise, as is demand. The unemployment rate in the euro area fell to 10% in the third quarter, and deflation risks have clearly decreased. We expect inflation to reach 1.6% in 2018, which is very close to our objective.

However, to bring about a sustainable recovery, additional support will be needed from the political sphere in the shape of structural reforms in various areas. Only in this way can we reverse the growth trend over the long term and increase growth potential.

Although the return to price stability is taking longer than originally expected and has become more difficult in structural terms, this is no reason to deviate from our goals – whether in relation to our definition of price stability or to its parameters. A central bank must be reliable, particularly in times of great uncertainty. As Abraham Lincoln said: don't change horses in mid-stream.

Recently, calls to adapt our inflation objective have been made more frequently, especially in the light of rising inflation rates. However, growth is still fragile and the inflation path still not sustainable, particularly in view of domestic price pressures.

In this context, how much longer can we continue to talk about even lower rates as being an option? Considering the importance of credibility for a central bank, we should not delay in making necessary adjustments to our language and actions. And yet, we should not be hasty. The fragility of the recovery calls for great caution.

Low interest rates and an accommodative policy remain appropriate in the current context. Adapting to new circumstances takes time.

Impact of Monetary Policy on Banks

For 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. They are not a permanent part of our active toolbox. But more on that later.

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

Let's first of all take a look at the banks: ECB analyses show that our measures are having a positive impact overall on bank profitability.[1] Over the longer term, however, abnormally low or negative interest rates, together with a very flat yield curve and negative term premia, can have adverse effects.[2]

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 long-term efficiency.

We are already seeing now 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, for example. 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.

Together with other factors, such as the still high share of non-performing loans in the balance sheets of some banks as well as regulatory challenges, this could have a negative impact on the economic recovery in the euro area. We are therefore monitoring developments in this area very closely.

What we have to avoid, however, is that banks are kept alive artificially, because in the long term this would only damage the economic recovery, as we have already seen in Japan. Moreover, "palliative medicine for banks" is simply not one of the tasks of a central bank.

Some banks have failed since the financial and economic crisis. We have reacted to this in Europe through measures such as the comprehensive assessment of the banks that the ECB has been responsible for supervising since 2014. The Bank Recovery and Resolution Directive (BRRD) establishes a uniform approach for dealing with failed banks in the EU, whereby losses have to be borne first and foremost by owners and creditors, and not by taxpayers.

Banks that are being wound down are no longer of any use to the real economy: they don't grant any new loans or take deposits, and their activity in the money market is limited. Such banks can no longer transmit our monetary policy impulses to companies and households. They should then not be drip fed by the central bank but should find other forms of refinancing.

The introduction of the BRRD and other rules represents considerable progress, and makes our financial system more stable. But we must now apply these rules consistently and avoid exceptions wherever possible. The inconsistent application of new rules to existing practices could expose the Eurosystem to unnecessary risks. For example, the ECB's "General Documentation" explicitly states that asset management vehicles (AMVs) resulting from a resolution-related separation of banks through the application of, for example, the BRRD are not eligible counterparties for ECB refinancing. However, entities that do not have the legal status of AMVs but act as wind-down entities as well as those that were created before the implementation of the BRRD are eligible. The various expert committees of the Eurosystem are currently assessing how to align the letter and spirit of our rules.

Shortage of Safe Assets

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

For many insurers in Germany, for example, 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 next 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 eight 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[3], consisting of the senior tranche of a portfolio of existing bonds from different euro area countries. The advantage here would be that there would be no joint liability, as there is in the case of other proposals of this kind.

It would most likely be difficult to counter the obvious assumption of public opinion that this would be a surreptitious mutualisation of sovereign debt, particularly since this model is very complicated.

This new type of debt security could be at most an interim solution on the way to a true fiscal union in the euro area, allowing for both joint income and federal control over spending. This would be the logical next step in European integration.

Increase potential growth

Allow me to conclude.

We have taken a closer look today at the causes of our non-standard monetary policy. Weakening global growth and a generally lower natural interest rate lead to low and even 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 an increased risk of deflation. So we had to act, and this prevented things from getting worse. Our analysis shows that the measures have been effective. The euro area economy is recovering, albeit more slowly than expected, and the risk of deflation has clearly receded.

To ensure that the recovery is 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. Nor are our measures intended to become a permanent feature of the system. They were put in place as temporary measures and therefore need to be unwound again as quickly as possible.

Given the volume of our purchase programmes, this will take some time, but any long-term use of our asset purchases, for example, would create false incentives for government financing. This could ultimately violate the prohibition on the monetary financing of governments and so would not be compatible with our mandate.

The economic recovery thus 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. Only then will our monetary policy be able to normalise again. We also need reforms which lead in particular to greater flexibility in labour and product markets and increase productivity.

Because we have a mandate that says that we have to achieve an inflation rate of below, but close to, 2% over the medium term. The longer it takes to achieve this objective, the greater the danger that the side effects of our measures will increase. While we are doing our bit to contain the side effects as best we can, the financial industry also has to do its bit by adapting to the new circumstances as far as possible.

In this context it is important that banks are not kept alive artificially by granting them unjustified access to central bank refinancing operations. There is a need for clarification on this.

It is ultimately in all our interests to do everything we can to return as soon as possible to a path of sustainable growth. So let's not waste any time.

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

2 BIS Working paper, Borio, C., Gambacorta, L., Hofmann, B., (2015), "The influence of monetary policy on bank profitability", October.

3 Brunnermeier, M., Langfield, S., Pagano, M., Reis, R., Van Nieuwerburgh, S. and Vayanos, D., "ESBies: Safety in Tranches", *ESRB Working Paper Series*, No 21, September 2016.