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TILTING THE POLICY MIX IN THE EURO AREA

Keynote Speech by Klaas Knot, Finanzmarktklausur Wirtschaftsrat, Berlin Thursday 26 January 2017

Ladies and Gentlemen,

Thank you for inviting me to speak at this event of your Wirtschaftsrat.

I would like to give you a central banker's perspective on the appropriate policy mix in the euro area.

I'm referring to the range of measures that policymakers take to influence economic growth.

And as you no doubt will know, we central bankers have played a large role in helping the economy stabilize and recover from the crisis.

INTRODUCTION – TILTING THE POLICY MIX

Since the onset of the financial crisis in 2008, the euro area economy has had to cope with a series of negative shocks.

The private sector has been in a deleveraging mode for nearly a decade.

And also many governments had to make large fiscal adjustments to ensure their debts remained sustainable.

These deleveraging efforts have been holding back growth, making this recovery one of the slowest in recent history.

As a result, over the past decade, economic policy mainly involved crisis management and demand stimulus.

In part because of the limited fiscal space in many euro area countries, monetary policy has done the bulk of the work.

Even after policy rates had been brought to zero, central banks have shown to be creative in finding ways to fight the cyclical problems the crisis had left behind.

Now, gradually, the economic outlook is more promising.
2016 was an eventful year, with the Brexit Vote, the surprising outcome of the US election and the Italian referendum.
But not only did the recovery of the euro area economy turn out to be resilient to these shocks, it is even gaining some momentum and becoming more broadly based.
The gradual firming up of the recovery allows us to refocus our attention to longer-term challenges.
As the late, widely-respected Hans Tietmeyer stated back in 1998:
"*Die Geldpolitik kann den anderen Politikbereichen – weder der Finanz- noch der Sozial- und Lohnpolitik – ihre Aufgaben nicht abnehmen*".
It now becomes time to rebalance the policy mix away from demand stimulus through unprecedented monetary accommodation, towards measures aimed at improving the longer-term outlook.

UNPRECEDENTED MONETARY POLICY ACCOMMODA-TION

To get where we are now, the Eurosystem has had to take far-reaching measures.
We have lowered our main policy rates substantially, even into negative territory, to stimulate consumption and investment.
Moreover, several non-standard monetary policy measures were taken to bolster the pass-through of low policy rates when tensions in financial markets persisted.

In spite of these policy actions, over the course of 2014, the outlook for inflation was deteriorating.
Even though the fall in inflation partly reflected a sharp drop in oil prices, persisting cyclical underperformance also played a role.
There were fears that low inflation expectations would become self-fulfilling, with concerns about downward deflationary spirals as we haven't seen since the 1930s.

Given that the policy rates were close to their lower bound, in 2015 the Eurosystem launched an asset purchase programme to provide further monetary policy accommodation and fight low inflation; a policy better known as QE.
By lowering long-term interest rates, our asset purchases have helped to further loosen financing conditions for households and firms.
This in turn should have a positive impact on their spending decisions, and ultimately on inflation – but the exact impact on output and inflation is more uncertain.

MONETARY POLICY STRETCHED TO ITS LIMITS

All in all, monetary policy has truly been stretched to its limits to achieve price stability in the face of negative economic shocks.
There has even been some public discussion on whether the ECB has over-stretched its mandate.
In particular, some question the legitimacy of public asset purchases as a monetary policy tool.

In my opinion, and this is confirmed by the EU Court of Justice, asset purchases are a legitimate albeit non-standard monetary tool, provided that the ECB complies with the limits and restrictions as set out in the Treaty.
Examples of such restrictions are the prohibition of monetary financing and the requirement that the Eurosystem shall act in accordance with the principle of an open market economy.
To make sure that we act within this legal framework, we have set up several safeguards.
One important safeguard is that we have introduced limits on the share of outstanding securities we can buy from a given issuance.
These limits prevent us from becoming a dominant creditor of euro area governments and help to safeguard the functioning of the market.
In our December meeting the legal importance of maintaining these limits has been reconfirmed.

NON-STANDARD MEASURES NOT WITHOUT SIDE-EFFECTS

Of course, the fact that a certain monetary tool is available to us doesn't mean that its use is always automatically justified.
We should always ask ourselves whether the expected benefits – in terms of the extent to which the measure helps us achieve our mandate of price stability - outweigh any potential costs.
After all, our monetary policy measures are not without side-effects; adverse side-effects that could actually be detrimental to maintaining price stability.
Let me briefly discuss two.

First, our non-standard monetary measures could result in an inefficient allocation of resources. Price signals are being suppressed, and the role of financial market discipline is weakened.
Cheap credit may help unproductive and non-viable firms to survive for too long.

This hampers the process of creative destruction, an important driver of productivity growth and, thus, increases in living standards.

Second, the low interest rate environment becomes increasingly harmful for financial institutions and poses risks for financial stability.
With interest rates declining further and retail bank deposits remaining sticky, banks' interest margins continue to narrow, reducing their profitability.
Going forward, this may reduce their willingness to lend.
A related concern is that the reduced profitability prospects encourage banks and other financial institutions to take excessive risks and build up leverage.

BALANCE BETWEEN BENEFITS AND COSTS INCREASINGLY LESS FAVOURABLE

Importantly, the longer our non-standard policies last, the larger the side-effects are expected to be.
Fortunately, the improved economic outlook reduces the need for additional monetary stimulus.
Our decision in December to continue our purchases until the end of 2017, but to very gradually begin reducing our monthly purchases from 80 bln euro to 60 bln euro, reflects this.
Importantly, the tail risk of a deflationary spiral is no longer imminent, removing one important rationale for large-scale asset purchases.

TILTING THE POLICY MIX

While central bankers are rebalancing their monetary policies, a better balance needs to be struck in the broader policy mix in the euro area.
Reliance on monetary policy to help us get where we are now, has been high.
But at the end of the day, monetary support alone is not enough to achieve sustainable economic growth.

Although the cyclical problems are waning, there is no time for complacency.
Several longer-term causes are still holding back growth.
In that spirit, it now becomes the time to open the debate on rebalancing the policy mix towards these long-run factors.
And this means that other policymakers will have to take on the baton from central banks.
They should tackle a number of structural and institutional factors.

STRUCTURAL CAUSES OF LOW GROWTH

Indeed, one important cause of the low growth prospects is structural.
Many countries have failed to adapt to the changing environment in recent decades, most importantly technological change and globalisation.
In addition, the monetary union removed the exchange rate as an adjustment mechanism for member states.
By 1999 it was clear that structural reforms were necessary for individual countries to strengthen alternative adjustment mechanisms, like wage and price flexibility.
But despite efforts like the Lisbon Strategy, structural differences only increased since then.
The European Commission now projects potential growth in the euro area a meager 1.1% per year.

This is a problem; one that calls for structural reforms that increase the growth potential and adaptability of member states.
Measures to this end could focus on product markets, including the service sector, and on stimulating innovation and the application of ICT.
In many countries the quality of institutions could also improve, like the efficiency of the judiciary system in settling disputes, protecting property rights and resolving non-performing loans.
The OECD estimates that the adoption of best practices in areas like these could increase GDP by 4-7%.

Still, it often remains difficult to find sufficient support for reforms.
Reforms may hurt the vested interests of specific groups in order to serve the common interest for society as a whole.
It is sometimes feared that structural reforms may increase inequality.
But that need not always be the case.
For example, practically everybody would gain when legal disputes are settled more quickly.
Except perhaps lawyers that are paid by the hour.
Existing regulations may not always protect against inequality either, because they protect some at the expense of others.
Several member states have highly protected permanent labour contracts, but as a result young people may have no other option than to settle for temporary jobs.

STRENGHTENING EMU FURTHER

Another part of the European growth problem is related to design flaws in the monetary union.
Much has already been done to tackle them.
The Stability and Growth Pact was strengthened and the Macroeconomic Imbalances Procedure was introduced.
The ESM was launched to provide financial assistance to countries in difficulties.
And the sovereign bank nexus was reduced with the banking union.
While this has diminished the risks of severe financial turbulence, EMU could still do with additional improvements.

First, we need a better balance between liability and control, as my dear colleague Jens Weidmann often emphasizes.
Member states now *share* risks via mechanisms like the ESM, but the rules to *reduce* risks should be enforced more effectively.
Compliance with the Stability and Growth Pact is reasonable in bad times when budget deficits are above 3%, but poor in good times when countries should balance their budget.
Compliance with the Macroeconomic Imbalances Procedure and the European Semester should also improve.
Of the recommendations issued in 2015, only 4% was implemented with substantial progress.
Around 46% was implemented with some progress while 52% showed limited or no progress.
Such a lack of enforcement increases the likelihood of new imbalances and future calls on European risk-sharing.

Second, EMU would benefit from more private risk sharing.
During the crisis European governments provided support with taxpayers' money.
But private companies, investors and banks shared far fewer risks.
Private risk sharing is underdeveloped in EMU, and there is much to gain on this score.
Academic research suggests that in the U.S., private risk-sharing smoothes out a larger percentage of shocks (around 62%) than does public risk sharing via the federal budget (around 13%), findings that are more or less confirmed for Germany as well.

DOES THE ANSWER LIE IN MORE INTEGRATION?

The key question of course is how EMU should be strengthened further.
It is often assumed that further European integration is the answer, for example by way of more binding policy coordination, which implies a transfer of sovereignty to Brussels.
Many also favour more public risk sharing, such as a European budgetary stabilization fund.
Further European integration would probably improve the functioning of EMU.
But these steps are controversial, and may not be politically feasible in the current environment.

In countries like Germany and The Netherlands, the controversy especially concentrates on a further increase in public risk-sharing.
The fundamental problem is that Member States still differ substantially in terms of adaptability, overall competitiveness and institutional quality.
If starting positions differ so much, a stabilization fund might not result in fair risk sharing, but in a permanent one-way transfer system.

Therefore, any further increase in public risk sharing should be accompanied by stronger risk reduction.
That would restore the balance between liability and control.
However, this would also necessitate a further transfer of sovereignty to Brussels; a policy that is equally controversial in many Member States.
As a result, large leaps forward in integration are hard to conceive at the moment.
But fortunately small steps may also combine to achieve a great deal of improvement.
Let me conclude by mentioning four no-regret options.

First, improve compliance with the Stability and Growth Pact and the Macro-economic Imbalances Procedure by simplifying and strengthening the rules.
Second, introduce some form of sovereign debt restructuring mechanism.
In the future, it should be ensured that the public debt is sustainable before countries get access to financial support from the ESM.
Third, regulate the sovereign exposures on bank balance sheets to further weaken the sovereign bank nexus.
Many banks still hold large government bond portfolios of their own sovereign.
While these exposures are treated as risk-free, the crisis has demonstrated that this is not always true.

Finally, encourage private risk-sharing via more robust financial integration.
The European Capital Markets Union is a good starting point in this regard.

CONCLUSION

Ladies and Gentlemen, allow me to conclude.
Over the past decade, the policy mix was mainly directed at the short-term, with a large involvement from the central bank.
But the outlook is improving, and policy should rebalance towards the *long-term* factors that hold back growth.
That still requires significant effort, but not necessarily from central banks.
Let me again quote some wise words of Hans Tietmeyer, that he mentioned at an event of this very Wirtschaftsrat in 2006.
"Es reicht […] nicht aus, auf konjunkturelles Wachstum zu setzen.
Es geht vielmehr darum, die Strukturprobleme […] nachhaltig zu lösen.
Nur so erreichen wir ein nachhaltig höheres Wirtschaftswachstum, nachhaltig mehr Beschäftigung, nachhaltig stabile Sozialsysteme und öffentliche Finanzen."

Ich danke Ihnen für Ihre Aufmerksamkeit.