Sabine Lautenschläger: Between low interest rates and bond purchases - has European monetary policy reached a dead end?

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Central bankers could lead such an easy and quiet life. They are independent, they have a clear goal – price stability – and they have a powerful tool to reach it – the interest rate.

Along these lines, in 2000 Mervyn King claimed that: “A successful central bank should be boring.” He added that a central bank should be “like a referee whose success is judged by how little his or her decisions intrude into the game itself.”

Well, that was 17 years ago, and we all know that history can change course in an instant. That’s what happened in autumn 2008 when the financial crisis erupted. Looking back, the signs had been there for quite some time – hindsight is always 20/20. For about a year before the crisis, tremors in the financial system could already be felt.

But on 15 September 2008, the big earthquake finally struck. On that day, an American investment bank failed: Lehman Brothers. The US government did not step in to support it, confounding market expectations. That was a sound decision in principle, but it sent the markets into a tailspin. The panic button had been well and truly pressed.

Within a few days, the crisis had spread around the globe and brought the financial system to the brink of collapse. The situation eventually stabilised, but that was not the end of the story. In the wake of the financial crisis, the global economy entered what we now call the “Great Recession”. Shortly afterwards, the euro area went through a banking and sovereign debt crisis.

And the life of central bankers? Well, it changed. Their institutions were no longer referees, as Mervyn King had said; they had become players in the game. For some time, it even seemed as if they were the only players on the pitch, in particular when other policymakers were unable to react quickly to the crisis.

Central banks became crisis managers. For the ECB, this meant that its goal remained the same – maintaining price stability. However, achieving that goal suddenly became much more difficult. It had to reach deeper into its toolbox than it ever had before. It had to find new ways to use existing tools, and even invent entirely new ones.

All this made some people uneasy. Particularly here in Germany, people see the new role and the new tools of the ECB as something risky. They are concerned that the low interest rates might destroy future wealth and ruin their retirement plans.

Outside Germany, however, the ECB has won respect for its forceful response to the crisis. People are focusing on the fact that the ECB helped to prevent worse things from happening. And some might even think that it could have done more.

So which view is right? Did the ECB save the euro and protect Europe from a crisis that could have been much worse? Or has it overreached and entered a dead-end road where it will eventually get stuck? This is a tricky question because, while it seems to focus on the past, it’s the future which holds the answer.

So let us do three things. First, let’s look back and ask what has happened so far. Second, let’s take a look at the present and ask where we are right now. And third, let’s look ahead and ask where we go from here.

The past – thinking outside the (tool)box

So the past is where we begin. In this case, 15 September 2008 – the day Lehman Brothers failed. And that was the death blow for something that was already severely wounded: trust.

Banks around the world started worrying about their exposures to what were known as subprime mortgage loans. Through new financial instruments, the risks from these loans had been spread across the banking sector – in very opaque ways. Banks did not know how many of these risks were on the balance sheets of their business partners. And they did not know how to price these risks on their own balance sheets.

Trust disappeared; banks stopped lending to each other and the interbank market broke down. There was a high risk that even healthy banks would run short of liquidity and fail. That was a serious problem, given how important banks are for the economy. A meltdown of the banking system would have been fatal for the economy.

And it would also have been a problem for monetary policy and price stability. After all, the banks transmit standard monetary policy to the real economy.

At that point, the ECB deployed one of the classic tools of central banking. It stepped in as lender of last resort. It gave banks unlimited access to liquidity at longer terms and against a wider set of collateral. And it began to buy covered bonds, which were a prime source of funding for banks. The ECB's goal was to keep otherwise healthy banks alive. Stabilising the banks was crucial to safeguarding price stability.

However, as a lender of last resort, the ECB can only do one thing – provide liquidity to banks. It cannot and should not solve banks' underlying problems. In 2008, many banks were still bloated with bad debt. Their problems went far beyond a mere shortage of liquidity. They were about to fail.

That was the moment when governments stepped in to save the banks and to prevent a systemic crisis. This added to the pile of public debt that many governments had built up over the preceding years. And then the pile became too big for some countries. The stage had been set for the second phase of the crisis.

In 2010, concerns started to grow in the markets that the Greek state might default on its debt. The sovereign debt crisis had begun. Similar fears spread to other countries. Portugal, Ireland, Spain and Italy faced rising borrowing costs, although the reasons for this were not always the same. This added to doubts about their public finances. Once again, the banks were at risk; this time because they had many government bonds on their balance sheets.

On top of that, government bonds are a key benchmark for borrowing costs in the private sector. When markets arrive at a critical assessment of a country's public debt, they put a risk premium on the private sector of that country. In this case, Greek companies were suddenly faced with much higher interest rates than otherwise identical German companies.

A financial market that had grown together over years broke apart; it became much more fragmented. And that made it much more difficult to implement a single monetary policy. So once again the ECB had to step in to ensure that monetary policy remained effective. It began to buy government bonds through its Securities Markets Programme, SMP for short.

For a while the SMP helped to rein in uncontrolled surges in government bond yields. This ensured that monetary policy remained effective. However, in 2012 it became clear that more was needed as markets had gone one step further. They had begun to price in a break-up of the euro area. The borrowing costs of governments surged, and the banks got into trouble.

In that situation, the ECB pledged to do "whatever it takes within its mandate" to preserve the euro. It announced that it would stand ready to buy government bonds of specific countries. This programme was termed OMT, short for outright monetary transactions. It was subject to strict conditions, of course; I will spare you the details. Right from the start, the OMT programme was described as a game changer. It restored trust in the euro area and, as a result, there was actually no need to activate it.

But the euro area was still caught in a recession, and growth slowed even further. The crisis had entered its third phase. As the economy slowed down, inflation fell. To revive it, the ECB cut interest rates twice in 2013, to a new low of 0.25%. But, in the following year, inflation declined further and even fell below 0% in December 2014. Among other things, this was due to a fall in oil prices. It became clear that the ECB needed to do more.

It had to prevent low inflation from becoming entrenched or even turning into deflation. But what could be done? With interest rates close to zero, the standard tools were only of limited use. The ECB's Governing Council thus decided to take three non-standard measures.

First, it broke through the zero lower bound of interest rates. In June 2014, the deposit rate was set to –0.10%. This gave banks an incentive to stop depositing their money at the ECB and pushed them to lend it to the real economy instead. At the same time, the ECB's decision made clear to the markets that interest rates can fall below zero. Markets adjusted their expectations about future interest rates, and this caused long-term interest rates to fall as well.

Second, the ECB provided longer-term refinancing to banks at very low rates. The amount that banks can borrow is linked to their loans to private companies and households. This should stimulate bank lending to the real economy, and make it easier for private companies and consumers to take out loans.

And third, the ECB used the tool of quantitative easing. Since March 2015, it has bought more than €2 trillion worth of public and private assets. Among other things, this brings down long-term interest rates via various channels. At the same time, ECB made it clear that it is committed to its goal of price stability.

The present – not quite there yet

So these are the measures that were taken. But where have they taken us? I think everyone would agree that they have taken us into uncharted territory. Some might say that they have taken us close to the limits of the ECB's mandate. And others might even argue that they have taken us past those limits.

At the same time, many people here in Germany argue that the ECB's policy has many negative effects. They feel that low interest rates penalise savers, hurt banks and destroy wealth.

It is true, of course, that low interest rates have many effects. Some of these are intentional – they make it cheaper to borrow money, spur investment, revive growth and, eventually, stimulate inflation. But they also have unintended side effects.

So yes, for savers low interest rates do mean that their money accumulates at a much slower pace than before. However, most people are not just savers – they also need to borrow money from time to time. And that's when low interest rates benefit them; when they borrow money to buy a house, for instance. The same applies to those who need a loan to set up a company.

It is a fact that monetary policy redistributes wealth. It always does, and there is no way around it. Low interest rates are good for borrowers and bad for savers. It's exactly the reverse with high interest rates: they're bad for borrowers and good for savers. But the ECB would not be fulfilling its mandate if these effects kept it from securing price stability. The ECB is responsible for price stability and price stability only. It is up to governments and parliaments to sort out redistribution policy.

Against that backdrop, the decision to lower interest rates was justified. And, in any case, what would the alternative have been? Savers might initially have been happy with higher interest rates, but the economy would have faltered. And over the medium to long term, savers would have felt that pain, too.

That said, there are other side effects of low interest rates that we must keep an eye on. Among other things, they set wrong incentives. This can lead to bubbles in the financial markets which eventually burst and hurt the economy.

So while low interest rates are justified, they have side effects. And these side effects grow over time, while the intended effects of expansive monetary policy wear off. The same is true of the bond purchases. They took us even further into uncharted territory. While they do have a desired effect on financial markets, they also have side effects similar to those of low interest rates. And, over time, these side effects could even threaten financial stability. But we won't be able to gauge the overall costs and benefits of our non-standard measures until many years have passed.

As for today, we could continue discussing all these things for hours on end. They are complex – and important. They directly affect the role of the central bank, its powers and its limits. However, there is another question I would like to consider. And this question is equally important. Did the measures work? Did they help us achieve our goal – an inflation rate of close to, but below, 2%?

Well, obviously, inflation is still some way from our goal. But does that mean the ECB's policy has failed? No, of course not. Monetary policy never influences prices directly. The mechanism for transmitting a monetary policy impulse to the real economy, and driving a change in prices, involves many different steps.

The first step is that low interest rates, bond purchases and other tools influence conditions in financial markets. They should make it easier for companies and people to borrow money. And that's what we have seen. Since 2014, lending rates for non-financial corporations and households have fallen a lot – by 119 and 100 basis points, respectively. And for small and medium-sized enterprises, they have even fallen further. That is important because these companies provide most of the jobs in the euro area. At the same time, lending rates in different countries have become less dispersed; the financial market has grown closer together again. So far, the measures taken have had the desired effect.

The second step is that conditions in financial markets influence economic growth. Companies can invest more, people can buy more goods and services, more jobs are created and the economy grows. And we have seen that as well. Growth has returned to the euro area, and so have jobs. We can look back on 17 quarters of economic growth and an unemployment rate that has fallen from around 12% to around 9%. Confidence is growing and demand is increasing. People in Europe have started spending again, and that supports the recovery. And the recovery is not confined to a few countries; it has taken hold across the euro area.

The third and final step is that stronger economic growth influences prices. As the economy comes closer to its full potential, production factors become scarcer. The supply of labour, for instance, begins to dry up. This boosts wages, which prompts companies to raise prices – and inflation returns.

And it is here that we have got a bit stuck. Inflation has picked up, but not as fast as we would have expected. So what is holding it down?

Low oil and commodity prices are one factor. From January 2014 to January 2016, oil prices fell by about 70%. That is quite a drag on inflation, as you can imagine. And it acts as a brake not just on headline inflation, which includes energy prices, but also on underlying inflation, which excludes them, because energy is an input for so many other products and services.

But there are other factors which also weigh on inflation. And the labour market is the place to look for them. After all, wages play a key role in inflation dynamics. If wages go up, inflation goes up. However, wages seem to be growing quite slowly even though the economy is recovering strongly. Why is that?

Well, one possibility is that the economy might be further from its full potential than we think. In that case, the labour market would be less tight, wages would not rise, and that would hold down inflation. And indeed it seems that the headline unemployment rate doesn't reflect some of the slack in the labour market. Using broader measures of unemployment reveals that the labour market is less tight than the general unemployment rate suggests.

A second factor is that inflation only tends to affect wages after a certain amount of time has passed. So the very low inflation from the past is still dampening wage growth. This has offset some of the effects that stem from an improved labour market, and is another reason why wages are reacting more slowly than usual to economic growth.

And then there is the question of whether something more fundamental has changed. Has inflation become less sensitive to changes in the real economy? Has the Phillips curve become flatter? It seems that it did become flatter during the crisis in ways that make inflation slower to react to economic growth. However, it may well be that the curve steepens again once the economy reaches its full potential.

So what does all this mean? The key message is that all the factors that are holding down inflation seem to be temporary. And this means two things.

First – we need to be patient. Inflation will react to the economic recovery; it will just do so slowly due to various factors. But over the medium term, it will return to our goal. It's just a question of time. And we have the time, because we made the decision to define our goal with a view to the medium term: inflation rates of below, but close to, 2% over the medium term.

And second – we need to maintain our expansive monetary policy to bring inflation back on a stable trend towards our goal.

But does that mean that monetary policies must continue as they are currently calibrated? Do we still need to continue adding assets to our balance sheet, for example? I don't think so.

I think we should begin reducing our bond purchases next year. This should be done gradually, until we are no longer purchasing additional bonds. For even if we phased out our net purchases of bonds entirely, some monetary accommodation would remain in place. This is because we reinvest all the money from maturing bonds. So the total volume of bonds would initially remain constant, as would the expansive effects. On top of that, our standard monetary policy measures would continue to have an effect as well.

And this takes me to the final part of my speech: the future.

The future – coming closer

Looking to the future, we can be confident that inflation will return to our objective. Thus, we need to think about how we can bring our unconventional measures to an end. We need to look ahead and design the exit. After all, it will be a major event for markets and the economy.

And this links to another important issue: communication. For a long time, central banks and monetary policy were very opaque. In the 1980s, Alan Greenspan claimed that he had to learn "Fedspeak" when he became Chairman of the Federal Reserve Board. He "learned to mumble with great incoherence". Back then central banks were secretive about monetary policy and vague, at best, when speaking to the markets.

So markets had to find ways to second-guess what the central bank was up to. Some of these ways were a bit odd. Alan Greenspan's briefcase was one of the more inventive indicators. Whenever the Federal Reserve had a meeting to discuss monetary policy, the markets apparently observed Alan Greenspan's briefcase. If it was bulging, markets concluded that interest rates would change; if it was thin, they concluded that no change was likely.

In the end, such ways of gauging what the central bank is up to are quite unreliable. Markets might easily draw the wrong conclusions and this might lead to unwanted volatility and turbulence.

That is one of the reasons why today, almost everyone agrees that central banks need to be transparent. It helps them to steer the expectations of markets and make their policies more effective. At the same time, it helps them be more accountable. Both of these things have become even more important against the backdrop of our unconventional measures.

So we need to communicate very carefully on our next steps. We must help markets get an idea of what the exit will look like. And we mustn't confuse them with vague or ambiguous ideas. We have to strike a delicate balance. And in my view, we need to find this balance now.

As of today, it is clear which sequence the exit will follow. Bond purchases will come to an end, while interest rates will remain low, well past the horizon of net asset purchases. But we still need to decide on a timeframe. From my point of view, it is important that we really move towards the exit – step by step, but steadily and in a clear direction.

Conclusion

Ladies and gentlemen,

I began by saying that the days of "boring" central banking are over. And I do hope that I have shown that to be true.

What is safe to say, though, is that central banks have stepped into the limelight and become a focal point of public debate. And it is a controversial debate. Some argue that the ECB handled the crisis well. Others are much more critical. Who is right?

Today I have argued that, given the low inflation, monetary policy needed to be expansive. Admittedly, the appropriate degree of expansion and the necessary tools are moot points. In any case, we must bear in mind that some of the ECB's more unconventional tools also have side effects. And these side effects will grow in magnitude the longer the tools are used. So, the future holds the final answer to our question of whether monetary policy was optimally calibrated.

If we manage to put the unconventional tools back into the box when the time comes, we will be able to claim that the ECB successfully achieved its objective. And in my view, this time has come. We need to discuss how to exit from our unconventional monetary policy, and then we need to do it. My opinion is clear: we should begin to scale back our bond purchases at the beginning of next year.

When we bring our unconventional measures to an end, it will mark the last chapter of this turbulent tale. Let's hope that we can then go back to our quiet and boring former life.

Thank you very much for your attention.