Sabine Mauder: Monetary policy challenges - exiting expansion and the "new normal" on the financial markets

Speech by Dr Sabine Mauder, Member of the Executive Board of the Deutsche Bundesbank, at the Euro Finance Week 2018, Berlin, 15 November 2018.

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1 Welcoming address and opening remarks

Ladies and gentlemen

Economic and monetary union is one of Europe's greatest projects. The combination of today's final keynote speeches – European policy by Jeroen Dijsselbloem and my perspective as a central banker – is thus fitting.

Since the financial crisis, central banks throughout the world have felt the need, one after the other, to turn to unconventional monetary policy. This has meant that central bank policy is having a greater impact on the banking sector and the financial markets than ever before.

The financial and economic crisis has more or less been consigned to history. Central banks are now starting to exit the non-standard policy measures introduced in response to the crisis. As you can well imagine, for me, it is an extremely interesting but also challenging time to take over the helm for markets on the Bundesbank's Executive Board and ultimately to be responsible, inter alia, for the operational implementation of monetary policy.

Experts are focusing their discussions on two main points. First, which challenges and necessities, risks and opportunities need to be taken into consideration during the exit procedure? But we are also pondering what will come next? What will the financial markets look like in the near future? I would like to present some initial ideas on this subject in my talk today.

2 What can we learn from other central banks' exit? Which decisions are coming up in the euro area?

Let me begin with the first point. What shape might our exit from non-standard monetary policy take? I shall start by looking a little further afield; to the United States and Japan. How are other currency areas dealing with expansionary monetary policy? I will then move on to consider individual measures in the euro area: interest rate policy, purchase programmes and refinancing.

Experience with quantitative easing in the United States and Japan

The United States started the quantitative easing experiment way ahead of the euro area, and is also much further along with the exit process. Many market participants are thus trying to use US monetary policy normalisation to second guess what will happen in the euro area. The debate always comes back to the length of a central bank's balance sheet.

At this point, I would like to have a quick look at the decisions taken by the Federal Reserve System. The Fed embarked on a very expansionary course of monetary policy back in 2008–2009. This included purchasing assets on a large scale; a practice known as quantitative easing. The Federal Reserve System concluded its last large-scale asset purchase programme in autumn 2014. From then until the autumn of 2017, the Federal Reserve System reinvested any funds that became available on a more or less regular basis. During this time – that is, from December 2015 – the Fed began steadily putting up interest rates. In October 2017, the Fed started gradually reducing the reinvestment of principal payments. In parallel, from December 2017 to date, the Fed raised its benchmark interest rate further. The Fed is still following this course. At the beginning of November, the Fed's asset holdings – not just from purchases – amounted to around US$3.9 billion. That is still a high level, even years after switching monetary policy.

At an early juncture, the Fed declared that it expected its balance sheet at the end of monetary policy normalisation to be much larger than before the crisis – but only as large as it deemed necessary to be able to implement monetary policy decisions effectively and efficiently. But how long should a central bank's balance sheet be in the future? That question remains unanswered as yet. In the meantime, regulation and endogenous market developments have also changed market participants' liquidity requirements.

Experience in the United States has shown how monetary policy normalisation could take place. But this could never be a one-for-one blueprint for the Eurosystem. While the two currency areas may share some similarities, there are also vast differences. This is especially true of financial market structures and the monetary policy transmission process which, in Europe, takes place to a greater extent via banks and less so via the capital market. But we can learn two things in particular from the Federal Reserve System's example. First, how to successfully communicate our exit from expansionary monetary policy. With carefully chosen and well-designed forward guidance, central banks can influence market participants' expectations. Second, monetary policy normalisation takes time.

Japan is another case entirely. In Japan, the speculative bubble burst in the early 1990s. In the ensuing "lost decade", the Japanese economy was plagued by a period of mild deflation. In 1999, the Bank of Japan adopted a zero interest rate policy; it has been pursuing quantitative easing since 2001.

At the beginning of the new millennium, the Japanese economy began to find its feet again. The Bank of Japan ended its quantitative easing in 2006 and was about to return its monetary policy to the money market rate. But at that moment, as of 2007, the money markets started to dry up and the global financial and economic crisis set in. Consumer prices in Japan tumbled. As a result, the Bank of Japan decided to return to a policy of "comprehensive monetary easing" in 2010, including interest rate targets for interbank interest rates, repo transactions and asset purchases – including in the real estate sector. In 2016, the deposit facility rate entered into negative territory (-0.1%) for the first time.

Today, the Bank of Japan holds around 50% of all outstanding Japanese government bonds. Debt accordingly amounts to about 85% of Japanese gross domestic product. Alongside demographic change, the enormous level of government debt is one of the main problems that Japan faces. Government debt has been growing since the early 1990s, accelerated by one crisis after another, and it is mainly held in the domestic domain. In the meantime, a nexus has emerged between government debt, the central bank and domestic creditors, and this is seriously limiting the economic scope.

The situation in Japan teaches us one important lesson: it is crucial that we do not miss the right moment for exit. This is a challenge of which we at the Bundesbank are well aware.

Upcoming decisions on phasing out non-standard measures

Another question of timing concerns the upcoming decisions by the ECB Governing Council on how non-standard monetary policy measures will be phased out. At the national central banks, such as the Bundesbank, we implement these decisions made by the Governing Council. Let me now take a closer look at three upcoming decisions: first, the purchase programmes; second, interest rate policy; and third, refinancing.

The purchase programmes are continuing to have an expansionary impact in terms of monetary policy, even if – provided that there are no further substantial changes – the Eurosystem will no longer be making net purchases as of January 2019. At that time, bond holdings will amount to around €2.6 trillion. As decided by the ECB Governing Council, the Eurosystem will reinvest the proceeds from maturing bonds “for an extended period of time and, in any case, for as long as necessary”. This keeps the level of excess liquidity high. There will therefore continue to be significant bond holdings on the central bank balance sheet – and, accordingly, an expansionary monetary policy stance – for a while longer.

To a certain extent, it is like driving a car: by reinvesting, the Eurosystem is keeping its foot on the accelerator. But we are not pressing any harder by making more net purchases. The ECB Governing Council will decide on the details of the reinvestment policy in December 2018. In this context, it has already been indicated upfront that the ECB capital key should remain the deciding factor in how the government bond purchases will be allocated among the central banks. In the Bundesbank’s view, it is vital that these purchases are market-neutral and do not lead to distortions. That also demands a certain degree of flexibility with regard to the investment horizon and reinvestment timing.

With regard to interest rate policy, normalisation will still require a long period of time. The ECB Governing Council’s forward guidance[1] is definitive: ECB key interest rates will remain at their present levels at least through the summer of 2019 and, in any case, for as long as necessary. The Bundesbank still believes that it is crucial that we do not miss the most opportune moment for an interest rate reversal.

We are currently in an environment of very high excess liquidity. This is also projected to remain the case for some time to come. The deposit facility rate is therefore likely to remain the definitive Eurosystem interest rate for a while still.

The third upcoming Governing Council decision concerns refinancing. In regular refinancing operations, we currently use a fixed-rate full allotment procedure when banks request liquidity from the central bank. In 2008, the full allotment procedure was intended to support – and has since partially replaced – the money market, which had become dysfunctional. Since 2014, the Eurosystem has issued central bank loans with terms of up to four years through its targeted longer-term refinancing operations (TLTROs). The final longer-term refinancing operation was carried out in March 2017. This means that the TLTROs – with an amount outstanding of more than €700 billion – will reach maturity by March 2021. Excess liquidity remains high, however. Whether TLTROs will nevertheless still be needed in the future depends, amongst other factors, on how well the money market will function and how well liquidity will be redistributed across borders. The current full allocation policy remains in effect until the beginning of 2020. It is therefore certain that the ECB Governing Council will be tackling the issue of refinancing conditions in the coming year. The question is whether it will be considered necessary to extend the full allocation policy in its entirety.

Résume 1

Purchase programmes, interest rate policy, refinancing: the ECB Governing Council will soon make decisions on these issues. What measures are still required in each of these areas in terms of monetary policy? In what order and how quickly will changes be made?

Eurosystem forward guidance will continue to play a key role, ensuring that the various players will be able to adapt to changes in monetary policy in good time. In the medium term, excess liquidity must be scaled back. And policy rates should again serve as the instrument signifying the course of monetary policy. In this respect, we can learn from the experiences of Japan and the United States.

So, to summarise: we need to ensure proper communication, the phase-out will take time and will have to be done carefully, and we cannot miss the most opportune moment.

3 What will happen afterwards? Questions on the "new normal"

If, step by step, we depart from the course of expansionary monetary policy, this raises the question of what "normal" monetary policy actually entails. Since 2009, the phrase "new normal" has worked its way through the financial press. The phrase was coined in 2009 by Bill Gros and Mohamed El-Erian, who at the time were managers at PIMCO. The essence of their message was that, after the Lehman collapse in the autumn of 2008, the world of finance would never again be the same as it had been prior to the crisis. Even if the phrase "new normal" originally had a different meaning, it has since taken on a life of its own as a buzzword. It stands for the notion that we find ourselves in the midst of an upheaval. We anticipate that, after this period of transition has passed, we will enter into a new era of stability.

Central banks' unconventional monetary policy was, above all, an emergency measure. With these measures coming to an end, we are now asking ourselves what the next – hopefully stable – phase will be like.

In the academic and political discussion on future monetary policy, these questions include: what monetary policy strategies will be employed? Which monetary policy instruments will be used? And what will monetary transmission look like in the various currency areas? That said, one thing is clear: monetary policy cannot ignore long-term changes in the underlying conditions. The new world will definitely not be the same as the old one. The circumstances surrounding monetary policy – such as the structure of the financial system and banks' business models – have changed. The key questions here are: in what way and to what extent?

Discussion of the post-crisis setting in monetary policy must be accompanied by an analysis of market conditions. If we wish to be able to steer monetary policy effectively and efficiently, then we may need to respond to the new state of affairs in an appropriate way. In this context, however, we must bear in mind that this state of affairs also shows the influence of monetary policy. Central banks certainly do not want to shape the financial system according to their own inclinations. That should be left to market forces and policy makers. Instead, the financial system is the channel through which monetary policy signals and impulses are transmitted to the real economy in order to achieve our goal of price stability. That is why monetary policy is, above all, dependant on the functional viability of the financial markets.

"Work in progress" – determining the "new normal"

As the Bundesbank Executive Board member responsible for markets, I would now like to draw your attention to several areas where the financial markets have witnessed change and are thus leaving their mark on the "new normal": notably, money market activity, the market muscle-power of new players, fragmentation in our monetary union, the implementation of digital changes, and modifications arising from regulations. That topic, incidentally, will be discussed in more detail by Jens Weidmann in his speech tomorrow at the European Banking Congress.

Let's look first at the money market. The 2007 financial crisis caused the traditional money market to dry up, effectively rendering it dysfunctional. Since then, we have seen heightened risk aversion. Banks hold larger liquidity buffers and are less keen to source liquidity from the market. Interbank turnover has dwindled considerably in the unsecured segment and the emphasis has shifted significantly from unsecured to secured money market funds.

Step by step, central banks have taken on the tasks previously performed by the now collapsed money market, not least via the aforementioned refinancing operations, but also by instituting asset purchase programmes. This is also reflected in longer central bank balance sheets.

Parallel to this development, new players have also gained a foothold in the market. Alongside standard banks, non-banks – such as insurers or money market funds – now play an enhanced role. The structural changes to the money market also impact the reform of reference interest rates, as do the provisions contained in the EU Benchmarks Regulation. With effect from October 2019, the ECB will make its new euro overnight rate, ESTER, available, which will include transactions with non-banks. The banking sector is also currently adapting the EURIBOR to the new regulation with the aim of basing it more on actual transactions and not simply on a survey approach. These developments show that the relationship between money markets and liquidity is more complex today than before the financial crisis. Our money market is practically a new ecosystem. But that is also a reflection of our monetary policy.

A further aspect of the “new normal” in the financial markets is the fragmentation between the member states of European monetary union. The high level of excess central bank liquidity stemming predominantly from the monetary policy purchase programmes is not really distributed, but concentrated in certain regions. This is mainly due to three factors.

First, liquidity gathers locally at financial centres. Financial centres, such as Frankfurt, are home to both national banks and banks from outside the euro area. Second, banks’ different business models draw more excess liquidity to certain countries than to others. Third, the general search for “safe haven” assets also plays a role.

Digital innovations are simultaneously changing the playing field and the rules of the game in the financial markets. In the past, monetary policy was based on the traditional banking sector. Today the terms “bank” and “banking business” have become more vague. The success of fintech firms, but also the growing influence of the big tech companies, is creating new conditions. They are establishing new forms of payment, trade and settlement. Fresh business ideas challenge established players with standard business models to transform and innovate. Structures and players in the financial sector change just as their business models and relative market positions do. Because this can have a significant impact on the force behind monetary policy impulses, we have to follow these developments carefully and analyse them.

In the wake of the financial crisis, regulation has altered financial markets and the money market. Particular examples that spring to mind are new provisions governing market risks, limitations on proprietary trading, and supervisory regulations effectively making many transactions more expensive. Banks are complying with the new regulatory provisions. This means that banks – in particular large banks – are scaling back their activities in the money market. It remains to be seen whether other market participants – for instance, insurers or large mutual funds – gain a role in intermediation.

A look at these five areas – the money market, new players, fragmentation, digital innovation and regulation – shows that they have all altered the financial markets – and the changes have been too many to mention here today. But one thing is clear: the new regime in the financial markets has yet to be put to a serious test over a full economic cycle. We do not yet know what further effects and changes lie ahead, even if we closely monitor the processes and circumstances. The “new normal” in the financial markets is, as such, a “work in progress”.

Résumé 2

In conclusion, a central bank’s monetary policy has a direct impact via the financial markets, their structures and their players. This environment – monetary policy’s ecosystem – has changed. And it will go on changing. Some of the changes were triggered by the financial crisis and the central banks’ and regulatory authorities’ crisis policies. Other changes have emerged independently and follow major trends, such as digitalisation. To ensure that monetary policy decisions are successfully implemented in the market and in the real economy, it is crucial to understand market structures. We are thus following and analysing these processes carefully.

If changes in the financial market are a “work in progress”, this ultimately means that the analysis of how monetary policy is transmitted to the financial markets is a “work in progress”, too. We are convinced that a central bank should be independent and committed solely to its objective of ensuring price stability. It should not attempt to reshape financial markets and banking beyond this remit. During the crisis, central banks stepped into the breach with their emergency measures – like it or not. Now, with the impending exit, we must engage in lively debate on controversial topics concerning fundamental issues of monetary policy. Which strategy is the most fitting? Which transmission measures are effective? Discussions have been underway in the United States for some time now, even about the mandate of the central bank.

However, we do not yet know for sure how the markets will function in the future. When discussing how monetary policy should potentially respond to changes in the markets, we thus caution against making hasty prior assumptions. This is because those parties who have previously achieved a degree of success with stability policy – and this goes for both the Eurosystem as well as the Bundesbank in the decades before – will recommend taking careful, well-thought-out steps in these discussions. We are closely monitoring changes in the markets, whilst also making sure that we do not lose sight of monetary policy's big picture: price stability. Price stability will remain our anchor – irrespective of old or new normal.

Thank you for your attention.

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[1] Forward guidance is one of the ECB's methods for communicating the longer-term orientation of monetary policy. The ECB switched to this form of steering expectations in 2013 in order to counter undesired developments in the markets.