

SPEECH

Narratives about the ECB's monetary policy – reality or fiction?

Speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the Juristische Studiengesellschaft

Karlsruhe, 11 February 2020

In recent years, Germany has experienced one of the longest economic upswings since the Second World War.^[1]

Since 2010 the German economy has grown at an average annual rate of 2%. Unemployment has fallen to its lowest level since German reunification.

The monetary policy of the ECB has contributed significantly to that expansion. By lowering interest rates and making use of new monetary policy instruments, the ECB has created financing conditions that support investment, growth and job creation across the euro area.

And it was the ECB's decisive action in 2012 that prevented a break-up of the euro area.

Despite these considerable successes, the public debate about monetary policy has become more heated in parts of the euro area, and especially in Germany.

The conversation is dominated by various narratives, such as the “expropriation” of German savers through “punishment rates”, the “flood of money” that will inevitably lead to massive inflation, and the creation of “zombie firms” as a result of expansionary monetary policy.

In my remarks today, I would like to take a closer look at some of these narratives and discuss them in the light of the facts.

I will demonstrate that the ECB's current monetary policy stance is necessary in order to achieve sustained price stability in the euro area, and that the use of unconventional monetary policy tools, such as negative interest rates and asset purchases, is largely a consequence of structural changes in the economy that lie beyond the ECB's control.

I will also discuss the potential side effects of these monetary policy measures and show that many of the fears that are frequently being expressed are based on half-truths and false narratives. The excessive criticism of the ECB is dangerous because it not only jeopardises trust in our single monetary policy, but also undermines European cohesion.

Economic developments and ECB policy: facts and perceptions

The mandate states that the primary objective of the European System of Central Banks is to maintain price stability.^[2]

Assigning the ECB a price stability objective was seen as particularly important in Germany, owing to fears of inflationary developments. The ECB's Governing Council has defined price stability in the euro area as an annual increase in consumer prices of below, but close to, 2% over the medium term.^[3]

Since the euro was introduced, inflation in the euro area has tended to be too low rather than too high (Slide 3). The annual inflation rate for the euro area as a whole has averaged 1.7% since 1999. And the rate for Germany has been 1.4%, significantly lower than during the period before the introduction of the euro.

Stable prices have been accompanied by significant economic growth (Slide 4). Over the past decade, in no other large industrialised nation has real per capita income growth been stronger than in Germany. In

2015 prices, each German has on average about €6,000 more in their pocket now than they did ten years ago.

In Italy, by contrast, average per capita income has remained broadly flat over the same period. At the same time, German unemployment fell to its lowest level since reunification.

These developments are all the more remarkable given the huge global disturbances we have seen in recent years, such as the financial crisis, the euro area crisis, trade tensions between the United States and China, and the United Kingdom's departure from the EU.

Economic success in Germany is reflected in high and rising approval rates for the euro (Slide 5). Support for the euro in Germany is higher than it has ever been. Eight out of ten persons in Germany support the euro, which is above the European average. And although trust in the ECB has typically been lower than in the euro itself, it remains above the European average in Germany.^[4]

Given these positive figures, it is surprising that the ECB has for years faced such fierce public criticism in Germany. The media and politicians never tire of pointing out the supposed perils and deficiencies of today's monetary policy.

Wide-ranging public debate and well-founded criticism are crucial for an independent institution like the ECB. However, the central criterion by which the ECB must be judged is whether it is fulfilling its mandate.

In Germany, however, criticism is all too often combined with claims and accusations that have no basis in fact. In addition – and this is something that worries me – discussions are taking place in an atmosphere of rising aggression and a coarsening of the language.

German media have, for example, made references to “Count Draghila” who “sucks dry” German savings accounts, or “the biggest expropriation project since the Soviet dismantling of industry and East German forced collectivisation” (Slide 6). Such images are hardly conducive to objective debate.

And this kind of aggressive language is not limited to the media. Politicians of various parties have referred to Mario Draghi as “the gravedigger of German savers” or “the speculators' accomplice”, who has “continuously expropriated” savers (Slide 7).

This public reaction far exceeds the usual degree of criticism about economic policy decisions. And it seems that negative interest rates are the chief cause of these deep feelings of discontent.

Indeed, negative interest rates are a relatively recent addition to the central banking toolbox (Slide 8). The ECB first took the deposit rate for banks into negative territory in June 2014 and subsequently lowered it to -0.5% in several steps.

Structural factors are the main driver of interest rates

Against this background, the question arises as to why the ECB needs to make use of negative rates, and why interest rates were much higher in the past?

If inflation needs to be pushed up, central banks need to bring the real interest rate – that is, the nominal interest rate adjusted for inflation – below what is called the “real equilibrium interest rate” – the rate at which all factors of production are at full capacity and inflation is stable.

The level of the real equilibrium rate is determined by a number of structural factors, such as a country's demographic situation or capacity to innovate.^[5]

The real equilibrium interest rate cannot be directly observed and instead has to be estimated. And almost all estimation methods show that the real equilibrium interest rate in the euro area has fallen markedly over the past 20 years (Slide 10).

Indeed, many estimates have even been showing negative values in recent years. This suggests that the supply of capital is matched with relatively low demand – in other words that the desire to save is meeting with a comparatively low propensity to invest.

Germany offers a prime example of this savings surplus. The vast and enduring current account surplus means that in Germany much more is being saved than invested.

The central bank, however, steers the nominal rate of interest – that is the sum of the real interest rate and expected future inflation. If the real equilibrium interest rate and inflation are both strongly positive, the central bank has considerable scope to stimulate the economy by cutting rates. But if the real equilibrium rate is close to zero or even negative, that scope is greatly reduced because monetary policy is constrained by the zero lower bound.

And so you can see that low equilibrium interest rates create problems for the central bank if its price stability mandate is threatened by too low inflation or even the risk of deflation.

The ECB is, however, not the only central bank faced with this problem (Slide 11). The equilibrium interest rate has been falling across large parts of the industrialised world since the early 1970s.

What is behind this negative global trend?

One important driver is the fall in long-term trend growth. This is determined by the amount of resources – labour and capital – used and by how efficiently those resources are used, as reflected by productivity.

And, indeed, all of these sources of growth have followed a declining trend in many advanced economies.

While annual productivity growth in the euro area in the 1980s was, on average, still around 2%, today it is somewhat less than half of that (Slide 12, left-hand side). And the working-age population in the euro area has for some time even been in decline. Demographic developments mean that this decline is highly likely to continue in the coming decades (Slide 12, right-hand side).

In addition, in recent decades, the leading industrial nations have undergone massive structural change, owing not least to digitalisation, and have been moving away from capital-intensive manufacturing industries towards less capital-intensive service industries.

Low interest rate environment requires unconventional monetary policy measures

A key conclusion that can be drawn on the basis of this analysis is that it is not primarily the central bank that is responsible for low interest rates. It is not within the power of the central bank to change the structural conditions that would turn around the negative interest rate trend.

The call for higher interest rates should instead be directed at governments and legislators, combined with the urgent demand for measures to strengthen the growth potential of our economies.^[6]

A second conclusion is that these developments have an impact on the toolbox of central banks.

In order to maintain price stability, central banks around the world had to resort to a number of unconventional instruments in order to bring inflation back to a level that is consistent with their medium-term inflation aim.

The ECB, for its part, turned to unconventional measures when very low and later negative inflation rates took hold in the euro area and inflation expectations noticeably weakened (Slide 13, left-hand side).

But unconventional measures were not restricted to negative interest rates. In addition, these included guidance on the future stance of monetary policy – known in technical jargon as “forward guidance” –, targeted longer-term refinancing operations that offer banks highly attractive conditions provided they extend credit to firms, and an extensive purchase programme for bonds issued by public and private issuers. This resulted in a massive expansion of the ECB’s balance sheet (Slide 13, right-hand side).

Overall, these measures have ensured that the borrowing costs of businesses and households in the euro area have fallen considerably over recent years, and more strongly than would have been expected solely on the basis of the reduction in key interest rates (Slide 14, left-hand side).

Favourable financing conditions have, in turn, stimulated demand for loans and thus supported investment and job creation (Slide 14, right-hand side).

Together, these monetary policy measures have given the euro area economy a decisive boost, as shown by Eurosystem economists’ estimates.^[7]

Overall, the estimates indicate that, in the period from 2015 to 2019, inflation in the euro area would have been around one-third to one-half a percentage point per year lower without the measures taken by the ECB since the middle of 2014 (Slide 15, left-hand side). Real GDP in the euro area in 2019 would have been between 2.5% and 3.0% lower and employment by more than two million lower (Slide 15, middle and right-hand side).

Thus these measures were not only necessary to fulfil the mandate of price stability. They also had considerable positive effects on growth and employment. In the current situation, a fundamental departure from this policy does not seem appropriate, not least in view of the weak economic developments in Germany as well as in other parts of the euro area.

Supposed and actual side effects of monetary policy

All of this does not mean, however, that unconventional policy measures do not have their problems. When conducting monetary policy, the ECB and other central banks monitor possible side effects of their policy and take these into consideration in their monetary policy decisions, insofar as this does not conflict with their mandate.

The question is, however, whether the side effects of the current monetary policy are as severe as German media coverage suggests.

In my remaining time today, I would like to examine three of the side effects that have attracted the most discussion.

The first concerns the effects of monetary policy on income and wealth distribution and the supposed “expropriation” of German savers. The second question concerns the effects on the corporate landscape and the purported emergence of “zombie firms”. And the last concerns financial stability and, above all, the effects on asset prices.

Are German savers being “expropriated”?

Let me begin with the narrative on the “expropriation” of German savers.

First, it should be pointed out that there is no entitlement to high interest rates on savings, which is what the term expropriation implies. And it is not part of the ECB’s mandate to ensure high interest rates for savers.

Yet, it is important to consider the facts and figures.

So far only a relatively small proportion of the deposits of private households in Germany have in fact been directly affected by negative interest rates (Slide 17, left-hand side). In the euro area it is even fewer (Slide 17, right-hand side).^[8]

More so, from a historical perspective, the current return on savings deposits is not at all as untypical as many observers suggest (Slide 18).

The reason is that what ultimately really matters for savers are real interest rates, that is, interest income less inflation. A high nominal interest rate is of little benefit to savers if, at the same time, the purchasing power of money has fallen by a similar or greater amount. That was the situation in the 1970s.

Many observers may be surprised to learn that the average real interest rate for savings and demand deposits in Germany since the introduction of the euro is around the average of the previous 24 years.

Moreover, Germany consists not only of savers, but also of borrowers, taxpayers, property owners and, of course, workers.

For the population as a whole, there is, for the period from 2007 to 2017, for a representative German household, even a small plus on the bottom line of the interest account, i.e. not taking into account wealth effects (Slide 19, left-hand side).

An average net saver may indeed have received around €500 per year less in interest income. However, an average net borrower has saved almost €2,000 each year in interest payments. In addition, there are more than €400 billion in interest rate savings for the German general government since 2017.

If the figures are broken down by income group, you can see that the middle income group, which is the group with the most borrowers, were the winners of the low interest rate policy (Slide 19, right-hand side).

In addition, among the distributional effects of monetary policy, its positive effects on the labour market must not be ignored (Slide 20, left-hand side).

The results of an empirical study by ECB economists show that, above all, poorer income groups have profited from the monetary policy measures because they benefit in particular from the fall in unemployment.

Finally, monetary policy may also have effects on the wealth distribution through its impact on asset prices, whereby those individuals with the largest wealth in the form of shares and real estate would stand to benefit the most.

One implication is that whether or not changes in asset prices ultimately cause an increase in wealth inequality depends, among other factors, on the rate of home ownership. And although home ownership

has traditionally been comparatively low in Germany, the latest available figures do not point to a material increase in wealth inequality between 2014 and 2017 (Slide 20, right-hand side).

Taken together, the above analysis indicates that the distributional consequences of monetary policy are much more nuanced than what the public debate would suggest. Indeed, in view of the diverse and partly opposing effects, it is not at all clear whether monetary policy is associated with a redistribution of income and wealth from the bottom to the top. And the overall effect is clearly positive.

Does monetary policy create “zombie firms”?

A second narrative deployed by some critics relates to the effects of the low interest rate policy on the corporate landscape. The theory is that low interest rates give sustenance to “zombie firms”, i.e. firms whose profitability is so low that they would not be viable if interest rates were higher.

I should start by pointing out that profitability is often a false measure of expected future economic success. Some of the most promising companies in the world, such as Tesla or, previously, Facebook and Amazon, did not make a profit for a long time.

But even if you take profitability as a yardstick, a systematic increase in unprofitable businesses in the years of expansionary monetary policy cannot be seen. Here we are looking at the latest calculations of ECB economists based on a micro dataset of several million firms.

The proportion of companies with very negative profitability – the red time series – has not increased in Germany in recent years (Slide 22, left-hand side). The proportion of highly profitable companies – the green time series – has even risen since the crisis.

One explanation for this is that more favourable financing conditions benefit all firms, but most of all profitable, healthy firms, to whom banks are more willing to provide favourable loans than they are to unprofitable and highly indebted ones.

In addition, profits and investment are subject to cyclical fluctuations. It is reasonable to assume that monetary policy has led to a decline in firms with negative profitability by stimulating the economy.

This positive effect of monetary policy is, of course, desirable, and contrary to what the zombie theory would predict, and it is especially noticeable in the countries that were particularly hard hit by the European sovereign debt crisis, such as Spain (Slide 22, right-hand side).

After increasing abruptly when the crisis broke out, the share of less profitable firms in that country gradually fell back to pre-crisis levels when economic growth picked up.

But such cyclical effects should not belie the existing structural deficiencies. Compared with other large economies, first and foremost the United States, Europe still has structural weaknesses which are curbing the potential growth of the euro area.

The structural reforms of recent years have helped to remedy some of these weaknesses in many former crisis-hit countries. All in all, however, the labour and goods markets in the euro area remain comparatively rigid, meaning that the broader conditions for growth and innovation need to be improved further with a view to counteracting the weakness in productivity growth.

Part of the problem here is the European banking and capital market.

The European banking sector has not yet recovered from the serious crisis that emerged around ten years ago. And it is still dealing with pre-crisis structural problems, such as inefficient cost structures.

The establishment of the banking union was a fundamental step towards enhancing the resilience of the European banking sector. Among the priorities of the new ECB Banking Supervision is the swift reduction of non-performing loans. Significant progress has been made in this regard in recent years (Slide 23, left-hand side).

The ratio of non-performing loans in Italy, for example, fell by half over the past four years. And initial successes can now be seen in Greece too.

These advances are likely to be far more important for the “de-zombification” of the European corporate landscape than monetary policy. For example, an ECB analysis shows that weak banks are more likely to extend risky loans to weak firms (Slide 23, right-hand side).^[9]

So the drive to press on with banking sector reforms plays a significant part in enhancing the forces of economic growth. This includes allowing weak banks to exit the market, which would at the same time alleviate the problem of weak profitability in the remaining banks.

In addition, we need a developed European capital market, which also provides capital to young, ambitious and risk-taking firms in Europe and continues to finance them throughout their growth phase. A functioning capital market is necessary for mastering the enormous challenges facing us today: climate change, digitalisation and demographic trends.

The European capital markets union can play a significant role here.

Monetary policy and asset price bubbles

The last narrative I would like to discuss this evening is the claim that loose monetary policy leads to price bubbles in the financial and real estate markets.

Fears that monetary policy entails risks for financial stability should indeed be taken very seriously. In fact, one objective of the current expansionary monetary policy is to revive risk appetite among investors, and thus promote growth and investment activity.

It is normal for asset prices to rise during phases of low interest rates. Equity prices, for example, reflect firms' discounted earnings expectations. If the interest rate falls, equity prices will go up, because future earnings will have a greater bearing on current valuations. However, earnings expectations themselves also tend to increase when interest rates are lowered, because investors anticipate stronger economic growth.

And, indeed, the current price/earnings ratio in the euro area is a long way off from the excesses of the dotcom bubble of 2000, and it is closer to its historical median than in other economies (Slide 25, left-hand side).

Nonetheless, central banks need to keep a close eye on such valuations, as purely liquidity-driven price gains can result in risks for financial stability in the long term.

Asset price bubbles pose a particular risk when they are largely credit-driven. This is typically more likely to apply to real estate than to equities. That is why developments in real estate prices are rightly coming under particular scrutiny.

Residential real estate prices in Germany have risen appreciably in recent years, especially in the larger cities, and the Deutsche Bundesbank has repeatedly pointed to possible price excesses.

Two factors are significant here.

First, prices always reflect the interplay of supply and demand. The pronounced price increase in German towns and cities reflects a noticeably stronger demand for housing that was unmatched by any corresponding expansion of supply.

There was a stronger influx of people to the towns and cities and a simultaneous increase in the demand for housing space per person. The low interest rates are likely to have further fuelled the demand for residential real estate, putting extra pressure on prices.

Second, despite the latest surge, CPI-adjusted real estate prices in Germany are still at a comparatively low level by international standards. Today, they are at around the same level than in 1990 (Slide 25, right-hand side). In the United Kingdom, by contrast, they doubled over the same period, while in Sweden they even rose by some 160%.^[10]

To assess the risks for financial stability, we must also look at the development of indebtedness.

Despite the real estate boom and low interest rates, private indebtedness in Germany and in the euro area as a whole (relative to GDP) has barely risen in recent years (Slide 26, left-hand side).^[11]

The development in private indebtedness thus differs markedly from the development prior to the global financial crisis.

Macroprudential supervision has the task of closely monitoring developments in lending and borrowing and of taking measures to rein in credit growth where appropriate. Many EU Member States have built up additional capital buffers in their banking sector, albeit generally rather late and only to a limited extent.

In the case of public debtors, however, the level of indebtedness in the euro area has risen considerably (Slide 26, right-hand side).^[12]

In the entire euro area, public debt (relative to GDP) is 22 percentage points higher than in 2007, although there is very significant heterogeneity across the Member States. In Germany, government debt is two percentage points lower than in 2007, while in Italy it is 31 percentage points higher.

Highly indebted Member States did not make enough use of the period of low interest rates to consolidate their government budgets. But it is up to politicians to tackle the problem of high public debt, not the ECB.

Conclusions

Let me conclude.

I have shown that many of the narratives about monetary policy cannot withstand careful analysis.

The level of interest rates has fallen sharply over the past years for structural reasons. In order to fulfil its mandate, the ECB therefore had to use new, unconventional instruments, such as negative interest rates and bond purchases.

In the absence of these monetary policy measures, the euro area's development would have been much weaker: growth and inflation would have been lower and the rate of unemployment higher.

At the same time, all monetary policy measures have side effects. They result in distributional effects, have an impact on the survival of unprofitable firms and harbour risks for financial stability.

But it is primarily up to other policymakers to counter such side effects. Distributional issues lie in the remit of fiscal and social welfare policy. And containing risks in the financial system is a task for financial market regulators and supervisors.

Of course, the central bank also needs to take the side effects into account when designing monetary policy measures, especially when they have repercussions for price stability. Careful consideration of the costs and benefits must be an integral part of monetary policy decisions. The question as to how exactly this should be done will be part of the ECB's review of its monetary policy strategy this year.

It is important that the public should accompany this process critically and constructively – but this should be based on facts rather than on narratives with no solid grounds.

Thank you very much.

[1] I would like to thank Marius Gardt and Johannes Lenschow for their contributions to this speech.

[2] The ECB's mandate is laid down in Article 127, paragraph 1 of the Treaty on the Functioning of the European Union.

[3] As measured by the Harmonised Index of Consumer Prices (HICP) for the whole euro area.

[4] Source: Eurobarometer, European Commission.

[5] This means that in emerging market economies, for example, interest rates are typically higher than those in advanced economies, since the development of new industries and public infrastructure – often accompanied by high birth rates – results in strong economic growth and high returns on investment. The real equilibrium rate also depends on external developments such as climate change that may damage an economy's long-term economic growth potential.

[6] This involves, for example, increasing the participation rate of women in the labour force, supporting the immigration of skilled workers and extending the length of working lives. It also means promoting innovation, exploiting the benefits from digitalisation and implementing growth-friendly climate policies.

[7] The estimates are based on a large number of models and methodologies in order to cater for the large degree of uncertainty inherent in such estimates.

[8] For companies in the euro area, the proportion is higher, but even there more than half of deposits are still exempt from negative interest rates.

[9] See Andrews, D. and Petroulakis, F. (2019), "Breaking the shackles: Zombie firms, weak banks and depressed restructuring in Europe", *Working Paper Series*, No 2240, ECB.

[10] Over the past few years this marked divergence from international developments has made the German real estate market attractive for international investors too, which probably intensified the pressure on prices.

[11] France, which shows a noticeable increase in private indebtedness, is an exception.

[12] At the same time, the public debt maturity structure in most Member States has lengthened, making it less vulnerable to an interest rate increase.

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