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A Return to Conventional Monetary Policy

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Economic policymakers and central banks need to keep asking themselves the hard question whether – despite all short-term stabilisation gains – their policies add to the long-term causes of instability. In the view of the chief economists of the Savings Banks Finance Group, overstretching the remit of monetary policy will inevitably lead to malfunctions, which may result in a total breakdown of the financial architecture, with the well-known disastrous political and social repercussions.

We advocate a return to the world of conventional monetary policy which does not need quantitative measures or long-term announcements of low interest rates. For this to happen, the ECB should

- continue to look for opportunities to scale back ultra-expansionary measures, providing that inflation expectations remain stable in the process,
- call for compliance with sound public finances in the euro area,
- categorically reject all calls for monetary coverage of government debt,
- draw more attention in the ongoing public debate to the fact that sustainable growth cannot be achieved by means of an expansionary monetary policy.

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A Return to Conventional Monetary Policy

More than ten years after the financial crisis that began in 2008, many economic indicators have returned to normal. In most of the national economies affected, capacity utilisation is back at the long-term averages. Unemployment has returned to normal levels; in many economies such as the United States and Germany, unemployment has even fallen far below these levels. The growth of the world economy has been above three percent again in the past five years, i.e. much higher than what many pessimistic observers had believed possible one decade ago.

Real economy further advanced towards normalisation

Only the monetary domain has not yet returned to normal, as clearly indicated by interest rates. As of autumn 2014, the ECB's refinancing rate for the euro area was at 0.05 percent; since March 2016, the rate has been at 0.00 percent even. In view of the current excess liquidity, the truly relevant key interest rate – the deposit facility – has even been negative for many years, at -0.4 percent.

By historical standards, interest rates are also extremely low in Japan, Switzerland, Sweden, Canada, and the United States. It is true that the central bank in the United States has dared to exit the zero-interest-rate world. However, it is also obvious that, when rates run above two percent, monetary policy faces strong headwind in financial markets and in the economy. There are also other indicators which show that, compared to the past, significant monetary policy anomalies still persist. It is slowly becoming clear how far central banks have moved into previously uncharted waters of expansionary monetary policy. New instruments such as "quantitative easing" (large-scale asset purchases) and "forward guidance" (long-term announcements of lower interest rates) are still being fully used in most industrialised nations. Due the use of these instruments, combined with persistently low inflation expectations, significant increases in interest rates are not expected in the financial markets for many years to come.

This view was bolstered by the ECB's decisions in March 2019, when an increase in interest rates was postponed far into the year 2020. In addition, the ECB announced new long-term tenders (TLTRO III) to avoid refinancing bottlenecks for banks. The fact that, unlike past tenders, these tenders will be subject to variable interest – in keeping with the key interest rates – makes them less attractive for credit institutions. However, this structure is intended to be part of instrumental normalisation. In view of the fact that the end of negative interest-rates has been further postponed with the ECB's recent decisions, the burden for the banking sector will also be prolonged. For this reason, one might take into consideration indirect relief schemes such as an exemption of a liquidity stock (e.g. a multiple of minimum reserves) from negative interest rates („Swiss Model").

ECB's March 2019 policy decisions postpone the turnaround

Against this background, some observers are concerned about the possible courses of action and the side effects of monetary policy. In 2018, the sustained global synchronous economic recovery showed signs of weakness. To what extent could monetary policy be used at all to take countermeasures in a future recession if its lever is already pointing toward the maximum expansionary setting?

Side effects of expansionary policy

Add to this the worries of people about their savings. With interest rates below the inflation rate, people whose monetary assets mainly consist of savings deposits are losing purchasing power. In Germany, where accumulating savings through investments in higher-yielding securities is poorly developed, savings deposits are particularly common and the loss of purchasing power is particularly high. However, continuing zero interest rates have a number of other negative effects. They restrict the necessary perpetual renewal of national economies by keeping afloat companies whose business models would no longer work if they had to service their debt "normally". The resources used by these companies will then not be available for structural change and innovation.

Another question that looms large is that of a new financial crisis. While the current extreme monetary policy measures were prompted by the last crisis, they are at the same time the cause for the next crisis: High stock prices and real estate prices as well as the high leverage ratios of economic players are the buzzwords in this context. Overall, it is difficult to escape the impression that, while monetary policy has 'pulled the chestnuts out of the fire' after the financial crisis, it is now, on the one hand, being overstretched by having to keep the economy going, and, on the other hand, monetary policy even increases the risk of a new wildfire spreading.

A new generation of central bankers takes over

Monetary policy is at a crossroads. In the financial markets, there is a growing impression that "old" monetary policy models and concepts no longer apply. In addition, a new generation of top managers is routinely taking the reigns of the central banks. Jeremy Powell is the first Chair of the Federal Reserve whose term of office is no longer about crisis management; instead, it is characterised by organising the "New Normal". Extensive changes of the acting persons are about to take place in the ECB's Governing Council. It is about time to think about the longer-term monetary policy perspectives and to correct problematic routes taken in the past.

Unambigous objective of monetary policy

In our view, the principal task of monetary policy is to ensure monetary stability, as reflected in a low and non-volatile inflation rate, i.e. an internally stable currency. In addition, however, many economists and policy-makers also expect central banks to perform tasks relating to economic recovery and growth. They are expected to use monetary policy in the short term to smooth cyclical variations and in the medium term to create the most favourable conditions for supporting growth. In our view, monetary policy cannot serve so many masters at the same time: It is not possible to achieve all of these objectives simultaneously. Monetary policy should be focused on one objective, and that is long-term monetary stability. The stabilisation of the banking sector alone may require measures which, in the long term, will conflict with the objective of safeguarding price stability. The question as to whether the other objectives can also be achieved, will depend on specific temporary circumstances; however, it will not be possible to manage this many objectives simultaneously. Monetary policy currently tends to be expected to resolve all concerns about growth. This is asking too much of monetary policy, even if high inflation is not a problem at present. In the long term, this will lead to monetary and financial instability.

One objective per instrument only

Brave new worls of central banks?

It is obvious that the monetary policy coordinates have shifted in the past few years. In the decades before the financial crisis, monetary policy in economic terms was considered to be nearly omnipotent. The magical powers of expansionary monetary policy were regularly used to stimulate economic activity in the national economies; central banks were able to effectively slow down this activity by introducing restrictive measures. Monetary policy was considered to be the principal corrective for cyclical variations: Monetary policy was used over and over again to overcome recessions, and at the other end of the spectrum, central banks were even seen as the primary initiators of recessions. One saying often quoted by monetary policy-makers suggested that none of the post-war expansions died of natural causes; all of them had to be murdered by the central banks. Otherwise, inflation would have been out of control. To be able to act swiftly and effectively, monetary policy-makers had worked hard to reach the status of independence. While formally part of the State, the decision-making process within the central banks was beyond the influence of political mechanisms. No parliament had to give its approval; the debates took place behind closed doors. This was the only way to implement unpopular measures in the first place, such as putting an end to an upswing by setting higher interest rates.

Technical character of normal monetary policy

These mechanisms of of the past no longer seem to work properly. For many years now, central banks have successfully stimulated economic activity and thus contributed to one of the longest periods of upswing in post-war Europe. However, this is a laborious undertaking: Growth rates are far below what could have been expected two or three decades ago from a comparable degree of monetary expansion. And what is even more dramatic: despite extremely strong stimulation, inflation has not been gaining momentum, so that, in the view of the financial markets, risks of deflation rather than inflation prevailed in the euro area, even at the peak of the current cycle.

Attempts have been made to explain these "anomalies" which, in principle, can be observed throughout the world economy: Demographic shifts, globalised production methods, the diminishing power of trade unions. Concepts such as "secular stagnation" and "savings glut" are used to describe allegedly sustained exceptional conditions. However, these constellations provide only limited explanations. So far, nothing has been put forward that would convincingly explain why wages and prices are not rising faster in the economies of the United States and Germany (which are operating at full capacity) or what triggered the persistent deflation in Japan, and most importantly, what economic policy recipes should best be applied to deal with the new circumstances. In this respect, there is also some catching up to be done in academia. It is particularly necessary to clarify whether what we are observing in the current decade is a temporary aberration from earlier regularities – an aberration caused by the shock waves of an epochal financial crisis – or if what we are experiencing is a sustained structural discontinuity. We tend to take the former view.

„Secular Stagnation" and „Savings Glut" explain a bit ...

... but not all

A Keynesian approach has been adopted in some concepts which attribute the dominant macroeconomic role to fiscal policy. According to these concepts, monetary policy is omnipotent when it comes to curbing skyrocketing inflation rates. However, they claim that when the opposite problem prevails – i.e. low inflation rates – monetary policy is less effective. Its interest-rate instruments are said to become too blunt near the zero line. If interest rates drop to an even lower level, there would be no transmission to the economy – on the contrary: If interest rates are too negative, they can have opposite effects. While large-scale asset purchases ("quantitative easing") can provide investment incentives in the real economy, these incentives can also be ignored, especially if the financial market is regulated at the same time, so that even the lowest interest rates do not stimulate lending, at least not in the banking sector. Figuratively speaking: "A rope cannot be used to push only to pull."

In this situation, monetary policy is believed to provide limited opportunities to stimulate the economy. Only fiscal policy can help. Wherever

private sector investments are no longer sufficient, only governments can step into the breach. And only the associated government debt would enable the far too numerous depositors to invest their savings in the first place, i.e. in government bonds. It is true that government debt would reach dizzying heights, but at least the renewal of infrastructure, the development of education, the advancement of research and innovation – and hence growth – would not stop. In this world, the role of monetary policy would be quite different from what it currently is: Governments would only be able to pursue such a deficit policy over many years with the help of central banks. Central banks already purchase government bonds on a regular basis and keep interest rates low, so that interest payments do not impose too much of a burden on national budgets. On this basis, some government debtors would push the limits of their debt sustainability to unprecedented extremes.

Independence in danger

However, direct ways of funding government debt through central bank financing are also increasingly being discussed today, whether through unlimited purchases of government bonds or helicopter money. This would mean that monetary policy would entirely abandon its independence. At best, a regime-change switch could be installed, which would enable central banks to take the helm again if their primary objective of keeping prices stable was jeopardised by an increase in inflation. In this world, central banks would also keep interest below the inflation rate (negative real interest rates) to achieve a continuous depreciation of high debt levels in real terms (financial repression strategy).

In our view, this brave new world of central banks is already a dangerous adventure today. Due to the apparent lifting of budget restrictions, such a system permanently provides misguided incentives which lead to inefficient use of public funds. A mushrooming use of public-sector loans can quickly overtax the production potential of national economies. The option of a regime change in the event that inflation rates are too high is not credible because financial stability would be lost immediately. In addition: who will make sure that the funds lent to governments will actually be spent on investments, instead of financing consumptive election gifts? And last but not least, significant risks would be posed for the financial system in the long term: While such a regime would prevent State bankruptcy over many years, this would last only as long as trust is maintained in the central bank. Regularly removing government bonds from the central bank's balance sheet would not prevent money supply from growing. At some point, this would trigger inflation and erode trust in the currency.

There's a trap lurking

Raising the inflation target?

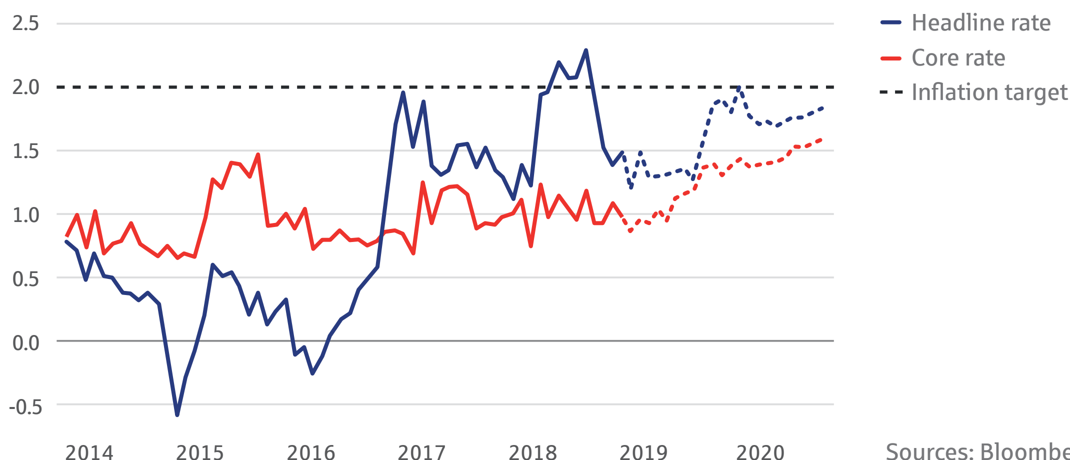
In addition to such proposals for a radical change in the role of monetary policy, there have also been suggestions within the existing paradigms. While the inflation rate has top priority for the stability of a currency, an inflation rate of 2 percent per year comes closest to the concept of price stability according to the prevailing view of academics. This level is well explained by improvements in the quality of goods, measurement errors, and the need to allow relative prices to breathe without having to make nominal cuts too often. For this reason, nearly all the central banks have included this figure in the definition of their target. However, some monetary economists have suggested that the target should be increased to four percent. They argue that two percent is too close to the zero line and that, in the event of a downward deviation, the scope for interest rate cuts will be exhausted too quickly. However, we do not believe that such a change in the inflation target is reasonable. First of all, we consider higher inflation rates to be a hindrance to growth because economic players are no longer able to plan their investment projects reasonably since a higher inflation target is associated with greater unexpected volatility. Secondly, we consider an increase in the target to be unrealistic, in view of the persistently low inflation rates. In addition, adjusting the target after a longer period when it was missed will destroy the central bank's reputation and trust that is sorely needed.

"looking trough" serves a purpose

Suggestions made to spread the central bank's target over time (e.g. either by allowing a longer period for achieving the target or by generally prolonging the horizon of communication) must be assessed differently. In principle, such proposals are suitable for dealing with the current problems caused by temporary undershooting of the inflation target. However, we would not resort to such concepts as price level management, where undershooting of inflation targets is to be offset by subsequent overshooting of the targets. This would lead to unnecessary variations in the inflation and market expectations of economic operators. For the time being, it would be sufficient to refer to a somewhat longer target achievement horizon in the context of the "forward guidance" communication strategy.

The inflation rates in the euro area currently range below the inflation target. When assessing the inflation rate, attention should also be paid to what is referred to as the "core rate of inflation", which blocks out highly volatile components such as the price of crude oil. In the euro area, the core rate currently amounts to approximately one percent. In the period after the onset of the financial crisis, inflation clearly followed a downward trend but then stabilised due to of the expansionary monetary policy and economic recovery. However, as far as the current situation is concerned, inflation is below the ECB's inflation target; in fact, the official headline rate is slightly below the target, and the core rate is well below the target.

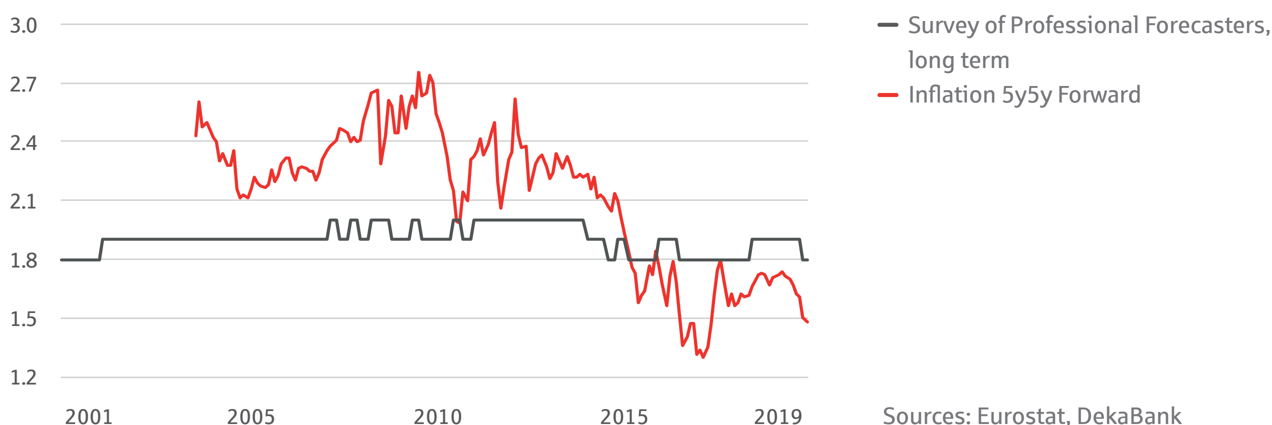
Euroland – Inflation rate and core rate of inflation



Sources: Bloomberg, DekaBank

The major factors in this context are not only the current inflation rates but also the economic operators‘ long-term expectations. As long as these inflation expectations are anchored in the inflation target, it is tolerable if current inflation rates temporarily miss the target. According to standard indicators, the long-term inflation expectations are stable at just above 1.5 percent. This shows that the ECB's inflation target has not lost credibility.

Inflation expectations in the euro area



Sources: Eurostat, DekaBank

Just like the ECB, we believe that disembedding inflation expectations – either downward or upward – should be avoided at all costs. Just like the ECB, we believe that, in the foreseeable future, there will be more of risk of a downward than an upward disconnection. In our view, it is therefore appropriate to continue to pursue an expansionary monetary policy in the foreseeable future. However, we do not believe that inflation is permanently "in the doldrums". Instead, the dynamics of capacity utilisation and wages suggest that fundamental inflation in the envisaged order of magnitude can be expected to persist.

Abolishing cash?

In our view, abolishing or taxing cash, as proposed by some economists, is also only a sham alternative to a "more effective monetary policy". The purpose of this initiative is to eliminate alternatives to the central bank's scriptural money in order to provide greater opportunities for setting negative interest rates, so as to be able to transmit monetary policy impulses even if inflation rates are negative. While this may be an interesting 'what-if' scenario from a technocratic perspective, we believe that it is politically unfeasible and socially undesirable. Whoever wants to undermine trust in the monetary system and politics as a whole should adopt such measures.

Conventional alternatives

We rely on conventional monetary policy and the stability of the financial system, and we want to leave the challenge of growth to economic policy. If policymakers want to enhance economic growth, they should become active in the following fields:

- → Structural reforms to support growth (e.g. reforms of the tax systems, investments in education and infrastructure)
- → Labour market reforms
- → Reducing over-indebtedness and strengthening the banking system (reducing bad loans, reforming insolvency law)
- → Strengthening confidence in the European financial architecture

In spite of all the calls for monetary policy "normalisation", interest rates are likely to remain low in the 2020s when compared with historical data. Even central banks cannot impose an arbitrarily chosen interest rate; instead, they have to adjust their monetary policy to the world economy's macroeconomic growth. In a world with shrinking populations in many industrialised nations, the supply of savings available for old-age provision is large, and the demand for savings for investment purposes is small, which depresses interest rates. The new neutral rate of interest can only be determined by means of theoretical considerations and, in the end, a trial-and-error process. However, we advocate the idea that monetary policy should acknowledge the associated restrictions of its effectiveness and not try to restore "old conditions" – with regard to growth, borrowing dynamics, asset prices – by adopting more and more unconventional measures.

At which level is the „neutral interest rate" today?

More specifically, we recommend continuing the efforts made to find suitable opportunities to exit the unconventional monetary policy measures introduced in the past. We do not believe that such an exit can be achieved "by hook or by crook" here and now. The ECB's current inflation target of just under two percent should remain credible. The current economic slowdown will therefore also postpone the prospects of the monetary policy exit for the ECB, and the Fed might have to terminate the exit it initiated prematurely. However, we expect that the world economy and the Europan national economies will continue their growth course in the medium term. This should enable the ECB to enforce a slight increase in the money market interest rate and reduce its own holdings of bonds and bank reserves in the first half of the 2020s. Here again, the central banks will need to slowly move toward a new normal level of total assets.

Careful „try and error“

It is true that, in the years to come, monetary policy will probably not have as much of an expansionary effect as in the past few years. In the event of an economic downturn caused, for instance, by an external shock, the role played by fiscal policy in the euro area will therefore be augmented, bearing in mind that the creditworthiness of states needs to be preserved. There are sufficient financial reserves for this purpose, at least in Germany. Elsewhere, a buffer would have to be developed. During periods of economic prosperity such as the one we are currently experiencing, every effort should therefore also be made to preserve or to continue to build up reserves with suitable fiscal policies. We do not believe that this is an inappropriate "austerity philosophy". There is a temptation to turn to misinterpreted Keynesian recipes during these times of significant growth challenges. In our view, however, the long-term damage caused by such a policy is too severe.

Debt plays a role

In fact, we believe that monetary policy should now be more clearly focused on the development of public and private sector debt. It would be asking too much of monetary policy to tackle misguided developments in specific sectors; this is more a matter for macroprudential regulation. In principle, however, we believe that it continues to make sense to pay close attention to lending in monetary policy. Overall, the monetary policy that is being pursued is appropriate, also with a view to the development of loans.

While the total debt of governments, private households and enterprises in the euro area is too high, this is a result of errors made in the past. The current development of credit aggregates and money supply is inconspicuous, although more and more attention needs to be paid to capital market finance.

European obligations?

Compared with other central banks, the ECB has to bear the additional burden of an imperfect monetary architecture. The euro is a currency without a fiscal union of its members, and this will remain this way for a long time to come. During the crisis years of 2011 and 2012, the ECB made extensive statements to the effect that solvent Member States would be financially shielded from market turbulence in the future, providing that they implemented economic adjustment programmes. While this financial backstop is justified by the ECB's monetary policy objectives as set out in the Statute of the ECB (maintaining the conditions for the transmission of its monetary impulses), it actually has little to do with monetary policy. It is the responsibility of fiscal policymakers to ensure that the debt of Member States and the banking system does not lead to monetary policy restrictions. There is currently no urgent need for the ECB to pursue a restrictive monetary policy. However, should such a need arise in the next few years, the current constitution of public finances in the euro area would not provide any stability. Compliance with the financial stability criteria is therefore the precondition for the continued existence of the Monetary Union.

Disclaimer

The present position paper of the Chief Economists does not necessarily correspond to the attitude of the DekaBank or the attitude of the respective Landesbanken and Savings Banks or the DSGV.

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