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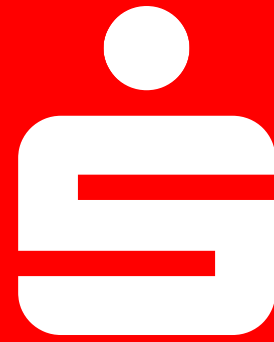

Review of the monetary policy strategy: maintaining objectives and increasing flexibility

Berlin, 6th February 2020

The ECB's first press conference in 2020 has made it more than clear that this year the monetary policy strategy will be subject to in-depth scrutiny. For the Chief Economists of the Savings Banks Finance Group, despite the importance of the debate, it remains fundamental not to ignore the following connections:

→ In 2020, it must be possible to formulate the prospects for a way out of negative interest rates and bond purchases. The interest rate as the price of loans and money has an important signal function. This must be revived in order to avoid lasting disruptions in the corporate sector (zombie companies) and among citizens (old-age provision and savings) and to achieve the consolidation of public finances at the expense of citizens and companies.

→ The monetary policy strategy must therefore review the extent to which the objectives and methods for measuring the inflation rate in the euro area are still appropriate.

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Germany in 2019: ageing everywhere

The European Central Bank announced the first outlines of the planned review of its monetary policy strategy at the press conference on 23 January 2020. The last evaluation took place in 2003 and its main findings were a clarification of the inflation norm („below but close to two percent") and a downgrading of the money supply as a criterion for the ECB's monetary policy decisions. Compared with the last time, the reason for this review is more serious this time. Whereas in 2002/03 the main reason was the predictability of monetary policy, the focus is now on strategic decisions to increase the effectiveness of monetary policy in an extremely low interest rate environment. In our view, there is also a need for better communication of monetary policy decisions in society.

The starting position: ever more powerful instruments, ever less impact

At the latest since the financial crisis in 2008, fundamental macroeconomic mechanisms have changed. Inflation and interest rates no longer react as quickly as before to changes in the degree of capacity utilization of the economy. In contrast to previous decades, it is no longer a question of inflation being too high, but too low: both, inflation and inflation expectations have fallen well below the ECB's target level. The neutral interest rate level is persistently maintained at levels close to zero. The reasons for this have not yet been conclusively researched, but they include demographic developments, a reduced bargaining power of employees, globalization and the resulting intensified international competition, the economic shock resulting from the financial and public debt crisis, and changed production processes and market conditions due to digitalization. The weaker correlation between capacity utilization and in-

flation in combination with interest rates close to zero makes the task of central banks much more difficult. In particular, their previous approach of stimulating economic activity by means of low interest rates, which normally leads to rising wages and prices with a certain delay, is now only working to a very limited extent.

If inflation does not want to get going despite strong growth, the obvious reaction of the central banks is to increase the monetary stimulus even further. This is precisely what they have done in recent years, by lowering key interest rates even further and buying securities on a large scale. With socalled unconventional measures, the ECB is influencing the overall interest rate level in the euro area, which has never been reached and has in some cases assumed negative levels. This development was also supported by the international interestrate context, since in 2020, starting in the USA, interest rates worldwide have entered a downward trend. The underlying reasoning behind the trend of falling interest rates is that the so-called „neutral“ key interest rate, i.e. the key interest rate below which one can only speak of an expansive monetary policy, has fallen due to the aforementioned structural (especially demographically induced) factors. However, since the expected success has nevertheless not materialised and considerable negative long-term effects are feared from a permanent use of the unconventional instruments, dissatisfaction with the concept of inflation targeting described above in its current form is growing.

Falling „neutral“ interest rate raises questions...

Monetary policy is currently finding no way out with its instruments. Negative/minus interest rates have fatal effects - the price mechanism on the financial markets threatens to cause major distortions on various markets. The side-effects on retirement provision, the weakening of economic change by keeping companies that are actually no longer able to survive in the market (so-called zombification) and the emergence of new bubbles in various asset classes will become more and more drastic as this ultra-expansive policy lasts longer. We should also warn against seriously considering even more expansive measures such as the introduction of helicopter money without well-founded indications of deflation. There is a threat of dangers and economic wait-and-see and stagnation, as can already be observed in other currency areas.

...which monetary policy instruments currently cannot solve

In the ECB, fears of a complete Japanisation are spreading: Once inflation is well below the target level and all available monetary policy instruments have been exhausted, there seems to be nothing more the central bankers can do. If the central bank at the zero lower bound no longer has any possibilities to further increase its use of instruments, there is even a danger of a downward spiral of falling inflation expectations, rising real interest rates and declining economic growth. The fear

that it will not be possible to stop such a deflationary development once it has got underway has led the ECB, the Fed and many other central banks in recent years to pursue a somewhat too expansive policy in case of doubt. Although there is no danger of deflation at the moment, the central banks of the industrialised countries are concerned that the notorious short-fall of their inflation targets will be reflected in inflation expectations.

We share the view that maintaining low but positive inflation expectations should remain an important objective of the ECB. To this end, the management of market expectations via forward guidance should continue to be used. However, the monetary policy instruments already in use are problematic. In particular, the instrument of large-scale bond purchases is controversial in its long-term effects. The ECB is also losing support among the broader social and political public. Against this background, the strategy review should aim to improve the effectiveness of the existing instruments and achieve greater flexibility even if the inflation target is not met. For us, the following key points remain essential.

Increase flexibility

→ No change of mandate

Up to now, the ECB have a legal mandate to maintain price stability in the sense of a stability of the average of all prices, i.e. virtually the price level. In addition, monetary policy must also keep in focus the stability of the financial system, at least as a secondary condition, even though special policy areas in the form of micro- and macro-prudential supervision are responsible for this as a preventive measure.

There are new academic ideas about extending the role of monetary policy. As long as there is no inflation, for example, monetary policy can provide public finance to stimulate growth or cushion demographic burdens. Although the mandate of monetary policy also includes support for the general economic policy of the European Union, we do not believe that such a merging of monetary and fiscal policy makes sense. Firstly, the Maastricht Treaty, by prohibiting monetary public financing, sought to exclude precisely this function of monetary policy and deliberately limited the scope for rapid reaction by the community‘s fiscal policy. Secondly, we see serious medium-term risks to the functioning of the financial system in such approaches. Such proposals should not and will not be the subject of the forthcoming evaluation.

→ Adaptation of the definition of the price index

Much has already been discussed about the correct measurement of inflation, especially the need to include asset prices such as stock prices or house prices in the central bank target. In principle, however, we believe that the current definition of inflation is the correct one. The quality criterion of a currency is above all the stability of prices of consumer goods for households. In this respect, inflation is intended to determine the purchasing power development of the annual income of private households. Prices for capital goods and thus the prices for future consumption must be distinguished from this: Both price levels cannot be controlled at the same time with one and the same instrument. In addition, asset prices fluctuate much more strongly. Control by the central bank would not be practicable because of the high fluctuations, as it would have a devastating effect on economic activity. In our view, a mechanistic integration of asset prices into the inflation target of a central bank is therefore out of the question.

Distinguishing purchasing power development and asset prices

However, it is necessary to check which price index underlies the inflation target. In our view, one weakness is that rent equivalents for homeowners are not included in the Harmonised Index of Consumer Prices. Furthermore, it is advisable not to be distracted in monetary policy by erratically fluctuating prices such as the price of crude oil. Therefore, a stronger orientation towards the so-called core inflation rate would make sense. Although there are a number of other concepts in price statistics for filtering out fluctuating prices from the trend, this has a negative impact on the clarity of the inflation figure, which is already difficult to communicate to the public.

→ Level of the inflation target essentially correct, but make it more flexible

In recent decades, a consensus has emerged among economists and central bankers that central banks should aim for inflation rates of around 2%. Since consumer price indices with rigid baskets of goods systematically overestimate actual inflation, a measured inflation rate of 2% comes

closest to the goal of price niveau stability. In addition, slightly positive inflation rates increase the adaptability of an economy, because the lack of flexibility of wages and prices plays a lesser role according to the bottom. A certain safety margin against deflation is also desirable. To increase this safety margin is behind the proposal of a higher inflation target, around four percent. We do not agree with this proposal, because as inflation increases, the fluctuation of inflation also increases and with it the uncertainty for the economy, and this would also require an even more expansive monetary policy. We continue to advocate an inflation target that would set inflation expectations at two percent.

Raising the inflation target economically unreasonable

→ Fulfilment modalities: Credible target path crucial

At present, the ECB aims to reach the inflation norm in the shortest possible time. This means, on the one hand, that its current use of instruments can only be reduced if inflation is sustainably heading towards two percent. On the other hand, it also means that if inflation threatens to slow down, usually as a result of slower economic growth, the use of instruments must be further increased so that inflation expectations do not fall even further. In this logic, the ECB - similar to the US Fed - reacted to a relatively moderate global economic slowdown last year with further interest rate cuts and a resumption of bond purchases.

Such a direct link to the economic events of the instrument is unnecessary to the extent that inflation expectations are more firmly anchored, i.e. independent of economic events. In order to improve this anchoring compared with the current situation, the central bank can aim to achieve the inflation target on average over several years. This means that if there are phases in which the inflation target is not met, the central bank must also actively strive for phases in which it is exceeded. This idea is formalised in the concept of price level control. Here, an explicit target path is defined, which the price level should follow over time. The slope of this path corresponds to the desired long-term average inflation rate. If inflation turns out to be lower in one year, the central bank must bring inflation rates slightly above the target value in the following years in order to return to the specified path. As long as this procedure and the target path announced for the price level are credible, long-term inflation expectations should be close to the level desired by the central bank. We consider the basic idea of such a „catching-up strategy“ to be reasonable,

but the formalised procedure of price level control is difficult because it requires fine-tuning of inflation, which is hardly possible in practice.

Concept of price level control remains important

A less stringent variant would be to formulate an inflation target with a permeable upper and lower limit. This would enable the central bank to temporarily tolerate upward deviations without having to compensate for any deviation in the opposite direction.

In our view, a combination of both approaches would be a promising solution. We advocate an inflation target of two percent with an upward and downward band of one percentage point and the statement that a significant shortfall of more than half a percentage point will be offset by a tolerance for overshooting by the same amount. In our view, this anchors inflation expectations closer to the middle of the 2 percent band and relieves the ECB of immediate pressure to act in the event of deviations.

→ Increase the role of monetary and credit aggregates again

A better anchoring of inflation expectations can make the ECB somewhat less dependent on immediate pressure to act in the event of failure to meet the inflation target. In the current situation, however, the ECB would still be forced to make historically unusually strong expansive use of its instruments. In order to keep the resulting threats to financial market stability under control, it uses the instrument of macro-prudential supervision, which is intended to protect at least the banking sector from such threats to stability.

Antagonistic effects of regulation and monetary policy

A striking example of contradictory action between macro-prudential supervision and monetary policy was demonstrated last year. In many European core countries, capital requirements were raised and at the same time the ECB switched monetary policy to an expansionary course. This makes monetary policy schizophrenic, as on the one hand it should stimulate lending and on the other hand protect the banking system from excessive lending.

Such divergences in objectives must be overcome. It must also be borne in mind that lending can also be changed by other means, such as bonds. For this reason, consideration should be given to giving monetary

and credit aggregates or even broader credit indicators more scope in monetary policy decisions. This could be done within the existing monetary pillar of the ECB strategy. In our view, monetary aggregates are less relevant for monthly monetary policy decisions than for the medium term. We therefore suggest that, within the framework of the existing regular cross-check of monetary policy decisions with monetary developments, greater importance should be attached in particular to the development of macroeconomic lending within and outside the banking sector.

→ Transparency on the right track

A credible monetary policy strategy makes it easier for the central bank to achieve its objectives by anchoring inflation expectations. In its operational implementation, it makes it easier for market participants to assess the central bank‘s reactions and thus reduces unnecessary market fluctuations. Nevertheless, uncertainties about the reactions of central banks remain in day-to-day monetary policy decision-making. This is acceptable; monetary policy strategies are not automatic. By explaining each monetary policy decision and subsequently publishing minutes of meetings, the ECB endeavours to help the market assess the central bank council‘s thinking. From a market perspective, these transparency measures are currently largely sufficient. However, they can be further strengthened by further developing, for example, a system of ECB ambassadors in the regions and capitals

ECB‘s public relations strengthen

However, this does not apply to the political acceptance of the historically very extreme monetary policy measures, which are now being perceived by all citizens in the currency area via the unusually low interest rate level. Even among experts, the effects of instruments such as negative interest rates or bond purchases are controversial. Independent central banks need stronger social backing than political institutions that are periodically legitimized by elections. The acceptance of monetary policy and thus also of the ECB in the monetary union has suffered in recent years, in some regions more, in others less. In order to counteract this, we consider it appropriate for the Governing Council to report separately on its deliberations and discussions on the benefits and costs of monetary policy instruments, for example, on how effectively a particular instrument contributes to the achievement of objectives or how close permanent bond purchases come to monetary public finance.

→ ECB as a sustainability actor also requested

As an intermediary between savers and investors in the real economy, the financial sector can provide great support in the urgent sustainability tasks, in particular by making offers for the diverse needs of savers for sustainable forms of investment. Legislators and financial policymakers can help by setting incentives for sustainable investment or by providing standards. In addition, financial service providers are called upon to act sustainably in their own decisions and organizational issues. This is also the basic understanding of the ECB as a sustainability actor. This means, first of all, that as an institution, it itself observes sustainability criteria in its business operations and invests according to sustainable criteria wherever its own funds are invested. When using its monetary policy instruments, the ECB can apply sustainability criteria as long as they do not hinder the effectiveness of monetary policy.

According to its mandate, the ECB may support the general economic policies of the EU to the extent that its primary objectives of price stability and the maintenance of payments are not jeopardised. This means that, in case of doubt, monetary policy concerns take precedence over sustainability aspects. Within this framework, for example, preferential purchases of bonds classified as sustainable are possible and sensible at market conditions and thus also promote the development of these market segments. In terms of their size and structure, however, these instruments cannot fully cover the implementation of the ECB's monetary policy operations. Furthermore, even with sustainable financial instruments, the ECB must not exceed the higher-level monetary policy rules of its mandate, such as the prohibition of public financing or the fixed quota system for government bond purchases.

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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