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Negative Interest Rate Policy is coming to an End

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TRUST AND RELIABILITY – ECB STARTS OFF IN THE TRADITION OF THE BUNDESBANK

The launch of European monetary union at the beginning of 1999 and the start of the work of the European Central Bank (ECB) were highly successful,particularly in terms of price stability. The annual rate of inflation for the eurozone as a whole was 2.2% on average during the first ten years of monetary union: a stability-oriented rate that many critics would not have thought possible, especially over such a long period, before the introduction of the single currency.

This success was due, among other things, to the institutional preparations for monetary union: the ECB was basically modelled on the Bundesbank.Price stability was declared its primary objectiveand enshrined in the EU Treaties along with the political independence of the ECB and the participating national central banks. But a transfer of reputation from the Bundesbank to the ECB was also possible because the Bundesbank managed to contribute heavily to the work of the ECB as its "stability policy conscience" right from the outset. The successful start was, moreover, eased by the global disinflationary environment of the late 1990s and the noughties.

PRAGMATIC "STEADY HAND" MONETARY POLICY

A key to the Bundesbank's successful stability policy in the decades before the launch of monetary union was, incidentally, its communication policy. Market players were given rough, long-term reference points, e.g. through a stability-oriented expansion of the money supply affecting demand. A rate of expansion for the money supply was thus set annually as an interim target for price stability.

Yet while the guardians of the German currency failed to reach

this interim target in almost half of all cases, they still managed during this period to further strengthen the high level of trust in their stability policy. This was mainly because they closely analysed target deviations and carefully explained the relevant special factors. But an important point was also that they always made clear that they do not submittheir monetary policy to any kind of automatism, but thoroughly examine the complex overall environment. This comprehensive, long-term approach enabled the Bundesbank to use its oft-quoted "steady hand" policy to also "look through" short-term fluctuations in key economic indicators. This, in particular, allowed greater steadiness and reliability in monetary policy.

STRUCTURAL PROBLEMS BECOME EVIDENT

The ECB faced particularly serious challenges during the financial crisis (2008-2010) and the subsequent European sovereign debt crisis. Especially during the sovereign debt crisis, the flaws in the architecture of monetary union, but also the preceding misguided developments in national economic policies, were painfully exposed.

The inadequate level of economic and economic policyconvergence between the individual eurozone countries was revealed particularly clearly. Despite monetary union and a single monetary policy, no common direction was pursued when it came to setting the national economic policy course in the eurozone countries. Above all, the target of common international competitiveness, which is a highly important one in a monetary union and may be reflected in, for example, the trend in unit wage costs, displayed sharp national divergences. Given the absence of any scope for devaluation in the eurozone, this would have called for appropriate measures by national governments to address the divergence in international competitiveness. But in actual fact thehardening imbalances in the development of unit wage costs and national inflation rates were more or less passively accepted.

This development can, incidentally, be explained quite clearly by "classical" patterns of behaviour in economic policy. Whilst some eurozone countries integrate their economy very pro-actively into international trade and respond to deteriorating competitiveness particularly by implementing structural reforms in their business sector and theireconomic operating environment, others were accustomed over decades to declining international competiveness being fixed solely by devaluation. These differing national patterns of behaviour are unfortunately still in place even after the launch of monetary union and ultimately hamper economic convergence.

FINANCIAL AND SOVEREIGN DEBT CRISES: ECB POLICY SUCCESSFUL ...

The ECB responded to the financial and sovereign debt crises very skilfully through its monetary policy. For example, to stabilise the economy, the ECB also undertook comprehensive "unorthodox" measures. Among other things, it introduced a negative interest rate on deposits and launched a massive bond-buying programme. Both measures were also designed to bring down interest rates on long-term loans further.

This policy was – partly, at least – justifiedat the time.After all, the economic situation of some eurozone countries was extremely precarious for a long time as a result of the European sovereign debt crisis. Yet, from the very start, two points of criticism were obvious:

- Firstly, the ECB was and is merely managing to buy time with its extremely expansive monetary policy. The underlying structural problems need to be tackled and eliminated by national economic policymakers.
- Secondly, it was clear that the risks and side effects of this monetary policy would increase in step with the duration and intensity of the measures adopted. These risks include, among other things, sharp fluctuations in risk pricing, the threat of asset price bubbles in some market segments, an extremely heavy strain on all fully funded forms of provision for retirement and an interest rate risk that continues to pile up – not only on banks' balance sheets but also in public finances.

... BUT FISCAL POLICY PRESSURE ON ECB IS GROWING

The ECB's monetary policy threatens to slip into a dilemma due to the only very hesitant economic reforms in the eurozone countries: the fiscal policy constraints are increasing and the room for manoeuvre in monetary policy following an interest rate hike that will sooner or later become necessary again is dwindling. What is more, to justify

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its ample supply of liquidity, the ECB has over the past three years adopted a tendency to embrace a quite mechanistic monetary policy, which is ultimately the exact opposite of a "steady hand" monetary policy geared to the long term.

A contributing factor is that the long-term inflation target, which was deliberately worded relatively vaguely at the launch of monetary union, has been reinterpreted in monetary policy practice virtually as a pinpoint target of 1.9% that should, if possible, be reached within a two-year forecast period. Disruptions of this shortened and highly mechanistic equation have led and are still leading to a continued expansion of the ultra-loose monetary policy measures.

MONETARY POLICY FRAMEWORK FUNDAMENTALLY IMPROVED

Over the past twelve to eighteen months, the setting for the ECB's monetary policy has, however, noticeably improved. This is due, above all, to a cyclical economic recovery and a sustained economic upturn in most industrialised countries. The eurozone, too, is now experiencing a robust economic upturn, which has gained in breadth and stability. Macroeconomic performance inthe eurozone will expandmuch more strongly this year than potential output for the third year in succession. Unemployment in the eurozone as a whole is dropping, though it is still relatively high. The inflation rate has moved well clear of the zero line. For 2017, an annual average rate of 1.5% is expected. Serious deflation risks have long since been overcome.

Bank lending to businesses and private households is also starting to pick up again. Yet measured against the ample supply of liquidity and historically low key interest rates, this recovery is still weak. It proves that the economic upturn in the eurozone was not – or at least not primarily – driven by monetary policy. On the contrary, in some eurozone countries there are signs that the prospect of interest rates remaining low for some time to come has actually encouraged businesses to adopt a wait-and-see attitude towards investment, particularly as this monetary policy outlook stands, in principle,more for economic pessimism.

Despite this fundamental change in the eurozone monetary environment, the ECB's monetary policy remains deep in crisis mode. The interest rate on the ECB's deposit facility remains negative (-0.4%) and, because of the bond-buying programme, the ECB's balance sheet is steadily growing. The extension of the bond-buying programme until at least September 2018 that was decided by the ECB Governing Council at the end of October 2017 means an additional monetary policy stimulus of €270 billion.

INFLATION TARGET NOT TO BE INTERPRETED AS A "PINPOINT TARGET"

ECB representatives always point out in this respect that the ECB has a clear mandate to maintain price stability and that the target inflation level of below, but close to, 2% has not been undercut in their forecasts so far.

Despite thepositive economic development, an only very moderate inflation trend is currently to be found in virtually all industrialised countries. There are many reasons for this, ranging from the only very slowly rising labour productivity limiting the scope for pay rises, to more price transparency, keener competition due to digital information technologies and China's integration into the global economy, which acted as a dampener on prices for many years.

The lower inflation expectations in recent years are also now braking price increase rates.

In addition, businesses' reduced fixed costs thanks to labour market reforms, as well asmore flexible production processes as a whole and the structural shift towards a service economy,probably play a role.

Yet the generally somewhat subdued price trend in the industrialised countries should not be takenas an opportunity to change the inflation target. The ECB should stick to its medium-term target of just under 2%. What should be changed, however, is the ECB's overly mechanistic focuson this inflation target that is interpreted in monetary policy practice as a pinpoint target of 1.9%. It would be helpful in this respect to recall the Bundesbank's communication policy, under which target deviations have always been analysed and then openly explained clearly and convincingly. The present interpretation of the ECB's inflation


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target as a pinpoint target of 1.9% is much too mechanistic and fails to take account of the many different influencing factors and the delayed impact of monetary policy.

EXIT FROM MONETARY POLICY CRISIS MODE NECESSARY ...

The Association of German Banks therefore believes that the ECB could now arguequite plausibly that it has stabilised the inflation trend in the eurozone and that there is at any rate nothing to prevent it from exiting the crisis mode in monetary policy – particularly when the growing risks and side effects of the ultra-loose monetary policy are borne in mind.

The ECB should therefore drop its over-fixation on the 1.9% inflation rate figure and communicate a timetable for exiting the monetary policy crisis mode as soon as possible. In our view, both an end to the net bond purchases and a swift exit from the negative-interest-rate policy are called for in the coming year.

... BUT A CHANGE IN KEY INTEREST RATES WILL BE A LONG TIME COMING

In its forward guidance, the ECB has, however, committed itself to leaving the key interest rates unchanged for a long time even after ending its net bond purchases. This means that, even if net purchases under the bond-buying programme are cut to zero in the course of the coming year, we will, from today's perspective, still have a negative deposit interest rate until well into 2019.

The persistent negative interest rates are, however, having a particularly adverse effect on commercial banks in the eurozone. They can scarcely pass on such rates to customers, as most customers would react highly sensitively and withdraw their deposits from their accounts. For commercial banks in the eurozone, the ECB's negative interest rate therefore works like a "special tax" that currently costs them more than €500 million a month – money that banks lack for their priority tasks: restructuring, driving forward digitisation and strengthening their capital base.

EXEMPTION THRESHOLD FORNEGATIVE INTEREST RATE ON EXCESS LIQUIDITY AS INTERMEDIATE STEP

To curb the risks and side effects of the negative deposit rate somewhat, the Association of German Banks suggested some time ago that commercial banks' excess liquidity deposited with the ECB should be exempted from the negative interest rate to a certain extent – a measure already taken by the Swiss central bank and the Bank of Japan when introducing negative interest rates. The Swiss central bank, for example, only charges a negative interest rate on deposits exceeding a threshold of 20 times the minimum reserve requirement, but at least 10 million Swiss francs per current account holder.

CONTINUED LOW LONG-TERM INTEREST RATES POSSIBLE

If an exit from the crisis mode in monetary policy is communicated in a convincing manner, there is a good chance that capital market interest rates will only rise slightly and that the economy will not be adversely affected. This is backed up not only by the still very moderate inflation outlook but also by the experience made with the change of course in monetary policy in the US. At 2.30%, the yield on 10-year US government bonds is currently less than 60 basis points above the average for the low-interest-rate year 2012. In the meantime, the bond-buying programme has been terminated, the key interest rate has been raised in four steps and, most recently, a start has been made on shrinking the Fed's balance sheet. In addition, the prospect of a soft interest rate turnaround could accelerate planned investments.

DEEPENING OF ECONOMIC AND MONETARY UNION NEEDED

At the same time, policymakers at European level and member states should be warned against leaving monetary policy to itself. In all eurozone countries, further structural reforms that boost weak growth potential and lead to stronger economic convergence are required.

And at monetary union level, we need further measures to establish a stable architecture in the long term. This includes an explicit understanding among the eurozone countries on strengthening the economic growth trend as the top priority in economic policy as well as creating incentive structures for greater economic convergence and strongerinternational competitiveness in the eurozone countries in order to eliminate the lack of regulatory compliance and institutional weaknesses. In the process, liability and responsibility should, in our view, go hand in hand at the same level as far as possible.

As concrete measures, we propose developing the European Stability Mechanism (ESM) into a European Monetary Fund (EMF) and investing it with accepted authority for continuous eurozone budgetary surveillance. In addition, a eurozone budget should be established by making available two special-purpose eurozone facilities for emergencies (such as natural disasters) and for supporting necessary structural reforms in the member countries alongside today's ESM (in the future, EMF) emergency facility for eurozone countries experiencing financing problems.Aeurozonefinance ministershould take over the chair of the Eurogroup, represent the eurozone countries externally on monetary issues and manage the facilities for emergencies and for supporting structural reforms.

The euro is a success story. In the long term, all EU member states should therefore join monetary union. There is a clear set of rules in place for this – also for the required level of economic convergence. These rules must be strictly respected and should not be exposed to any tactically-motivated political attempts to influence them. At the same time, it goes without saying that membership of monetary union against the will of a member state is out of the question politically.

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