



EUROPA
briefing

Low interest rates: Is the ECB's policy correct?

Since 2013, inflation in the euro area has been too low. In order to revive the economy and bring inflation back to target, the European Central Bank has implemented a low interest-rate policy which includes a bond-buying programme known as quantitative easing or QE. The ECB's measures, including historically ultra-low interest rates, also bear risks. For example, some observers fear the formation of a bubble in real estate and stock markets or complain about one-sided capital gains for wealthy households.

When are low interest rates problematic?

In times of crisis, central banks lower interest rates so as to boost economic activity. Credit gets cheaper and investments should be boosted in turn. The jobs that thereby are created should help increase wages and, in the medium term, prices as well. During the euro crisis, however, this mechanism broke down. The euro-area economy recovered only sluggishly and inflation remained stuck at zero percent, significantly below the → **price stability** target of just under two percent for a long time.

Zero percent inflation is dangerous for the economy. For consumers, there is less incentive to spend money today. Potential purchases are put on hold, because their money will still be worth just as much tomorrow. In this situation, the entire economy could come to a standstill and → **deflation** sets in.

With low interest rates the ECB intends to bring inflation back to target. This involves risks: cheaper loans could lead to households and companies getting into excessive debt.

With little or no interest on savings, providing privately for retirement becomes difficult. Banks earn less and less from their traditional lending business and go on to take increasingly large risks.

The economic situation in the euro area varies greatly from one country to another. Therefore, countries have different preferences with regard to monetary policy. In Germany, the economy is growing and inflation is already close to its target, so the disadvantages of the current monetary policy attract plenty of (negative) attention. Italy, however, is battling high debt and unemployment. There the risks linked to an interest rate hike are felt particularly strongly. However, the ECB can only implement policies for the Eurozone as a whole, that is for a fictitious average country (“one-size-fits-all”).



Price stability

Price stability is enshrined in the European Treaties as a mandate of the European Central Bank. The ECB defines price stability as an annual interest rate of close to but below two percent. This level is considered desirable because it provides a safety buffer against deflation without eroding savings too quickly.

Deflation

This means falling prices. When consumers expect a product to become cheaper in the future, they delay buying it. This leads to a slump in demand. A dangerous cycle emerges that the central bank is powerless to prevent.



“The ECB needs to have a policy that is suitable for Europe as a whole. It is too loose for Germany. When ECB President Mario Draghi embarked on the expansive monetary policy, I told him he would drive up Germany’s export surplus.”

Wolfgang Schäuble, German Federal Minister of Finance
in an interview with Der Tagesspiegel on 4 February 2016



“The impulse cannot come from the ECB alone. [It] does as much as it can, it does what it has to do [...], but if the states and Europe do not shoulder their responsibility as well, growth cannot rise again.”

François Hollande, President of the Republic of France
at EuropaNova in Paris on 15 October 2016

What is the ECB doing to increase inflation?

In 2013 and 2014, deflation in the euro area became a serious threat.

In December 2014, the inflation rate fell below zero percent for the first time. At that point, the → **base interest rate** was already at zero percent. Like all major central banks, the ECB resorted to non-conventional monetary policy measures. The key one is the asset purchase programme, usually referred to as → **quantitative easing** or QE.

As part of its QE program, the ECB has been buying bonds worth 60 billion euro (temporarily even as much as 80 billion euro) each month since March 2015. The programme is set to continue at least until September 2018, although at a reduced pace of 30 billion euro from January 2018 onwards. To put this figure in perspective, the German defence budget for 2017 is around 37 billion euro. By purchasing these bonds, the ECB is creating enormous demand for debt instruments across the board. This makes it attractive for banks to issue more loans on more favourable terms to companies and households. The investments financed via such lending create both growth and inflation.

There are initial signs that the QE programme is proving effective:

Loans for companies and households have become cheaper and unemployment in the euro area has fallen. However, the inflation rate remained stubbornly low heading into the winter of 2016. Furthermore, growth rates varied greatly from one country to another.

There are several reasons for the limited success of the ECB policy:

In many Eurozone countries, banks and companies are still struggling to reduce the debt and bad loans that accumulated before and during the financial crisis. At the same time, moderate long-term growth prospects are preventing companies from making adequate investments. What's more, the European Single Market is not sufficiently integrated for a proper currency union. For example, large parts of the services sector remain largely protected from cross-border competition.



Base interest rate

A central bank uses the base rate to determine the price of money. In the short term, banks can borrow money from the central bank at this rate. This impacts all other interest rates in the economy.

Quantitative easing (QE)

In a QE programme, a central bank buys debt instruments – bonds from governments and companies for example – on a large scale. As it does not usually buy these securities from the debtors themselves but from their creditors (usually banks), this puts extra money into the financial system.



“Germany is a country that has always called for the European Central Bank to pursue an independent policy [...]. Because of that we will not influence the behaviour of the ECB. And as a result, I cannot and do not want to change the situation as it is.”

Angela Merkel, German Chancellor
on a state visit to Sweden on 31 January 2017



“Over the medium-term, it is unambiguous that monetary policy [of the ECB] has positive distributional effects through macroeconomic channels. Most importantly, it reduces unemployment, which benefits poorer households the most.”

Mario Draghi, ECB President
in Berlin on 25 October 2016

LOW INTEREST RATES



A look ahead

SCENARIO 1

What is the ECB counting on?

The ECB hopes that inflation will soon revert to target, so it can then wind down the QE programme. In this process, it wants to avoid endangering the recovery by exiting the QE programme too early. Should exit lead to a relapse into low inflation, private sector confidence could also be undermined. And that trust is required for the recovery on the labour market to continue.

In light of an improving economic environment, falling unemployment and stronger growth across the euro area, the ECB reduced the volume of QE in April 2017 and announced to further cut monthly purchases to 30 billion euro in January 2018. Yet, against the backdrop of still too low inflation, the central bank has opted against a full wind down of QE, also known as tapering, and leaves its end-date open for now.

This course is contentious as some observers are concerned with the growing side-effects. As monetary policy takes time to feed through and inflation has already recovered somewhat, they fear the ECB could miss the right point in time for an exit.

It is unlikely that interest rates will rise again immediately after QE has stopped. The ECB has communicated clearly that it will keep key interest rates at their current levels well beyond the end of asset purchases.

SCENARIO 2

What is the worst-case scenario?

If the situation in countries such as Italy or Greece deteriorates again, the danger of deflation could return quickly. The central bank retains the option of extending the QE programme once again if there is another economic downturn in the euro area.

However, experts dispute the extent to which any further intensification of special measures would help revive the economy. The US example shows that the first use of a QE programme is usually the most effective. Moreover, the market for secure bonds that the ECB can purchase is limited. A shortage on these markets could endanger the programme.

Two side-effects of the QE programme are particularly risky:

First, the ECB is actively intervening in the distribution of wealth. The owners of real estate or equities benefit particularly from low interest rates as increased investment drives up the value of these assets. Exacerbating wealth inequality undermines trust in the ECB.

Secondly, the increased demand for riskier financial instruments such as shares or company bonds and rising real estate prices may result in new price bubbles. A subsequent market correction could cause another economic downturn.

SCENARIO 3

What can governments do?

Leaving the burden to deal with the euro-area debt crisis on the ECB alone is very risky. For the central bank to return to conventional monetary policy and raise interest rates again the euro area needs above all lasting growth. Inflation will in turn rise as a by-product. National governments can help by providing stimulus and investment programmes, thereby speeding up the recovery. In particular, countries with healthy government finances such as Germany have room for manoeuvre here.

Economic reforms can increase the euro area's growth potential and thus ease the pressure on monetary policy. The elimination of regulatory barriers in the Single Market would allow European companies to grow faster. This could help to create new business models, especially in poorly integrated sectors such as digital or energy.

Unlike the ECB, governments can deal with economic weaknesses in a targeted way. At the same time, the countries with the largest problems have the smallest financial leeway. A policy mix of monetary policy, fiscal policy and structural reforms is difficult to coordinate, but is more effective in fostering growth and price stability than if the ECB carries the entire burden.

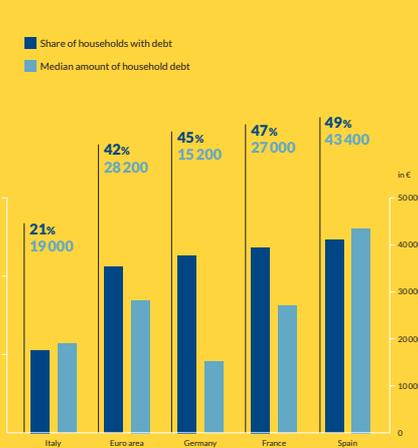
FACT #1 Development of inflation in the euro area and adjustment of the base interest rate by the ECB



The figure shows the development of inflation in the euro area since 2006 and how the ECB adjusted the base rate accordingly. Apart from a brief exception in 2011, the ECB has repeatedly reduced interest rates since 2008 to prevent a drop in inflation. Nonetheless, the inflation rate has consistently fallen since 2012 and only rose again in December 2016.

Source: ECB, Eurostat.

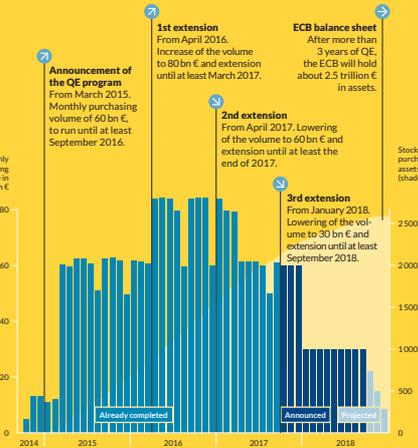
FACT #2 Household debt levels



Those that benefit from the low interest rates include households that want to take on debt, for example to purchase a property. In the euro area, that applies to two out of five households on average. In 2014, 84,000 households in the euro area were surveyed on this issue.

Source: ECB.

FACT #3 Progress of the ECB QE program: Monthly purchasing volume and asset stock



The figure shows the progress of the ECB's QE programme since it was announced in January 2015. The flags mark the different points in time at which the ECB announced changes to its programme.

Source: ECB, author's calculations.



"The ECB's policy was decisive in tackling the euro-area crisis. As economic conditions improve, it must decide what it believes is more important: price stability or economic stimulus for crisis countries. When inflation returns to target, the ECB should focus on its mandate and abandon the crisis mode. The member states have the responsibility to reform themselves."

Philipp Ständer
The author is a Research Fellow at the Jacques Delors Institut - Berlin.

EUROPA

briefing

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