Position paper

Strategy review of the European Central Bank

Summary of the position paper

The European Central Bank (ECB) wants to review its monetary policy strategy. The Association of German Banks welcomes this project. Our position paper is intended to make a constructive contribution to the public debate.

Design of the inflation target

- The ECB’s inflation target should in future be interpreted as a kind of inflation or tolerance range of between 1 and 2%. Among other things, this would represent a symbiosis between the originally worded target of “below 2%” and the 2003 revised wording of “below, but close to 2%”.
- Missed targets should not trigger an automatic monetary policy response.

Consideration of side effects

- The ECB should always keep a close eye on the risks and side effects of its monetary policy. All the more so when it makes use of “unconventional” instruments, which usually have even stronger side effects, or if its monetary policy has been moving in the same direction for a very long time.
- A tiered interest rate should be used to reduce to the fullest extent the undesirable side effects of negative interest rates on the banking sector. In Japan, over 90% of excess liquidity is exempt from negative rates. In the euro area, the figure is less than 50% at present.

“Green” monetary policy

- The European Central Bank could pursue climate change mitigation policies under its “secondary” mandate, which authorises it to support general economic policies in the European Union. But despite the crucial importance of climate protection, which the Association of German Banks strongly supports, a clear hierarchy of objectives and
responsibilities nevertheless continues to apply, with price stability the ECB’s primary goal.

- An efficient way of managing climate risks would be to adequately reflect the effects of climate change in prices and risk assessments. If progress was made in this regard (by setting corresponding requirements, for example, and making suitable adjustments to the general economic policy framework) climate aspects would ultimately feed “automatically” into monetary policy.

Communication

- The ECB’s management of monetary policy should be as transparent as possible to market participants, academics and the general public. Differing views on monetary policy in the ECB Governing Council should also be made public.

- As the ECB gains greater flexibility for action by introducing an inflation band, for example, the demands on its communication and transparency to the public will increase further.
Positions on the European Central Bank’s strategy review

The new President of the European Central Bank (ECB) has announced a review of the bank’s monetary policy strategy. The review is scheduled to start in 2020. Only once before – in 2003 – did the ECB review and significantly modify its monetary policy strategy.

Mandate and objective of the ECB

The mandate of the Eurosystem (the ECB and all national central banks to have adopted the euro) is set out down in the Treaty on the Functioning of the European Union (TFEU) and the Statute of the European System of Central Banks and of the European Central Bank, which is also a protocol to the TFEU. These state that the primary objective of the ESCB* is “to maintain price stability”. Without prejudice to price stability, the ESCB “shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union”.

On the launch of monetary union, the Governing Council of the ECB stated that “price stability” would be maintained if the Harmonised Index of Consumer Prices in the euro area was below 2% over the medium term. Following a review of monetary policy strategy in 2003, the Governing Council also introduced a kind of lower limit for “price stability”, though the wording “below, but close to 2%” consciously made it less precise than the upper limit.

*The ESCB (European System of Central Banks) comprises the ECB and all the central banks of the EU member states; the TFEU assumes that all member states will ultimately adopt the euro.

The background to the announced review is complex.

- A key issue is that the rate of inflation in the euro area in recent years is judged to be too low. According to this view, the ECB’s inflation target of “below, but close to 2%” has therefore not been met for years. Against this backdrop, the review should at a minimum clarify how close the inflation rate ought to be to the 2% mark. Specifically, does it make good sense to interpret the inflation target as a precise target of 1.9%?

- Further aspects to be considered in the review should be long-standing global inflation and productivity trends. Globalisation and digitalisation evidently also have significant effects on inflation. They act as a structural brake on the inflation rate by increasing competition and enhancing price transparency. The demographic change in industrialised
countries also plays a major role since it is accompanied by higher savings, which depress interest rates and demand.

- On top of that, “unconventional” monetary policy measures have now become a permanent fixture. Measures such as negative interest rates and a large-scale asset purchase programme have considerable side effects and were originally intended to be only temporary.

- And in the already ongoing public debate on ECB strategy, the question of whether and to what extent the ECB can gear its monetary policy to climate and sustainability criteria is playing an increasing role.

The Association of German Banks welcomes the ECB’s strategy review. It also considers the review to be necessary because the negative interest rate policy is encountering a growing lack of understanding among the general public – not only in Germany. Yet without the broadest possible public backing, monetary policy will become less effective and efficient.

**1. Design of the inflation target**

In a market economy and a currency union made up of 19 fiscally sovereign states, monetary policy can only steer the general rate of price increases indirectly and with a considerable time lag. All in all, it is a rather blunt instrument. The deeper and closer integration of local economies into global markets also makes it more difficult to tailor monetary policy to national needs. The ECB should take this inexactitude into account when designing its inflation target. This will enable it to retain a necessary degree of discretionary room for manoeuvre and respond appropriately to special circumstances or changing environmental conditions.

This means, first, that the inflation target should best take the form of a sufficiently broad range. Second, deviations from the target should not trigger an automatic response from the central bank. Even inflation rates that lie outside the target range should first be analysed and thoroughly explained. This applies especially if interest rates are already very close to, or even below, the zero per cent threshold (see info box below).
Zero per cent threshold and negative interest rates

The Association of German Banks believes zero per cent still represents a special threshold in interest rate policy. The general public find it extremely difficult to understand and accept the need for negative rates. There is a considerable danger of undesirable side effects and evasive action. Since banks fear a sudden mass withdrawal of deposits by customers, they are reluctant to pass on negative policy interest rates. This disrupts the transmission of monetary policy and the policy impulse has little or no effect on the banks’ customers. Negative policy interest rates therefore tend to act as a special burden that banks remain largely “stuck” with, which ultimately reduces their profitability and thus their lending capacity.

On top of that, there is the economic debate about the so-called reversal rate. This refers to the central bank interest rate at which the negative effects of an expansive monetary policy start to outweigh the positive effects. This may occur, for example, if the savings rate of households actually increases as a result of the compound interest effect disappearing when interest rates are zero or negative.

Though it is not possible to pinpoint the precise level of the reversal rate, it is likely to be below the zero per cent threshold. If the central bank’s policy interest rate is in negative territory, moreover, the increasing side effects of monetary policy may even – according to the authors Brunnermeier and Koby, who explored the basics of this concept in an academic article – push the reversal rate towards zero.

Over the course of the last few years, the ECB has gradually narrowed its self-set inflation goal to an exact target of 1.9%. It has also reacted in a comparatively mechanistic way whenever this target has not been met. There has been very little communication with the public, with the ECB explaining the impact of structural price-dampening factors – especially globalisation, demography and digitalisation – on its inflation target. Instead, there has been repeated stress on the risks of deflation. The lessons of recent economic experience, which has shown that slightly negative inflation rates – even over a longer period of time – do not trigger a sustained downward spiral of general price levels, consumption and wage increases, have barely, if at all, been mentioned.
Position of the Association of German Banks

- The ECB’s inflation target should in future be interpreted as a kind of inflation or tolerance range of between one and two per cent. First, this would represent a symbiosis between the originally worded target of “below 2%” and the 2003 revised wording of “below, but close to 2%”. It would also
  - take account of the structural changes in price trends, both the moderate development of inflation worldwide and the fact that even zero inflation rates are not the starting point for a dangerous deflationary spiral,
  - maintain the 2% ceiling which has been clearly formulated from the outset,
  - ensure sufficient distance from significantly negative inflation rates, and
  - give the ECB greater room for manoeuvre again.

- When modifying the inflation target, the ECB should publish extensive information on the prerequisites and mechanics of deflationary spirals. The public frequently equates even slightly negative inflation rates with deflation – this is not appropriate, in our view.

- Where possible, the ECB should work together with the European statistical authorities on developing a more accurate way to measure consumer price trends in the euro area. There are legitimate concerns, for example, that owner-occupied housing costs are underrepresented in the eurozone’s consumer inflation figures.

- Irrespective of this, the ECB should analyse whether it would benefit monetary policy management to focus more when setting the inflation target on the development of the core inflation rate (consumer inflation less items that are particularly volatile, such as energy prices) or on the private consumption deflator.

- Missed targets should not trigger an automatic monetary policy response. The ECB should carefully and continuously analyse the precise environmental conditions governing price trends and explain to the public in detail the reasons for a missed target.

- The argument that the undershooting of targets in recent years has somehow been stored in a kind of inflation memory and first needs to be “offset” by future exceedance of the target is tantamount to a knee-jerk policy response as well. But such a course of action should also be rejected because there is no objective reason why missed targets in the past should justify further missed targets in the future, quite apart from the fact that the idea of an exact “netting” of various missed targets presupposes an ability to fine-tune monetary policy that simply does not exist in practice.
2. Consideration of side effects

Apart from a brief interruption with two interest rate hikes in April and July 2011, the ECB’s monetary policy has for over ten years been in an unprecedented expansionary phase. During this period, a number of “unconventional” monetary policy instruments have also been deployed, especially in the wake of the European sovereign debt crisis. These include above all the negative rate on the deposit facility (from June 2014) and the extensive net purchases of government bonds (from March 2015 to December 2018 and since November 2019).

The ECB’s highly expansive monetary policy has risks and harmful side effects. These will become increasingly serious the longer and more vigorously this approach is pursued and are even likely to ultimately impair the monetary policy transmission mechanism. The major risks and side effects include:

- the risk of distorted risk prices and misdirected investments,
- possible price excesses in some asset markets (e.g. real estate or bond markets),
- excessive liquidity hampering market adjustments and structural change, and
- serious damage to funded provision for retirement, especially private and occupational pension schemes.

For banks in the eurozone, the ECB’s negative deposit rate also represents a sort of “special tax”. Since the start of the negative interest rate policy, eurozone banks have paid the ECB over €25 billion for their excess liquidity. Banks in Germany paid almost €2.5 billion in 2018 alone. Given that German banks posted a pre-tax profit of just under €19 billion in 2018, the negative interest rate represents a substantial burden. This burden is depressing the profitability of the banks and will ultimately even constrain their lending capacity.

For a long time, the ECB took the view that the risks and side effects of its monetary policy had to be accepted or that it was up to other economic policy institutions to mitigate them. It argued that macroprudential supervision, for example, was established specifically to address stability risks in the financial system.

Recent months have seen a shift in emphasis in the ECB Governing Council. First, the ECB now clearly acknowledges that there are damaging side effects associated with its current monetary policy approach, especially the negative interest rate policy. It also stresses that these unwanted effects have increased over time.

To alleviate the side effects of the negative interest rate policy on banks, the ECB introduced a tiered system of interest rates for excess liquidity at the end of October 2019. Banks no longer have to pay negative interest on an amount set at six times their minimum reserve. The relief provided by this tiered
The system is nevertheless very modest. It primarily compensates for the additional burden on banks caused by the renewed cut in the deposit rate from -0.4% to -0.5% in September 2019. As things stand, the banks in the eurozone will have to pay around €5 billion annually in negative interest to the ECB, the tiered system notwithstanding. Should excess liquidity in the European banking system rise further as a result of the new asset purchase programme, this amount could quickly reach €6 or 7 billion again.

Position of the Association of German Banks

- The ECB should always keep a close eye on the risks and side effects of its monetary policy. All the more so when it makes use of “unconventional” instruments, which usually have even stronger side effects, or if its monetary policy has been moving in the same direction for a very long time.

- The ECB should undertake a holistic analysis of the impact of the side effects and ascertain whether these side effects can be efficiently mitigated by other institutions. The results of its analysis should be made public and feed into monetary policy decisions.

- It is oversimplistic to claim that financial stability is primarily a matter for macroprudential supervisors. Macroprudential policy is still in its infancy everywhere – and there is as yet scant experience of how its instruments function or of their effectiveness in practice. What is more, disruption in the financial markets has a strong impact on the transmission of monetary policy and – with a certain time lag – on consumer prices. The ECB should therefore not draw too strict a distinction between its monetary policy tasks and responsibility for maintaining financial stability.

- Not least the debate surrounding the reversal rate shows that the side effects of negative rates are especially far-reaching. Negative rates should therefore not be regarded as a “standard” monetary policy instrument. They are a crisis instrument that should only be used if there is a serious risk of deflation. This point should be continually stressed in the ECB’s communication with market participants and the public.

- Since negative interest rates are a crisis tool of monetary policy, different exit criteria should apply to those governing standard monetary policy instruments. The ECB could, for example, indicate prospects of an exit from negative rates as soon as severe deflationary risks have been overcome, even if the inflation rate has not yet sufficiently approached the ECB’s target range. This would mean the ECB removing negative interest rates from its forward guidance instead of signalling that they will remain in place for the long term.

- Decisive steps should be taken to reduce the undesirable side effects of negative interest rates on the banking sector. The ECB’s mitigation of the burden it has imposed not only came very late but also goes nowhere near far enough with the tiered rate in its present form. Other central banks that operate with negative interest rates, such as the Swiss National Bank or the Bank of Japan, mitigated the burden on
banks as soon as the negative rates were introduced. While less than half the excess liquidity in the eurozone is exempt from the negative deposit rate at present, the figure in Japan is 90%. The ECB needs to adjust its policy in this area without delay. It could increase the multiplying factor for the exempt amount, introduce an additional exempt amount based on the scale of a bank’s individual excess liquidity over, say, the past twelve months or apply a positive interest rate to the minimum reserves which banks have to hold at the ECB.

3. “Green” monetary policy

The new ECB president wants to include climate protection and sustainability considerations in monetary policy decisions. Public discussion of this idea is already underway: non-governmental organisations and academics have sent an open letter to the ECB, for example, urging it to exclude bonds issued by carbon-intensive companies from its asset purchase programme.

Climate change most certainly has monetary policy implications. Weather extremes pose risks for companies and economies and can lead to severe fluctuations in economic growth and inflation.

There is nevertheless a risk of overburdening monetary policymakers with general policy objectives that will expose the central bank to greater political pressure. The desire of certain social groups and politicians to see monetary policy used to influence further socio-political goals would be likely to increase. This would make it more difficult to maintain the tried and tested political independence of the central bank at its current level. The Network for Greening the Financial System, a worldwide group of central banks and supervisors working to promote a more sustainable financial system, has also highlighted these limitations.

A similar situation threatens to arise if the ECB abandons the principle of market neutrality in its monetary policy measures. If the ECB gave preferential treatment to climate-friendly companies in its bond-buying programme, for example, the distinction between monetary policy and active industrial or structural policy would become blurred, to say the least. The ECB neither has a mandate to actively conduct industrial or structural policy nor is it subject to the political oversight mechanisms needed to do so. On top of that, it would be hugely challenging to carry out an objective assessment of individual companies’ climate policies. Despite its dynamic growth, moreover, the market for green bonds is still very small. Intervention by the ECB could therefore trigger substantial swings in this market.

For these reasons, among others, far more efficient action can be taken to protect the climate by exploring options in the area of general economic policy, such as setting uniform requirements and framework conditions for the entire market.
Position of the Association of German Banks

- The tools needed to conduct effective and efficient climate policy lie above all in the hands of general economic policy-makers. Attempts to use monetary policy to pursue ecological goals could lead to conflicting objectives, a lack of transparency and less efficient monetary policy.
- If consideration is given to extending the roles and responsibilities of the ECB, it should be borne in mind that the long-standing phase of low interest rates severely limits the scope for additional monetary policy action. Ever greater use would have to be made of "unconventional" instruments, which normally come with greater side effects as well.
- The ECB could nevertheless pursue climate policy objectives under its “secondary” mandate to support the general economic policies of the European Union. If, for example, the European Commission places greater emphasis on climate policy objectives, the ECB’s potential scope for action in this area should also increase. Even then, however, the same clear hierarchy of objectives and responsibilities will continue to apply, meaning that measures can only be geared towards fulfilling the secondary mandate if the primary objective of price stability is deemed met.
- An efficient way of managing climate risks, both in monetary policy and in the financial system as a whole, would be if the effects of climate change were properly reflected in prices and risk assessments. If progress was made in this regard (by setting corresponding requirements, for example, and making suitable adjustments to the general economic policy framework) climate aspects would ultimately feed “automatically” into monetary policy.

4. Communication

Central bank communication with market participants and the public has become increasingly important in recent years. Credible explanations about the targets announced by the central bank and the bank’s possible response patterns have the potential to considerably improve the transmission mechanism of monetary policy. Monetary policy then becomes more effective and efficient.

Good central bank communication also includes being open about the difficulties and shortcomings of monetary policy. In the medium term, confidence in a central bank is likely to be higher if it carefully analyses and publicly explains the reasons for deviations from its targets than if it tries to emphasise its determination by making ever greater use of policy instruments.

Deutsche Bundesbank, for example, announced an annual money supply target every year between 1974 and 1998. Although the target sometimes took the form of a fairly broad corridor of up to three percentage points, the Bundesbank missed its target in almost one in two cases. But since the
Bundesbank carefully explained the reasons for the missed targets, it was nevertheless able to maintain and even consolidate its reputation for stability.

Position of the Association of German Banks

- The ECB’s management of monetary policy should be as transparent as possible to market participants, academics and the general public. Differing monetary policy views among members of the Governing Council should also be made public.
- Voting by members of the Governing Council should be published – if necessary, in anonymised form.
- As the ECB gains greater flexibility for action by introducing an inflation band, for example, the demands on its communication and transparency to the public will increase further. Decisions – and this includes deciding to leave monetary policy measures unchanged – need to be explained carefully and comprehensively.
- The ECB should strive to increase transparency about the side effects of its monetary policy. The action needed ranges from expert analysis and systematic overviews to explanations that can be readily understood by the general public.
- In its communication, the ECB should make it clear that negative interest rates are a crisis management tool to combat the risk of deflation. A clear exit scenario should always be presented when a tool of this kind is deployed.