

Why the ECB is not to blame for low interest rates

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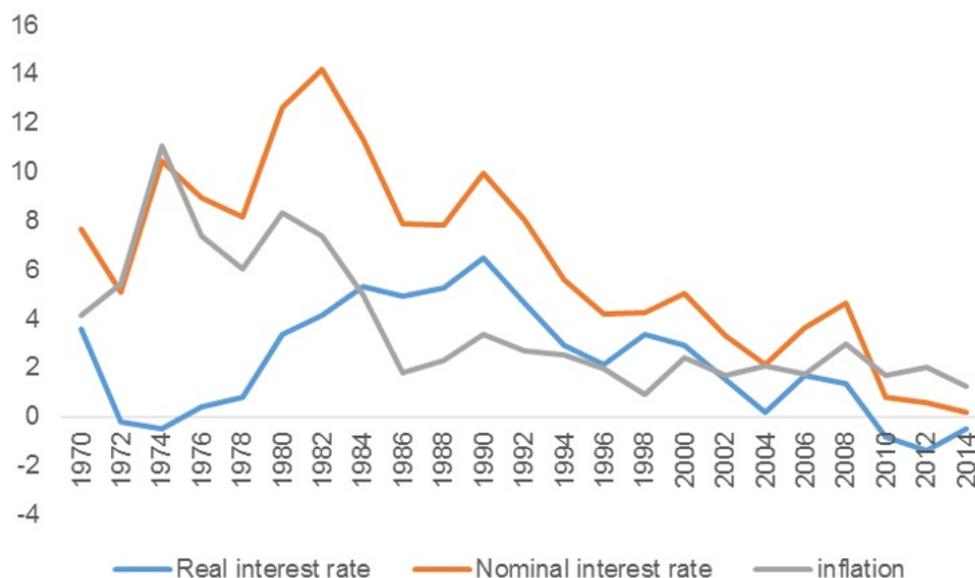
In the latest set of EU stress tests, several German lenders performed poorly. As [Markus Demary](#) writes, some of this performance has been blamed on low interest rates squeezing the profitability of lenders. He argues that while the ECB has frequently been blamed for this situation, the reality is more complex and instead reflects long-term trends which can only be addressed by lasting structural reforms.



The low interest rate environment is hotly debated in Germany. The debate is mostly focused on the risks of a prolonged period of low interest rates for financial stability, for old-age-provisions and for wealth inequality. While all these risks are real, the debate mostly sees the European Central Bank (ECB) and its monetary policy as the sole cause.

But this narrow view is counterproductive. Taking a more balanced view allows for policy measures to be deduced. In the narrative I sketch out here, we can see instead a long-run trend decline in nominal interest rates which started in the 1970s in most industrialised countries and an additional crisis-induced drop which occurred in the second half of 2008.

Figure: Inflation, nominal and real interest rates



Note: Figures are the median of Austria, Belgium, Canada, France, Germany and the USA, in percent. **Source:** OECD, own calculations

Starting in the 1970s, interest rates and inflation were both high in most industrialised countries, while real interest rates, i.e. inflation-adjusted interest rates, were low and even negative. At that time, high inflation and high interest rates were the result of loose monetary policies. As central banks became more inflation-averse with the consensus of defining price stability as an average inflation rate of 2 per cent, inflation and thereby interest rates declined. The process of declining inflation endured until the end of the 1980s. This is the monetary view on interest rates. Since then inflation evolved mostly in a horizontal way at approximately 2 per cent and declined only in recent years

towards deflation.

While the decline in interest rates was mostly due to declining inflation at that time and resulted in increasing real interest rates, something surprising happened then which challenged the monetary view explained above. While inflation moved horizontally, interest rates declined further, indicating that factors beyond monetary policy were at work. In fact, it was a decline in the real interest rate which caused a decline in the nominal interest rate. This decline can be explained by the change in demographics which affected the supply and the demand for capital and thereby the real interest rate.

Life expectancy in OECD-countries has increased from 67 to 80 years since 1960, while the **retirement age** has remained on average constant. Given that people intend to maintain a certain level of their old-age consumption, increasing life expectancy means that people have to finance a higher level of old-age consumption by increasing their savings. Higher savings mean a higher **supply of capital**.

During the same time span the growth rate of the **work force** has also declined. A lower growth of the workforce translates into a lower growth rate of investment and thereby capital demand given that the ratio of capital goods per worker stays constant: for example, because one employee only uses one computer at the same time. If savings increase more than investment, the real interest rate has to decline to restore **equilibrium**.

As the economies' interest rate level decreased because of decreasing inflation and decreasing real interest rates, central banks had to adjust their policy interest rates to the economies' new interest rate level. After the global financial crisis in the year 2008 central banks cut their interest rates further, which can be interpreted as an additional effect on interest rates, i.e. a crisis-induced drop. The financial crisis led to large losses in banks' balance sheets and triggered the deepest recession since the great depression in the 1930s. Central banks had to cut rates and expand their balance sheets to prevent a catastrophe.

Eight years after this crisis, interest rates are still at a record low. While the Federal Reserve is presently trying carefully to hike interest rates, other central banks have moved to negative interest rates. The diverging monetary policies might be due to different approaches to bank recapitalisation. While the US reacted to the financial crisis with a consequent recapitalisation of its banks, the European countries allowed banks to increase their equity capital ratios by shrinking their risk-weighted assets, i.e. by cutting lending.

The break-down of the **bank lending channel** is a serious problem for the ECB's monetary policy because the Eurozone is traditionally dependent on a bank-based financial system. While 90 per cent of **debt finance** is conducted through capital market instruments in the US, 80 per cent of debt finance is conducted by banks in the Eurozone. Therefore, the ECB is dependent on a functioning bank lending channel for its monetary impulses to transmit to firms and households. As long as a scarcity of bank equity capital limits lending, the ECB cannot effectively stimulate demand and therefore has to rely on low or negative interest rates.

The low interest rates can also be based on a political-economic problem between debtors and the ECB. Public measures to help troubled banks caused sovereign debt to become nearly unsustainable and the bursting of property bubbles deteriorated firms' and households' balance-sheets. In such a balance-sheet recession, debtors cut spending in order to reduce debt, which causes economic growth to slow, which in turn hampers balance-sheet-repair.

While low interest rates might be helpful to the process of balance-sheet-repair, debt hinders the ECB from increasing interest rates, since higher interest rates would force indebted firms and households to cut spending even more, triggering deflationary dynamics. The political-economic problem arises because near-zero interest rates make the prolongation of debt attractive for debtors as well as for creditors. Creditors would thereby prolong a loan contract in order to prevent a default, which increases the chance that unproductive investment is financed, while productive companies suffer from restricted access to finance.

The above analysis shows that it is extremely difficult for the ECB, and even the Federal Reserve, to lift interest rates, and that no easy solution to escape the low interest rate environment is available. If interest rates rise too fast and cause a recession, the problem of low interest rates will be exacerbated.

Escaping the low interest rate environment requires long-run structural reforms instead. As a first step, reforms in the banking sector that enable the bank lending channel to function are necessary. Policy measures which help to finish the balance-sheet-recession and thereby to revive investment in the long-run would help to increase real interest rates. In the end, policy measures to dampen the demographic effect of ageing on interest rates, i.e. an increase in the retirement age, should be implemented.

But it will take a long time until these measures will show an effect on interest rates. In the meantime, financial stability risks and increasing difficulties for old-age provisions prevail. Policy makers should therefore avoid further delaying reforms, thereby prolonging the low interest rate environment even further.

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