

Economic Insight

3 April 2019

ECB: Zero rates forever?

„If you are in trouble double“. This famous trading advice may work sometimes, but it is very risky. This should also be true for Finnish central bank chief Olli Rehn's suggestion to revise the ECB's monetary policy strategy and to introduce temporary price level targeting. If the ECB were to keep its zero interest rates much longer in its fight against low inflation, the risk of dangerous bubbles in the financial and real estate markets would rise.

A monetary policy strategy of temporary price level targeting

Olli Rehn, a possible successor to ECB President Mario Draghi, picked up an idea of former Fed chairman Ben Bernanke¹ and proposed a new monetary policy strategy for periods when the ECB's policy rate has already reached the zero-lower bound and inflation is still below the target of two percent. Within the framework of the so-called temporary price level targeting, the ECB should only raise its policy rate once inflation has exceeded two percent for a while and has fully compensated for the previous period of below two percent inflation. The zero interest rate policy would therefore be maintained for much longer than with the current inflation targeting strategy, which aims to prevent the inflation rate from rising above two percent. The expectation of a lower-for-longer zero interest rate should make monetary policy more expansionary, boost the economy and thus shorten the phase of too low inflation. This will be necessary more frequently in the future, because the ageing of the society e.g. causes people to make more private provisions which lowers the so-called natural rate of interest. The ECB, which needs an even lower policy rate to stimulate the economy, would then more frequently hit the zero-lower bound. This would make it more difficult for the central bank to prevent too low inflation or even deflation. But the monetary policy strategy of extending zero interest rates will not solve this problem and has further considerable weaknesses.

ECB partly to blame for reaching the zero lower bound

First, central banks are not innocent that they frequently reach the zero-lower bound on interest rates. This is because the interest rate level they have to undercut to stimulate the economy is low not just because of a demographically caused savings glut. Rather, the central banks themselves have contributed to this by buying government bonds on a massive scale. If the ECB wants to be less frequently thwarted by the zero-lower bound, it should reduce its bond holdings instead of keeping them constant by reinvesting the proceeds from maturing bonds.

Low inflation not a big problem

Secondly, the fixation on preventing low inflation rates is exaggerated. The Bank for International Settlements has shown for 38 countries that even slightly declining consumer prices have not burdened economic growth over the past 150 years.² Since the turn of the millennium, Japan's per capita GDP has risen at a rate similar to that of the USA, despite inflation of almost zero percent.

ECB fights against inflation dampers

Thirdly, the supporters of a strategy of extended zero interest rates overlook that inflation is being depressed by global value chains, with digitalization as the next inflation damper already in sight. It is doubtful whether the ECB will succeed in raising the inflation rate to over 2% without leaving key interest rates at zero for an unacceptably long time (see box on p. 2).

Dangerous side effects

Fourthly - and this is the most important objection - a strategy of longer-for-lower interest rates has dangerous side effects. For example, the US Fed raised its policy rates far too late after

¹ „Temporary price-level targeting: An alternative framework for monetary policy“, Brookings, blog from October 12th 2017.

² Bank for International Settlements, Quarterly Review, March 2015, Seite 36

For important disclosure information please see pages 3 and 4.

research.commerzbank.com / Bloomberg: CBKR

Author:

Dr Jörg Krämer

Chief Economist

+49 69 136 23650

joerg.kraemer@commerzbank.com

the bursting of the stock market bubble in 2000. For too long, interest rates were well below the level that would have been justified by growth and inflation, said the renowned US economist John Taylor. The Fed thus promoted the emergence of the real estate and debt bubble, which burst in 2007 and plunged Western economies into a severe recession and contributed to low inflation in the euro zone. If the monetary policy strategy of price-level targeting recommends zero interest rates for even longer, it will turn the lessons of recent economic history upside down.

ECB needs a strategy of comprehensive stabilization

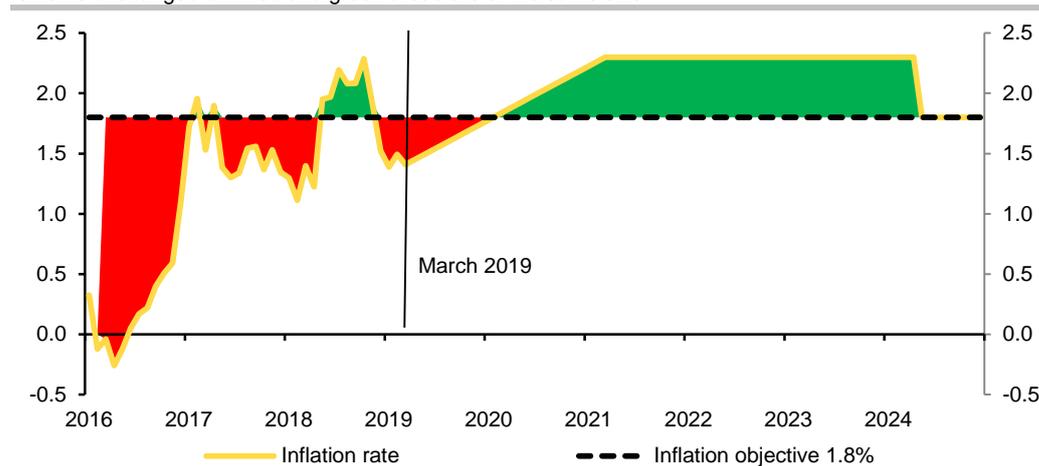
A reform of the ECB's monetary policy strategy must not lead to an even looser monetary policy, in other words to more of the same, even if the finance ministers of the highly indebted Southern European states would welcome it. Instead, the ECB needs a strategy of comprehensive stabilization.³ It should strive not only for price stability, but also for financial stability. If, for example, house prices or credit volumes rise too sharply, it should raise its policy rate even if inflation is low, in order to avoid a dangerous bubble.

Simulation of temporary price level targeting

In order to illustrate what temporary price level targeting could mean for the ECB's key interest rates, we run a simulation which assumes that the central bank would introduce this strategy immediately, i.e. in March 2019. If the ECB mechanically adheres to the new strategy, it would have to keep its refinancing rate constant at 0% as long as any fall of the inflation rate below the target value (1.8%) (since the introduction of the zero-interest rate policy in March 2016) is fully compensated by a corresponding overshooting of the inflation target, so that in chart 1 the red and green areas are of the same size. We assume that the ECB is able to gradually raise the inflation rate to 2.3% (0.5% percentage points above the target of 1.8%) over the coming two years and to keep it there in the following years. Assuming the trajectory of the inflation overshooting as shown in the chart below, the policy would thus be kept constant until spring 2024.

CHART 1: Inflation undershooting is compensated by a corresponding overshooting

Euro area CPI, year-on-year change in %; simulation of temporary price level targeting; key interest rate remains unchanged until red and green areas are of the same size



Sources: Eurostat, Commerzbank Research

³ „Towards a monetary policy of comprehensive stabilisation“, Economic Insight, Commerzbank Research, Dec 2nd 2016.

In accordance with ESMA MAR requirements this report was completed 03/04/2019 11:14 CEST and disseminated 03/04/2019 11:15 CEST.

This document has been created and published by the Research department within the Corporate Clients division of Commerzbank AG, Frankfurt/Main or Commerzbank's branch offices mentioned in the document. Commerzbank AG is a provisionally registered swap dealer with the CFTC.

If this report includes an analysis of one or more equity securities, please note that the author(s) certify that (a) the views expressed in this report accurately reflect their personal views; and (b) no part of their compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or views expressed by them contained in this document. The research analyst(s) named on this report are not registered / qualified as research analysts with FINRA. Such research analyst(s) may not be associated persons of Commerz Markets LLC and therefore may not be subject to FINRA Rule 2241 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

It has not been determined in advance whether and in what intervals this document will be updated. Unless otherwise stated current prices refer to the most recent trading day's closing price or spread which may fluctuate.

Conflicts of interest

Disclosures of potential conflicts of interest relating to Commerzbank AG, its affiliates, subsidiaries (together "Commerzbank") and its relevant employees with respect to the issuers, financial instruments and/or securities forming the subject of this document valid as of the end of the month prior to publication of this document*:

Please refer to the following link for disclosures on companies included in compendium reports or disclosures on any company covered by Commerzbank analysts: http://research.commerzbank.com/web/commerzbank-research-portal/public-page/disclosures*

*Updating this information may take up to ten days after month end.

Disclaimer

This document is for information purposes only and does not take into account specific circumstances of any recipient. The information contained herein does not constitute the provision of investment advice. It is not intended to be and should not be construed as a recommendation, offer or solicitation to acquire, or dispose of, any of the financial instruments and/or securities mentioned in this document and will not form the basis or a part of any contract or commitment whatsoever. Investors should seek independent professional advice and draw their own conclusions regarding suitability of any transaction including the economic benefits, risks, legal, regulatory, credit, accounting and tax implications.

The information in this document is based on public data obtained from sources believed by Commerzbank to be reliable and in good faith, but no representations, guarantees or warranties are made by Commerzbank with regard to accuracy, completeness or suitability of the data. Commerzbank has not performed any independent review or due diligence of publicly available information regarding an unaffiliated reference asset or index. The opinions and estimates contained herein reflect the current judgement of the author(s) on the date of this document and are subject to change without notice. The opinions do not necessarily correspond to the opinions of Commerzbank. Commerzbank does not have an obligation to update, modify or amend this document or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate.

This communication may contain trading ideas where Commerzbank may trade in such financial instruments with customers or other counterparties. Any prices provided herein (other than those that are identified as being historical) are indicative only, and do not represent firm quotes as to either size or price. The past performance of financial instruments is not indicative of future results. No assurance can be given that any financial instrument or issuer described herein would yield favourable investment results. Any forecasts or price targets shown for companies and/or securities discussed in this document may not be achieved due to multiple risk factors including without limitation market volatility, sector volatility, corporate actions, the unavailability of complete and accurate information and/or the subsequent transpiration that underlying assumptions made by Commerzbank or by other sources relied upon in the document were inapposite.

Commerzbank and/or its affiliates may act as a market maker in the instrument(s) and/or its derivative that has been mentioned in our research reports. Employees of Commerzbank and/or its affiliates may provide written or oral commentary, including trading strategies, to our clients and business units that may be contrary to the opinions conveyed in this research report. Commerzbank may perform or seek to perform investment banking services for issuers mentioned in research reports.

Neither Commerzbank nor any of its respective directors, officers or employees accepts any responsibility or liability whatsoever for any expense, loss or damages arising out of or in any way connected with the use of all or any part of this document.

Commerzbank may provide hyperlinks to websites of entities mentioned in this document, however the inclusion of a link does not imply that Commerzbank endorses, recommends or approves any material on the linked page or accessible from it. Commerzbank does not accept responsibility whatsoever for any such material, nor for any consequences of its use.

This document is for the use of the addressees only and may not be reproduced, redistributed or passed on to any other person or published, in whole or in part, for any purpose, without the prior, written consent of Commerzbank. The manner of distributing this document may be restricted by law or regulation in certain countries, including the United States. Persons into whose possession this document may come are required to inform themselves about and to observe such restrictions. By accepting this document, a recipient hereof agrees to be bound by the foregoing limitations.

Additional notes to readers in the following countries:

Germany: Commerzbank AG is registered in the Commercial Register at Amtsgericht Frankfurt under the number HRB 32000. Commerzbank AG is supervised by both the German regulator, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), Graurheindorfer Strasse 108, 53117 Bonn, Marie-Curie-Strasse 24-28, 60439 Frankfurt am Main and the European Central Bank, Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany.

United Kingdom: This document has been issued or approved for issue in the United Kingdom by Commerzbank AG London Branch. Commerzbank AG, London Branch is authorised by Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), and the European Central Bank and is subject to limited regulation by the Financial Conduct Authority and Prudential Regulation Authority. Details on the extent of our regulation by the Financial Conduct Authority and Prudential Regulation Authority are available from us on request. This document is directed exclusively to eligible counterparties and professional clients. It is not directed to retail clients. No persons other than an eligible counterparty or a professional client should read or rely on any information in this document. Commerzbank AG, London Branch does not deal for or advise or otherwise offer any investment services to retail clients.

United States: This document has been approved for distribution in the US under applicable US law by Commerz Markets LLC ("Commerz Markets"), a wholly owned subsidiary of Commerzbank AG and a US registered broker-dealer. Any securities transaction by US persons must be effected with Commerz Markets, and transaction in swaps with Commerzbank AG. Under applicable US law; information regarding clients of Commerz Markets may be distributed to other companies within the Commerzbank group. This research report is intended for distribution in the United States solely to "institutional investors" and "major U.S. institutional investors," as defined in Rule 15a-6 under the Securities Exchange Act of 1934. Commerz Markets is a member of FINRA and SIPC. Any derivatives transaction with US persons must be effected in accordance with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Canada: The information contained herein is not, and under no circumstances is to be construed as, a prospectus, an advertisement, a public offering, an offer to sell securities described herein, solicitation of an offer to buy securities described herein, in Canada or any province or territory thereof. Any offer or sale of the securities described herein in Canada will be made only under an exemption from the requirements to file a prospectus with the relevant Canadian securities regulators and only by a dealer properly registered under applicable securities laws or, alternatively, pursuant to an exemption from the dealer registration requirement in the relevant province or territory of Canada in which such offer or sale is made. Under no circumstances is the information contained herein to be construed as investment advice in any province or territory of Canada and is not tailored to the needs of the recipient. In Canada, the information contained herein is intended solely for distribution to Permitted Clients (as such term is defined in National Instrument 31-103) with whom Commerz Markets LLC deals pursuant to the international dealer exemption. To the extent that the information contained herein references securities of an issuer incorporated, formed or created under the laws of Canada or a province or territory of Canada, any trades in such securities may not be conducted through Commerz Markets LLC. No securities commission or similar regulatory authority in Canada has reviewed or in any way passed upon these materials, the information contained herein or the merits of the securities described herein and any representation to the contrary is an offence.

European Economic Area: Where this document has been produced by a legal entity outside of the EEA, the document has been re-issued by Commerzbank AG, London Branch for distribution into the EEA.

Singapore: This document is furnished in Singapore by Commerzbank AG, Singapore branch. It may only be received in Singapore by an institutional investor or an accredited investor as respectively defined in section 4A of the Securities and Futures Act, Chapter 289 of Singapore ("SFA") pursuant to section 274 or section 275 (as applicable) of the SFA. Nothing in this document constitutes accounting, legal, regulatory, tax, financial or other advice and/or recommendations to the recipient of this communication. Further, the communication/information provided herein does not constitute a "financial advisory service" within the meaning of the Financial Advisers Act, Chapter 110 of Singapore ("FAA") and therefore, the regulatory requirements and duties that may be owed to a client pursuant to or in connection with the FAA are not applicable to the recipient in connection with this communication. Recipients are advised to seek independent advice from their own professional advisers about the information discussed herein.

Hong Kong: This document is furnished in Hong Kong by Commerzbank AG, Hong Kong Branch, and may only be received in Hong Kong by 'professional investors' within the meaning of the Securities and Futures Ordinance (Cap.571) of Hong Kong and any rules made there under, and persons whose ordinary business is to buy or sell shares or debentures.

Japan: This information and its distribution do not constitute and should not be construed as a "solicitation" under the Financial Instrument Exchange Act (FIEA). This information may be distributed from Commerzbank international branches outside Japan solely to "professional investors" as defined in Section 2(31) of the FIEA and Section 23 of the Cabinet Ordinance Regarding Definition of Section 2 of the FIEA. Please note that Commerzbank AG, Tokyo Branch has not participated in its preparation. Not all financial or other instruments referred to in this information are available within Japan. You should contact the Corporate Clients division of Commerzbank AG for inquiries on availability of such instruments.

Australia: Commerzbank AG does not hold an Australian financial services licence. This document is being distributed in Australia to wholesale customers pursuant to an Australian financial services licence exemption for Commerzbank AG under Class Order 04/1313. Commerzbank AG is regulated by Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) under the laws of Germany which differ from Australian laws.

People's Republic of China (PRC): This document is furnished by Commerzbank AG and is only intended for institutions that are eligible for financial transactions. No-one else may rely on any information contained within this document. Any derivative transactions by PRC persons may only be entered into by PRC financial institutions which are permitted to conduct derivatives business in the PRC and have obtained all necessary regulatory approvals in the PRC.

© Commerzbank AG 2019. All rights reserved. Version 9.27

Commerzbank Corporate Clients

Frankfurt	London	New York	Singapore	Hong Kong
Commerzbank AG	Commerzbank AG	Commerz Markets LLC	Commerzbank AG	Commerzbank AG
DLZ - Gebäude 2, Händlerhaus Mainzer Landstraße 153 60327 Frankfurt	PO BOX 52715 30 Gresham Street London, EC2P 2XY	225 Liberty Street, 32nd floor, New York, NY 10281-1050	71, Robinson Road, #12-01 Singapore 068895	15th Floor, Lee Garden One 33 Hysan Avenue, Causeway Bay Hong Kong
Tel: + 49 69 136 21200	Tel: + 44 207 623 8000	Tel: + 1 212 703 4000	Tel: +65 631 10000	Tel: +852 3988 0988