ECONOMY AND ECOLOGY 16.05.2022 | Peter Bofinger

Return to positive interest rates requires a safety net

An interest hike could stifle the European economy. But inflation in the eurozone can be tempered without jeopardising recovery

The energy price explosion is increasingly feeding into the general price trend. In the euro area, the core inflation rate (adjusted for energy and unprocessed food prices) almost doubled in the six months to April, from 2.1 to 3.9 per cent.

In a recent interview, Isabel Schnabel, a member of the executive board of the European Central Bank, indicated a growing willingness within the ECB to move away from the policy of negative interest rates more quickly than previously envisaged. That policy was introduced by the then bank president, Mario Draghi, in the summer of 2014, to avert the risk of deflation and it no longer fits the macroeconomic landscape.

But could such an interest hike stifle the European economy, already heavily burdened by the persisting effects of the pandemic and the war in Ukraine? Recall that the economic effects of monetary policy are determined not by the nominal but the real interest rate (discounting inflation expectations from the former). Thus, if the ECB were to raise policy rates by half a percentage point now, in line with increased inflation expectations, real interest rates would remain at an unchanged and still very low level.

The main risk in the inevitable adjustment of short-term interest rates is an excessive rise in interest rates on the capital market. Since the beginning of the year, the ten-year euro benchmark bond yield has already risen by one percentage point. The ECB's planned termination of bond purchases in the third quarter of 2022 could lead to additional pressure on the capital market. This would impair the economic recovery of the eurozone, with potentially amplified effects on the bond yields of the more heavily indebted member states, disproportionately affected by higher long-term rates.

Intensive debate

It is difficult to assess the extent of that risk. The decisive question is whether interest-rate developments on the capital market are something to be passively endured by the central bank. In the intensive academic debate on the reasons for low long-term rates, the view prevails that these are essentially driven by real factors outside the control of central banks — above all by trends in productivity and demographics as well as the risk preferences of investors.

A different approach can though be found in Joseph Schumpeter's 1939 book, *Business Cycles*. He dismissed outright the concept of an interest rate determined by real factors: 'For us, however, there is no such thing as a real rate of interest ... it is the monetary rate which represents the fundamental phenomenon, and the real rate which represents the derived phenomenon.' This monetary view is supported by a recent analysis by Bianchi, Lettau, and Ludvigson, according to which two-thirds of the decline in real interest rates since the early 1980s can be attributed to regime changes in monetary policy.

The view that long-term interest could and should be actively managed by the central bank goes back to John Maynard Keynes, who wrote in his *Treatise on Money*: 'It should not be beyond the power of a Central Bank (international complications apart) to bring down the long-term market rate of interest to any figure at which it is itself prepared to buy long-term securities.'

In the *General Theory*, Keynes went even further: '[A] complex offer by the central bank to buy and sell at stated prices gilt-edged bonds of all maturities, in place of the single bank rate for short-term bills, is the most important practical improvement which can be made in the technique of monetary management.'

Yield-curve control

Keynes' notion that monetary policy can control not only the short end of the interest-rate spectrum but also the entire interest-rate structure has found its way into practical monetary policy. It is referred to as 'yield-curve control' (YCC).

This was firstpractised in the United States from April 1942 to March 1951. To keep borrowing costs for the government low, the Federal Reserve capped yields at 3/8 per cent for short-term rates and at 2.5 per cent for long-term rates (25 years plus). Inflation, however, rapidly increased in the winter of 1950-51 and YCC was stopped — against the

declared wish of the government — via an accord between the Treasury and the Fed.

In recent times, the Bank of Japan instigated YCC in September 2016, with a target of -0.1 per cent for the short-term rate and around zero per cent for the long-term. These targets have not since been changed. An early analysis (the Capstone report) under the guidance of Richard Clarida came to a balanced, but overall positive, judgment.

The Federal Reserve Bank of Australia began YCC in March 2020, with the aim of maintaining the yield on three-year Australian bonds at 0.25 per cent. In November 2020, the target rate was reduced to 0.10 per cent and a year later it was suspended. In retrospect, the central bank arrived at the assessment that 'the yield target has been effective and has supported the recovery of the Australian economy'.

Possible solution

Thus, at least from a technical perspective, history shows that central banks can control long-term interest rates directly for a prolonged period. But could YCC be applied to the eurozone, where there are only bonds issued by national central banks?

One possible solution could be for the ECB to take its orientation from the euro-area ten-year government benchmark bond yield, which is calculated as an average of the bond yields of the member states, weighted by their gross domestic products. If it were to manage this rate with bond purchases according to the capital key of the member states, it could avoid being criticised for improperly financing individual countries. Such an approach would then also not require any conditionality.

It is questionable whether it would make sense to set concrete targets for long-term interest rates. It suffices to announce that the ECB will take action if long-term interest rates become incompatible with the fundamental macroeconomic situation of the eurozone.

In fact, the ECB is already very close to such a monetary approach to long-term interest rates. In an interview with the *Financial Times* in March 2021, the ECB's chief economist, Philip Lane, said:

'[O]ur objective is basically to make sure that yield curves — which play an important role in determining overall financing conditions — do not move ahead of the economy. Because, as you know, financial markets are very forward-looking and you can have a steepening in yield curves which

is not conducive to maintaining progress in terms of the inflation dynamic. It is really a shift in monetary policy away from focusing on just the short-term rate by looking at all financing conditions. For many economic decisions, especially under the conditions we have now, the longer end also matters.'

And Schnabel said in the *Handelsblatt* interview mentioned above:'We will decisively counter any sudden jumps in yields that have no fundamental justification.'

In such a perspective, the long-term interest rate is not the result of secular trends in real factors — it is a policy variable targeted by the central bank in line with cyclical macroeconomic requirements. This is exactly what, in the *General Theory*, Keynes had in mind (emphasis in original): 'If there is any such rate of interest, which is unique and significant, it must be the rate which we might term the *neutral* rate of interest, namely the natural rate in the above sense which is consistent will *full* employment, given the other parameters of the system; though this rate might better be described, perhaps, as the *optimum* rate.'

In sum, it is good news for a frictionless normalisation of monetary policy that the ECB does seem not to leave the capital markets to their own devices. If investors are sent the signal that there is an ECB safety net in case of emergency, this should — in the sense of a self-fulfilling prophecy — ultimately not demand any active intervention by the bank.



Peter Bofinger
Würzburg

Peter Bofinger is professor of economics at Würzburg University and a former member of the German Council of Economic Experts.