Vítor Constâncio: Monetary policy and the European recovery

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the XXXI Reunión Círculo de Economía, Barcelona, 30 May 2015.

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Ladies and gentlemen,

I start by thanking Círculo de Economia for inviting me to participate in this prestigious event. The theme of this year's conference is on ways to "consolidate the recovery". The ECB's monetary policy measures aim at precisely that: supporting the recovery in order to reach our price stability objective. Our policies have however, a broader impact, also being part of the European response to the challenges that the euro area has been confronted with for some time.

The first challenge was precisely the need to overcome the situation of low growth and low inflation then prevailing. The second, referred to the necessity of overcoming the financial and economic fragmentation among the members of the monetary union. The third, corresponded to the goal of repairing and strengthening the banking sector in order to improve the financing of the recovery. The last challenge consisted in increasing the rate of potential growth which is essential.

In different degrees these challenges are still with us but a remarkable set of initiatives started to deal with them in a more forceful way. Besides our own monetary policy decisions, from the Outright Monetary Transactions (OMT) announcement to the recent Asset Purchase Programme (APP), we need to recall the Banking Union project; the operational start of the Single Supervisory Mechanism in the ECB; the Comprehensive Assessment and Stress Tests that preceded it; the creation of a Single Resolution Mechanism; the launch of the European Fund for Strategic Investments aimed at spurring investment and finally, the announcement of the ambitious goal of creating a Capital Markets Union.

In my remarks today, I will explain the rationale for the monetary policy measures taken since mid-2014 and the effects they are having on the on-going recovery. Secondly, I will address some financial stability risks portrayed in our just published Financial Stability Review.[1] Subsequently, I will reflect on the macroprudential policy framework needed to deal with those risks and on the role that the Capital Markets Union may have in improving the efficiency of our financial system and on the creation of private risk sharing mechanism, particularly important for our monetary union.

The rationale for the ECB's monetary policy and its effects on the recovery

A phase of active management of the size of our balance sheet and our monetary base, started once inflation fell below 1%, in the second half of 2013, and kept drifting down over the first semester of 2014. These developments were also accompanied by a significant decline in various measures of long-term inflation expectations. During the same period, economic growth was faltering reflecting a general lack of demand in the euro area with corresponding high unemployment. A more expansionary monetary policy stance was needed to maintain price stability in the face of insufficient aggregate demand and downward inflationary pressures.

In response to these developments, the Governing Council of the ECB in June and September 2014 cut the monetary policy rate, decided on a negative deposit facility rate; introduced two asset purchase programmes, for asset backed securities (ABS) and covered

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[1] See http://www.ecb.europa.eu/pub/fsr/html/index.en.html.

bonds, and launched a new liquidity facility to provide longer-term funding to banks conditional on their credit performance (TLTROs).

The relatively weak use of the first tranches of the TLTRO by the banks and the fact that inflation turned negative in December, led the ECB to enlarge the Asset Purchase Programme (APP) by including sovereign bonds and by deciding to calibrate a monthly amount of €60 billion purchases of the three types of assets.

The switch to a more active steering of the ECB balance sheet is the distinguishing feature of the new phase of our non-standard measures. It is important to underline the nature of this new phase. We are not thinking of increasing our monetary base, expecting that through the workings of a stable multiplier, monetary aggregates will increase, thereby causing an upward movement in inflation, by whatever ways the traditional quantitative approach conceived. We decided on a Large Scale Asset Purchase (LSAP) mostly to be able to use several new channels of transmission of an expansionary monetary policy. The increase of the monetary base and the total balance sheet is a consequence of these new types of monetary stimulus.

By purchasing this type of long-maturity assets, we intervene directly on medium-term rates, we extract duration from the market, we provide liquidity directly to non-bank entities, and we open space in banks' balance sheets for increasing credit. Also, by reducing persistent market spreads, in ABSs for instance, we encourage banks to increase their supply. As new money origination can only be achieved through the creation of more loans, this measure has the potential to increase the supply of credit and reduce the price at which it is granted.

Another important channel through which asset purchases work in the euro area is the broad portfolio balance channel. If different assets are imperfect substitutes, interventions by the central bank that affect the supply of various assets available to private investors could influence the prices of many other assets, including investment grade bonds, equities, real estate or foreign assets with consequences for the exchange rate. Higher valuations facilitate the process of balance sheet repair that is on-going in the euro area, and more generally contribute to support credit growth. We see that the various effects also impact the credit channel.

Finally, asset purchases also operate through a signalling effect, i.e. by affecting expectations of future inflation and the future likely path of the key ECB rates. For the U.S., there is indeed evidence suggesting that quantitative easing contributed to increase inflation expectations, and therefore that asset purchases by the Fed reduced real interest rates. Lower real rates stimulate aggregate consumption and investment, and ultimately contribute to a faster return of the euro area inflation rate to levels consistent with our definition of price stability.

All these transmission channels show that the effects of our policy go well beyond the direct effect on the yields of the purchased securities. Therefore, the criticism that the policy would not be effective on account of already low sovereign yields is not well founded. Even less valid is the argument that sovereign bond purchases ease the pressure on governments to do structural reforms. It is not the task of a central bank to exert more or less pressure on governments to adopt policies for which governments' are responsible. They should implement the reforms that are necessary. In order for central banks to deserve their independence they have to fulfil their responsibility of ensuring price stability in the medium-term, an objective that monetary policy has the power to achieve. To be credible, central banks must act in a symmetric way, avoiding both too high and too low inflation.

Recent figures confirm that our policy is indeed working according to plan. Conditions in a host of asset markets, from equities to bonds or foreign exchange, have reacted in the expected way through the portfolio rebalancing transmission channel of monetary policy. Since January, equity prices have gone up by 14% and by 18% since last May, lowering the cost of equity for non-financial firms and banks; the effective exchange rate has come down by 3% since January and by 12% since last May; corporate bond yields have come down by

56 basis points since mid-last year, yields of bank bonds by 66 basis points and bank lending rates decreased, on average, by 70 basis points. This last point shows that our policies are also improving the credit channel, which is confirmed by the fact that credit to the private sector reached a turning point and has shown positive monthly flow in the last few months until April. Annualising this recent positive growth we come to an annual rate of 2%[2] which contrasts with negative rates in the more recent years. On the other hand, the euro area composite spot 5-year real interest rate which had increased by around 60 basis points between September 2014 and January 2015 shows now a decrease by 85 basis points between mid-January and May. More expansionary financial conditions are supporting the recovery and also the expected increase in inflation expectations that reduced the real interest rate.

All these improvements in financial conditions justify our staff projections published in March pointing to a sustained recovery that leads to a real growth rate of 2.1% in 2017, the elimination of the present negative output gap and an inflation rate of 1.9%. This 4% nominal growth rate is equal to the average between 2000 and 2008 and much higher than the meager 0.87% average from 2009 to 2014, with 1.8% last year. If the exogenous external factors implicit in those projections materialize and our policies are successful, it is very important to underline the deep significance of what these numbers imply. First, the normalisation of inflation within the range in our mandate would be an important achievement, underpinning the credibility of the ECB, and ensuring price stability which is important for the well functioning of our decentralized economies dependent on price signals for the allocation of resources. Second, those numbers would also represent a significant contribution to financial stability by overcoming the low nominal growth that has been portrayed as the underlying factor of the main risks for financial stability in the euro area in the recent years. It was indeed underlying the deflationary risks perceived by some commentators, it was underlying the increased burden of servicing the high debt of both the public and the private sector which constituted a drag on the recovery; and it was underlying the weak profitability of the banking sector.

Needless to say, all projections are surrounded by uncertainty. Some risks are still to the downside as, for instance, those associated with the still low real investment or to possible external shocks that may create unexpected difficulties. We have to be cautious and, above all, persist in our policies as promised, given that these encouraging projections are predicated on the full implementation of our purchase programmes until next year.

Sometimes criticism is directed at our policies, either because by reducing interest rates now we hurt savers or because low rates are contributing to excesses in assets valuations. Implicitly, these views are attributing the responsibility of the low interest rate environment to central bank policies. But the case is exactly the opposite: central banks are only reacting and trying to correct a situation that they did not create.

Medium and long term market interest rates are mostly influenced by investors and market players as the recent so-called “bund tantrum” illustrates. More importantly though, it should be pointed out that for a few decades now we see a sort of secular trend for lower real interest rates. This trend is related to secular stagnation in advanced economies, resulting from a continuous deceleration of total productivity growth and an increase in planned savings over less buoyant investment prospects. Monetary policy short-term rates are low because of those developments, not the other way around. At the same time, our monetary policy has to be accommodative precisely in order to normalise inflation and growth rates therefore getting to higher interest rates.

2 Annualised six month growth rate of MFI loans to the private sector adjusted for sales and securitisations.

Furthermore, in the present short-term conditions, with fiscal policy blocked, it is monetary policy that can create the hope that this normalisation will protect savers in the future and improve net margins for banks.

Financial Stability risks and macroprudential policy

Clearly, no policy intervention is without side effects. A prolonged period of low interest rates contributes to search for yield and to possible rich asset valuations which may generate financial stability concerns. In our Financial Stability Review published two days ago, this is acknowledged and described as the first risk to stability: the possibility of an abrupt reversal of risk premia and asset valuations that could induce capital losses and disturb the recovery.

It should be however noted that, to date, no generalised overvaluations in asset markets have been identified. While euro area stock prices are increasing rapidly, the Schiller measure of cyclically adjusted average price-earnings-ratio in the euro area stock exchanges is 14, which is close but still below its historical average, whereas it stands at around 26 in the U.S. Valuation metrics for the euro area as a whole suggest that residential property prices are broadly in line with fundamentals and below their historical average, with the opposite holding for prime commercial property, given continued strong price increases. Likewise, our internal model-based assessments of the euro area corporate bond market do not signal overvaluations and excessive bond premia to date.

In the present context, there is nevertheless, the need to remain vigilant and continuously monitor developments. Monetary policy must however remain focused on inflation and/or on growth. Therefore, such risks need to be addressed by policy instruments dedicated to ensuring financial sector resilience while curbing financial cyclical excesses – that is, by supervision and macroprudential policy.

Macroprudential policy has two main objectives: to enhance the resilience of the whole system and to smoothen the financial cycle, i.e. the fluctuation of credit, leverage and asset prices that may lead to boom-bust episodes.

As financial and business cycles are not always aligned across countries and sectors in the euro area, area wide monetary policy needs to be complemented by more targeted macroprudential policy. Unlike monetary policy that influences the euro area across the board macroprudential policy instruments can be applied in a granular manner, addressing risks at the country, sector and institutional level. Macroprudential policy therefore provides the most appropriate instruments for mitigating financial stability risks, thereby supporting the price-stability focused monetary policy.

An effective macroprudential policy requires policy interventions in a timely and bold manner, significantly affecting the normal behaviour of financial markets or financial institutions. This poses challenges. First, should there be a need for policy intervention measures need to be admittedly intrusive, going well beyond the new capital and liquidity regulatory framework. Secondly, the macroprudential tool-kit that has been legislated – including the one entrusted to the ECB/SSM – is centered on banks. Instruments would need to address other financial activities and institutions, notably those pertaining to the shadow banking sector. This growing sector is posing new potential risks, albeit in an incipient way, as identified in the ECB Financial Stability Review.

Regarding the instrument tool-kit at its disposal, the ECB may use all macroprudential instruments laid down in the European legislation CRD IV/CRR, in the sense that it may top-up specific macro-prudential measures if it considers actions by national designated authorities as insufficient to mitigate systemic risks. It covers capital instruments, such as the counter-cyclical capital buffer, the systemic risk buffer, capital surcharges of systemically important institutions as well as liquidity instruments, such as the liquidity coverage ratio. In addition, the ECB can also increase risk weights on real estate exposures or set higher limits on large exposures.

In a single currency area, macro-prudential policies are particularly important to deal with sectoral and regional risks that cannot be accounted for by a common monetary policy. Measures such as the caps on loan-to-value (LTV) or debt-to-income (DTI) ratios are suitable instruments to address these developments. In this context, recent research suggests that exposure-based measures, such as LTV and DTI could be more efficient than capital-based measures. On the other hand, they may generate important cross-border spill-overs and leakages, and moreover, are now solely in the remit of national authorities. Implementing them will therefore require co-ordination and the ECB will play an active role to facilitate this in the euro area.

Now, the present tools of macroprudential policy are mostly focused on the banking sector while important risks are emerging from the steadily growing shadow banking sector. The sector is engaged in maturity transformation and, while mostly funded via equity, shadow banks are also subject to the short-term redemption risk. If they experience substantial redemptions, they may, like banks, be forced to promptly sell assets to fulfil their obligations, which may give rise to fire sales. This is particularly worrisome, since 98% of almost 95 thousand non-money market investment funds operating in the euro area in 2014 are open-ended funds, which means that the investors can redeem their shares in the funds at any time. Moreover, the funds' buffer of liquid assets has dropped in recent years thereby increasing the illiquidity risks.

In this context, it is necessary to intensify the supervision of systemically important non-bank institutions The U.S. Fed has been given the competence to place non-bank financial institutions within the supervised perimeter. Some shadow banks grew too-big-to-fail and hence, should be subject to the same surveillance as Global Systemically Important Banks (G-SIBs). In fact, the Financial Stability Board (FSB) is preparing a methodology for identifying Global Systemically Important Non-bank Financial Institutions (G-SINFIs).

Regarding the asset management industry that is the main component of the shadow banking sector, direct measures such as additional liquidity requirements, guided stress tests, minimum and time-varying load and redemption fees should be part of the macroprudential toolbox. Well defined limits to leverage, especially synthetic leverage which is built-up with derivatives, should also be introduced, accompanied by harmonized methods to calculate it.

Countercyclical haircuts could limit volatility and leverage in financial markets more effectively than the minimum haircut requirements recently recommended by the FSB to be applied to repos and other securities financing transactions. Another important FSB workstream focuses on re-hypothecation and re-use of securities in the repo market which create chains of inside liquidity that enhance the "illusion of liquidity" that tends to disappear in times of stress. I would encourage further work in order to fully assess the effects of these tools and how best to apply them in practice.

Capital Markets Union and Monetary Union

A last element of the European response to the recent challenges that I would like to touch upon today is the Capital Markets Union project, recently launched by the European Commission. It is a very important initiative, in particular for the countries participating in the Monetary Union. Fully integrated capital markets would facilitate the implementation of the single monetary policy, and would enhance the mechanisms of risk sharing through private markets. This could improve the objectives of income and consumption smoothing among countries and thereby mitigate economic fragmentation.

Income and consumption smoothing between countries, also known as risk-sharing, can increase welfare by making income growth less sensitive to output growth in a country. For countries in a monetary union, risk-sharing is particularly important because monetary policy is unable to address asymmetric shocks, whereby some countries are in a recession and others are booming. It is understood that the high degree of effective risk-sharing in the U.S. is essential in making it a successful monetary union.[3]

There are three main mechanisms whereby risk-sharing can take place between member states in an economic area. First, countries can share risk via cross-ownership of productive assets, a mechanism facilitated by developed capital markets. Second, a system of taxes and transfers can serve as a vehicle for further income smoothing. Third, member states can smooth consumption by adjusting their asset portfolios, for example, by lending and borrowing in international credit markets.

The U.S. have traditionally been characterised by a very high degree of income and consumption smoothing across states that has only been increasing over time. The available evidence suggests that about 75% of income shocks in individual states are smoothed, with 13% smoothed by the federal tax-transfer and grant system, 39% smoothed by insurance or cross-ownership of productive assets, and 23% smoothed by borrowing or lending. In other words, 62% of state-specific shocks in the U.S. are smoothed through market transactions, almost five times the contribution of the federal government to income smoothing.[4]

With comparatively less developed financial markets and more rigid labour markets, with low mobility of labour, and an absent federal system of taxes and transfers similar to that in the U.S., pre-euro Europe exhibited much lower levels of risk-sharing. The existing literature estimated that only between 40% and 43% of country-specific GDP shocks were smoothed among European countries before 1998, with roughly half of this smoothing achieved through national government budget deficits and half achieved by corporate saving patterns.[5] These low levels of risk-sharing contrasted with very high levels within individual European countries; for example, in pre-unification Germany, 91% of shocks to per capita state gross product were smoothed, with the bulk (54%) smoothed through the federal tax-transfer and grant system.[6]

Risk-sharing among euro area member states seems to have increased after the introduction of the euro. Available estimates suggest that in 2008–2009, 57% of shocks to state gross product per capita were smoothed.[7] However, in 2010 risk-sharing declined significantly in most EU countries and essentially collapsed in countries under fiscal stress.[8]

A significant contribution to private risk sharing would, in my view, require the development of a genuine CMU with a high level of financial integration. Full integration is reached if all market participants, with the same relevant characteristics firstly face a single set of rules when they decide to deal with financial instruments and/or services; secondly, have equal access to a set of financial instruments and/or services; and thirdly, are equally treated when

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3 Sala-i-Martin, X., and J. Sachs (1992), "Fiscal federalism and optimum currency areas: Evidence for Europe from the United States", in: M. Canzoneri, P. Masson, and V. Grilli, eds., *Establishing a Central Bank: Issues in Europe and Lessons from the U.S.,* Cambridge University Press: London.

4 Sorensen, B., and O. Yosha (1998), "International risk sharing and European monetary unification", *Journal of International Economics 45*, pp. 211–238; Afonso, A., and D. Furceri (2008), "EMU enlargement stabilization costs and insurance mechanisms", *Journal of International Money and Finance* 27, pp. 169–187.

5 Hepp, R., and J. von Hagen (2013), "Interstate risk sharing in Germany: 1970–1991", *Oxford Economic Papers* 65, pp. 1–24.

6 Kalemli-Ozcan, S., Sorensen, B., and O. Yosha (2005), "Asymmetric shocks and risk sharing in a monetary union: Updated evidence and policy implications for Europe", in: H. Huizinga and L. Jonung (eds.), *The Internationalization of Asset Ownership in Europe*, Cambridge University Press: New York.

7 Balli, F., and B. Sorensen (2007), "Risk sharing among OECD and EU countries: The role of capital gains, capital income, transfers, and savings", MPRA Working Paper 10223.

8 Furceri, D., and A. Zdzienicka (2013), "The euro area crisis: Need for a supranational risk sharing mechanisms?", IMF Working Paper 13/198.

they are active in the market. This level-playing field would contribute to stimulate cross-border risk-taking between EU Member States.

A final point to underline is that despite other positive effects stemming from greater financial diversification and market-based finance, more financial integration can also entail financial stability risks. It can exacerbate the size and speed of contagion. In addition, the “push” towards market-based financing may lead to the build-up of risks in this part of the economy, typically less regulated and lacking information.

This brings me back to the importance of an effective macro-prudential supervision and regulation, i.e. one that considers all systemically important financial entities and activities. In order to make CMU a success with stronger capital markets and deeper cross-border financial integration in bank- and market-based financing, we need to further strengthen the European macro-prudential framework.

Concluding remarks

Let me conclude. The economic recovery in the euro area is now broader and it is firming itself but still in need of achieving higher investment to make it more self- sustained. ECB policies are working and making a significant contribution to the normalisation of economic conditions in the short term. Let me add that they also help the medium-term as, by closing the negative output gap, they reduce the detrimental of effect of hysteresis on the labour supply and the capital stock. A prolonged recession contributes to reduce the qualification and employability of the unemployed, and the capital stock becomes less productive, as replacement investment subsides.

On the back of the fall in capital accumulation and labour utilisation, euro area potential output growth declined from a level close to 2% in the years preceding the crisis to less than 1% on average between 2008 and 2012. Unfortunately, since the start of the crisis, euro area total factor productivity growth has remained subdued, falling behind productivity growth in the U.S., where it rebounded after reaching a trough in 2009. To increase potential output growth against the background of a decreasing working age population, the euro area has to rely on more investment and capital deepening but, crucially, more so on total factor productivity growth which needs to resume growing at least at an annual growth pace around 1%, the rate prevailing at the beginning of the previous decade.

This will not be achieved without a continued effort to implement structural reforms for which monetary policy is not responsible. It is however our task, especially now that the ECB was given supervisory responsibilities, to ensure, besides price stability, proper conditions of financial stability in the euro area by continuing to work as we have been doing, to build up a resilient, robust and efficient financial system that is essential for the long-term prosperity of our monetary union.

Thank you for your attention.