Peter Praet: Steering the economy in a challenging environment

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the 16th Euro Finance Week, Frankfurt am Main, 19 November 2013.

*   *   *

I would like to thank Florian Heider and Jan Felix Hammermann for their contribution to preparing this speech

Introduction

Ladies and Gentlemen,

It is a pleasure to speak at the 16th Euro Finance Week here in Frankfurt.

The euro area economy is seeing the infancy of a frail recovery. The turn-around in economic conditions that we have observed earlier in the year will bring citizens some relief after an exceptionally long phase of negative growth. But it will be some time before economic conditions will normalise. We expect credit to enterprises to lag behind, as we have experienced in past recoveries. Probably, the retarded reaction of productive credit to a change in economic conditions will be even more delayed this time, as households and companies, as well as banks, are trying to reduce their debt. Investment, as a consequence, has not bounced back yet – and probably will not for a while – at the same speed that is customary to see in the early quarters of an economic upturn. Unemployment has settled at unacceptably high levels. Part of it will be reabsorbed as companies will start hiring on more favourable demand prospects. But a fraction will trail, as it will take time for the longer-term unemployed to adapt to the post-crisis dislocations in the labour market.

Today, I will share my views on the challenges the euro area faces in these conditions. I would like to talk about our objective as monetary policy maker, particularly our duty to keep inflation in check. And the role we play in supporting the economy. In doing so, I will give you my perspective over the latest decision taken by the ECB in early November: to reduce our main policy rate to 0.25%, to re-assert our forward guidance, and to extend in time our pledge of unlimited supply of liquidity to banks against appropriate collateral until July 2015.

But I will also be clear on the limits to monetary policy actions. The ultimate source of growth and employment is not monetary accommodation. It is a competitive environment, a highly skilled workforce and a sound financial system.

Diagnosis: what are the challenges?

The economic landscape I described a minute ago is exceptionally atypical. What are the challenges we face?

First, the economic recovery is dependent on factors and events that are partly exogenous to policy choices taken in the euro area, and are traditionally uncertain. Euro area economic activity should, in principle, benefit from a gradual strengthening of the external demand for exports. But despite the visibly growing sprouts of global recovery, there are cross-currents. Some emerging economies may need to curb domestic absorption, after a protracted interval of credit expansion and rising corporate leverage. And the transmission and side effects of an eventual withdrawal of accommodative monetary interventions in the US are still unknown.

Second, as I said, banks in the euro area are in a serious phase of deleveraging. Part of this process is cyclical: in recessions, the demand for credit falls and net credit redemption pulls down credit figures in the aggregate. But part of what we observe today is structural in nature. What caused the financial crisis was primarily a debt overhang – private or public – going into reverse. Banks participated in the excesses, and therefore today they have to work off the consequences of the excesses. So, selling assets and paying off debt is for them a precondition for a return to a healthy and sustainable business model. Banks need to downsize and cleanse their balance sheets. But this structural transition may at some point represent a constraint on the expansion capacity of borrowing units: firms in the first place. Demand for finance may at some point recover as corporate borrowers and households respond to new profit and income opportunities. But credit may simply fail to be forthcoming on terms that reflect a fair evaluation of the borrower risk. In fact, loans (adjusted for sales and securitisation) to the non-financial private sector in the euro area have been shrinking on an annual basis since September 2012. The shrinking mostly affects non-financial corporations (–2.9% in August and –2.7% in September, adjusted for sales and securitisation). At the same time, the growth of loans to households has been stagnating at subdued levels since the beginning of this year.

The third challenge is the uncertainty around the on-going process of institutional reforms. While necessary, reforms do not come without risks. Setbacks in the reform agenda are possible and could harm economic recovery, especially in those countries where growth and economic reform are most intimately connected. Any delay in the financial reform agenda towards a banking union, in particular, could be perceived as a signal of waning commitment and could severely undermine investor confidence.

Inflation and price stability

All of this has coloured the complexion of our recovery, making it very pale and sickly. And inflation – a thermometer of the underlying state of economic strength – has given us warning signs.

Inflation has been on a downward trend since early 2012. Over the last four months, the trend has accelerated noticeably. To be sure, neither the scale nor the composition of the recent disinflation has been very unusual: most of the recent fall in headline figures has been driven by an unwinding of past bouts of price increases in the most volatile components of the consumer basket. For example, fresh food in the very recent period saw the reversal of price tensions that were registered earlier in the year. Likewise, favourable base effects and moderate corrections in crude oil prices led to a sharp correction in the energy component.

Nevertheless, if one corrects for these erratic effects, the downward trend in the non-energy and no-food part of our inflation index – the HICP – was no doubt a rapid one. Also, the negative momentum introduced by energy prices comes at a point in time where the non-energy factors are also drifting down. None of the various components of the inflation index are below their historical lows, if taken in isolation. The fact that they are all at their minima *at the same time* is something that we have not observed in recent times.

Why is this a source of concern? And why is it policy relevant?

The Treaty that has established the ECB has given the new central bank a well-defined mandate: to maintain price stability. It did not say more than this. What is price stability?

In response to this question, at the very start of monetary union in October 1998, the Governing Council of the ECB defined price stability as a *positive* rate of inflation below 2%. If inflation rates are kept within this range over the medium term – so was the thinking behind this quantification – economic decisions will not be distorted by the pure drifting of the nominal scale. Inflation rates within this range are sufficiently low to not interfere with an efficient allocation of resources. They do not promote that sort of arbitrary redistributions of wealth and income that has proved so disruptive in inflationary contexts. By implication, the central bank – which is responsible for determining inflation over longer horizons – does its best in terms of contributing to the economic welfare of society if it succeeds in delivering inflation that on average gravitates within this interval.

Mind one thing. The definition provided in 1998 already ruled out negative inflation: *de*-flation. Why so? Because an economy with positive potential growth cannot grow at potential if it falls into a self-sustaining deflationary spiral. If prices are expected to fall, demand will be deferred to a future point in time when prices will be lower. But the fact is: that point in time will never come. And demand, income and production will keep falling with prices.

In May 2003, the Governing Council went beyond this numerical characterisation of price stability. The Governing Council provided more clarity on its policy orientation *within the range*. Indeed, while all positive inflation rates below 2% may be equally attractive from a pure – and narrowly static – welfare perspective, additional considerations regarding the dynamic stability of the macroeconomic system argued for selecting some specific values within the range. This is why in May 2003 it was decided that, over the medium term, the Governing Council would aim for inflation rates below, *but close to*, 2% in the medium term. In other words, within the price stability interval, a medium-term inflation rate not too far from 2% was considered a superior goal for monetary policy.

What are the further considerations that suggested clarifying a policy aim within the price stability interval? Two main considerations led to that decision.

The first was to make sure that the steady state inflation *in the euro area as a whole* would incorporate a sufficient buffer away from zero. If the steady state inflation is close to zero, the steady state nominal interest rate that the central bank has to set in order to keep inflation at that level on average is also not too far from zero. But then, if a sharp recession hits, a central bank rapidly runs out of space for an effective standard easing of monetary conditions. If the distance between the steady state nominal rate and zero is small, there is not much scope for cutting rates to defend price stability in the face of a negative shock. If the aim is to maintain inflation within the price stability range, and avoid *deflation*, the central bank may find itself out of standard monetary policy ammunition in the face of falling prices. Of course, the central bank can always activate more unorthodox instruments of intervention, even when it exhausts the space for further rate cuts. But these unorthodox instruments are generally untested, less effective than standard measures, and probably more intrusive of market pricing. If deflation is detrimental to welfare, as I tried to argue before, so is an inflation rate that is too close to zero, as it may increase the probability of falling into deflation.

The second motivation for the May 2003 communication was associated with *intra-euro area inflation differentials*. In a heterogeneous currency area, inflation differentials across member economies reflect their different cyclical conditions, economic structures, and policy frameworks. Some of these factors are equilibrium phenomena, others require a correction. A focal point for policy within the price stability range sufficiently away from zero allows the correction of cross-country relative prices to take place without forcing national inflation rates to excessively low or even negative levels. In current circumstances, many countries in the periphery with past competitiveness deficits have to strive for low inflation rates relative to the euro area average: there is no other way for them to redress their imbalances and restore their economies to growth. But the issue is the nominal anchor around which this correction in the relative prices of stressed countries should take place. If that anchor – the euro area average inflation – is too low, the country adjustment may run against major structural impediments which can delay the process and make it more painful – for themselves and for the whole of the euro area.

The 2003 definition gives us clear guideposts for assessing risks to price stability and act accordingly.

Here, I can only cite what Otmar Issing said at the May 2003 press conference – where the clarification of the ECB's strategy was announced and explained to the media. When questioned about the "below but close to 2%" notion, he said: "*[I]f we were to identify a risk of inflation approaching very low levels on a sustainable basis and threatening to fall below 1% in a persistent way, then we should of course be extremely concerned. With our clarification now, that we aim to keep inflation at close to 2%, I think it is clear enough that we are not* *blind in the eye which identifies deflationary problems. We have both eyes – as Paul Samuelson said in a slightly different context – watching deflationary as well as inflationary developments*."

I would not have more to add. Only three footnotes to explain our decision to reduce our main policy rates in early November.

First, although we had been surprised by a drop in inflation in October to 0.7%, that was *not* the reason we lowered the rate on the main refinancing operations on 7 November. The reason was that we were expecting inflation to remain weak – around levels testing the lower half of our price stability range – for an extended period of time. As we had repeated before, we saw inflation weakness extending into the medium term.

Second, as I said already, the decline in inflation was across a broad spectrum of components of the price index. It is a broad-based downward shift that was policy-relevant, and its association with weak demand. The fragile recovery is characterised by persistent spare capacity. Price pressure from the labour market is weak in the light of high levels of unemployment and low labour costs. In addition, monetary indicators point to persistent subdued dynamics in money and credit. The confluence of evidence pointed to demand factors behind the fall in inflation.

Third, we believe our decision has rebalanced the risks to price stability, which had become tilted to the downside. We think deflation was not in sight before, and has become even more unlikely after our decision. Our decision has increased the buffer against unwelcome price surprises.

It has increased the probability that we hit our objective in the medium term. It is only in conditions in which the economy is restored to steady growth, and demand develops solidly in line with the supply potential that interest rates can go back to levels that citizens would regard as fair remuneration for their savings. Prolonged stagnation in incomes and negative inflation can only bring destruction of income and saving. As Japan teaches, permanent stagnation brings decades of zero or even negative returns for savers.

Standard and non-standard action

As I anticipated already, at our last meeting in November we reduced the main refinancing rate to a record low of 0.25%. The reduction in our main policy rate to 0.25% can introduce additional accommodation through two channels.

First, under forward guidance, its diffusion across the whole spectrum of term rates in the money market has been empowered. Monetary policy decisions are effective only to the extent that they affect interest rates at longer maturities, starting from those longer-term rates that banks determine in their interbank transactions. It is the expectations of future money market overnight rates that play a key benchmark role in setting the basis for the pricing of the entire spectrum of credit contracts in the broader economy. Our forward guidance has extended the horizon over which investors operating in the short end of the money market expect monetary policy to remain very accommodative – in tune with the fragile conditions of the economic recovery. This explains why the reduction in the rate on our main refinancing operations has determined a material shift in the entire term structure of money market rates. We trust these lower rates will be transmitted by banks and financial operators to the rates on mortgages and lines of credit for retail borrowers.

Under guidance communication, we have been expressing our conditional expectation that the policy rates will remain at current or even lower levels in the future for an extended period of time. At our last meeting in early November we activated the easing bias that was implicit in our previous guidance communication, and we reconfirmed the guidance and its easing bias moving forward. We still have not reached the effective lower bound. And we still have not exhausted our standard policy lever in conditions in which the risks that I have enumerated before could pose further threats to our price stability objective, and may thus call for more action.

Second, within the fixed rate full allotment operational framework that we have prolonged in time, the rate on the main refinancing operations can act as a backstop for money market borrowing and lending activity over an extended horizon. This effectively can cap upward volatility in the money market rates. If banks expect to be able to draw central bank credit on demand over an extended horizon, the cost of interbank credit in the money market, even for longer tenors, will be unlikely to increase much beyond the rate at which the ECB is expected to lend under the main refinancing operations in the future. This, again, helps flatten the yield curve in the money market and keep the cost of credit in the broader economy constrained.

This latter feature of our current system of liquidity provision is important, particularly in conditions – like at present – in which excess liquidity in the money market is shrinking. Indeed, since the peak of the sovereign debt crisis in the summer of 2012, we have witnessed a significant reduction in the amount of excess liquidity. Excess liquidity is the amount of cash over and above the level that banks collectively need to fulfil reserve requirements, to meet the demand for currency by their customers and to cope with other exogenous factors that drain liquidity from circulation occasionally. Banks participate less in new refinancing operations and are also using the option to repay liquidity obtained in our two three-year LTROs in late 2011 and early 2012. In other words, banks seek less insurance against funding shocks from public sources (the ECB) and return to the private market place to fulfil their demand for finance.

This is all welcome. And we observe with relief the consequences that this process is having for the TARGET-2 balances, which have dropped by 30% since the summer of last year. With our decision to lower the rate on our main refinancing operation under forward guidance, and extend the application of the fixed-rate with full allotment policy, we will allow this process to continue without negative implications for market rates. This combination of policies will make money market conditions less dependent on excess liquidity and its uncertain evolution.

Institutional reform in the financial sector

The challenges of conducting and implementing monetary policy in the current environment are a fitting reminder of a more general challenge. Monetary policy can support a recovery by shielding it from risks. But monetary policy cannot substitute for structural reforms that tackle problems at their root. The normalisation of money market conditions goes hand in hand with unstable rates because there is more need to improve the health of the banking sector.

Much has already been achieved. Fresh capital has been raised, problematic legacy assets have been removed and, as a result, Core Tier 1 ratios of the largest euro area banks now stand at 11%, well above the new Basel III capital requirements. But more must be done and progress is on its way in the form of a European banking union. Before the first element of the banking union, the single supervisory mechanism, takes up its role, a comprehensive balance sheet assessment must be undertaken. This task has recently begun.

The asset quality review has three specific goals: first, to achieve transparency about the current quality of balance-sheets; second, to repair balance sheets where necessary; and third, as a as a result of the first two, to regain the confidence of all major stakeholders in banks. Only then will banks be the financiers of the real economy.

Conclusion

Let me conclude.

Five years after the collapse of Lehman Brothers and one and a half year after the peak of the sovereign debt crisis, the worst seems over. A recovery has started, but it is still in its infancy and fragile. The global environment remains uncertain. Structural reform and fiscal sustainability are underway, but must be pushed to completion. Financial sector regulation is being thoroughly revamped.

Steering the economy under these conditions presents formidable challenges. However, we have a clear mandate: to maintain price stability. Our recent decision to cut rates was warranted by our mandate. To ensure the effective transmission of monetary policy we provide forward guidance and provide ample liquidity. But we can only provide an environment conducive to long-term growth. Growth itself comes from a structurally sound economy. The banking union and the forthcoming asset quality review are part of structural reforms whose success is key for the economic future of Europe.