Peter Praet: Current issues of monetary policy

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the 8th Kiel Institute Summer School on Economic Policy "Reassessing Monetary Policy", Kiel, 3 July 2014.

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I would like to thank Jan Felix Hammermann and Arthur Saint-Guilhem for their contribution in the preparation of this speech.

Dear President Snower,

Dear Professor Lehment,

Ladies and Gentlemen,

It is a real pleasure to be here with you today.

This year marks the centenary of the Kiel Institute for the World Economy.

Over the past 100 years, the Kiel Institute has contributed thoughtfully to the debates on the most pressing economic policy issues in Germany, Europe and the global economy. It has become one of the leading independent think tanks in the world.

You chose a truly interesting – and challenging – topic for this year's summer school: reassessing monetary policy. Over the past six years monetary policy has been firmly in the spotlight – more than central bankers are normally used to. The financial crisis has had important consequences for central banks and monetary policy. In particular, financial stability considerations are far more present in central banks today.

Still "re-assessing" sounds in my view somewhat too strong. I would argue that the principles of sound monetary policy remain largely unchanged. What has changed, in particular, is the environment in which monetary policy is operating and the measures that are needed to combat risks to price stability. My predecessor, Otmar Issing, has dubbed this a "lost paradise".[1]

If you recall, in the years preceding the start of the crisis, at the time of the so-called "Great Moderation", there was a widespread impression that monetary policy had become an easy job. Central banks had managed to win the battle against inflation, and the victory was seen as permanent. Low and stable inflation, in addition, was seen as a sufficient condition to contain cyclical fluctuations in the real economy. While low inflation has proven a stable asset, the expectation that the macroeconomy could grow along a steep and uninterrupted path has been proven too optimistic. We have discovered that what we thought to be paradise was in fact – at least to some extent – an illusion.

Does this mean that central banks were left without resources when the crisis erupted? Certainly not! On the contrary, central banks' actions were decisive in addressing many challenges raised by the crisis.

The forceful response by central banks, especially in major advanced economies, involved unprecedented cuts in policy rates to levels close to zero and resorting to non-standard measures. Those non-standard measures included asset purchases and liquidity provision to the banking sectors to stabilise financial conditions. And in doing so, central banks averted even more serious declines in output in advanced economies', thus supporting their ultimate goal of maintaining price stability.

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1 See Issing, Otmar (2012), "Central Banks – Paradise Lost", *CFS Working paper*, No. 2012/06.

For its part, the ECB has acted forcefully and decisively in pursuing its price stability mandate. Like other central banks, we have deployed a host of standard and non-standard policy measures: We have reduced our key interest rates to unprecedented low levels and provided banks with unlimited liquidity for extended maturities against an expanded set of collateral. And at the nadir of the crisis, when we were confronted with rising concerns of a euro area break-up, we announced our Outright Monetary Transactions programme. These measures were instrumental in addressing risks to price stability and avoiding a scenario of more severe distress.

Last month, the Governing Council decided on an additional set of measures aimed to provide further monetary policy accommodation, ease credit conditions and inject complementary liquidity. We lowered our key interest rates further, to a level that can be considered to be the effective lower bound. This cut implies that one of our three main policy rates is now in negative territory, an unprecedented move for a large currency area. Moreover, we announced a series of targeted longer-term refinancing operations aimed at relaxing lending conditions and ensuring that these low interest rates reach the real economy (TLTROs).

The Governing Council complemented this measure on the liquidity side with the decision to continue the fixed rate tender procedures with full allotment for as long as necessary, and at least until December 2016. In addition, we decided to suspend the weekly fine-tuning operations sterilising the liquidity injected under the Securities Markets Programme, which was discontinued two years ago. These measures mutually reinforce each other. Together, they also underpin our forward guidance that key ECB interest rates will remain at present levels for an extended period of time.

To understand better the Governing Council's most recent decisions, one has to understand the particular challenges that we, as monetary policy makers, are currently facing in the euro area. These challenges will be the focus of my talk today. Concretely, I would like to focus on three main challenges.

The first challenge concerns the possible risks and implications associated with a prolonged period of low inflation. I will focus on the driving forces of current low inflation and discuss how monetary policy can best address risks to price stability in this environment.

The second challenge concerns the effectiveness of our standard monetary policy measures in steering inflation in line with our medium-term price stability objective. With monetary policy rates at their effective lower bound, the financing conditions for sovereigns, banks and large corporates have become rather favourable. However, our accommodative monetary policy stance appears not to feed through to lending rates for households and smaller firms. This impairment in the bank lending channel creates its own challenges for monetary policy.

The third challenge is of longer-term nature and goes beyond recent monetary policy decisions. As the on-going recovery remains moderate despite substantial policy support, some observers have recently pointed to the risk of long-term economic stagnation, not just for the euro area but also for some other advanced economies. The term "secular stagnation" has been applied to this phenomenon, meaning a persistent state of economic depression in which the natural interest rate – the real interest rate consistent with output at potential and/or stable inflation – has become negative. I will briefly elaborate on this risk as well as on the implications for monetary policy and other policies.

First challenge: Risks of a prolonged period of low inflation

Let me start with the first challenge namely the risks associated to a prolonged period of low inflation.

Over the past years, we have seen a pronounced decline in inflation rates. Inflation stood at 3.0% in late 2011, and has dropped since then to a mere half percent in May 2014.

It is fair to say that a decline of this magnitude was not anticipated, neither in the prices of financial assets nor in the forecasts of international economic institutions. To give you an example, Eurosystem staff inflation projections for 2014 were revised significantly downwards over the recent months. In December 2013, Eurosystem staff projected HICP inflation at 1.1% for 2014. In the most recent projection round of June 2014 – that is, about six months later – inflation was expected to be only 0.7% in 2014.

Indeed, inflation developments continue to disappoint: In the first quarter of 2014 we saw HICP inflation at only 0.7%. For June 2014, Eurostat reported a flash estimate of 0.5% which would imply an inflation rate of 0.6% for the second quarter of 2014.

Looking further ahead, there is little momentum in inflation dynamics. In fact, inflation is expected to remain at rather moderate levels. Pipeline pressures on headline inflation remain subdued and sluggish labour cost growth puts little pressure on inflation. The latest June 2014 macroeconomic projections of Eurosystem staff, therefore, see HICP inflation edging only slowly upwards to 1.1% in 2015 and 1.4% in 2016.

The Governing Council's focal point of aiming at inflation rates below, but close to, 2% in the medium term has to be seen in a symmetric way: Inflation rates above and below this focal point are a matter of concern for us. The subdued inflation outlook provides little safety margin against unexpected adverse shocks that may give rise to downside risks to price stability. Inflation rates are thus outside of what we consider as a "zone of comfort".

One may argue that disinflation is in itself not necessarily problematic. Indeed, low prices may boost the purchasing power of consumers, especially if this is driven by improvements in a country's terms of trade, like a decline in commodity prices. Moreover, in certain stressed countries, the on-going disinflation reflects in part the first successes of structural adjustments. This constitutes a prerequisite for regaining competitiveness. Competitive disinflation can be beneficial, as suggested by the experience of some European countries in the past.

At the same time, a prolonged period of low inflation creates risks. For one, it makes the on-going relative price adjustments more difficult. Perhaps more perniciously, if the period becomes too prolonged there is a heightened risk that inflation expectations become unanchored.

Assessing these risks requires a clear understanding of the drivers of inflation developments. Or put differently, one should be wary of concentrating too mechanically on inflation observations, without also assessing the underlying forces that explain those observations.

Looking at recent developments, the decline in inflation from 3.0% to 0.5% in about two and a half years has been to a large extent driven by the contribution of food and energy prices. In fact, the energy component alone accounted for around half of the decline in overall inflation.

How should monetary policy respond to such negative shocks in energy prices?

In general, the optimal monetary policy response to risks to price stability depends on the specific nature of the shock.

For a wide variety of shocks – such as demand shocks – a prompt reaction will not only preserve price stability but will also stabilise the economy. For instance, a negative global demand shock pushes down both inflation and growth. Here, a decisive monetary policy stimulus helps to stabilise output and inflation at the same time – there is no trade-off between the two.

But for other types of shocks, such as supply shocks, a trade-off may occur between stabilising inflation and stabilising growth, requiring a different monetary policy response. For instance, a positive oil supply shock exerts downward pressures on prices but goes along with an expansion of real activity. Lower energy prices boost real disposable incomes. The downward drift of inflation away from the focal point of just below 2% would warrant additional accommodation. But at the same time, a monetary policy stimulus would bring output further away from its sustainable level.

Hence, in the case of supply shocks, like a decline in energy prices, a gradual response is appropriate both to avoid unnecessarily high volatility in real activity and to maintain price stability over a longer horizon. Here, monetary policy should be more inclined to look through temporary deviations from the price stability definition and wait until the impact of the fall in energy prices on overall inflation subsides.

However, this distinction of monetary policy responses according to the nature of shocks may become blurred the more permanent supply shocks become. In this case, they can morph into demand shocks via second-round effects.

For example, a series of negative energy price shocks may not only push down inflation over a prolonged period, but may feed into people's expectations of future inflation. In this case, households and firms would adjust their price and wage setting behaviour. And, against the background of subdued inflation expectations, households may postpone their expenditure plans. Aggregate demand falls as a result. The reason is that, as a result of the lower expected inflation, the real interest rate increases, thus giving rise to downward inflation pressures that are typically associated with tight monetary policy conditions. In other words, when a sustained string of positive supply side shocks is allowed to pass through into inflation expectations, the shocks mutate into demand shocks.

In these circumstances, the policy recommendation differs from the case of a standard supply shock: as in the case of negative demand shocks, monetary policy should provide additional accommodation to ensure that inflation expectations remain anchored.

Therefore, it is crucial to assess whether such second-round effects are likely to occur. In the current euro area context of low inflation, a persistent undershooting of our inflation objective could in fact introduce greater "backward-lookingness" into the formation of inflation expectations – that is dependence on past inflation. In other words, inflation expectations could become more unanchored if agents start attaching more weight to past inflation in their assessment of future inflation.

To illustrate that point, let me refer to the Phillips curve relationship that links current inflation to its past outcomes, the central bank's inflation objective and a measure of economic slack. In that framework a de-anchoring of inflation expectations would lead to a downward shift of the Phillips curve. The downward shift means that the Phillips curve would predict lower inflation for an unchanged level of slack. Lower inflation expectations can thereby exert a pronounced "gravitational pull" that keeps inflation low despite a moderate recovery under way and a gradual reabsorption of unutilised capacity.

How acute is the risk of supply shocks morphing into demand shocks?

What is our assessment of the risk of inflation expectations becoming unanchored in the euro area? Let me emphasise three elements.

First, long-term inflation expectations based on surveys remain in line with our focal point for price stability, but market expectations for inflation have fallen. Market participants seem to factor in a longer period of low inflation. Since summer 2012, following movements in HICP inflation, market-based measures of inflation expectations have been on a declining trend. In particular, declines have been observed in shorter-term inflation expectations. At this juncture, market-based inflation expectations suggest a rather slow increase in inflation over the next years.

Second, the decline in inflation is broad-based across sectors. HICP inflation has oscillated between 1.0% and 0.5% since last October. But the same holds when excluding the volatile components like energy, food, alcohol and tobacco. Such a measure of core inflation has also been bound between 1.0% and 0.7% since last October.

Low inflation is also broad-based across countries. Looking at the three euro area countries with the highest HICP inflation record in May, we see inflation rates of just 1.4% in Luxemburg and 1.0% in Finland and Slovenia. Hence, low inflation is not only a challenge that concerns few individual euro area economies; it concerns the euro area as a whole.

Third, these downward movements of current and expected inflation occur in an environment characterised by already weak demand. The recovery is too moderate to push inflation decisively back to our focal point for price stability on its own. According to the latest ECB staff projections, real GDP is expected to increase by 1.0% in 2014, 1.7% in 2015 and 1.8% in 2016. Hence, the adverse shock to inflation will not correct itself easily. A continued accommodative monetary policy stance is therefore necessary to maintain price stability.

It is against this background that the Governing Council decided last month on the package of mutually reinforcing measures to further strengthen the degree of monetary policy accommodation. We lowered the interest rate on the main refinancing operations to 0.15% and the rate on the marginal lending facility to 0.40%. The rate on the deposit facility was lowered to –0.10%. Furthermore, we continued our forward guidance and clarified that that key ECB interest rates will remain at present levels for an extended period of time.

As part of the set of measures, it is our objective for this rate cut to stimulate activity through improved borrowing conditions. It should also provide incentives to banks to lend to other banks, rather than deposit excess liquidity with the Eurosystem. The fact that with the negative deposit facility rate banks now have to pay money for such deposits may be particular relevant in that respect. The lower deposit facility rate also prevents a compression of the interest rate corridor. Such a compression could negatively affect money market activity as banks lack incentives to actively manage their liquidity position. Thus the reduction in the deposit facility rate should also contribute to reducing the persisting fragmentation in cross-border lending in euro area money markets. Overall, the lower rates will contribute to an appropriate monetary policy stance and thereby aim to ensure our objective of maintaining price stability.

Second challenge: Still hampered monetary policy transmission

Let me move to the second challenge: As long as we are below our focal point for inflation over the medium term, we want to ensure that our measures are effective in pushing inflation back to our medium-term price stability objective and that they are transmitted smoothly and quickly through the economy. This is especially important when approaching the lower bound on interest rates.

How does this apply to current circumstances? Under normal circumstances, a reduction in our key policy rates is translated relatively smoothly to financing conditions across different euro area countries. Certainly, we have seen improvements in overall market financing conditions. These improvements are apparent, for example, in the sharp compression of credit spreads across various markets for fixed-income credit. Yet bank lending conditions for the real economy remain tight. In a bank-based financial system like the euro area, this creates a significant drag on the effectiveness with which we can steer inflation outcomes via standard monetary policy measures.

Let me explain first how I see the bank lending situation, and second how I interpret it.

First, lending *volumes* are still subpar. Loan growth to euro area non-financial corporations has been in negative territory since mid-2012. While the rate of contraction has stabilised somewhat since mid-2013, ECB internal analyses based on several alternative models show that the growth rate of loans in the first quarter of 2014 remains below a level consistent with credit demand determinants. This assessment is shared across the four larger euro area economies. In Spain in particular we observe a large discrepancy between the actual and the counterfactual scenario for loans extended to the manufacturing sector.

Second, lending *rates* have not declined in line with improvements in financial markets. Lending conditions for SMEs remain particularly challenging in Spain and Italy. Customers in these countries face sustained high bank lending rates for small loans, standing on average between one and two percentage points above comparable rates in Germany.

While these lending rates reflect credit risk, which has increased in these economies, this is not entirely a passive variable. Indeed, lending rates can themselves become a propagator and amplifier of economic distress. On a macroeconomic level, borrower's credit risk is endogenous. It depends on macroeconomic outcomes and, crucially, on the prevailing lending rate itself. High lending rates contribute to higher loan delinquencies; and in equilibrium, higher delinquencies justify high lending rates ex post. The result may be a mutually reinforcing spiral of high lending rates, high credit risk and poor macroeconomic outcomes.

We see some signs of this: borrowers with similar risk profile are being charged higher lending rates if located in a stressed country, pointing to the continued impairment of the bank lending channel in these countries.

To sum up, bank credit flows to firms – particularly small ones – are disappointing. There is always a lag between corporate bank financing and the economic cycle, but data increasingly reinforce the hypothesis that this lag is greater in this recovery than in past episodes. Bank lending rates have also not declined sufficiently smoothly and uniformly. In fact, financing costs have barely improved in some countries, despite significant reductions in policy rates.

Against this background, it is clear that the impaired bank lending channel is impeding the monetary policy impulse from policy rate reductions from being transmitted efficiently to the wider economy. It thus constitutes a drag on the recovery of output and prices.

In general, when monetary policy transmission is impaired, there may be a case for the central bank to directly address it. This is particularly so if the impairment is related to liquidity problems of banks, something that central banks are well equipped to address. This is why the ECB adopted many non-standard measures aimed at strengthening monetary policy transmission at a time when interest rates were still far away from the effective lower bound.

When approaching the effective lower bound on interest rate, however, one could argue that the focus on repairing the transmission channel becomes even more justified. This is because muted policy transmission can no longer be compensated through a stronger signal – that is, more forceful cuts in policy rates.

How did monetary policy respond?

In this context, the Governing Council decided last month to adopt several credit easing measures – by which I mean, measures aimed at ensuring that the accommodative policy stance is translated into a corresponding easing in credit conditions. In particular, these measures include a series of targeted longer-term refinancing operations (TLTROs) aimed at easing credit conditions.

The TLTROs are expected to ease overly tight lending conditions, lower lending rates and stimulate credit volumes through several channels. The first and most important channel is through a reduction in term funding costs for banks. Funding relief, however, does not per se guarantee better credit conditions for banks' customers, unless the supply of loans shifts in parallel and lending mark-ups are kept constant or even pushed down. This is why the targeted nature of the TLTRO is important: by making funding relief conditional on generation of new lending volumes, the TLTRO will encourage a shift outward in the credit supply curve.

By simply moving along the demand schedule, this outward shift will reduce the price for lending while increasing new loans. If banks do not manage to exceed a certain benchmark in terms of net lending, they will not benefit from the TLTRO. This shows that the TLTROs are indeed targeted, rather than a broad-based unconditional provision of liquidity as in the case of the earlier 3-year LTROs.

Second, the TLTROs are expected to increase excess liquidity, which reduces interest rates in the short-term money market. Remember that banks take into account the risk-free yield curve when pricing their loans. This curve depends in turn on the expected evolution of the short-term, i.e. money market, interest rate curve. By keeping the money market base rate stable at compressed levels, the TLTROs will reinforce the lowering of the ECB's key interest rates.

Third, by partially substituting for term funding in the market for bank bonds, the TLTROs can create a scarcity of investible assets, which will result in lower yields and easier market funding conditions even for banks that have not taken part in the operations. It may also create spillover effects to other segments of the corporate credit market, thereby lowering yields on various securities beyond the initial impact. The latter mechanism is not dissimilar to the "portfolio balance channel".[2]

Through these combined effects, we believe that a widespread use of this facility has the potential to halt the vicious circle of constrained lending, weak macroeconomic conditions and elevated loan delinquencies, and re-ignite a positive "credit multiplier" process.

Our credit easing package will provide an effective and well-targeted response to impaired bank lending, which we see as a significant factor holding back the economic recovery. Those euro area banks that have already strengthened their balance sheets will be able to make full use of its benefits. The TLTROs will also be attractive for banks making efforts to turn around their past lending trends.

Faced with a still fragile recovery and weak credit dynamics, our credit easing package, combined with the rate cuts and the ancillary liquidity measures adopted at last month's meeting, constitutes an effective response tailored to the specific challenges that may jeopardise the recovery. It will contribute to safeguarding medium-term price stability in the euro area.

Does such ample provision of liquidity pose risks to financial stability?

That being said, monetary policy needs to be aware of the potential implications that a protracted period of monetary accommodation may have for financial stability. There are two major risks: first, postponement in bank balance sheet repair; and second, bubbles in asset prices.

The first risk is that cheap funding allows banks to back-load the deleveraging of their balance sheets. After a financial crisis, banks have to undergo a thorough clean-up. Otherwise, they may continue to roll over legacy loans, thus restricting the resources available for new lending in support of the real economy – so-called "ever-greening".[3] This risk is being countered through the ECB's on-going comprehensive assessment of banks' balance sheets – consisting of the asset quality review and a stress test – which will be

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2 The existence of a "portfolio balance channel" has been extensively discussed recently in the context of the Fed's large scale asset purchases. There is a vast literature assessing empirically the portfolio balance channel in that context. See, for example, Gagnon, Joseph, Matthew Raskin, Julie Remache and Brian Sack (2011), "The Financial Market Effects of the Federal Reserve's Large-Scale Asset Purchases", *International Journal of Central Banking* 7 (1), pp. 3–43.

3 See Caballero, Ricardo J., Takeo Hoshi and Anil K. Kashyap (2008), "Zombie Lending and Depressed Restructuring in Japan", *American Economic Review* 98 (5), pp. 1943–1977.

completed roughly in parallel with the launch of the first TLTRO. Thus, banks will not be able to benefit from funding relief without also repairing their balance sheets where necessary.

The design of the measures should also limit to some extent the second risk to financial stability, the build-up of bubbles. The TLTROs exclude explicitly loans to households for house purchases. Furthermore, credit developments are always closely monitored when the assessment from the economic analysis is cross-checked with the signals coming from the monetary analysis, the two pillars of the ECB's monetary policy strategy. Thus, concerns that the measure could stoke a housing bubble seem unwarranted. Nonetheless, it is important to keep in mind the distinction between what monetary policy can and should do, and what is the domain of macro-prudential policy. Monetary policy has the clear primary objective to maintain price stability in the euro area over the medium-term. Macro-prudential measures should be used, if needed, to smooth the financial cycle in specific sectors or jurisdictions.

Third challenge: Risk of protracted low growth

Let me turn to the third and final challenge: the risk of protracted low growth. We are now more than five years after Lehman, and we see financial conditions normalising in advanced economies. Yet, in many countries, there are no signs of a strong recovery in growth or a fast catching-up processes, such as one would expect in normal upswings – and despite monetary policy remaining accommodative.

To explain this apparent contradiction, some observers have pointed to the risk of secular stagnation, arguing in particular that advanced economies such as the US have been trapped in a persistent state of economic depression in which the natural interest rate – the real interest rate consistent with output at potential and/or stable inflation – has become negative.[4] A negative natural rate could reflect reduced demand for debt-financed investment, declining rates of population growth, changes in the distribution of income leading to a higher propensity to save, or a trend towards an accumulation of larger foreign exchange reserves by central banks in many regions.

In this configuration, it is argued that the lower bound on nominal interest rates and low inflation constrain monetary policy from generating sufficiently negative real interest rates to stimulate demand and match saving and investment. In other words, the economy enters a liquidity trap in which monetary policy becomes ineffective in the presence of a lower bound on nominal returns.

Against this background, some observers have advocated that central banks increase their inflation objective to guard against the risk of hitting the zero lower bound in the future.[5] Let me say upfront that this proposal seems to me ill-advised. Price stability has been a difficult terrain to conquer and it took us considerable time and efforts to do so. The costs of higher inflation certainly outweigh the hypothetical benefits of raising inflation targets. And one important lesson of the crisis is that central banks have a large set of instruments at their disposal to deliver their objective, even when approaching the zero lower bound.

Having said that, how does the secular stagnation hypothesis apply to the euro area perspective?

It is true that the on-going rebalancing process in the euro area – and the associated shifts in the relative supply of private savings and demand for loans – will tend to affect the natural interest rate. In particular, downward pressures can be expected from increased saving and

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4 See Summers, Lawrence H. (2014), "U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound", *Business Economics* Vol. 49, No. 2, pp. 65–73.

5 See Blanchard, Olivier, Giovanni Dell'Aricia and Paolo Mauro (2010), "Rethinking Macroeconomic Policy", IMF Staff Position Note SPN/10/03. See also Paul Krugman (2014), "Inflation Targets Reconsidered", draft paper for ECB Sintra conference, May 2014.

supply of funds as public and private balance sheets are strengthened. In terms of demand for funds, investment has fallen during the crisis as a result of increased risk aversion and a decline in the measured rate of return, which also exerts downward pressures on real interest rates.

That said, I would not take this process as a firm signal of future economic stagnation. Recoveries after financial crises following a long period of excessive leverage and debt build-up are typically slower than after normal business cycles.[6] The process of balance sheet repair tends to weigh on demand expansion for debt-constrained households and sectors in the post-crisis phase. At the same time, other less indebted sectors experience a more pronounced rebound. All in all, these developments result in a subdued growth pattern until the unwinding of the debt overhang in some sectors has been fully achieved.

Expectations of long-term growth in the euro area, which drive the prospective return on investment and, in turn, investment decisions, remain positive. For example, the latest Consensus Forecast survey point to longer-term estimates of GDP growth for the period 6 to10 years ahead of about 1.5%.

Finally, let me stress that the natural rate of interest is not observable and its estimation is subject to uncertainty. This calls for caution when interpreting the data. The simplest and most direct way to measure the natural interest rate is market expectations for the future level of the real risk-free interest rate. However, market-based measures suffer from significant shortcomings. In particular, they are exposed to bouts of optimism or pessimism disconnected from fundamentals and they tend to be distorted by time-varying premia. At present, reflecting the strongly accommodative stance of monetary policy, various measures of longer-term term premia have turned negative.

Thus, we see various factors affecting the level of long term real interest rates, some temporary and some more persistent. But the case supporting the hypothesis of economic stagnation is in my view not settled.

Let me be clear on one important point: in case further risks to price stability were to emerge the Governing Council stands ready to use all tools available to deliver its mandate. If required, we will act swiftly with further monetary policy easing to address possible risks to price stability. The Governing Council is unanimous in its commitment to using also unconventional instruments within its mandate should it become necessary to further address risks to price stability.

Yet, while monetary policy can provide support, especially through non-standard measures, to overcome the risk of secular stagnation, the underlying causes of low growth are structural and need to be addressed by other policy areas. This is visible in the relatively weak estimates of potential output growth for the euro area.

The on-going structural, fiscal and financial sector policy reform should lead to a rebalancing of saving and investment over the medium-term accompanied by a stronger demand for investment and therefore a higher natural rate of interest. But there is clearly considerable scope to raise potential growth in the euro area even further given the relative inflexibility of product and labour markets and the incompletion of the single market. A concerted process of structural reform, continuing the progress made in recent years, would tend to raise investment demand by increasing expectations of future productivity and thereby making larger set of investment projects profitable. Creating new opportunities through a reduction in entry barriers into specific areas, such as highly regulated service sectors, or by increasing the scope for cross-border projects would support also investment incentives.

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6 See Rajan, Raghuram (2013), "A step in the dark: unconventional monetary policy after the crisis", Andrew Crockett Memorial lecture.

Conclusions

Let me conclude. The good news is that the euro area is on a gradual but nevertheless fragile recovery path. But we face important challenges. First, inflation has declined to very low level and is expected to come back to levels close to 2% only very gradually. Here, we have to ensure that these developments do not become entrenched in inflation expectations, which can pose a threat to our primary objective to maintain price stability. Second, while financial market conditions are improving, our accommodative monetary policy does not reach the real economy evenly. Credit conditions for SMEs in particular are still tight and access to credit is limited. Third, and more generally, we need to be mindful of possible risks of falling into a regime of long-term economic stagnation, if not countered by appropriate policies. Although the role of monetary policy is clearly limited in this context, a scenario of secular stagnation entails important potential challenges for monetary policy.

In June, the Governing Council decided a package of measures to provide additional monetary stimulus and support lending to the real economy. The upcoming TLTRO is an important element in our strategy to deliver on our price stability mandate. It is meant to provide an attractive means of refinancing for banks to ease credit conditions and spur new lending. In this way, banks can play their part in providing sufficient financing to the real economy and help return the euro area economy to sustainable long-term growth and employment.