Peter Praet: Recent monetary policy measures supporting the euro area recovery

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the IIF Annual Membership Meeting, Washington DC, 10 October 2014.

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Ladies and Gentlemen,

It's a great pleasure to speak to you at this year's IIF Annual Membership Meeting. Today, I will discuss the latest monetary policy measures by the ECB and explain how they will contribute to supporting the euro area recovery. I would also like to expound how our measures, as they work their way through to the economy, will contribute to bringing inflation in the euro area back to levels closer to 2%, which is where we want to see it over the medium term.

The last twelve months were eventful: we have cut our key policy rates all the way down to the lower bound – including by taking the deposit facility rate into negative territory; we have launched an important programme of targeted lending operations, the TLTROs; and we have announced two distinct purchase programmes, one of which targets asset-backed securities whilst the other targets covered bonds.

In my remarks today, I want to focus in particular on these asset purchase programmes and explain a novel element to our communication that came with their announcement – that is, our emphasis on the impact of these measures on the ECB's balance sheet.

But first I will briefly review the economic situation in the euro area to provide you with some context for our decisions.

Macroeconomic context

Following a flat reading for real GDP in the second quarter, the euro area economy is likely to resume its recovery path in the third quarter, but only at a modest pace. In fact, the latest data point to a loss in the cyclical growth momentum, with the outlook surrounded by elevated uncertainty and downside risks. Geopolitical tensions remain severe and the growth drivers appear rather anaemic, with macroeconomic adjustments, high unemployment and sluggish investment behaviour acting as a drag on economic dynamism.

Inflation developments continue to surprise on the downside and recent weakness in wage growth casts doubt on the expected strengthening of domestic price pressures. Inflation in the euro area has declined from a high of more than 3% at the end of 2011 to a low of 0.3% in September. And the volatility we have seen recently in medium- to longer-term inflation expectations is a cause for extra vigilance.

In short, the latest data on the euro area economy point to a continued but increasingly fragile recovery and the uncertainties and downside risks surrounding the recovery have intensified. All the while, we are facing continuously sluggish money and credit dynamics – even if growth rates of some key aggregates have edged up in recent months.

Consistent with this subdued picture, the latest ECB staff projections foresee growth and inflation to pick up only gradually. And, by the end of the projection horizon, annual HICP inflation is still expected to fall short of our target of a rate of inflation of below, but close to, 2% over the medium-term.

It was against this backdrop of a persistently weak inflation outlook, a slowing growth momentum, and subdued monetary and credit dynamics that we decided on a package of measures between June and October to provide further monetary policy accommodation and support lending to the real economy.

Impact of June-October policy decisions

The policy announcements since June, together with the rate cuts, have already led to a further considerable easing of the effective monetary policy stance – although the liquidity injections via the TLTROs and purchase programmes will only gain pace in the coming months. This additional easing is evident from various metrics of the market-based cost of financing.

Since the beginning of June, forward money market rates have shown steep declines across the maturity spectrum. Now, the forward curve consistently lies below zero over a two-year horizon. EONIA is not expected to exceed 25bps before well into 2018. The 3-month EURIBOR rate, which is an important conduit of monetary policy impulses to lending rates, dropped to all-time lows and now stands close to zero. And the policy decisions, in particular those announced in September, triggered a compression of spreads across other asset classes, including ABS, covered bonds and sovereign bonds.

The recent sharp compression of ABS spreads since June is particularly important. To the extent this compression of secondary market spreads is passed-through, this would support loan origination and promote credit flows at lower lending rates.

As indicated, this market response has materialised although the lion's share of the liquidity injection of the measures is yet to come. In September, we conducted only the first out of eight TLTROs. Notably in December, counterparties will have another opportunity to participate in the TLTROs drawing on their initial allowance of 7% of their outstanding stock of loans to the non-financial private sector, excluding loans to households for house purchase. As of next year, there will be additional quarterly allotments, in which counterparties will be able to receive additional funding determined by their recent lending performance.

Moreover, starting in the fourth quarter this year, the liquidity injections through the TLTROs will be accompanied and reinforced by the ABS and covered bond purchases. The covered bond purchases will already start this month.

Taken together, we expect that the combination of our measures – the TLTRO as well as the ABS and covered bond purchase programme – to have a sizeable impact on our balance sheet, as stressed in the Governing Council's communication since September.

This communication on the Eurosystem balance sheet has attracted attention among ECB observers and I would like to take a few minutes to explain its underlying rationale.

Two dimensions of uncertainty

Let me start by recalling the broader monetary policy environment. The distinctive feature of the current situation is that monetary policy interest rates have reached their lower bound. Hence, the ECB – like other major central banks before us – must rely on unconventional monetary policy initiatives to provide additional accommodation. Inherent in these unconventional measures is that they work through channels that are still under-studied compared to the well-known channels of conventional monetary policy measures. This, in turn, gives rise to various dimensions of uncertainty.

One dimension of uncertainty relates to the final macroeconomic impact per unit of liquidity injected via the measures. Of course, it is always and everywhere difficult to estimate that impact – even for standard policy measures. But the connection between the market price that the central bank can influence through its interventions and the price of credit that matters for the macro-economy is generally thought to be more remote and tenuous than under conventional policy. We manage this uncertainty by tailoring our measures to those specific financial market segments that we assess to be at the source of impaired monetary policy transmission. But still, some uncertainty remains.

The second dimension of uncertainty relates to the overall scale of liquidity injected via the latest policy initiatives. This source of uncertainty is in some way more pronounced for the Eurosystem than for other central banks whose policy measures operate primarily through outright interventions in deep and liquid markets.

Let me explain.

One key building block of our recent policy initiative, namely the TLTROs, takes the form of credit operations. This choice follows the long-standing monetary policy tradition in the euro area, which in view of our financial structure is centred on lending to counterparties. But, inevitably, this makes the overall scale of the measures to a large extent dependent on banks' autonomous decision to participate and borrow, which is itself influenced by banks' appraisal of the strength of the recovery and the prospects for a sustained rebound in credit demand. In conditions in which these expectations may be re-appraised, the force of the overall monetary policy stimulus that can be expected to be introduced through the TLTRO is bound to become more uncertain.

The purchase programmes do not run into this problem. But the capital market segments they target are not as deep and liquid as their equivalents in other leading economies. This is particularly the case for the ABS market, which has yet to recover from a protracted period of minimal issuance activity and disappearing trading traffic. ECB intervention will, in itself, partly mitigate this problem by encouraging issuance activity as well as the unfreezing of ABS and covered bonds that are currently retained on intermediaries' balance sheets. However, these dynamic effects are difficult to estimate precisely.

Taken together, these factors mean that not only the efficiency of the measures per euro of liquidity injection, but also the overall scale of the measures is difficult to anticipate.

Balance sheet communication

These considerations interact with our recent communication as follows: the clarification that the measures will have a sizeable impact on our balance sheet is a way to manage the second dimension of uncertainty, the scale. It underpins our commitment to ensure a powerful transmission of the measures adopted in June and September. And it gives reassurance that the liquidity injections will be scaled appropriately to ensure the intended macroeconomic impact, namely to bring inflation rates closer to 2%, materialises.

This reassurance provides market participants with a broad orientation on our future policy conduct that will help them navigate the uncertainties inherent in the current policy environment. This is all the more important since the TLTROs and the two purchase programmes are likely to gain pace only gradually.

All in all, it should thus be clear that the balance sheet communication does not establish an additional target for monetary policy. Instead, in assessing the ECB's monetary policy measures, the primary metric of success remains their impact on inflation rather than on the balance sheet.

So how will these measures contribute to stimulating higher inflation?

The purchases of simple and transparent ABS will strengthen the direct pass-through effect of the TLTROs, i.e. the extent to which the funding cost relief for banks will be passed along to their borrowers. This is because the ABS market remains severely impaired. As a consequence, the potential for interventions to change dynamics in this particular market is high. And the link between the spreads at which ABS are traded and the lending rates which banks apply on the underlying credits is probably tight.

CBPP3 will further complement the TLTROs and the ABS purchases. Covered bonds share important features with ABS. The link on the issuing bank's balance sheet between the covered bond on the one side, and the underlying loans on the other is also reasonably tight. As the prices for covered bonds are bid up, banks are likely to respond to the market incentives by originating more saleable covered securities, and thus more loans to collateralise them.

Furthermore, outright interventions in this market will complement ABS purchases by reinforcing the portfolio rebalancing channels of transmission. That is: the expansion in liquidity that will result from the combined outright operations promotes a diversification of investment patterns in the investor community, and thereby an easing of financing conditions more broadly.

Conclusion

Let me conclude.

Together with the monetary accommodation already in place, the determined implementation of our new measures will underpin the firm anchoring of medium- to longer-term inflation expectations.

We expect that the policy measures adopted in June and September will provide relevant support to the euro area recovery and bring inflation in the medium -term back to levels consistent with where we want to see it within our price stability range.

Should it become necessary to further address risks of too prolonged a period of low inflation, the Governing Council is unanimous in its commitment to using additional unconventional instruments within its mandate. As the ECB President said at the European Parliament, and again yesterday in Washington, this means that we are ready to alter the size and/or the composition of our unconventional interventions, and therefore of our balance sheet, as required.

Thank you for your attention.