Mario Draghi: Monetary policy – past, present and future

Speech by Mr Mario Draghi, President of the European Central Bank, at the Frankfurt European Banking Congress, Frankfurt am Main, 20 November 2015.

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Summary

The ECB's monetary policy measures have clearly worked, in fact they are probably the dominant force spurring the recovery. They have been instrumental in arresting and reversing the deflationary pressures that hit the euro a year ago. Yet growth momentum remains weak and inflation remains well below our objective of below but close to 2%.

Composite lending rates for non-financial companies declined more than 70 basis points for the euro area as a whole between June 2014 and today, and by between 110 and 120 basis points in stressed economies. That is a formidable pass-through. Small businesses also report improvements in access to external sources of finance.

To highlight three risks: global growth this year will be the weakest since 2009; this is the weakest euro area rebound since 1998; and the recovery remains very protracted in historical perspective.

We cannot say with confidence that the process of economic repair in the euro area is complete. At the December Governing Council meeting we will thoroughly assess the strength and persistence of the factors that are slowing the return of inflation towards 2%. If we conclude that the balance of risks to our medium-term price stability objective is skewed to the downside, we will act by using all the instruments available within our mandate. We consider the asset purchase programme to be a powerful and flexible instrument, as it can be adjusted in terms of size, composition or duration to achieve a more expansionary stance. The level of the deposit facility rate can also empower the transmission of APP, not least by increasing the velocity of circulation of bank reserves. If we decide that the current trajectory of our policy is not sufficient to achieve our objective, we will do what we must to raise inflation as quickly as possible. That is what our price stability mandate requires of us.

Dear Lord Mayor Feldmann,

Your Excellencies,

Dear Governors,

Dear Mr Fitschen and Mr Blessing,

Ladies and Gentlemen,

A year ago in this venue I said that it was essential to bring back inflation to target without delay, and that monetary policy would do its part to achieve that. In the following months we took the decision to reinforce our credit easing measures and to expand our asset purchase programme.

That decision reflected the very difficult situation the euro area found itself in late last year. After a promising start in the spring of 2014, the economic recovery had faltered in the summer and, as the year drew to a close, we feared a renewed lapse into recession. This would have come at a time when inflation was falling and inflation expectations were already clearly destabilised. Our price stability objective was under threat.

Today, the economic recovery is on a firmer footing. Domestic demand is gradually strengthening and replacing exports as the engine of growth. Consumption continues to be the main driver of real activity. And while global trade slowed remarkably in the first half of 2015, euro area export growth has held up relatively well.

Our measures have therefore clearly worked – in fact, they are probably the dominant force spurring the recovery that we see today. They have been instrumental in arresting and reversing the deflationary pressures that hit the euro area a year ago.

Nevertheless, that positive picture of the economy has to be seen in a wider context where risks still remain. Though the recovery has proven resilient to shocks, growth momentum remains weak for an economy coming out of a deep recession, and the headwinds blowing from the global economy have increased. The recovery in the path of real growth has also not yet been mirrored in the path of inflation, which still remains well below our objective of below but close to 2%.

So what I would like to discuss in my remarks today is how and why our monetary policy measures have been effective and, in view of the prevailing risks, whether they are still providing sufficient monetary accommodation to secure our price stability mandate.

Effectiveness of asset purchases

There are many reasons why asset purchases should have a strong impact on activity and inflation. Purchases compress yields and reduce the cost of financing in the economy through direct pass-through and portfolio rebalancing effects. For banks they make lending to the real economy more attractive than purchasing government bonds. Higher financial and real estate asset prices can also increase demand via wealth effects and lower the cost of equity for firms.

When we launched the APP, however, it was in an environment where the strength of these conventional transmission channels was questionable – at least in the eyes of some observers.

One concern was that the impact of interventions might be meagre given that yields were already very low at the start of the purchase programme. As such, savers selling securities to the ECB might not feel substantially richer and spend more, while borrowers might not perceive a material easing in their financing costs and borrow more. Indeed, at the launch of the APP nominal borrowing conditions for virtually all sovereign issuers were the most favourable in post-war history.

But the low yields we saw in January were not a limiting factor on our programme; they were proof that it was already working. Following our communication on our reaction function in the first half of last year[1], interest rates had in fact been falling consistently over the months preceding the launch of APP, as markets began to price in our likely response to a prolonged period of too-low inflation. Taking the GDP-weighted average of the euro area 10-year government bond yields, yields fell by around 150 basis points between early June 2014 and early March 2015, interest rates had in fact been falling consistently over the months preceding the launch of APP, as markets began to price in our likely response to a prolonged period of too-low inflation. Taking the GDP-weighted average of the euro area 10-year government bond yields, yields fell by around 150 basis points between early June 2014 and early March 2015.

That also had spillover effects, through portfolio rebalancing, to the cost of market finance across the economy. Yields of bank bonds fell, on average, by 75 basis points between early June 2014 and the start of the APP. Yields of investment-grade bonds issued by firms also fell by about 100 basis points over that same period. Studies by ECB staff attribute a significant portion of those declines to the credit easing package and the announcement of the APP.

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[1] See speech by Mario Draghi, ***Monetary policy communication in turbulent times***, at the Conference De Nederlandsche Bank 200 years: Central banking in the next two decades, Amsterdam, 24 April 2014.

For asset purchases to boost activity and inflation, however, these improvements in financial markets need to be passed through into credit conditions for the real economy. Here there was another concern about the effectiveness of our policy – that with banks deleveraging, trying to enlist them as vehicles of monetary policy might be futile, as banks would retain the stimulus and try to deleverage rather than create more loans. In fact, the power of transmission through the banking system has been *rising* through the life of our programme.

Between June 2014 and today, composite lending rates for non-financial companies have declined by more than 70 basis points for the euro area as a whole, and by between 110 and 120 basis points in stressed economies in the euro area periphery. That is a formidable pass-through. To give you a comparison, we estimate that in normal times our policy rate has to be *instantaneously* reduced by 100 basis points to see a similar impact on lending rates after such a short time period. Banks' rate-setting process is typically slow, but not this time.

And we are not only seeing this pass-through for larger firms, but also for small- and medium-sized enterprises (SMEs). Remember that at the height of the crisis in 2012, the rates on very small business loans, which are typically given to SMEs, were about 2.5 percentage points higher than those on large loans. Other terms and conditions, such as collateral, were also more demanding. As documented by our surveys on SME access to credit, at this time "access to finance" was considered the dominant concern for small enterprises, right after "finding customers" for their business.

Our measures are gradually changing that picture. Since the first round of our survey in April this year, "access to finance" has dropped to among the least important concerns for SMEs. They in fact report an improvement in the availability of external sources of finance, and in the willingness of banks to provide credit. Terms and conditions have also sharply converged towards those enjoyed by large corporate borrowers.

So why has transmission been so accelerated?

There are two reasons. First, the APP was launched against the backdrop of the completion of our Comprehensive Assessment of bank balance sheets, which ensured that banks were in the strongest possible position to transmit the boost to credit supply. Second, and even more fundamentally, banks' lending processes react to macroeconomic conditions in a feedback loop. For much of the crisis, that loop was pernicious. But our measures have been able to turn it positive.

When the economy was weak, banks tended to increase lending rates because they feared that the probability of default on their loans would rise. Those higher rates meant good credit demand fell and the economy worsened further. As the slump deepened, servicing credit then became more difficult for firms and households with outstanding loans, pushing higher numbers of borrowers into delinquency. The loop then returned back to the beginning, as banks' original increase in lending rates was validated ex post.

Starting in the summer of 2014, however, our measures began to increase competitive pressures on banks to reduce lending margins. The Comprehensive Assessment meant that more banks were in a position to benefit from low funding costs and lend, while the Targeted Long Term Refinancing Operations (TLTRO) gave them stronger incentives to do so. Bank credit therefore became more affordable, which in turn stoked higher credit demand. And as that has fed through into a better macro picture, loan delinquencies have fallen. Indeed, since the second quarter of this year non-performing loans (NPLs) have been declining, even in those economies where banks had built up high stocks of bad quality assets.

What this underlines is that policies that are good for the economy are good for banks. Even though low interest rates put pressure on banks' unit margins, that is compensated for by volume effects – there is more activity in the banking sector as a whole because monetary policy is supporting the recovery. Moreover, as NPLs have started to go down banks have been able to reduce provisions, which also supports profitability. Evidence from our Bank Lending Survey suggests that, for the euro area in aggregate, the net impact of our measures on bank profitability is broadly neutral.

The macroeconomic impact of our policy on small firms is already clear. In the most recent October round of our survey, the number of SMEs reporting an increase in revenues was almost 20% larger than those which reported the opposite. The improvement has also been widespread across most countries, with the notable exception of Greece. For the first time since 2009, the net percent of firms that register an improvement in business activity has turned positive for all size sub-groups, including for the micro-firms that had in the past suffered most.

Reviving the supply of credit to these firms has also helped lay the ground for an economy-wide recovery in investment, activity and employment. Think that SMEs are 99 out of every 100 businesses in Europe, produce 58% of value added and employ two-thirds of all employees. And those benefits have accrued not only to countries with a high concentration of SMEs, such as those in the euro area periphery. Removing the obstacles that have suppressed growth in those economies reverberates across the whole euro area.

In particular, the budding recovery in vulnerable countries today provides a partial cushion for exporters in core economies against the fall-off in demand from emerging markets. Between 2011 and late last year, extra-euro area exports were systematically stronger than intra-euro area exports for those countries. But more recently, while shipment of goods and services to China, Russia and Brazil has dropped, export substitution to vulnerable countries has partly offset that shock.

Importantly, what this story shows is not just that our policy is effective. It shows that concerns that asset purchases would lead only to asset price inflation, and that would benefit only more wealthy groups, were misguided. It is true that our purchases raise the market value of financial assets. But what matters for the economy is the exact mirror effect of this: a lower cost of capital for firms and an associated boost in their spending power. That has a much broader impact on output and inflation, and eventually on employment and incomes, which reduces income inequality.

Do we need to do more?

So the economy is responding to our measures in the direction we had anticipated, and today we can look at our prospects with cautious confidence. The question we face now is not therefore whether we have the tools available to provide the appropriate degree of monetary stimulus. We have proven that. The question is one of calibration – whether, in view of the increasing headwinds we have faced since the summer and the impact they are having on the balance of risks for inflation going forward, the calibration of the monetary stance decided in January is still sufficient now to ensure a return of inflation towards our objective, and without undue delay.

Let me highlight three risks in particular which are relevant for that calibration.

First, the downside risks to our baseline scenario for the euro area economy have increased in recent months due to the deterioration of the external environment. The outlook for global demand, especially in emerging markets, has notably worsened, while uncertainty in financial markets has increased. Global growth this year will be the weakest since 2009.

Second, even factoring in those headwinds, the strength of the underlying recovery is modest. Taking the Purchasing Managers' Index, the present upswing which started in 2013 is the weakest euro area rebound since 1998. That is striking considering that we are in the early phase of a recovery, where one would expect to see a much more vigorous pickup. Deferred spending typically comes back on stream in a bulky way, aided by more favourable financing conditions.

It is also striking considering the important tailwinds helping the economy along – not just our monetary stimulus, but lower prices for energy. None of those previous rebounds since 1998 could benefit from cheapening energy: in fact, oil prices have been a constant headwind blowing against previous recoveries. Moreover, in none of those previous upswings was monetary policy, measured by real EONIA rates, as supportive as it is now.

Third, the recovery remains very protracted in historical perspective. It took between five and eight quarters for the countries now making up the euro area to recover their pre-recession level of real output after the slumps of the 1970s, 1980s and 1990s. During the recent recession – which was admittedly the worst since the 1930s – it took the US economy 14 quarters to reach its pre-crisis peak. If our current assessment is correct, it will take the euro area 31 quarters to return to its pre-crisis level of output – that is, in 2016 Q1.

This matters not just because of the lost output in that time. Such a prolonged downturn also inevitably impacts the way firms and social partners set wages and prices, and this will continue to affect the recovery of inflation. Though the most volatile components – principally energy prices – explain much of the recent decline in inflation, indicators of underlying inflation are also at a low level. That could imply relatively weak price pressures going forward.

We see subdued wage growth in the euro area, suggesting that the output gap is still exerting downward pressure on wages. The so-called core measures of inflation – which strip out volatile components – have also been drifting down since mid-2012 when the euro crisis hit its climax, and have been hovering around 1% for nearly two years. The increase in October to 1.1%, while encouraging, is not sufficient to fundamentally change that picture.

Low core inflation is not something we can be relaxed about, as it has in the past been a good forecaster for where inflation will stabilise in the medium-term. And while core industrial goods will receive support from the depreciation of the euro, an increase in core services inflation – today close to an all-time minimum – will depend on rising nominal wage growth. For that to pick up the economy needs to move back to full capacity as quickly as possible.

Putting the whole picture together, we have a situation where we cannot yet say with confidence that the process of economic repair in the euro area is complete. The moderate growth and price dynamics imply that we need to monitor closely whether – if left to its own forces – the economy will be able to reach a self-sustaining growth trajectory in conditions of price stability. If not, then it will require more monetary stimulus, which the ECB will not hesitate to provide.

At our December Governing Council meeting, we will thoroughly assess the strength and persistence of the factors that are slowing the return of inflation towards 2%. We will use as one input the Eurosystem staff projections. Another input will be the work of our staff in consultation with the Eurosystem Committees on the monetary policy stimulus that has been achieved so far, and the range of instruments available in case more accommodation is seen as necessary.

If we conclude that the balance of risks to our medium-term price stability objective is skewed to the downside, we will act by using all the instruments available within our mandate. In particular, we consider the APP to be a powerful and flexible instrument, as it can be adjusted in terms of size, composition or duration to achieve a more expansionary policy stance. The level of the deposit facility rate can also empower the transmission of APP, not least by increasing the velocity of circulation of bank reserves.

In making our assessment of the risks to price stability, we will not ignore the fact that inflation has already been low for some time. Looking forward, monetary policy will remain accommodative for as long as needed to secure a sustained adjustment in the path of inflation. That means we want to feel suitably confident that inflation will not only converge to, but also stabilise around levels close to 2% over the relevant medium-term horizon.

So let me reiterate what I said here last year: if we decide that the current trajectory of our policy is not sufficient to achieve that objective, we will do what we must to raise inflation as quickly as possible. That is what our price stability mandate requires of us.