Peter Praet: How does monetary policy secure price stability over the medium term?

Intervention by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the 4th European Technical Consumer Goods Retail Summit, Berlin, 30 March 2017.

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The origin of the global financial crisis

In 2008 the global economy faced a calamity unparalleled since the Second World War. The crisis had been preceded by a mood of over-optimism in several advanced economies. Expectations about future income were at odds with slowing underlying growth, giving rise to an "expectations gap". In the euro area, expectations were reinforced by a revived sense of economic prosperity that was associated with the introduction of monetary union. Firms were borrowing against their future income expectations in some countries; households and governments were doing likewise in other countries. Also, considerable financial liberalisation and deregulation had taken place which made debt accumulation easier. In the euro area, this was compounded by increased financial integration which led to a substantial rise in intra-euro area cross-border flows. As banks acted as intermediaries in both debtor and creditor countries, they too had become overexposed.

When the cycle did turn, central banks were confronted with a multifaceted and pernicious challenge. The "expectations gap" had left a number of economic agents overindebted and in need of balance sheet repair. Overextended banks needed to deleverage. And with this, a so-called balance sheet recession ensued.

Monetary policy responses to the crisis

The euro area crisis evolved in three main phases, each of which required a different monetary policy response.

The first phase was an abrupt liquidity crisis triggered by the turning of the global financial cycle and the subsequent collapse of Lehman Brothers. Banks suddenly became very uncertain about the underlying health of other banks and stopped lending to each other. Consequently, global central banks stepped in with forceful and coordinated interventions to provide essential liquidity to the banking sector. Without this response, the financial system would have collapsed and a far deeper recession would have occurred.

This phase of the crisis had profound effects on the banking sector – effects which in the euro area were not addressed as swiftly as in other jurisdictions due to the incompleteness of its institutional set-up. Sovereigns needed to support their national banking sectors even though they lacked the fiscal capacity to do so, aggravating the link between banks and governments in the euro area.

This paved the way for the second phase of the crisis: the sovereign debt crisis and its amplification through the "bank-sovereign" nexus. As the cost of borrowing for certain governments increased, banks with exposures to this debt came under intense market pressure, ultimately leading to entire national banking systems losing market access. This in turn resulted in financial fragmentation and a serious disruption to the monetary transmission mechanism. In other words, as the ECB lowered interest rates, these reductions were not being passed on to firms and households to the same extent in every euro area country.

First, to ensure banks could depend on longer-term funding, central bank liquidity was made available for up to three years and the list of eligible collateral that could be used to access

central bank money was expanded. This eased the pressure on banks to sell less liquid assets at depressed prices to access obtain cash, a process which would have rapidly reduced the flow of credit to the economy.

Second, the announcement of Outright Monetary Transactions (OMT) in 2012 removed the euro area break-up risk which was being priced into governments' borrowing costs and the severe economic dislocation that would have occurred. Second, the announcement of Outright Monetary Transactions (OMT) in 2012 reduced the likelihood of a break-up of the euro area. This risk was being priced into governments' borrowing costs and would have resulted in severe economic dislocation. Nonetheless, the sovereign debt crisis left a damaging legacy on the euro area economy and laid the groundwork for the third phase of the crisis.

In the subsequent years, as the euro area recovery struggled to gain traction, banks in large parts of the euro area – particularly in vulnerable countries – were engaged in a drawn-out process of deleveraging their balance sheets on account of the legacy from [impact of] the second phase of the crisis. In early 2014 the third phase of the crisis started and by that summer, it was clear that additional monetary policy measures would be required. Inflation had begun to drift downwards and there was a palpable risk of a self-sustained period of deflation.

As the main policy interest rate, the interest rate on the deposit facility, was already at zero, the Governing Council needed to introduce new measures to provide additional stimulus to the economy and steer inflation back to levels below, but close to 2%. To this end, the ECB sought to affect the range of interest rates which are relevant for private sector financing conditions.

Starting in June 2014, the Governing Council introduced a negative deposit rate of –0.1%, and reduced it by a further 10 basis points in September 2014. This marked the first round of cuts into negative territory and was viewed as a way of providing additional stimulus to the economy as it extended the scope of conventional monetary policy.

Over the same period, a credit easing package was announced which included targeted longer-term refinancing operations (TLTROs I), a third covered bond purchases programme (CBPP3) and an asset-backed securities purchase programme (ABSPP).[1] The overarching motivation underpinning the design of this package was twofold. First, to improve the pass-through for each euro of liquidity injected into the financial system to private sector borrowing costs and second, to reinforce the accommodative monetary policy stance.

Credit easing measures influence the economy via three main transmission channels: direct pass-through, portfolio rebalancing and signalling.[2] The direct pass-through channel is the most prominent one. It directly lowers banks borrowing costs, which in turn lower lending rates for firms and households, and this supports consumption and investment. In the case of the TLTROs I, which were specifically aimed at encouraging bank lending to the private sector in an environment of deleveraging, banks were able to borrow at a very favourable interest rate from the Eurosystem. The cheaper funding costs were intended to increase competition in the market for bank loans, which would consequently lower borrowing costs for firms and households. For the CBPP3 and ABSPP, purchases increase the demand for these securities and as a result lead to higher prices and lower yields. As these securities are backed by loans to firms and households, the price increase encourages banks to issue more loans so that they can be used to issue more asset-backed securities and covered bonds. This increase in loan issuance also fosters competition and lowers borrowing costs for firms and households.

At the beginning of 2015, the inflation outlook had deteriorated and there was an increasing risk of a too prolonged period of low inflation. As a result, in January 2015 the Governing Council announced the expanded asset purchase programme (APP), which encompassed the CBPP3 and the ABSPP as well as the introduction of a public sector purchase programme (PSPP). The monetary stimulus from the PSPP works through several transmission channels, but the most

powerful is via portfolio rebalancing. For example, this can mean that not only the asset prices increase in market segments where direct purchases occur, but higher prices can also spill over into non-targeted market segments. This leads to a decline in yields and lowers the cost of borrowing on capital markets for firms. At the same time, the general compression of yields across all asset classes incentivises banks to rebalance their portfolios towards assets with higher risk-adjusted returns, such as loans to firms and households.

Not long after the APP became operational, the Governing Council introduced the second round of cuts to the deposit interest rate. This decrease into more negative territory meant that the negative deposit rate was now viewed as an instrument to empower the portfolio rebalancing channel of the APP, as it incentivised banks to invest the proceeds they received from selling assets in higher yielding assets.

Overall, these measures have been designed to complement each other and have proved adaptable and effective to the series of shocks which have buffeted the euro area economy since their introduction. Indeed, the APP has been recalibrated three times since its introduction and in March 2016 the Governing Council announced four more targeted longer-term refinancing operations (TLTROs II) to further support credit availability to euro area firms and households.

The economic impact of monetary policy measures

Our measures are working their way through the financial system and have led to a major easing of financing conditions for euro area firms and households, benefited credit creation and contributed to a more robust and sustained economic recovery.

A week ago we conducted the fourth and last operation under the second round of Targeted Long-term Refinancing Operations (TLTROs), the so-called TLTRO-II, which we announced in March 2016 as part of an effort to forestall the risks of renewed transmission impairments that we saw early last year – in the wake of another episode of acute financial instability – and the consequences that a break-down in bank transmission could have had for price stability in the euro area. The total amount borrowed under TLTRO-II, EUR 740 billion, has surpassed our internal expectations by far. Together with its predecessor, TLTRO-I, these instruments were among the most effective components of the policy package which we have been enacting since June 2014. The main channel through which they played through to the broad economy has been the interest rate channel. When the facility was announced in June 2014 the ECB had been easing its monetary policy stance for almost three years. Yet, despite a reduction of the overnight interest rate to levels close to zero, banks in a large fraction of the euro area economy had not been reducing their lending rates at the same pace and, in some countries, in fact they had tightened credit conditions dramatically. The stimulus was not moving downstream to reach the real economy.

That trend was reversed almost instantly after the June 2014 announcement. Already over the summer of 2014 – even before the first operation was allotted in September of that year – lending rates plunged to levels unseen since 2010. Why did this happen? The new facility gave banks a long-term source of funding at a very moderate cost on condition that they would lend the funds on to the economy. This turned up the competitiveness temperature in the market for bank credit which, up to that point in time, had become polarised between banks with scarce access to funding and limited capacity to create credit, on the one hand, and banks with normal access to funding on the other. None of the two types of banks had a capacity or an incentive to provide credit to the economy on affordable conditions. The new operation put all banks on the same funding footing and thus created the conditions for the banking industry as a whole to start competing again for good credit.

As a result of TLTROs and, in due time, the other instruments that were added, bank lending rates for both firms and households have dropped by more than 110 basis points since 2014 and are now at historical lows. Encouragingly, the improvement in credit conditions is occurring both

within and across euro area countries. Borrowing costs in vulnerable countries are now approaching levels observed in the less vulnerable countries. Euro area small and medium-sized enterprises (SMEs) appear to have particularly benefited from the increasing pass-through of policy rates. Lending rates on very small loans (below €250,000) have declined by 177 basis points, and bank lending rates on all non-financial corporation (NFC) loans have declined by 113 basis points.

This sharp decline in bank lending rates has also been accompanied by improvements in access to credit for firms and households. Bank lending volumes have been on an upward trend. In January, lending to households recorded its fastest growth rate since May 2011, while corporate lending, as in the previous month, recorded its highest reading since 2009. Since September 2014, when the first TLTRO was conducted, bank loans to households have increased by 3.8%, while bank loans to non-financial companies have increased by 3.1%.

As overall financing conditions have eased and credit growth increased, improvements in the euro area's economic performance have followed. Indeed, the current recovery is showing considerable resilience, which to a large extent reflects the fact that domestic demand is the primary driver of growth. At the same time, there are encouraging signs that both global growth prospects and world trade are strengthening and may well act as tailwinds to further support the recovery.

Monetary policy is playing a central role in supporting consumption: lower interest rates are ensuring favourable borrowing conditions and encouraging households to bring forward durable consumption as well as firms' investment. Consumption of durable goods has rebounded in recent years, and especially in countries where credit was previously very tight. While investment has responded more slowly, monetary policy is helping create the conditions for a stronger investment revival through its overall effect on the economy.

The euro area cyclical recovery is gaining momentum, broadening across sectors and countries. While the economic outlook is now better than it has been for many years, downside risks remain, albeit less pronounced than they once were.

The firming of the recovery has not yet translated into a durable strengthening of inflation dynamics. Headline inflation has increased, but for the most part this reflects rising energy and food price inflation. Underlying inflation pressures continue to remain subdued. According to our latest projections, inflation is expected to move towards levels below, but close to, 2% over the forecast horizon. We are not yet sufficiently confident that inflation will converge to levels consistent with our aim in a durable manner. Inflation dynamics still remain reliant on the very substantial degree of monetary accommodation which prevails.

Against this background, the Governing Council has reaffirmed its monetary policy stance, including its forward guidance, in order to secure a sustained convergence in inflation towards our aim objective.

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[1] The first TLTROs took place in September 2014. In September 2014, the ECB announced the launch of the CBPP3 and the ABSPP.

[2] For more details see "The transmission of the ECB's recent non-standard monetary policy measures" ECB Economic Bulletin, Issue 7/2015.