Peter Praet: Ensuring price stability

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Belgian Financial Forum colloquium on "The low interest rate environment", Brussels, 4 May 2017.

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Accompanying slides.

I would like to thank Leopold von Thadden for his contribution to this speech.

The cyclical recovery of the euro area economy is becoming increasingly solid and downside risks to the growth outlook have further diminished. Today the configuration of risks around the most likely growth outlook is closer to balance than it has been in some time. Yet, downside risks still prevail, being mainly related to remaining fragilities in the global outlook. Also, despite the cyclical recovery, underlying price pressures remain subdued as unutilised resources continue to weigh on domestic wage and price formation. As yet the evidence continues to indicate insufficient progress towards a *sustained adjustment in the path of inflation* towards levels below, but close to, 2% over the medium term, which is a condition we have indicated for the ECB to start a gradual process of normalisation in its monetary policy stance. In view of this evidence, the Governing Council in its April meeting has judged that the complex set of instruments that we have put in place over the past three years to counter downside risks to price stability, including our forward guidance, is still needed to support a durable and self-sustaining inflation convergence. After a prolonged period of exceptional monetary policy accommodation, any change in our policy stance should be gradual. It should be motivated by sufficient evidence that the present indications of an acceleration in activity find confirmation in hard data and that a more robust growth feeds through into a sustainable adjustment in the path of inflation.

What are the conditions that led to the adoption of this complex package of monetary policy measures? And how can we measure their success in fostering progress in our economy, as a pre-condition for a lasting return of inflation to levels more consistent with our objective of price stability over a medium term horizon? Let me first lay out the strategy that we followed over the past challenging years since the collapse of Lehman in 2008 to counter a deeper and more damaging economic contraction and ward off risks of deflation and of a prolonged period of below-norm inflation. What I will refer to as the three phases of the crisis have called for the deployment of different policy instruments, so I will start establishing a correspondence between the chronology of the crisis and the taxonomy of our instruments.[1] I will then turn to the current state of the economy to extract inferences about the effectiveness of our strategy. I will then conclude looking forward.

Monetary policy responses to the crisis

In the euro area, the crisis has evolved through three phases. The first phase was triggered by the abrupt liquidity strains that almost paralysed the global financial system in the immediate aftermaths of the collapse of Lehman Brothers. Banks – both in the euro area and elsewhere – suddenly became very uncertain about the underlying health of other banks and stopped lending to each other. The ECB was very swift in its response, faithful to its responsibility to guarantee appropriate liquidity conditions to solvent banks. Together with other major central banks, the ECB stepped in with forceful and coordinated interventions to provide essential liquidity to the banking sector. In the euro area, liquidity was made available in virtually unlimited amounts – against eligible collateral – and at increasingly longer tenors, which helped those banks that were being negated access to market refinancing to remain in business and continue their key intermediation function. Without this response, the financial system would have imploded and a far deeper contraction would have occurred.

The second phase of the crisis came as a consequence of the loss of confidence in some sovereigns. It brought on the development of redenomination risk and thereby threatened the integrity of our currency. The sovereign debt crisis found impulse in some cases from a weak fiscal position, whereas in others from a weak banking system. But irrespective of its initial impulse it quickly became a two-way interaction through the "bank-sovereign" nexus. Banks remained dependent on fiscal authorities for solvency assistance, and the financial obligations vis-à-vis banks that this responsibility created on the side of some national fiscal authorities with weak fundamentals further undermined their credit standing. 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. The ECB had not remained inactive in the face of such vicious feed-back loop, as it saw the implications that such dynamics could have for price stability. But, as the ECB lowered interest rates, these reductions were not being passed on to firms and households in a large part of the euro area, signalling an unusual disconnect between expanding central bank liquidity, exceptionally stimulative monetary policy interest rates and contractionary loan dynamics to NFCs and households.

The ECB then responded to these unprecedented conditions with a twofold reaction.

First, the ECB revived the longer-term refinancing instrument that had proven particularly effective in the aftermaths of the Lehman demise. Central bank liquidity was made available to banks for up to three years. This eased the pressure particularly on banks located in the jurisdictions that had been hit by the sovereign debt crisis.

Second, the announcement of Outright Monetary Transactions (OMT) in the summer of 2012 removed the euro area break-up risk which markets – by that time – had started to price into the yields of securities issued by the governments most impaired by the sovereign debt crisis. The impact of the announcement on market sentiment was instantaneous and material to an extent few had anticipated. The steep fall in interest rates and improved monetary policy transmission in those countries most affected by the sovereign debt crisis averted a deeper recession in the euro area as a whole. 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, the trauma that the debt crisis had caused for the banks located in the vulnerable countries triggered among those banks a drawn-out process of deleveraging aimed at shedding the most risky components of their balance sheets: loans to the economy. This, once more, impeded transmission of the stimulus introduced by OMT and by the liquidity operations to the real economy and threatened to derail the very tenuous recovery that had started in 2013.

The third phase of the crisis started in 2014, as it became clear that the incipient recovery was too fragile and dependent on progress in transmission to warrant inaction on the side of the ECB. Additional monetary policy measures were required to repair the bank lending channel and to arrest the accelerated decline in both headline and underlying measures of inflation that had become visible since early 2013. While inflation had started to drift downwards, there was a palpable risk that the disinflationary pressure would de-stabilise long-term inflation expectations and usher in a self-sustained period of deflation.

As the main policy interest rate, the interest rate on the deposit facility, had already been brought to zero in summer 2012, the Governing Council introduced innovative measures to provide additional stimulus. Starting in June 2014, the Governing Council brought the interest rate paid on banks' deposits of excess liquidity with the Eurosystem to –0.1%. At the same time, a credit easing package was announced which included targeted longer-term refinancing operations (TLTROs I), a programme to purchase covered bonds issued by the banks (CBPP3, a new version of two earlier programmes with a similar scope) and a novel asset-backed securities purchase programme (ABSPP).

Generally speaking, credit easing measures influence the economy via three main transmission channels: direct pass-through, portfolio rebalancing and signalling. All three channels supported the key motivation underpinning the design of this package, namely to improve the pass-through for liquidity injected into the financial system to private sector borrowing costs and to reinforce the accommodative monetary policy stance.

The credit easing measures were immediately effective in turning around the credit crunch situation prevailing in a number of countries and favouring a pronounced easing in bank lending conditions for companies and households. But, also due to the headwinds coming from the international economy, the inflation outlook continued to deteriorate in the summer and in the autumn of 2014 and long-term inflation expectations started to give concrete signs of destabilisation. As a result, in January 2015 the Governing Council announced the expanded asset purchase programme (APP), which included a large-scale purchase programme targeting public securities (PSPP).

The purpose of the new programme was to reinforce the direct path-through effects generated by CBPP3 and ABSPP by promoting a general compression of yields across all asset classes. This in particular brought about extra incentives for banks to rebalance their portfolios towards assets with higher risk-adjusted returns, such as loans to firms and households.

Overall, these measures have been designed to complement each other and have proved effective and adaptable to the series of shocks which have hit the euro area economy since their introduction. Indeed, the deposit rate has been reduced further (now standing at –0.4%). This decrease into more negative territory incentivises banks to invest the liquidity they receive as a consequence of the asset purchases into longer-maturity and higher yielding assets. The APP has been recalibrated since its introduction and in early 2016 the Governing Council announced four additional targeted longer-term refinancing operations (TLTROs II) to further support credit availability to euro area firms and households.

All these elements adopted in the third phase are still in place. Moreover, the ECB has adopted an integrated system of forward guidance that governs the future path of asset purchases and short-term interest rates, as well as the sequencing of these different policy tools. I will come back to this at the end of my talk.

The cyclical recovery in the euro area is becoming increasingly solid

Our monetary policy works and the effects of our measures on the euro area economy are becoming increasingly visible. Euro area real GDP has expanded for 15 consecutive quarters, with the quarterly growth rate for the final quarter of 2016 standing at solid 0.5%. For the first quarter in 2017, according to Eurostat’s preliminary flash estimate, the same quarterly growth rate of 0.5% can be expected. This suggests that the economic expansion is likely to have firmed and broadened in the first few months of this year. The euro area composite PMI output, in particular, hit in April a six-year high, signalling a strong start to the second quarter.

While the optimistic picture inspired by recent soft data still awaits validation in hard data releases, we take comfort in the fact that euro area growth seems increasingly robust to adverse overseas influences, as domestic factors have become key drivers of the on-going economic expansion. This is a crucial difference to earlier, abortive recoveries. Robust employment growth continues to strengthen households’ labour income and to support consumption. The euro area unemployment rate stands at its lowest level since April 2009. Private consumption has been a main driver of growth throughout last year, expanding in 2016 at an annual real rate of 2%.

Reflecting a more synchronised upswing across economic regions on a global scale, international trade has picked-up recently at a rather strong pace which should further support the euro area recovery.

It is also comforting to see the euro area recovery broadening across countries, sectors and labour markets. If one looks at the percentage of all sectors in all euro area countries that have positive growth, the figure stood above 80% at the end of last year, well above its historical average of 73% and the level observed during the 2009–11 recovery. Similarly, the dispersion in growth rates across both sectors and countries has also narrowed significantly and both are now at their lowest level since 1997. The same evidence is visible for employment. Just as for GDP growth rates, the dispersion of employment growth across euro area countries is now at record low levels.

The fact that the cyclical recovery is becoming increasingly solid reflects the effectiveness of the various monetary policy measures – both standard and non-standard – that have been undertaken by the ECB, in particular since mid-2014. Our policy has not only eased financing conditions on average, but triggered a remarkable convergence in borrowing costs across different euro area countries. Non-standard measures are estimated to be particularly effective in counteracting bank funding and financial fragmentation in some jurisdictions. This is reflected also in the lending conditions faced by the real economy. In June 2014 the median lending rate for firms in vulnerable economies was 120 basis points higher than for those in stronger ones – despite overnight rates being close to zero. Today the difference is only 20 basis points.

These improvements have led to rising credit volumes and improved access to finance, especially for small and medium-sized enterprises. Loan growth has proceeded along a path of gradual recovery since 2014. And across financial intermediaries, the banks which participated in the TLTROs have experienced higher loan dynamics than the non-participating ones. Model-based analysis indicates that the contribution of non-standard measures to the annual loan growth to NFCs is in the order of 2 p.p. at the current juncture, and should remain supportive going forward.

This assessment is corroborated by the ad hoc questions of the Bank Lending Survey on the impact of APP, negative DFR and TLTRO which point to significant easing effects of the measures on broad credit conditions, despite some restraints on bank profitability.

The Bank Lending Survey also shows that euro area banks have reacted to the package of measures by easing significantly the terms and conditions that they offer on loans. It is interesting to delve into the factors that banks cite to explain the change in their lending behaviour[2]. While heightened "risk-perceptions" and low capacity by banks to "tolerate risk" were consistently mentioned by banks as two key factors contributing to tighter credit standards throughout what I referred to as the third stage of the crisis, the last three years have seen an evolution in the composition of factors explaining the changes in credit standards. Whereas the unwinding of "risk perceptions" has offered a material contribution to the easier credit standards that we have observed since 2014 (with only a slight reversal in the most recent period), "risk tolerance" has remained moderate and, in fact, since 2015 has even tended to offset the easing impulse coming from other factors. This can be interpreted as evidence that, despite a turnaround in the market for bank credit and in the general economic prospects more broadly, banks continue to apply prudent standards when deciding whether to extend new credit. This being said, taking a longer term perspective, the ad hoc question on the level of credit standards indicates that credit standards are tighter today than in the pre-crisis period, and since 2010 have eased only to some extent and in some jurisdictions.

The monetary impulse from non-standard measures is also reflected in broad monetary dynamics. Evidence on the sectoral allocation of the ECB's asset purchases, and on portfolio rebalancing decisions towards monetary instruments, would indicate that current M3 growth is significantly supported by the APP. The support of central bank liquidity to broader monetary aggregates is further vindicated by the growing contribution of households and firms deposits to

M1 and M3 growth. Judging from their leading indicator properties on economic activity, this might also bring some confidence on the strength of the underlying economic recovery.

Underlying inflation dynamics remain subdued

Is macroeconomic repair complete? I would not conclude in this direction.

First, while the drag on domestic activity from abroad – which was considerable in certain stages of the crisis – has largely faded, and while global data and indicators point to sustained momentum in activity and trade early in 2017, the ongoing synchronised recovery is still depending on a high degree of policy support. And even if on the upside there is a possibility that stronger sentiment in financial markets and confidence indicators translate into a faster pick-up in activity than currently foreseen, risks to the global economy over the medium term are stacked to the downside and weigh on euro area prospects. These relate to re-escalating geopolitical tensions, the possibility of a less favourable resolution of some remaining fragilities in key EMEs, particularly China, as well as questions related to Brexit and the future policy choices of the US administration.

Second, most importantly, the strengthening of economic activity has yet to find correspondence in inflation developments: underlying inflation and domestic price pressures remain subdued.

Headline inflation has been exceptionally volatile over recent months. After a sharp rebound between November and February, in March HICP inflation has dropped sharply to 1.5%, reflecting lower inflation rates for all main components – energy, food and HICP excluding food and energy – only to return to 1.9% in April, according to the Eurostat flash estimate of last week. Inflation excluding food and energy for April is currently estimated to have reached 1.2%, up from an almost all-time low of 0.7% in March. However, inflation is predicted to oscillate around one and a half percent for the remainder of the year before resuming a gentle path toward levels closer to 2% in the following two years. Inflation stripped of the most volatile price components is also expected to follow an upward path which should bring it to levels comparable with those of headline inflation by 2019, but the trajectory is expected to remain slow. More sophisticated measures of underlying inflation pressures have yet to show a convincing upward trend.

There is not yet sufficient evidence that the observed strengthening of producer price inflation at the earlier stages of the pricing chain will be durably transmitted to later stages which matter for HICP inflation. Annual global producer price inflation excluding oil remained elevated at 3.1% in February, standing above its long-term average. Yet, further up the pricing chain, producer price inflation for domestic sales of non-food consumer goods increased only slightly to 0.3% in March. A clear sign of a turning point is not yet visible. One way to reconcile the increasing price pressures at the earlier stages with weak producer price inflation of consumer goods is a squeeze in margin. In any case, a lagged transmission of pipeline pressure up the pricing chain would be in line with past observations.

Similarly, the GDP deflator, the broadest measure of domestic price pressures and one closely linked with developments in underlying inflation, does not yet provide evidence of strengthening. In the fourth quarter of 2016 the annual growth rate of the GDP deflator decreased further, although mainly on account of a weaker contribution from unit taxes. A strengthening of unit labour cost growth and profit margin growth can be a reliable signal that domestic demand is exerting a material traction on inflation. From this perspective, profit margin growth has increased in the last two quarters of 2016 after it had been depressed by the waning terms of trade effects. By contrast, unit labour cost growth has been broadly flat.

This suggests that in order to achieve a sustained adjustment in the path of inflation wage growth has to be stronger. This will require that higher employment levels not only reduce the slack in labour markets, but also feed through into wage dynamics. At this juncture it is not easy to predict how quickly this will happen. In particular, while the amount of slack plays a decisive role for underlying inflation, there is high uncertainty around its measurement. A strengthening labour market may attract "marginally attached" workers back into the labour force, or encourage those "underemployed" to seek more hours, causing the effective supply of labour to rise in tandem with demand. Due to such effects, measures of labour underutilisation which are broader than the recorded unemployment rate would have predicted lower inflation in the last two years and thereby offered a better account of observed inflation outcomes than more traditional Phillips curve specifications. In view of this evidence domestic wage pressures may therefore only materialise at a relatively late stage in the economic expansion.

Mirroring still weak domestic price pressures, market-based inflation expectations have failed to correct in a sustainable manner and continue to suggest only a very slow adjustment towards 2%.

Appropriateness of the current very accommodative monetary policy stance

In view of currently available evidence, the Governing Council in its April meeting has judged that there is not yet sufficient evidence of progress towards a durable and self-sustaining convergence in the path of euro area inflation that would warrant a scaling back of the exceptional degree of monetary policy accommodation. For us to conclude that a self-sustaining convergence in the path of inflation is accomplished, we will not only need to build confidence that inflation is on an upward path reaching levels close to 2% within a meaningful medium-term horizon. We will also need to verify that inflation is sufficiently robust to a firming of policy. In other words, inflation would need to maintain its trajectory even with diminishing support from monetary policy. In this context it should be recalled that the latest ECB staff projections from March this year include a material contribution from monetary policy to the path of inflation.

In sum, continued monetary policy support for demand remains key to inflation convergence. The recovery of inflation still depends on the very favourable financing conditions that firms and households are facing, which in turn is largely due to the current very accommodative monetary policy stance.

The forward guidance on the future course of our policy is an integral component of our stance, as re-asserted by the Governing Council at its last meeting in April. The Governing Council's forward guidance is structured around two fundamental elements: *conditionality* which links the horizon of the APP to the sustained adjustment in the path of inflation consistent with our inflation aim, and the *sequencing* which gives indications about the expected path of our key policy rates during the life of our net asset purchases and beyond. These fundamental features of our forward guidance have a clear logic. They are meant to communicate that our set of measures will evolve over time in a way that can most efficiently internalise and exploit the intimate complementarities among the various instruments, notably the asset purchases and the negative rate policy. All other features of our forward guidance are of a parametric nature and can be recalibrated depending on incoming data.

Looking forward to our next monetary policy meeting in June, we will be able to draw on a more expanded information set than is available today, organised around new projections and including an updated assessment of the distribution of risks surrounding the economic outlook.

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[1] For a more detailed account of these phases, see: The ECB and its role as lender of last resort during the crisis Speech at the Committee on Capital Markets Regulation conference on The lender of last resort – an international perspective, Washington DC, 10 February 2016.

[2] The BLS has traditionally combined risk factors in one single factor. However, since 2015Q1 the survey has asked banks about the contribution to easing standards coming from two distinct risk factors, "risk perceptions" and "risk tolerance".