Peter Praet: Global monetary policies - similarities and differences on the way to the new normal

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the GIC/SUERF/Deutsche Bundesbank Conference "Monetary and economic policies on both sides of the Atlantic", Frankfurt am Main, 8 February 2018.

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Accompanying slides

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One of the main features of central banks' response to the crisis – and the threat it posed to their statutory objectives – was the deployment of additional monetary policy instruments. Some of these instruments, such as asset purchases, had featured in the traditional toolkit of central banks in the early years of central banking before largely falling out of use in some parts of the world. Others, such as forward guidance on the future direction of policy, were a more recent invention, but had been used with some regularity even before the crisis erupted in 2007. And some instruments, such as moderately negative interest rates, were more specific to certain jurisdictions. Overall, these measures have been very effective and helped set in train the synchronous expansion the global economy is currently experiencing.

As the global economy emerges from the greatest slump since the end of the Second World War, the focus is on calibrating the degree of monetary accommodation that is still required. In the United States, where real GDP returned to pre-crisis peak level back in 2011, the tightening cycle has been under way for some time. The Federal Reserve stabilised its monetary policy portfolio in October 2014 and started to raise the federal funds rate more than a year later. More recently, it has started to reduce its balance sheet.

In the euro area, the sovereign debt crisis meant that the cyclical recovery took considerably longer to materialise than across the Atlantic. Real GDP did not return to its pre-crisis peak level until 2015, four years later than in the United States.

Nevertheless, the euro area is currently experiencing a solid and broad-based economic expansion, with the economy in 2017 growing at its fastest pace for a decade. The very accommodative monetary policy measures we have taken since 2014 are judged to have had a significant impact on output growth. Looking ahead, real GDP growth is projected to remain consistently above potential growth in the coming years.

Despite these favourable developments, inflation continues to be lacklustre and to date is not receiving sufficient support from underlying inflationary pressures. While our measures have clearly played a decisive role in keeping inflation expectations anchored and have contributed to an improved inflation outlook, an ample degree of monetary accommodation therefore remains necessary to secure a return of inflation rates towards levels that are below, but close to, 2% over the medium term.

How is our monetary policy likely to evolve in the foreseeable future?

Our monetary policy stance is currently determined by the combination and mutual interaction of the asset purchase programme (APP), our policy rates and our forward guidance on each of these tools. Additional stimulus is provided by the targeted longer-term refinancing operations (TLTROs), which will remain outstanding for the next three years.

Once our key interest rates had reached exceptionally low levels, the APP became for all practical purposes the primary policy tool for calibrating our monetary policy stance. This is why, since January 2015, we have been signalling the traditionally tight connection between the ECB's monetary policy and the price stability objective by linking an assessment of the medium-term outlook for inflation to the size and duration of our net asset purchases. Accordingly, we have consistently communicated our intention to continue with our chosen pace of monthly net purchases until we see "a sustained adjustment in the path of inflation consistent with our inflation aim". In addition, the pledge to reinvest the proceeds from the principal payments that accrue from the maturing securities in our portfolio should be seen as a necessary complement to the net asset purchases.

Forward guidance on both policy rates and the APP plays a key role in determining our monetary policy stance. Its function has evolved significantly over time. In July 2013, when we announced for the first time that we expected our "key interest rates to remain at present or lower levels for an extended period of time", forward guidance on interest rates was intended as a protective measure to insulate the euro area money market from the global financial turmoil that had followed the "taper tantrum" a few weeks earlier.

As the macroeconomic environment deteriorated in late 2013 and early 2014, our policy needed to become distinctly more accommodative, and forward guidance turned into a vehicle for easing the monetary policy stance. Forward guidance has not taken the same form across all major economies, differing in terms of both its degree of conditionality and the instruments to which it is attached

In the euro area, since the APP has been in place, forward guidance has been extended to key parameters of our purchases and has helped investors form expectations about the size of the APP and its duration. In particular, we have indicated a minimum horizon – an intended end-date – until which time we plan to carry out net monthly purchases, while retaining the option of extending the programme beyond that intended end-date if the "sustained adjustment" condition has not been met.

The mutually reinforcing nature of our forward guidance on policy rates and the APP became even more evident in March 2016, when the Governing Council clarified the future sequencing of these two instruments. By stating that policy rates were expected to remain at present levels "well past the horizon of our net asset purchases", the Governing Council made it clear that keeping policy rates well anchored for the entire lifespan of the asset purchases was an enabling condition for the purchases to exert their full impact.

Looking ahead, monetary policy will evolve in a data-dependent and time-consistent manner. The transition towards policy normalisation will begin once the Governing Council judges that there is a sustained adjustment in the path of inflation. This assessment will be based on three criteria for the inflation outlook: convergence, confidence and resilience.

Convergence implies that headline inflation will have to be on course to reach levels below, but close to, 2% by the end point of a meaningful medium-term horizon. This first criterion is a necessary but not sufficient condition for a sustained adjustment. The Governing Council needs to be confident that the expectation of an upward adjustment in inflation has a sufficiently high probability of being realised on a sustainable basis. So, a sufficient degree of confidence in our inflation projections will be a key requirement for declaring that a sustained adjustment has been achieved. Our third criterion, resilience, measures the robustness of inflation convergence to a partial withdrawal of monetary policy accommodation. Ultimately, we will need to verify that inflation would remain on a sustained path of adjustment even in a less accommodative monetary policy environment.

The lessons learnt from the financial crisis have shown that it is crucial to test the confidence criterion and assess the resilience of the economy and of transmission to a partial withdrawal of accommodation.

The strong cyclical momentum, the ongoing reduction of economic slack and increasing capacity utilisation strengthen our confidence that inflation will converge towards our aim. However, measuring the degree of remaining unutilised resources in the economy remains challenging. In the labour market, the elasticity of labour supply during the recovery has been greater than assumed in our baseline scenario. This can be partly attributed to pension and labour market reforms as well as to migratory flows. Increased labour supply has resulted in muted wage dynamics, thereby keeping a lid on underlying price pressures. Overall, the uncertainty surrounding the upward path in inflation that we consider in our baseline scenario is still too high.

Experience demonstrates the importance of our third criterion, resilience. Monetary policymakers always face a delicate balancing act at turning points in monetary policy. In 2011, when we increased interest rates, economic activity indicators were pointing to buoyancy and, of course, inflation was high on account of oil prices. Hindsight gives us today a clearer view of the underlying conditions of the economy than it was possible to have at the time, and we now know that the apparent robustness of the economy was in fact masking vulnerabilities that made the economy prone to sudden reversals. And in the summer of that year, a sudden reversal was indeed what we saw. In 2013, we experienced a similar, if less dramatic, difficulty in our assessment of the economic situation. Over that year, banks started to repay the funds that they had borrowed under the two three-year LTROs which we had offered between late 2011 and early 2012. Many observers at the time interpreted this massive reimbursement – including from banks that had been hit particularly hard by the sovereign debt crisis – as a sign of normalisation. In reality, it was a symptom of the aggressive deleveraging that banks were pursuing, which made ECB borrowing unnecessary and costly to maintain on-balance sheet for many of them. While reimbursing excess liquidity made a lot of sense from the individual bank's micro-perspective, it was hurting the economy in the aggregate.

Today, we want to make sure that the economy is on a sufficiently robust footing before there is a turn in policy. From that perspective, there is still some way to go before all three criteria for a sustained adjustment are met at the same time. So, we still need patience and persistence in our monetary policy.

We need patience because it takes time for price pressures to build up. And we need persistence because the pick-up in inflation is the result of the prevailing monetary policy stance. If the flow of incoming data were to confirm the expectation of a gradual build-up of inflationary pressures, this would not necessarily be sufficient to affirm a sustained adjustment as less supportive monetary policy conditions could imperil the inflation trajectory.

Once the Governing Council judges that the three criteria for sustained adjustment have been met, net asset purchases will expire, in line with our guidance. From that point in time, the evolution of inflation will remain conditional on reinvestments continuing for an extended period of time, and on policy rates remaining at their present levels well past the end of our net asset purchases, and in any case for as long as necessary to ensure that inflation stabilises durably around levels below, but close to, 2%.