

## Peter Praet: Providing monetary policy stimulus after the normalisation of instruments

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the conference "The ECB and its watchers XX", Frankfurt am Main, 27 March 2019.

\* \* \*

The financial crisis and its aftermath ushered in the need for central banks across the world to broaden the means by which they achieve their statutory mandates.<sup>1</sup> The ECB's responses to the first two phases of the crisis, namely the immediate aftermath of the collapse of Lehman Brothers and the euro area sovereign debt crisis, were largely centred on conventional tools being used in unconventional ways. The key ECB interest rates remained the instrument for adjusting the monetary policy stance.<sup>2</sup> Meanwhile, refinancing operations continued to be the vehicle for providing reserves to the banking system, but by adopting fixed rate tender procedures with full allotment, expanding the eligible collateral pool and offering additional longer-term funding, we provided the banking system with the ample liquidity it was trying to secure in an elastic manner. Unconventional tools – namely limited purchases of covered and sovereign bonds (Securities Markets Programme), as well as the announcement of outright monetary transactions (OMTs) – were used to promote and safeguard the smooth transmission and singleness of our monetary policy.

Things changed during the third phase of the crisis. This phase was characterised by a deleveraging process that fed into a renewed macroeconomic downturn, producing a pernicious cycle of contracting credit growth and weak demand dynamics that required a forceful monetary policy response. Additional accommodation was initially provided by further reductions in the key ECB interest rates – eventually to negative levels – and the introduction of forward guidance on their expected path, while targeted longer-term refinancing operations (TLTROs) were conducted to support bank lending to the real economy. But with the deposit facility rate in negative territory and limited scope for additional rate cuts, purchases of private and public sector securities became the tool for adjusting the level of monetary accommodation.

Following its announcement in January 2015, our expanded asset purchase programme (APP) was recalibrated a number of times in response to changes in the inflation outlook. These recalibrations consisted of changes in the monthly purchase volumes, expansions in the list of eligible asset classes and extensions of the minimum horizon over which purchases would take place.<sup>3</sup> The aim of the APP was to prevent acute and persistent disinflationary pressures from destabilising medium-term inflation expectations and potentially spiralling into outright deflation. That intention was hard-wired in the conditionality – or, in academic parlance, the “policy rule” – that governed the forward guidance on the evolution of the APP from its inception. The programme was to continue at a pre-set monthly pace of purchases until the Governing Council saw inflation on a sustained adjustment path towards levels below, but close to, 2% over the medium term.

We've come a very long way since the APP was launched. Last December, we took a first step on the path towards “normalisation” by completing the rotation of instruments from a configuration relying on the pace and horizon of monthly bond purchases to one founded on forward guidance on our policy interest rates as the principal instrument of monetary policy. There is an important distinction to be made here between the normalisation of the hierarchy of policy instruments and the normalisation of the monetary policy stance – that is, the degree of monetary stimulus that we provide to the economy. The normalisation of instruments was implemented in such a way as to preserve the degree of accommodation necessary for continued inflation convergence even after the end of net asset purchases.

### Rotation back to the “normal” instrument of monetary policy

When announcing our APP in January 2015, we made clear that we intended to conduct net asset purchases until we saw inflation on a sustained adjustment path towards levels below, but close to, 2% over the medium term. While further accommodation was initially provided by additional cuts in policy rates into negative territory, the APP became the tool for adjusting the level of monetary accommodation. In March 2016 we adjusted our forward guidance on the key ECB interest rates to imply a sequencing between the interest rate policy and the net asset purchases, thereby exploiting the complementarities between these two key components of our monetary policy conduct. The APP enhanced the effectiveness of our forward guidance on policy rates via the signalling channel, underscoring our commitment to keep rates low for as long as necessary to achieve the stated objective of our policy.<sup>4</sup> In addition, the APP gave rise to a portfolio rebalancing channel; this put downward pressure on longer-term interest rates, thereby complementing the impact of forward guidance on short to medium-term interest rates. The APP, as well as the TLTROs, also resulted in a liquidity creation effect.<sup>5</sup> In conjunction with our negative interest rate policy, which increased the opportunity cost of holding reserves, the abundance of liquidity in the system reinforced the compression of longer-term interest rates.

In assessing progress towards a sustained adjustment in inflation, the Governing Council was guided by three criteria: convergence, confidence and resilience.<sup>6</sup> First, headline inflation needed to be on a trajectory to converge to levels below, but close to, 2% by the end of a meaningful medium-term horizon. Second, we needed to be confident that the upward adjustment in inflation would be realised with a sufficiently high probability. Third, the convergence of inflation towards our aim needed to be resilient to the ending of net asset purchases.

By June last year, substantial progress had been made on the inflation front in terms of our three criteria. Inflation was projected to be on a gradual upward path, uncertainty around the inflation outlook had narrowed sharply and the inflation trajectory was tested to be sufficiently robust to an ending of net asset purchases. So the time had come to bring net asset purchases gradually to an end. We therefore initiated a rotation away from net asset purchases and back to interest rates as the principal instrument of monetary policy by signalling our intention to end net purchases in December 2018, subject to incoming data, and by enhancing our forward guidance on the key interest rates. We also expressed our intention to maintain our policy of reinvesting maturing securities for an extended period of time after the end of our net asset purchases and in any case for as long as necessary.

Our net asset purchases had borne fruit, and in December 2018 we assessed that they had set inflation on a sustained adjustment path towards our aim, but that continued inflation convergence still required significant monetary policy stimulus. Our successive downward adjustments in the volume of monthly purchases had supported our confidence that inflation convergence would be sustained even after the end of net asset purchases, underlining the increasing role of the stock of acquired assets in determining the stance of our monetary policy.

In the process of rotating back to forward guidance on policy rates as our main instrument, it was essential to preserve the degree of monetary accommodation required for continued inflation convergence. To prevent the risk that our instrument rotation would leave expectations about our key interest rates – which since March 2016 were expected to remain unchanged “for an extended period of time, and well past the horizon of our net asset purchases” – without a tangible anchor, we enhanced our forward guidance on interest rates when announcing our anticipation that we would bring net purchases to an end. Specifically, we decided last June on a new conditionality formula for our forward guidance that – by and large – mirrored the one we had used for steering APP expectations. This conditionality consists of both date and state-contingent legs. The smooth financial market reaction to the end of net asset purchases suggests that our enhanced forward guidance had the intended effect.

Our reinvestment policy reinforces the effects of forward guidance on policy rates. Today, the stock of securities acquired under the APP has reached such a sizeable level that our

reinvestment policy is sufficient to ensure the degree of continued duration extraction needed to keep a lid on term premia.<sup>7</sup> Keeping the stock of securities constant also contributes to maintaining favourable liquidity conditions. Ample volumes of excess reserves ensure that the overnight interest rate stays close to the floor of the interest rate corridor, which is provided by the deposit facility rate. This, together with forward guidance on the expected evolution of our policy interest rates, reduces rate uncertainty across maturities and thus adds to the compression of term premia brought about by the duration extraction channel.

## **Preserving significant monetary stimulus**

At the beginning of March this year the Governing Council was faced with a delicate call. On the one hand, the economic expansion was clearly losing steam and the sagging economy threatened to slow the pace at which inflation was expected to climb back to our objective. Indeed, for the first time in a number of projection rounds, the March staff projection exercise had downgraded the inflation outlook uniformly throughout the horizon, including at the end point. On the other hand, there was no doubt that underlying conditions had come a long way since the start of our asset purchase programme, in terms of both the overall progress achieved and the resilience of the economy to negative shocks. The weaker economic momentum had not fundamentally undermined the conditions on which progress towards our aim ultimately depends, but it was slowing the pace of inflation convergence.

In the light of the downward revisions to the macroeconomic outlook, additional measures were needed to preserve the ample degree of monetary accommodation supporting inflation convergence towards our aim. In March we adjusted our forward guidance on the key ECB interest rates, our main instrument, while announcing some other measures to preserve favourable lending conditions and the smooth transmission of monetary policy.

Long-term interest rates and, indirectly, financial conditions depend on market participants' expectations of the path that monetary policy interest rates are likely to follow. Today, this path is constrained on the downside, as the overnight interest rate – which underpins the whole term structure of risk-free interest rates – is already negative. So, under current conditions, our indications regarding the most likely evolution of the policy rates are a key instrument for setting the monetary policy stance.

Our interest rate forward guidance consists of both date and state-contingent legs. The state-contingent leg expresses the anchor of our policy-setting: keeping inflation stably on its sustained path towards levels that are below, but close to, 2% over the medium term. It says that the policy rates won't be raised until we are sufficiently confident that inflation will reach levels below, but close to, 2% over the medium term.

We further define our forward guidance with additional wording which we refer to as the date-based leg. Through that wording the Governing Council relays to the market information about its expectation of the earliest date at which, given the likeliest path for inflation, the state-contingent part might dictate a first rate increase. As such, it is not a stand-alone proposition. It is a clarification about the rate path that we see as most consistent with the inflation outlook that we face, and with our commitment to achieve our policy objective over the medium term. The date-based leg of our forward guidance directly affects the formation of market expectations by clarifying the course of interest rate policy over a well-defined period of time. It influences the risk-free curve by truncating the left tail of the distribution of market expectations for policy rates.

In the run-up to our March meeting, the state-contingent part of our forward guidance with its link to the evolving inflation outlook had already influenced investor expectations a great deal. As investors had been revising their outlook, the point at which they expected a first rate increase had also been extending dynamically into the future, as they were internalising the Governing Council's commitment – expressed in the state-contingent part of forward guidance – to an

inflation-dependent “policy rule”. The term structure of money market interest rates had been shifting lower and flattening as a result. So, a gap had formed between the market-implied date of a rate lift-off and the Governing Council’s indications, under its time-bound component of forward guidance, of the earliest date at which such a lift-off was likely to occur. Since June 2018 this time-bound part of forward guidance had signalled that policy rates were very likely to remain at present levels “at least through the summer of 2019”. In March we assessed the risks to price stability and concluded that recalibrating the date-based leg of our forward guidance was necessary to preserve the appropriate degree of monetary accommodation. Therefore, we decided to communicate that we now expect to keep our policy rates unchanged “at least through the end of 2019”.

Our reinvestment horizon is chained to our forward guidance on interest rates, as the full reinvestment horizon is defined as “an extended period of time past the date when we start raising the key ECB interest rates, and in any case for as long as necessary...”. By extending the earliest date for a rate increase, we effectively also pushed out the time over which reinvestments are intended to continue. This will not only help to maintain favourable liquidity conditions but also reinforce the downward effect of our rate forward guidance on the risk-free curve by suppressing term premia.

We also decided to launch a new series of quarterly TLTROs to help preserve favourable bank lending conditions and support the smooth transmission of monetary policy. Bank funding conditions – while still accommodative – could be affected by high refinancing needs resulting from maturing bank bonds and outstanding TLTROs. According to ECB staff estimates, after taking into account excess liquidity holdings, banks in the euro area face combined refinancing needs of around EUR 800 billion from June 2020 to May 2021, amounting to around 20% of the currently outstanding stock of debt securities issued by banks in the euro area. This could give rise to “congestion effects” as banks try to issue large volumes of bank bonds in a short period of time to replace maturing sources of funding. A rise in funding costs could affect banks’ ability to provide sufficient credit to the economy. Especially in the current environment, it is imperative to preserve the favourable bank lending conditions that have been instrumental in spurring and supporting the ongoing economic expansion and the gradual return of inflation towards our objective.

The new series of TLTROs is intended to do just that. TLTROs are a flexible tool with a number of parameters which can be calibrated to meet the needs of monetary policy at a given point in time. Starting in September 2019, banks will be able to borrow funds with a two-year maturity on a quarterly basis until March 2021. These operations will feature built-in incentives for credit conditions to remain favourable and will help to preserve a smooth and efficient transmission of our monetary policy to the real economy. Counterparties will be entitled to borrow up to 30% of the stock of eligible loans as at 28 February 2019 at a rate indexed to the interest rate on the main refinancing operations over the life of each operation, with further details on the precise terms of the new operations to be communicated in due course.

Finally, we extended the fixed rate tender procedure with full allotment. This means that we will continue to provide banks with a liquidity backstop against sufficient and adequate collateral.

These measures give us renewed confidence that growth will return to its potential level, supporting the continued convergence of inflation towards our aim.

## **Concluding remarks**

Our monetary policy is bearing fruit, and we remain confident that the labour cost pressures that have strengthened and broadened amid high levels of capacity utilisation and tightening labour markets will continue to support underlying inflation over the medium term. The process of inflation convergence takes time. While the sluggishness of the transmission mechanism can in part be attributed to the persistence of uncertainties related to geopolitical factors and the threat

of protectionism that still cloud the euro area economic outlook, persistent, patient and prudent monetary policy creates the conditions for the fundamental economic relationships to prevail and for inflation to converge to our aim in a sustainable manner.

In any case, we stand ready to adjust all of our instruments, as appropriate, to ensure sustained inflation convergence towards levels below, but close to, 2% over the medium term. All our instruments remain available following the return to rate forward guidance as our main policy tool. The activation of any existing or new instruments always depends on our assessment of the risks to price stability and our judgement of the effectiveness of those instruments in ensuring the convergence of inflation to levels that are below, but close to, 2% in the medium term. In March we judged that recalibrating the date-based leg of our rate forward guidance, complemented with the announcement of a new series of TLTROs, was appropriate to respond to the weaker economic momentum and the related slowdown in the pace of inflation convergence to our aim.

Monetary policy acts in full independence, but not in isolation. The mildly expansionary euro area fiscal stance and the operation of automatic stabilisers are also providing support to economic activity. Growth-friendly public finances based on sustainable fiscal plans and a sound composition of taxes and expenditures are essential for macroeconomic stabilisation and lasting economic prosperity. In order to reap the full benefits from our monetary policy measures, other policy areas must contribute more decisively to raising the longer-term growth potential and reducing vulnerabilities.

---

<sup>1</sup> I thank Danielle Kedan for her support in preparing this speech.

<sup>2</sup> For further discussion on the phases of the crisis, see Praet, P. (2016), “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.

<sup>3</sup> For further discussion of the implementation and effects of the APP, see Hammermann, F., K. Leonard, S. Nardelli and J. von Landesberger (2019), “Taking stock of the Eurosystem’s asset purchase programme after the end of net asset purchases”, Economic Bulletin, Issue 2, European Central Bank.

<sup>4</sup> See Coenen, G., M. Ehrmann, G. Gaballo, P. Hoffmann, A. Nakov, S. Nardelli, E. Persson and G. Strasser (2017), “Communication of monetary policy in unconventional times”, Working Paper Series, No 2080, European Central Bank.

<sup>5</sup> See Praet, P. (2018), “Challenges to monetary policy normalisation”, speech at the SUERF conference entitled “Sustainable Policy Responses: EU and US Perspectives”, New York, 20 September.

<sup>6</sup> For further discussion, see Praet, P. (2018), “Maintaining price stability with unconventional monetary policy”, speech given at the Council of the European Union, Brussels, 29 January

<sup>7</sup> See Praet, P. (2017), “Maintaining price stability with unconventional monetary policy measures”, speech at the MMF Monetary and Financial Policy Conference, London, 2 October and Praet, P. (2018), “Assessment of quantitative easing and challenges of policy normalisation”, speech at The ECB and Its Watchers XIX Conference, Frankfurt am Main, 14 March.