Isabel Schnabel: Paving the path to recovery by preserving favourable financing conditions

Speech by Ms Isabel Schnabel, Member of the Executive Board of the European Central Bank, at New York University Stern Fireside Chat, Frankfurt am Main, 25 March 2021.

* * *

Accompanying slides

For more than a year now, central banks worldwide have been tackling the fallout from the coronavirus (COVID-19) crisis with unprecedented measures. The pandemic has posed enormous challenges to monetary policy, which have varied over time.

The first phase of the crisis caused severe dislocations in global financial markets. Liquidity dried up, asset prices plunged and markets became fragmented, causing a broad-based flight to the safest assets in what became known as a “dash for cash”.

By offering to purchase large amounts of securities, central banks succeeded in restoring orderly trading conditions. In the euro area, we established the pandemic emergency purchase programme, the PEPP, under which we bought assets worth more than €200 billion over a period of just two months.

In doing so, we prevented the public health crisis from turning into a full-blown financial crisis, a risk that was particularly acute in the euro area. Concerns about the impact of the pandemic on public finances caused a wide divergence in the borrowing conditions for euro area sovereigns, impairing the transmission of our monetary policy. The PEPP immediately instilled confidence in financial markets and succeeded in reducing fragmentation. This was reinforced, in a strong act of European solidarity, by the agreement on the EU Recovery and Resilience Facility.

However, restoring financial market stability did not remove the risks to our primary mandate of price stability. As the rise in infection numbers in Europe began to accelerate again after the summer and the risks of a second wave materialised, the economic and inflation outlook in the euro area deteriorated notably.

Just when the outlook was at its darkest, news of the imminent arrival of multiple vaccines brought the long-awaited light at the end of the tunnel. The sources of uncertainty then shifted from *whether* the crisis can be contained to *when* we can expect a return to normality.

The December staff macroeconomic projections suggested that this path could still be long and bumpy. Consumer price inflation was projected to reach no more than 1.4% in 2023, well short of our medium-term aim of below, but close to, 2%. Beyond the near-term damage that the pandemic was inflicting on the economy, economic slack was expected to weigh on price pressures for a considerable period of time.

Further decisive monetary policy support was needed to offset the effect of the pandemic on the projected path of inflation, in line with our mandate. The question facing the ECB’s Governing Council at its meeting on 10 December 2020 was how to best provide this support.

Our policy response needed to take two factors into account.

One was that the unprecedented fiscal and monetary policy support had succeeded in delivering highly favourable financing conditions. The nominal euro area GDP-weighted yield curve stood at its lowest ever recorded level (left chart, slide 2). Yields up to a maturity of ten years were in deep negative territory.

Real long-term expected risk-free interest rates stood at around –1.5%, close to the lowest level ever recorded in the euro area (right chart, slide 2). Bank lending rates, which are the rates that matter most for households and small and medium-sized enterprises, were also at historical lows.

The other factor was that large uncertainty, risk aversion and wide-ranging mobility restrictions meant that a significant part of the economy was unlikely to be able, or willing, to take advantage of these financing conditions in the near term, delaying the effect of monetary accommodation on aggregate demand.

Surveys suggested that a large share of households did not plan to make major purchases over the next 12 months (left chart, slide 3). Their savings intentions remained at historically high levels as uncertainty continued to weigh on sentiment and consumption opportunities remained restricted amid renewed containment measures (right chart, slide 3).

In other words, there was a substantial degree of monetary accommodation that, if preserved, could be expected to provide a measurable boost to aggregate demand and underlying price pressures.

The Governing Council responded to these conditions with a powerful commitment to preserve favourable financing conditions.

What distinguishes a policy of preserving favourable financing conditions?

Two main characteristics distinguish this policy from the way asset purchases had been conducted before.

The first is a departure from a policy that attempts to push interest rates even lower.

The effectiveness of monetary policy is highly state-contingent. The benefits from reducing interest rates further from very low levels may still outweigh the costs in certain circumstances. And since we are not yet at the effective lower bound, such actions remain possible in the future.

But when uncertainty is large and private demand constrained, monetary policy is like “pushing on a string”.[1] Pushing harder in such circumstances would likely have limited effects.

In addition, a growing body of evidence suggests that the potential benefits of pushing rates lower may diminish even when uncertainty fades.[2]

The central idea behind lowering interest rates is to provide incentives to bring forward consumption and investment. But when rates have been low for a long time, fewer and fewer firms and households are left to respond to an additional monetary policy impulse, in particular when investment and durable goods demand are both “lumpy” and infrequent, as a large body of evidence suggests.[3]

One way of looking at this is to consider the share of new variable short-term loans for house purchases (left chart, slide 4). This share has fallen visibly in the euro area as many borrowers have already renegotiated their mortgages to lock in more favourable rates, potentially dampening the sensitivity of credit demand to lower rates.[4]

These effects may be amplified if the pass-through of market and policy rates to bank lending and deposit rates weakens or slows in the vicinity of the effective lower bound (right chart, slide 4), or if a flatter yield curve reduces banks’ incentives to undertake maturity transformation.[5]

Lowering interest rates further from very low levels may not only result in diminishing returns, it may also come with increasing costs.

A case in point is financial stability risk. Years of monetary stimulus have made asset price valuations highly sensitive to changes in interest rates. In the United States, for example, the yield that investors currently earn in excess of a real ten-year US government bond yield has fallen measurably (left chart, slide 5). In the euro area, signs of overvaluation are increasingly visible in real estate markets (right chart, slide 5).

Hence, the harder we push today, the larger the potential risks may be for price stability tomorrow.

In such circumstances, monetary policy can best support the economy by ensuring that favourable financing conditions prevail for as long as needed.

The second characteristic is the way we deliver on our commitment to preserve favourable financing conditions.

Rather than absorbing assets at a constant pace, we purchase flexibly according to market conditions. We buy more when financing conditions are becoming less favourable, and we buy less when they are stable or improving. This flexibility helps increase the efficiency of our purchases.

In other words, our pledge to preserve favourable financing conditions shifts the focus from quantities – the amount of assets we purchase – towards prices – the conditions at which sovereigns, firms and households can access credit.

During the first phase of the crisis, quantities were an end in themselves. They were necessary to restore market functioning and bring about appropriately accommodative financing conditions. Today, they are a means to an end: they are used to the extent necessary to deliver on our commitment to preserve favourable financing conditions.

Preserving favourable financing conditions: a reaction function

How, then, can this policy be implemented in practice? And what is the reaction function?

Markets will be able to better anticipate our actions if they understand which movements in market prices are likely to be considered favourable and which ones are not. And the better investors internalise our policy, the larger the potential efficiency gains will be.

Let me start by recalling two fundamental principles of monetary policy.

One is that *real* interest rates affect consumption and investment decisions. In themselves, *nominal* interest rates typically have little bearing on the behaviour of firms and households.[6] And since higher nominal rates can go hand-in-hand with higher growth and higher actual inflation in the future, they are not a good indicator of the degree of monetary policy accommodation.

The other principle is that the favourability of financing conditions is a relative concept. Historically low real interest rates do not necessarily imply that the degree of stimulus is historical too.

The latter crucially depends on how real interest rates compare to real equilibrium rates – that is, those rates that are consistent with a stable rate of inflation. Monetary policy is only accommodative if actual real rates fall below these equilibrium rates.

Conversely, an increase in real interest rates is not necessarily a sign that financing conditions are becoming less favourable. For example, as the economy recovers, real and nominal long-term rates will gradually rise in tandem with the real equilibrium rate.

Monetary policy will not tighten in this case. It will retain the same level of accommodation as the gap between the actual real rate and the equilibrium rate remains unchanged.

These considerations are what distinguishes a policy of preserving favourable financing conditions from yield curve control.

The latter targets a fixed level of nominal yields with a view to increasing, rather than preserving, the degree of monetary accommodation.

This would not be consistent with the considerations I outlined above: it would mean that real rates were not sufficiently accommodative to begin with, and that lower real rates come at no cost.

To see this more clearly, it is useful to look at current estimates of the real interest rate gap.

Until a few years ago, policymakers mostly focused on the real *short-term* interest rate gap. But this exclusive focus is no longer appropriate in a world where central banks increasingly try to influence long-term interest rates through forward guidance and asset purchases. The real *long-term* interest rate gap has become equally important over time.

Although there is considerable uncertainty regarding real equilibrium rates, let alone their term structure, ECB staff estimates suggest that the gap between the actual real ten-year rate and the estimated real ten-year equilibrium rate is likely to be highly significant, even when accounting for model uncertainty (left chart, slide 6).

Monetary policy has thus managed to remain highly accommodative despite the steady decline in equilibrium rates over time (right chart, slide 6).[7] A policy that commits to preserving such a degree of accommodation provides measurable support to aggregate demand and hence underlying price pressure.

There are, however, instances where rising rates would unduly tighten our policy stance.

For example, a rise in the real term premium – that is, the compensation that investors demand for risks related to the future path of real short-term interest rates – could signal growing uncertainty around the monetary policy outlook or indigestion of duration supply.

A rising real term premium was the main reason behind the sharp uptick in bond yields seen during the 2013 taper tantrum in the United States and in March last year (left and middle panel, slide 7). These types of movement, if sizeable and persistent, make financing conditions less favourable as they are not accompanied by a corresponding increase in real equilibrium rates.

This channel seems to have played less of a role in recent weeks (right panel, slide 7) but we are conscious of the fact that it may well affect financing conditions in the current environment.

The reason for this is that protecting society from the appalling consequences of the pandemic will require continued strong fiscal support, and hence high net public debt issuance, resulting in an increase in duration risk to be absorbed by markets (left chart, slide 8). This could put unwarranted upward pressure on the real term premium over the period of net asset purchases (right chart, slide 8).

A firm commitment to favourable financing conditions therefore requires a certain minimum purchase volume to offset this effect on real interest rates.

Rising rates are also a concern if the market is driven by animal spirits – if investors start to price in a strong recovery, albeit one that is still subject to considerable uncertainty − or if rates increase as a result of global spillover effects. Such price dynamics risk increasing volatility and uncertainty and could result in vital policy support being withdrawn prematurely.

Preserving favourable financing conditions therefore puts the drivers of changes in financing conditions, and their speed of adjustment, into the focus of our assessment.

In this assessment, cross-asset price correlations can help identify and interpret potential changes in real interest rates. For example, if stock markets increase and credit spreads tighten in response to a rise in real interest rates, markets are likely to price in a stronger growth outlook that could leave financing conditions favourable.

In addition, changes in market-based financing conditions have to be assessed jointly with the likely future trajectory of the economy, in particular the inflation outlook. The Governing Council meetings in which we discuss the quarterly ECB/Eurosystem staff projections have an important role here.

But it is important to note that this does not limit our flexibility to adjust purchase volumes in the period between meetings. If market conditions require, the pace and composition of purchases can be flexibly adjusted in both directions at any time.

Assessing recent market developments

Between the December decision and our most recent Governing Council monetary policy meeting on 11 March, we saw a rapid increase in global and euro area nominal interest rates.

How should these changes in financing conditions be assessed?

The factors that have caused a rise in risk-free interest rates have been largely benign in the euro area. At the time of our meeting, nominal ten-year overnight index swap (OIS) rates were up by about 30 basis points, entirely reflecting a rise in the inflation component (left chart, slide 9).

These movements should not be seen as reflecting a genuine reappraisal of the expected future path of inflation. Term structure models suggest that much of the recent rise in nominal ten-year OIS rates reflects an increase in term premia which, in turn, likely reflects a rise in the inflation risk premium (right chart, slide 9).

In other words, markets have started to revise the balance of risks around the medium-term inflation outlook. After a long period in which inflation persistently and repeatedly surprised to the downside, markets no longer exclude the risk that inflation may rise more strongly than previously expected.

There are a number of reasons why investors might think this way.[8]

One is that accumulated excess savings resulting from a lack of spending opportunities are large enough to meaningfully affect the trajectory of the economy in the medium term (left chart, slide 10). It is difficult to predict what portion of these savings will end up being spent.

It is also unclear how firms will adjust their profit margins to make up for lost income and higher leverage. Before the pandemic, profit margins were a key contributor to weak inflation by absorbing cost-push pressures.[9]

But the pass-through of higher input prices – for example for oil and copper – to final consumer prices may change in an environment of weaker balance sheets, supply bottlenecks and large pent-up demand (right chart, slide 10).

Yet, rising nominal rates have not been accompanied by a rise in real rates.

Real ten-year yields fluctuated over the period but have returned to their December levels, thereby protecting the prevailing high degree of accommodation. Real rates up to a maturity of five years have even continued to reach new historical lows in recent weeks (left chart, slide 11).

The stability of real interest rates is likely to have reflected a combination of two factors.

First, the PEPP's calendar-based forward guidance, promising net asset purchases until at least March 2022, has allayed fears of early tapering in the euro area, keeping the real term premium anchored at very low levels, supported by our continued net asset purchases.

Second, the near-term growth outlook for the euro area remains highly uncertain and clouded. Large parts of the euro area economy remain paralysed. Vaccination campaigns are progressing slowly, infection numbers are rising and containment measures are stricter than in other parts of the world.

This interpretation is consistent with the picture painted by the latest ECB staff macroeconomic projections, which foresee an economic and inflation outlook that is largely unchanged from the December 2020 projections. While the risks surrounding the growth outlook over the medium term have become more balanced, downside risks remain in the near term, mainly owing to the rapid spread of virus mutations.

In the light of these risks, the speed of adjustment of nominal yields was considered to pose a threat to the recovery. There was a risk that markets were getting ahead of themselves. Movements in financial markets had become disorderly at times, increasing volatility and thus uncertainty.

The risk of an overly abrupt and premature withdrawal of vital policy support was corroborated by model-based evidence that suggests that a significant part of the rise in ten-year OIS rates reflected global spillovers (right chart, slide 11).

Against this backdrop, the Governing Council announced that we would significantly step up purchases under the PEPP in the second quarter, in line with market conditions.

Conclusion

Let me conclude.

Preserving favourable financing conditions is a powerful policy response to the challenges we are currently facing. It is a strong commitment to protect an exceptional degree of policy accommodation for as long as needed. It signals our unwavering determination to offset the impact of the pandemic on the projected inflation path. And it is a promise to the people of Europe that the ECB will do its part to mitigate the social and economic costs of this crisis.

This promise is underpinned by a purchase envelope that is unprecedented in the history of the ECB. We will continue to deploy this envelope resolutely and efficiently, guided by our commitment to price stability. If favourable financing conditions can be maintained with asset purchase flows that do not exhaust the envelope over the net purchase horizon of the PEPP, the envelope need not be used in full. Equally, the envelope can be recalibrated if required to maintain favourable financing conditions to help counter the negative pandemic shock to the path of inflation. We will flexibly adjust our purchases over time and across asset classes and jurisdictions in a way that ensures favourable financing conditions for the entire economy and paves the path to recovery.

Thank you.