Mario Draghi: Monetary policy in the euro area

Opening keynote speech by Mr Mario Draghi, President of the European Central Bank, at the Frankfurt European Banking Congress, Frankfurt am Main, 21 November 2014.

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Summary

Mario Draghi, President of the European Central Bank, today opened the Frankfurt European Banking Congress, with an analysis of the economic situation facing the euro area and of the ECB's monetary policy response.

The economic situation in the euro area remains difficult and confidence in the overall economic prospects is fragile and easily disrupted, feeding into low investment, Mr Draghi said. In this context, the inflation situation in the euro area has also become increasingly challenging.

The ECB President emphasised the risk that a too prolonged period of low inflation becomes embedded in inflation expectations, and that the firm anchoring of inflation expectations is critical under any circumstances. This is why the Governing Council has communicated its expectation that the combination of all the monetary policy measures it has decided on will expand the Eurosystem's balance sheet towards the levels prevailing in early 2012, Mr Draghi said. The addition of purchases of covered bonds to ABS purchases will allow us to conduct interventions on a scale that will achieve the intended effects in terms of portfolio rebalancing and signalling.

He added the ECB would continue to meet its responsibility: "We will do what we must to raise inflation and inflation expectations as fast as possible, as our price stability mandate requires of us. If on its current trajectory our policy is not effective enough to achieve this, or further risks to the inflation outlook materialise, we would step up the pressure and broaden even more the channels through which we intervene, by altering accordingly the size, pace and composition of our purchases," Mr Draghi said.

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Ladies and gentlemen,

Last September a significant shift took place in the monetary policy of the ECB. Faced with continuously weak inflation, we reached the effective lower bound on our policy interest rates, and we resorted to asset purchases as a means to expand further our monetary policy stance.

Today I would like to describe the context in which this shift has taken place, and how the new instrument of asset purchases operates.

The current situation in the euro area

Two and a half years ago, the euro area faced a very bleak situation. We had a fragmented financial system, a banking sector that would not lend and an economy in recession. European economies were on diverging but generally downward paths.

Since then governments and the ECB have taken several steps to address fragmentation, and the financial situation in the euro area has improved dramatically. Spreads on government bonds have fallen on average by 3 percentage points. Interest rates on corporate and bank bonds have also converged substantially. And the fragmentation of financial flows across borders has receded, although it is still higher in some markets than it was before the crisis.

The process of cleaning up the banking sector has also advanced considerably. In particular, our Comprehensive Assessment has encouraged banks to frontload their balance sheet repair and recapitalisation efforts, as well as identifying €25bn in capital shortfalls and imposing important prudential requirements. All this increases confidence in the sector and puts euro area banks in a better position to restart lending to the real economy.

Nevertheless, these positive developments in the financial sphere have not transferred fully into the economic sphere. The economic situation in the euro area remains difficult. The euro area exited recession in the second quarter of 2013, but underlying growth momentum remains weak. Unemployment is only falling very slowly. And confidence in our overall economic prospects is fragile and easily disrupted, feeding into low investment.

Indeed, the latest flash euro area Purchasing Managers Index released yesterday suggests a stronger recovery is unlikely in the coming months, with new orders falling for the first time since July 2013.

In this context, the inflation situation in the euro area has also become increasingly challenging. Headline inflation has fallen significantly over the last year. Last November, it still stood at 0.9%. This was low, but it was generally expected to rise safely above 1% by now. Instead, the latest reading for headline inflation is 0.4%.

This downward movement of inflation was primarily driven by declines in energy and food price inflation, which are two components that tend to be volatile and whose effects are typically temporary. So to some extent the ECB could "look through" them. Indeed, in our current environment low energy and food prices give valuable support to economic activity by raising real disposable incomes.

But we also see that core inflation is low – the inflation rate that strips out these volatile and temporary components. The annual rate of change in core inflation has been consistently below 1% over the past year, with the latest reading for October at 0.7%. A low reading for core inflation for such a period of time indicates that it is not only temporary factors that are operative: underlying demand weakness is also playing a role.

Indeed, we have clear signs from survey data that weak demand is contributing to low pricing power among firms. We also know that with high unemployment in many euro area countries workers have less power to negotiate higher wages, which reduces inflation pressures. Compensation per employee increased by only 1.1% year-on-year in the second quarter of this year, the lowest increase in three years.

We have had low headline inflation in the past driven by energy prices – it was even negative in 2009. But at that time, core inflation was already moving upwards as the economy was rebounding, which provided us with comfort that inflation would pick up over the medium-term. This time around, the overall picture is different.

So we cannot be complacent – we have to be very watchful that low inflation does not start percolating through the economy in ways that further worsen the economic situation and inflation outlook. There are several channels through which low inflation can have this effect, including by complicating relative price adjustment between euro area countries, and worsening the effects of the debt overhang that prevails in parts of the euro area.

But a channel I particularly want to focus on is the risk that a too prolonged period of low inflation becomes embedded in inflation expectations. The firm anchoring of inflation expectations is critical under any circumstances, as it ensures that temporary movements in inflation do not feed into wages and prices and hence become permanent. But it is even more critical in the circumstances we face today.

This is because if inflation expectations fall, the *real* interest rate rises, which is the interest rate that matters most for investment decisions. And because nominal short-term rates in the euro area have already reached the effective lower bound, they cannot be adjusted downwards further to compensate for this. In other words, any de-anchoring of expectations would cause an effective monetary tightening – the exact opposite of what we want to see.

We are currently seeing some volatility in inflation expectations. Longer-term indicators are on the whole within a range that we consider consistent with price stability. Over shorter horizons, however, indicators have been declining to levels that I would deem excessively low. Survey-based measures of inflation expectations have generally been more stable, but the latest Survey of Professional Forecasters also indicates some decline – and at all horizons.

If we put this all together, we see that it has been essential that the ECB has acted – and is continuing to act – to bring inflation back towards 2% and ensure the firm underpinning of inflation expectations.

The monetary policy response

So how have we responded? Our response has certainly been unconventional, in the sense that our measures are unprecedented – but it is far from unorthodox. We have responded in a way that any central bank with a strict price stability objective would do. It has essentially involved three overlapping steps.

The first step, as I said, was to lower overnight interest rates all the way to their effective lower bound – including below zero for the deposit facility. But once we reach this point, and if inflation is still too low and more monetary stimulus needed, the central bank has to adopt new instruments to fulfil its mandate.

The next logical step to ease monetary conditions is to influence more directly the term structure of interest rates, which we did by introducing forward guidance in July of last year. We have recently re-affirmed our forward guidance that key policy rates will stay low for an extended period of time in line with the subdued outlook for inflation. And in the Targeted Long-Term Refinancing Operations (TLTRO) programme we have backed this up, by providing term funding over up to four years at a very low fixed rate.

As a result, the level of the forward interest rate curve in the euro area is currently uniformly lower than it has ever been – and also lower for instance than at any point in the US since the start of the financial crisis.

Both these steps have in common that they operate through steering current and forward money market rates. However, once the margin for manoeuvre here becomes exhausted – that is, overnight and near-term money market rates are both at the lower bound – a third step becomes necessary. If further monetary stimulus is needed, central banks need to by-pass the money market and intervene directly in other asset markets to affect, through prices and quantities, the various transmission channels of monetary policy.

Speaking in Amsterdam earlier this year, I clarified the circumstances under which the ECB would need to resort to asset purchases to increase meaningfully the degree of monetary accommodation. In what I called the “third contingency”, I referred to a broad-based weakening of aggregate demand that would threaten our baseline scenario of recovery and/or a loosening in the anchoring of medium-term inflation expectations.

And this is the point the ECB has reached with the Governing Council’s decision to initiate purchases of asset-backed securities (ABS) and covered bonds.

How asset purchases contribute to the ECB’s objective

With our monetary policy decisions in June and in particular in September, we have transitioned from a monetary policy framework based predominantly on passive provision of liquidity to a more active and controlled management of our balance sheet.

This means that it is now changes in the *size and composition* of our balance sheet that determine our monetary policy stance – or to be more specific, the markets in which we intervene, and the magnitude and pace of our purchases. We expect such interventions to affect output and inflation through two main channels.

Direct pass-through effects

The first is by addressing impairments in financial markets that have a *direct pass-through effect* to the real economy. And this effect will naturally be stronger in those markets that are more important for the transmission of monetary policy.

With this in mind, we began our shift to actively deploying our balance sheet by focusing on the ABS market, as this was a market that was *both* impaired *and* that had a tight link with bank lending, which is the main transmission mechanism of monetary policy in the euro area. This reinforced our overall aim to ensure there are no barriers to credit supply as credit demand progressively picks up.

Purchases of ABS will push down market spreads on senior tranches, reduce volumes available for investors in those markets and thereby encourage banks to relieve this scarcity by originating more ABS. As they can only do this by creating more loans in the first place, this ought to increase the supply of credit and reduce the price at which it is granted.

The impact of these purchases will be bolstered by the scaling-up in parallel of the TLTROs. As banks receive cheap long-term funding on the condition that they expand loans to households and firms, the TLTRO will increase credit supply, which in turn should lead the price of credit to fall in a competitive environment.

And both these measures will arrive in the context of the successful completion of the Comprehensive Assessment, which puts banks in a much stronger position to transmit our new monetary policy impulse.

Indeed, there is already evidence that in expectation of the roll-out of these measures, banks are lowering lending rates and increasing loan volumes. Our latest Bank Lending Survey reported a net easing of credit standards on loans to non-financial corporations and, more generally, suggests we have passed a turning point in credit growth.

Portfolio balance effects

The second channel through which we expect asset purchases to work in the euro area is the broad *portfolio balance channel*. Let me explain how in principle that channel operates.

As we buy assets, investors are likely to substitute the lower risk assets we buy with riskier assets such as longer-term assets, equities and possibly real estate. This has well-known effects on interest rates across the curve, on the cost of capital, on wealth – via higher equity and real estate prices – and therefore on balance sheets more generally.

There are certainly question marks as how strong these effects are in the euro area. We do not have precedents and therefore empirical data for an economy such as ours, which has a different financial structure from the US or Japan. But there is no question as to the *sign* of the effects – it is clearly positive.

Indeed, given our relatively greater reliance on banks as a source of finance, these balance sheet effects could work particularly through the bank lending channel. On the bank side, rising asset prices would free up capital resources for additional lending. While on the side of firms and households, an improvement in net worth, combined with a general improvement in economic prospects and hence future earnings, can expand their capacity to borrow.

Substitution of assets can also take place across jurisdictions, which would take the form of investors rebalancing portfolios away from euro-denominated assets towards other jurisdictions and currencies providing higher yields.

For example, there is evidence that both the various Large Scale Asset Purchase programmes of the Fed as well as the Bank of Japan's Quantitative and Qualitative Easing programme led to a significant depreciation of their respective exchange rates, even in a situation in which long-term yields were already very low, as in Japan.

Finally, through these portfolio balance effects the central bank can also expect to have a strong *signalling effect*. They signal that we will use all means available to us, within our mandate, to return inflation towards our objective – and without any undue delay. This in turn helps anchor inflation expectations and thereby lower real interest rates, boosting activity and inflation. This is also a channel that was operative in the US and Japan.

Both economic theory and international experience suggest that the magnitude of portfolio balance effects is a function of the size of the central bank's balance sheet. As this effect stems from the displacement of portfolios, it is logical that the greater the purchases, the greater the displacement across asset classes.

This is why the Governing Council has communicated its expectation that the combination of all the decided measures will expand the Eurosystem's balance sheet towards the levels prevailing in early 2012. And in this context, the addition of purchases of covered bonds to our ABS purchases will allow us to conduct interventions on a scale that will achieve the intended effects in terms of portfolio rebalancing and signalling.

Let me underline however that contingent on outcomes, we are committed to recalibrate the size, pace and composition of our purchases as necessary to deliver our mandate. This is why the Governing Council has tasked ECB staff and the relevant Eurosystem committees with ensuring the timely preparation of further measures to be implemented, if needed.

Conclusion

Let me conclude.

For all the reasons I have mentioned, it is essential to bring back inflation to target and without delay. Monetary policy can and will do its part to achieve this. But it is also clear that, as monetary policy works on the demand side of the economy, other policies can assist in this process – or at least not counteract it.

This means that the aggregate fiscal stance of the euro area has to be consistent with our position in the cycle. And it means that this fiscal stance must be achieved in a confidence-enhancing way – that is, consistent with the fiscal governance framework – otherwise lack of confidence will undermine investment and offset the positive effects of fiscal policy on demand.

And as investment does not only create current demand, but also future supply – by raising growth potential – appropriate structural policies are also a key part of the policy mix. We need to create a business environment where new investment is attractive. And this in turn would also help monetary policy to reap its full effects.

In short, there is a combination of policies that will work to bring growth and inflation back on a sound path, and we all have to meet our responsibilities in achieving that. For our part, we will continue to meet our responsibility – we will do what we must to raise inflation and inflation expectations as fast as possible, as our price stability mandate requires of us.

If on its current trajectory our policy is not effective enough to achieve this, or further risks to the inflation outlook materialise, we would step up the pressure and broaden even more the channels through which we intervene, by altering accordingly the size, pace and composition of our purchases.