Erkki Liikanen: Monetary policy and its transmission to the economy

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the 4th FIN-FSA Conference on EU Regulation and Supervision, Helsinki, 9 June 2015.

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Original presentation is on the Bank of Finland's website: Slides (PDF).

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Commitment to accommodative monetary policy benefits economic outlook

The Governing Council of the ECB has taken a series of monetary policy measures to stimulate the economy. The aim is to maintain price stability over the medium term. The most recent comprehensive monetary policy easing cycle from June 2014 to January 2015 consists of several standard and non-standard measures:

[SLIDE 3] Interest rate policy in 2014

In June and September the Governing Council cut the monetary policy lending rates and decided on a negative deposit facility rate.

[SLIDE 4] The decisions to support provision of credit in 2014

The Governing Council also introduced two asset purchase programmes, for asset backed securities (ABS) and covered bonds. It also launched a new liquidity facility to provide longer-term funding to banks conditional on their credit performance.

[SLIDE 5] The decisions on large scale asset purchases and forward guidance in January 2015

In January 2015, the Governing Council judged that there was additional need for easing of the monetary policy stance, as the inflation outlook had weakened further.

Through the expanded asset purchase programme, the Eurosystem extended its purchases to bonds issued by euro area governments, government agencies and European institutions. Purchases will be continued until inflation is sustainably on a path leading to a level close to 2%.

Engaging in large scale outright asset purchases switched the Eurosystem from a demand-driven approach to a more active steering of the Eurosystem balance sheet and monetary base.

The motivation behind the decision to expand purchases to euro-denominated public sector securities was the weakening of the inflation outlook: euro area inflation, core inflation and both short and long-term inflation expectations declined strongly during the second half of 2014.

The Governing Council has stated that "they are intended to be carried out until end-September 2016 and will in any case be conducted until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term."

With this forward guidance, we, i.e. the Governing Council, indicate that our commitment to the accommodative monetary policy to align inflation with the price stability objective is the key component of our January decisions.

Extensive securities purchases allow a substantial easing of monetary policy in a situation where there is no longer room for lower monetary policy interest rates.

The commitment to an accommodative monetary policy stance is all the more important, the lower interest rates are, and the further inflation expectations are from the price stability objective. The confidence is key to raising inflation expectations amongst economic agents.

Expanded asset purchases stimulate both demand and inflation

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Two main channels of large scale asset purchases – often referred to in the literature – are the signalling effect and the portfolio balance effect.

[SLIDE 7] Signalling and portfolio balance effects of a large scale asset purchase programme

The signalling effect contributes to stronger anchoring of inflation expectations in line with our medium-term objective. This effect also contributes to reducing real rates further along the yield curve.

[SLIDE 8] ECB's accommodative monetary policy

The portfolio balance effect broadens the effects to the whole financial system even if only a comparatively narrow range of high-quality securities are purchased. With this effect, investors are encouraged to shift holdings into other asset classes – e.g. from sovereign to corporate bonds, from debt to equity, and across jurisdictions.

In combination, the lower cost of debt finance, reduced cost of equity and weaker exchange rates all contribute to making some investment projects profitable that were previously deemed unattractive.

[SLIDE 9] Commitment to accommodative monetary policy stance has already raised inflation expectations

Conditions in a host of asset markets have developed in line with the presumption. Commitment to the accommodative monetary policy stance has raised inflation expectations, thereby lowering the real interest rate.

[SLIDE 10] Divergence in monetary policy cycles reflected in the euro

The divergence in international monetary policy cycles has had an impact on the external value of the euro. This development is partly a result of tightening monetary policy expectations in the USA.

[SLIDE 11] Sharp fall in long-term bond yields over the past year, some reversal recently

The asset purchase programme has already led to lower reference interest rates gradually resulting in more favourable borrowing conditions for non-financial corporations and households.

[SLIDE 12] Stock prices have increased

A policy of quantitative easing also boosts asset prices. Equity prices have gone up, lowering the cost of equity for both non-financial corporations and banks.

As to the recent general reversal in financing conditions and volatility, the Governing Council was unanimous in its assessment in June that we should look through these developments and maintain a steady monetary policy stance. At the same time we are aware that at very low levels of interest rates, asset prices – bond prices in particular – tend to show higher volatility.

The drop in the real interest rate, general relaxation in financial conditions and improved confidence will work their way through to the economy to boost demand and drive faster inflation. It will, however, still take time until we see the full impact.

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Monetary policy transmission to the real economy is improving

The expanded purchases started at the beginning of March. The full impact of our measures, especially if accompanied by firm actions from other policymakers, will be seen in the months and years ahead.

[SLIDE 14] Monetary policy measures support bank lending

Recovery in bank lending and strengthening of other sources of financing are important factors behind the current monetary policy in the euro area. Our policies are also improving the credit channel, which is confirmed by the fact that credit to the private sector is gradually picking up.

Monetary policy transmission via the banking system requires that banks have sufficient capital to increase their lending, and hence risk-taking.

In 2014, the ECB conducted a comprehensive assessment of the balance sheets of banks in the euro area. Completion of the comprehensive assessment, together with the steps taken by the ECB, is improving monetary policy transmission to the real economy via bank lending.

Monetary policy transmission through the banks is, however, still beset with challenges. Although the banking system is currently stronger as a whole, the operating environment remains challenging.

[SLIDE 15] Monetary policy transmission via bank lending is improving

The ECB's monetary policy measures enhance financial intermediation in a number of ways. They lower funding costs for banks, which should make lending cheaper and more profitable, thereby boosting the volume of lending. Most of all, banks benefit from the ECB's measures via their positive impact on the real economy.

[SLIDE 16] Monetary policy transmission to non-financial firms improved, but still uneven

These extraordinary monetary policy measures have contributed to a broad-based easing in financial conditions and more favourable borrowing conditions for firms and households. They support economic activity in all countries, especially in those having suffered most from stressed conditions in recent years but having at the same time executed substantial structural measures to improve the performance of their respective economies in the longer run.

[SLIDE 17] Corporate bond yields remain low, some reversal recently

The importance of market funding for non-financial corporations is increasing in the euro area. The asset purchases support the corporate bond markets, as investors selling government bonds are expected to switch to higher-risk corporate bonds, reflecting the portfolio balancing effect.

Corporate bond yields reached a record low in the euro area in early 2015. Although corporate emissions have partially compensated for the decline in bank lending in the case of large corporations, SMEs do not have the same access to alternative sources of funding and are therefore still highly dependent on bank lending.

The accommodative monetary policy is also pushing up share prices. This could boost corporations' willingness to invest, as the market value of the corporations rises while their funding costs decline.

[SLIDE 18] Corporate sector debt ratios declining

However, the low price and improved availability of credit will be insufficient to restore more vigour to the economy if very indebted corporations decide to reduce their debt instead of investing. The debt ratio of non-financial corporations in the euro area (aggregate debt relative to GDP) has come down from the heights of 2009. The euro area corporate sector in general cannot be considered to be particularly indebted.

There are, however, large differences between countries. High corporate debt ratios in some countries may still be a partial cause of the weak developments in corporate borrowing and investment. The more relaxed financing conditions for non-financial corporations and the reasonable level of indebtedness in the euro area's corporate sector should, however, provide fertile ground for recovery in investment.

[SLIDE 19] Average interest rates on new housing loans have declined

From the perspective of achieving price stability it is vital that monetary policy measures have a positive effect not just on investment, but also on consumption. The process of reducing the household debt burden is still hampering consumption in several euro area countries.

The accommodative monetary policy stance can help with unravelling household debt. The average interest on the euro area household loan stock has already come down to around 3% and can be expected to fall somewhat further. There are, however, large differences between euro area countries in the transmission of monetary policy via households to the real economy.

[SLIDE 20] Eurosystem projections in June 2015

As a result of the monetary policy measures taken between June 2014 and January 2015, both the inflation and growth outlook have improved considerably. Eurosystem staff projections published last week point to a sustained recovery that leads to a real growth rate of 2.0% and an inflation rate of 1.8% in 2017. These projections are based on full implementation of the purchase programmes as announced.

[SLIDE 21] Inflation outlook has improved

These numbers also represent a significant contribution to financial stability by overcoming the low nominal growth that has been portrayed as the underlying factor of the main risks for financial stability in the euro area in recent years. In any case, our monetary policy stimulus will stay in place as long as needed for its objective to be fully achieved on a truly sustained basis.

The accommodative monetary policy is beneficial to the euro area and also to the Finnish economy. A Bank of Finland estimate[1], to be published tomorrow in the context of the staff forecast, assesses the impact of the expanded asset purchase programme on the Finnish economy. According to these calculations, lower interest rates and a weaker exchange rate will increase the GPD growth rate in Finland by 0.3 percentage points in two years. This positive indirect impact is also taken into account in the forecast for Finnish exports.

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Financial stability risks and macroprudential policy

While the current monetary policy measures are necessary for the ECB to achieve its primary objective, the monetary policy stance may in some circumstances have unintended side effects on the financial system. A key concern is that a prolonged period of accommodative monetary policy could result in a misallocation of resources that would ultimately undermine financial stability.

[SLIDE 23] The mandate of the ECB

The Eurosystem's primary objective is to maintain price stability, and monetary policy decisions are based on the assessment of the risks to price stability in the euro area as a

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[1] Elisa Newby and Seppo Orjasniemi: "Suomi hyötyy eurojärjestelmän arvopaperiostoista", Euro & talous 3/2015.

whole. Higher risks to financial stability should be met primarily through domestic macroprudential policy.

In a single currency area, macro-prudential policies are particularly important to deal with sectoral and regional risks. Macroprudential policy provides the most appropriate instruments for mitigating financial stability risks, and thereby supporting the price-stability-focused monetary policy.

[SLIDE 24] The ECB's role in the new supervisory architecture

From the perspective of financial stability, the euro area is now in a substantially better position than a few years ago. We are now operating in a new regulatory and supervisory environment. In November last year, the ECB took over the responsibility for supervising banks in the countries belonging to the Banking Union. It is less well-known that, at the same time, the ECB became the ultimate macroprudential decision-maker in the Union.

[SLIDE 25] The ECB reinforces but cannot substitute national macroprudential policies

More specifically, the ECB can apply higher requirements for specific macroprudential tools than proposed by the designated national macroprudential authorities, if it deems that the suggested national measures are inadequate.

In contrast to the single monetary policy, macroprudential policy in the Banking Union is a joint responsibility between different authorities. The main responsibility in macroprudential policy lies with national authorities. They are in the best position to detect country-specific systemic risks and take appropriate measures to address them.

The role of the ECB in macroprudential policy is to enhance national policies and reduce the inaction bias inherent in taking potentially unpopular and intrusive national actions.

The European Systemic Risk Board (ESRB), in turn, monitors the development of EU-wide cross-border and cross-sectional systemic risks and provides guidance and recommendations to the national authorities.

[SLIDE 26] Macroprudential policy is important in a time of exceptionally accommodative monetary policy

A necessary precondition for successful macroprudential policies is the availability of sufficient macroprudential toolkits. Importantly, the Capital Requirements Regulation and Directive (CRR/CRD IV) provide the ECB and the national authorities with a common minimum set of macroprudential tools for the banking sector. These include countercyclical capital buffer requirements, capital surcharges for systemically important institutions and minimum risk weights for real estate exposures, for example.

However, in most euro area countries, the national toolkits should be strengthened. For example, in many countries the tools for containing excesses in housing markets and for building resilience against the realisation of housing-related risks are not strong enough.

The availability of strong national macroprudential toolkits and the courage to use those tools are of utmost importance in the environment of very low interest rates. The ECB's Governing Council is closely monitoring any potential risks to euro area financial stability, including those from excessive risk taking. Currently, these risks are contained. Should they emerge, macroprudential policy would be best suited to address them.

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Transparency improves the accountability and effectiveness of monetary policy

In January this year, when the Governing Council decided to expand its asset purchase programme, it also decided to publish a summary of that meeting's deliberations before the next monetary policy meeting. The days of "never excuse, never explain" and central banks acting as opaque and secretive institutions were over for good.

[SLIDE 28] Transparency, accountability and efficiency: Accounts of the monetary policy meetings

A high degree of transparency is an important tool for an independent central bank like the ECB, as it facilitates accountability. We are accountable to achieve our mandate, price stability. By explaining the reasoning behind our monetary policy decisions and helping a better understanding of monetary policy we make it easier to attain our objective, facilitating efficiency.

In mid-2013, by introducing forward guidance and through 2014 conveying the Governing Council's "reaction function" we increased our influence over the shape of the yield curve. When we had decided on our purchase programme in January, long-term nominal interest rates declined, as we had communicated our reaction function.

We have emphasized that we will evaluate the likelihood for inflation not only to converge to levels that are closer to 2%, but also to stabilize around those levels with sufficient confidence thereafter.

The decision to publish an account of our monetary policy meetings was preceded by long and thorough discussions by the Governing Council.

At the same time, we felt that even differences of views can be communicated without compromising the credibility and singleness of our monetary policy. Such differences are quite normal and should exist in any committee having meaningful and analytical discussions.

The accounts we decided to start publishing are intended to provide a richer summary and convey the flavour of the discussion among Governing Council members.

In our view, providing a fair and balanced summary of the main arguments put forward was the best way to achieve this. The language we use reflects our collegiate, consensus-oriented mode of discussion and decision-making.

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Let me conclude.

The economic recovery in the euro area is broadening. ECB policies are working, as economic conditions in the short term are improving. Other policymakers are responsible for their own efforts to strengthen the euro area economies and their potential growth in the medium to longer term. This will be achieved mainly by implementing structural reforms based on each country's own needs and capabilities.

It is, however, our task, especially now that the ECB has been given supervisory responsibilities, to ensure, besides price stability, also proper conditions of financial stability in the euro area. We must work continuously to build up a resilient, robust and efficient financial system that is essential for the long-term prosperity of our monetary union. In this work cooperation between the Eurosystem, the SSM and national central banks and supervisors is essential.

Thank you for your attention.