Erkki Liikanen: Monetary policy and its effectiveness

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at a public lecture at the Croatian National Bank, Zagreb, 10 September 2015.

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Accompanying slides can be found on the Bank of Finland's website

Ladies and Gentlemen,

It gives me great pleasure to have this opportunity to address you today. At the moment, we are at a very interesting juncture in the economic and monetary developments in the EU and the euro area. The economic conditions of all countries in our continent –big or small, northern or southern – are deeply interconnected, so I believe that we share many of our concerns and interests.

It has been a long and arduous journey for the EU and not least the euro area from the crisis of 2008–2009 until today, when at last we see a real promise of economic recovery in the area as well as increasing confidence that a solid foundation for lasting financial stability has been laid. There are a lot of uncertainties, of course, in the global economy, in regional geopolitics, and so on – but there are also signs that economic recovery is underway.

So, it is an exciting time and monetary policy is once again an important part of the overall picture. It is my purpose today to concentrate on monetary policy and some related questions. I will survey the monetary policy situation from the point of view of the euro area and from my perspective as a member of the ECB's governing council.

It is useful to start by a review of our recent monetary policy, which is very exceptional by historical standards, both in terms of its strength and its instruments. So, what exactly are we doing? How will it impact the euro area economy? What else needs to be done to ensure a balanced and sustainable recovery?

[SLIDE 2] Commitment to accommodative monetary…

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 euro area economy. The aim of these measures has been to maintain price stability over the medium term.

The most recent monetary policy easing cycle, starting from June 2014, consists of several measures. In addition to interest rate policy, we have used so-called non-standard measures in an unprecedented scale.

[SLIDE 3] Interest rate policy in 2014

In June and September 2014 the Governing Council of the ECB cut the monetary policy lending rates and decided on a negative deposit facility rate. In consequence monetary policy interest rates are reduced to the zero lower bound.

[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 refinancing facility to encourage banks to increase their lending for productive investments.

[SLIDE 5] The decisions on large scale asset purchases and forward…

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.

In this situation we launched the biggest asset purchase programme in Eurosystem history. Through this expanded asset purchase programme, the Eurosystem extended its purchases to bonds issued by euro area governments, government agencies and European institutions.

Within this programme, the Eurosystem will buy securities to a value of EUR 60 billion per month until September 2016, or beyond if necessary. Thus, the total purchases will be more than EUR 1,000 billion. Euro area government bonds will make the most of the purchases.

The motivation behind the decision to expand purchases to euro-denominated public sector securities was the increasing probability of euro area falling into deflation and the adverse effects stemming from prolonged period with low inflation. The Governing Council of the ECB wanted to prevent price stability objective from losing its role as a firm anchor to inflation expectations and price formation in the euro area.

The Governing Council has stated that purchases "are intended to run until the end of September 2016, or beyond, if necessary, and, in any case, until we see a sustained adjustment in the path of inflation that is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term." And it has flagged readiness to carry on purchasing more securities if necessary. With this forward guidance the Governing Council indicates its commitment to a monetary policy which will realign inflation with our price stability objective.

In January euro area headline inflation was a negative –0.6%, and has hovered around 0.2% over the past few months to August 2015. With nominal short-term interest rates already at the zero lower bound, fading inflation expectations pushed up real interest rates, effectively tightening monetary policy.

[SLIDE 6] Large scale asset purchases stimulate

Large scale asset purchases stimulate both demand and inflation

The two main channels of effect for 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…

The signalling effect contributes to stronger anchoring of inflation expectations in line with the medium-term objective of price stability. This effect also contributes to reducing anticipated real rates. Depending on the monetary policy reactions in the rest of the world, the signalling can also put downward pressure on exchange rates.

The portfolio balance effect broadens the effects of the securities purchases to the whole financial system even if only a comparatively narrow range of high-quality securities are purchased by the central bank. 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. This has an indirect effect on the prices and required rates of return in the financial markets as a whole.

[SLIDE 8] ECB's accommodative monetary policy

Overall, the ECB's accommodative monetary policy lowers real interest rates and eases financial conditions in the economy, boosting demand. Consumption increases and the lower cost of debt finance, reduced cost of equity and weaker exchange rates in combination contribute to making some investment projects profitable that were previously deemed unattractive.

This supports private consumption through various channels. Also, the lower cost of debt finance, reduced cost of equity finance, and the weaker exchange rate all contribute to making investment projects more profitable.

[SLIDE 9] Divergence in monetary policy cycles has weakened the euro

The divergence in international monetary policy cycles is putting downward pressure on the external value of the euro. This development is partly a result of tightening monetary policy expectations on the other side of the Atlantic.

[SLIDE 10] Renewed decline in oil price puts downward pressure…

Conditions in wide spectrum of asset markets have developed broadly as intended when the current cycle of monetary policy easing. However, the slowdown in emerging markets and recent sharp fluctuations in financial and commodity markets have brought some downside risks to the outlook for growth and inflation. The renewed decline in oil price puts downward pressure on inflation in the short run.

[SLIDE 11] Commitment to accommodative monetary policy stance…

Commitment to the accommodative monetary policy stance supports inflation expectations, thereby lowering the real interest rate. More recently, renewed downside risks have emerged and inflation expectations have decreased.

However, owing to sharp fluctuations in financial and commodity markets, the Governing Council judged it premature to conclude whether these developments could have a lasting impact on the outlook for prices, or whether they should be considered to be mainly transitory.

[SLIDE 12] Sharp fall in long-term bond yields…

The ECB's asset purchase programme has already led to lower reference interest rates over the whole maturity spectrum and is gradually resulting in more favourable borrowing conditions for non-financial corporations and households. Despite somewhat higher bond yields recently, borrowing conditions remain favourable and loan dynamics are expected to improve.

[SLIDE 13] Stock market turbulence in August

A policy of quantitative easing boosts property prices and stock markets. In August, however, equity prices fell sharply in China and also globally as the uncertainty over the state of the Chinese economy increased. This has sent jitters in the stock markets through the world. It remains to be seen whether the uncertainty is increased in a more permanent fashion.

[SLIDE 14] Monetary policy transmission to the real economy…

Monetary policy transmission to the real economy is improving

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

While we have already seen a substantial effect from our measures on bond yields and asset prices, what ultimately matters is when there is an equivalent effect on investment, consumption and inflation.

[SLIDE 15] Monetary policy measures support bank lending

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

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. And the banks benefit from the measures via their positive impact on the real economy.

An improving real economy will eventually be reflected in expanding balance sheets and improved profitability as, for example, the share of non-performing loans in the loan stock declines. At the same time, banks' credit risks will decline, making it easier for them to increase lending.

[SLIDE 16] Monetary policy transmission to non-financial corporations…

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 of the euro area 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 in the longer run.

[SLIDE 17] Corporate bond yields remain low…

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.

[SLIDE 18] Average interest rates on new housing loans…

From the perspective of achieving price stability it is vital that monetary policy measures have a positive effect not just on corporate expenditure, but also household expenditure.

[SLIDE 19] The recovery in the euro area is expected to continue

The recovery in the euro area is expected to continue

[SLIDE 20] ECB staff projections in September

As a result of the accommodative monetary policy measures, the inflation and growth outlook have improved. The information available in September indicates a continued though somewhat weaker economic recovery and a slower increase in inflation rates compared with earlier expectations. The recovery will be supported by domestic dynamics, while the external environment has become less favourable. Despite downward revision, ECB staff projections published last week still point to a sustained recovery leading to a real growth rate of 1.8%.% in 2017.

[SLIDE 21] Inflation outlook subdued 2015–2016

Inflation is expected to remain very low but is projected to rise over the projection horizon, reaching 1.7% in 2017. The projection for HICP inflation also entails a downward revision, largely due to lower oil prices.

[SLIDE 22] Finland falls further behind euro area growth

The accommodative monetary policy is beneficial to both the euro area and the Finnish economy. The Bank of Finland has assessed 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.

However, Finland has fallen further behind euro area growth as exports have suffered and the labour market situation has deteriorated. Unfortunately, Finland is not expected to reach the pace of the recovery in the rest of the euro area in the near term.

[SLIDE 23] Financial stability risks and macroprudential policy

Financial stability risks and macroprudential policy

While the current monetary policy measures are necessary for the ECB to achieve its primary objective of maintaining price stability and to ensure that inflation does not remain too low for too long, the current monetary policy stance may also have unintended side-effects on the financial system. A key concern is that a prolonged period of very accommodative monetary policy could result in a misallocation of resources that would ultimately undermine financial stability.

[SLIDE 24] 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 whole. Higher risks to financial stability should be addressed primarily through domestic so-called macroprudential policy in the different member countries.

In a single currency area, macroprudential policies are particularly important for dealing with sectoral and regional risks that cannot be accounted for by the single monetary policy. Macroprudential policy therefore provides a much needed instrument for mitigating financial stability risks and thereby supporting the price-stability-focused monetary policy.

[SLIDE 25] 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 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 26] The ECB reinforces but cannot substitute…

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 ECB will help to identify potential financial stability risks and foster a coordinated stance for macroprudential policies among the euro area Member States.

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 27] Macroprudential policy is important in a time of…

A necessary precondition for successful macroprudential policies – both at a national level and for the Banking Union as a whole – 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 realization of housing-related risks are not strong enough. In addition, we should develop new tools to address systemic risks potentially developing in the shadow banking sector.

The availability of strong national macroprudential toolkits and the courage to use these tools are of utmost importance in the current 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.

It is clear that much work remains to be done to make the European financial system safer. We need to evaluate the sufficiency of the toolkits of the national authorities and the ECB, as well as learning how to use the new tools most effectively; this is a work in progress and should continue. But we are taking important steps in the right direction.

[SLIDE 28] Transparency improves the accountability…

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 29] Transparency, accountability and efficiency:..

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 and the markets understood it.

Most recently, and going forward, President Mario Draghi has clarified our reaction function by discussing the conditions that will determine the duration and intensity of our expanded asset purchase programme, above and beyond our expressed intention to carry out our purchases until end-September 2016.

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. As we have been increasingly resorting to unconventional measures to meet our mandate, we decided that we need to be more open with the public about how we reached our decisions.

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.

This implies that in reporting on our monetary policy deliberations the independence of the members of the Governing Council must not be put at risk. At the same time, it is also very important to us to preserve the collegiality of our deliberations. That is why we do not attribute positions to individual 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. And not publishing a voting record allows members to support the decision of the committee, even if they may have personally preferred a different course of action.

[SLIDE 30] Thank you!

Let me conclude.

The economic recovery in the euro area is proceeding, albeit at a slower pace than expected. ECB policies are working, as underlying economic conditions are improving despite recent financial and commodity market volatility.

Other policymakers, such as national governments are responsible for their own efforts to strengthen the euro area economies and their growth potential in the medium to longer term. This will be achieved mainly by implementing structural reforms based on each country's own needs and capabilities.

The Governing Council will closely monitor all relevant incoming information. It emphasizes the willingness and ability to act, by using all the instruments available within its mandate and, in particular, recalls that the asset purchase programme provides sufficient flexibility in terms of adjusting the size, composition and duration of the programme.

In the meantime, we will fully implement our monthly asset purchases of €60 billion per month. These purchases have already had and will continue to have a favourable impact on the cost and availability of credit for firms and households. As I already noted, we have taken a decidedly medium-term approach, as reflected in our commitment to continue our asset purchases until the end of September 2016, or beyond, if necessary, and, in any case, until we see a sustained adjustment in the path of inflation that is consistent with our definition of price stability.

Thank you for your attention.