Erkki Liikanen: Eurosystem's monetary policy and its transmission

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Rotman ICPM Forum, Helsinki, 5 October 2015.

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Accompanying slides (PDF) can be found on the Bank of Finland's website.

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Welcome

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[Slide 3: I – Eurosystem's Expanded Asset Purchase Programme (EAPP): Background]

[Slide 4: Decisive action by the Eurosystem stabilised financial markets]

The financial crisis created great uncertainty and increased challenges from the monetary policy-making. Not just the Eurosystem but central banks around the world reacted by cutting policy rates, increasing their banking system's liquidity and adopting so-called non-standard measures of monetary policy.

In July 2012 the President of the ECB, Mario Draghi, committed to do "whatever it takes to preserve euro". This came to mark a turning point for the crisis: markets calmed down and fears of euro area breaking down were removed.

During the same month, in its monetary policy meeting, the ECB's Governing Council cut the main policy rate to below 1 percent, and the deposit rate to zero. By mid-2014 all crisis countries apart from Greece were again able to borrow from private markets.

[Side 5: Traditional monetary policy restricted by the ZLB]

Despite stabilisation of the financial markets, the operating environment of monetary policy remained challenging. Inflation and expected inflation continued to slow down and short term money market rates increased, which meant that further monetary policy easing was needed to maintain price stability over the medium term.

The policy rate is, indeed, the most straightforward tool the central bank has to steer market interest rates. By 2014 we, the Governing Council, had cut the policy rates almost to zero. The deposit rate was cut to negative in the June 2014 policy meeting.

The sheer existence of a lower bound for policy rates complicates monetary policy decision making as it creates asymmetry: A central bank can always increase its policy rate to control inflation but the policy rate cut is limited by the zero bound even if inflation drops to very low levels.

[Slide 6: Real interest rates increase if inflation expectations fall]

The zero lower bound creates a challenge, as falling inflation puts upward pressure on real interest rates. It is the real interest rates, and expectations of them – not the central bank's policy rate – that has the ultimate impact on household consumption or firm investment decisions.

Increasing real interest rates thus indicated that further monetary easing was necessary despite the policy rates being close to the zero lower bound.

[Slide 7: Eurosystem's accommodative monetary policy]

In the June 2014 monetary policy meeting, the Governing Council eased the stance of monetary policy. As a part of the package, we cut the deposit rate to negative, extended the guarantee of banks' access to unlimited central bank finance (given that they provide sufficient collateral) by extending fixed rate full allotment policy, and we set up a series of additional long-term refinancing operations that provide the banks with finance on the condition that they increase the value of their loans to the real economy.

The current cycle of monetary policy easing started in October 2014 when we introduced two private sector asset purchase programmes: the asset backed securities purchase programme and the third programme for covered bonds.

In January 2015 the Governing Council judged that additional monetary policy easing was needed as the inflation outlook weakened further. The Eurosystem extended its purchases to bonds issued by euro area governments, government agencies and European institutions.

[Slide 8: II – Key features of EAPP]

Let us now discuss the current, expanded asset purchase programme, in more detail.

[Slide 9: The Eurosystem sets the liquidity of the euro area banking system]

The Eurosystem is able to regulate the euro area banking system's liquidity with two tools.

Firstly, the Eurosystem organises regular refinancing operations: tenders. The interest rate applied to these operations is the main policy rate, which currently stands at 0.05%. With these refinancing operations the Eurosystem steers short-term money market rates. The tender operations are demand driven: banks can decide whether or not to participate.

In contrast, outright asset purchases are not demand driven. By asset purchases the central bank actively steers liquidity of the banking sector by bond purchases.

Participants of regular tender operations consist of monetary policy counterparties, mainly banks. Outright purchases reach directly a much broader set of financial institutions, some of which are not even located within the euro area.

As instruments bought by the Eurosystem may have maturity of up to 30 years, with these purchases the Eurosystem is able to steer longer term interest rates.

[Slide 10: EAPP consists of two parts]

The Eurosystem's asset purchase programme consists of two parts.

The first one is the private sector purchasing programme. In this programme the Eurosystem purchases covered bonds and asset backed securities issued in the euro area both from primary issuance and secondary markets.

The second part is the public sector purchase programme, PSPP. Under this programme the Eurosystem buys bonds only from the secondary market.

[Slide 11: Key features of the programme]

The monthly size of purchases is 60 bn. euros. This includes ABSs, covered bonds and public sector bonds.

The Governing Council stated in January that purchases '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, indicated that our commitment to the accommodative monetary policy to align inflation with the price stability objective was the key component of our January decisions.

The organisation of the programme inside the Eurosystem is such that the ECB co-ordinates the programme but national central banks conduct the purchases. According to this division of labour, the national central banks buy domestic bonds. For example, the Bank of Finland buys Finnish government bonds from a broad range of financial institutions. The size of each country's purchases are calculated via the country's capital key. This parameter reflects the relative population and output of each euro country. As a result, the Bank of Finland purchases, on average, about 700 million euros worth of public sector bonds each month.

In order to minimise market disturbances, the Eurosystem participates in securities lending. Purchases extend from short, 2 years, maturities to very long ones, up to 30 years.

[Slide 12: III – Impact EAPP]

[Slide 13: Transmission of central banks' asset purchase programmes]

The Eurosystem buys securities with newly issued central bank money. The Eurosystem's balance sheet expands, and liquidity of the banking system increases.

The impact of asset purchases transmits to output and inflation via the financial markets: yield curves, lending rates, asset prices and exchange rates. Financial market prices react rapidly, but output and prices only gradually over time.

[Slide 14: Implementation of EAPP has been smooth. "It is a marathon"]

This slide presents all outright asset purchase programmes of the Eurosystem, including those that are no longer active. The current expanded asset purchase programme started off smoothly and purchases followed the agreed plan. As you can see, purchases of bonds in particular have increased the Eurosystem's balance sheet.

If the EAPP is compared with a marathon, we now have 15 km behind us.

[Slide 15: EAPP affects inflation and output via several channels]

In what follows I will focus on four main channels via which the purchase program transmits to the real economy. These channels are: the expectations channel; the signalling channel; the portfolio balance channel; and the exchange rate channel.

[Slide 16: 1. Expectations: First impact, immediate intraday movements in asset prices on 22 January]

Financial markets expected already in the second half of 2014 that the Eurosystem would expand its purchases to public sector bonds. Despite this, financial markets reacted strongly to the Governing Council's announcement on 22 January to the launch of bond purchases. Stock indices increased by a percentage, euro depreciated against the US dollar by 1.4% and yields of Spanish and German government bonds fell by 0.25 percentage points. The market response was comparable on 5 March when the Governing Council, at its monetary policy meeting, announced further details of the programme and that purchases would commence almost immediately.

The Governing Council's announcement exceeded market participants' expectations, which was a positive surprise shock to the markets.

[Slide 17: 2. Signalling: Forward guidance is an integral part of EAPP]

Already in 2013 the Governing Council employed forward guidance to reduce expectations of an early exit from accommodative monetary policy. The Governing Council said explicitly that interest rates would be kept 'at present or lower levels for an extended period of time'.

The asset purchase programme signalled itself a continuation of accommodative monetary policy. This was further amplified by the Governing Council's forward guidance. If markets were to interpret the asset purchases as just a temporary measure, it would not bring about a broad-based decline in long-term interest rates.

The Governing Council has stated 3 September 2015 that the EAPP is intended to be carried out until end-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.

[Slide 18: Signalling: Money market rates expected to remain low]

Forward guidance has been credible in a sense that expectations on money market rates remain low well into the future. The money market rates are expected to remain zero at least until 2017.

[Slide 19: 2. Signaling: Transmission of low policy rates to provision of credit has improved]

Further increase in accommodative monetary policy by asset purchases has worked itself through banks' retail interest rates. Since the announcement of the purchase programme, the average interest rates of new corporate loan agreements have kept falling, especially in GIIPS countries. As banks' expectations on the Eurosystem's monetary policy stance eased, the money market interest rates fell. For example, the 12-month Euribor declined by almost 50 basis points since mid-2014, to 0.15%. Almost 60 % of euro area corporate loans are linked to Euribor rates.

[Slide 20: 3. Portfolio balance: Share prices have increased, recently increase in volatility]

The portfolio balance channel broadens the effects of asset purchases to the whole financial system. If a central bank purchases long-term debt securities, the average duration of debt securities on the market decreases. Narrowing of the yield spread encourages investors to purchase bonds with even longer maturities, and long-term bond yields decline further.

Investors will also have to look for substitutes for government bonds they sell to the Eurosystem. Rebalancing investment portfolios is reflected in corporate bond yields and equities. A decline in yield of corporate bonds reduces funding costs and encourages investments. A rise in securities prices increases the wealth of securities holders and thus consumption.

[Slide 21: Portfolio balance: Effects of EAPP on pension funds]

In the short run, a bond purchase programme lowers yields and increases the value of asset classes such as stocks. Therefore, effectiveness of the portfolio channel depends partly on the ability of investors to sell their sovereign bond holdings to the Eurosystem and invest in other securities.

This is an issue that might be challenging to institutional investors such as pension funds, as rules limit their ability to invest in riskier assets. On the other hand, search for yield and higher returns might make some investors to take on excessive risk.

Central banks' asset purchase programmes are not the only reason for the globally low interest rate environment. In any case, medium term profitability of pension funds may be challenging in the low interest rate environment. For those companies that have in past made contracts with high return guarantees, the low interest rate environment is particularly difficult.

The ultimate aim of the Eurosystem's asset buying programme is to support economic activity and contribute to a sustained return of inflation towards the price level target. Weak nominal growth is globally a key source of risks to financial stability. In the long run, sustainable economic growth is a prerequisite of a sound pension system.

Finally, it is worth noting that financial sector risks cannot be eliminated by monetary policy. Macroprudential policy is needed to promote financial stability. It is conducted by national bodies and by pan-European institutions such as the ESRB, European Systemic Risk Board. In September, the board published a report on systemic risks in the EU insurance sector, including those originating from low interest rate environment.

[Slide 22: EA governments bonds make 24 % of insurance companies' and pension funds' assets]

Government bonds and other fixed-income assets represent a large share of all assets of euro area insurance companies and pension funds. Government bonds alone account for 24% of the assets. The rest are diversified across various asset classes.

[Slide 23: Exchange rate: The fall in EUR/USD since mid-2014 reflects policy divergence]

The Eurosystem's asset purchase programme, as well as divergence in monetary policy stance, have weakened the exchange rate of euro. Firstly, the increased supply of euros relative to other currencies lowers the exchange rate. Secondly, many institutional investors may have considered the US and UK government bonds as substitutes for bonds of high-rated euro area countries. Demand for other currencies leads to depreciation of euro. The nominal exchange rate of euro has depreciated by 8 % since January 2015.

However, the purchase programme is not the only reason for the weakening euro. In addition, economic growth, inflation and interest rates are higher in the US than in euro area.

[Slide 24: Actual and expected inflation trended down before the EAPP decision; since then, the probability of deflation has declined]

The impacts of the purchase program that I have mentioned so far – expectations, interest rates and exchange rates – are elements of the transmission mechanism of monetary policy. The ultimate aim is price stability. The Eurosystem's purchasing programme has played a crucial role in reducing the probability of deflation as perceived by financial market participants.

[Slide 25: Renewed decline in oil prices have put downward pressure on prices]

Most recently, the main reason behind sluggish inflation has been the decline in the price of oil. It has put strong downward pressure on inflation globally. The ECB's policy actions and improved confidence have been key factors supporting inflation expectations in the euro area.

[Slide 26: Lending volumes have improved]

The effects of the accommodative monetary are being felt in bank loan developments. The growth of loans to the private sector has been positive from the beginning of the purchase programme. Investment activity has increased in euro area on average, and private sector confidence has strengthened.

[Slide 27: ECB staff projections in September]

The ECB's latest staff forecast from September indicates a continued, though somewhat weaker recovery in the euro area. Mainly due to the global uncertainties -- especially the slowdown in China and the moderation in world trade -- growth projections were revised downwards from June. Increase in inflation is also slower than expected. We monitor all relevant information. And we are ready to act, if warranted. We recall that the programme provides flexibility in terms of adjusting the size, composition and duration of it.

[Slide 28: Thank you!]