Peter Praet: The ECB's monetary policy – back to medium-term price stability of below, but close to, 2%

Opinion piece by Mr Peter Praet, Member of the Executive Board of the European Central Bank, published in Süddeutsche Zeitung, 13 January 2016.

* * *

ECB remains faithful to its monetary policy strategy

The EU Treaties define the maintenance of price stability as the European Central Bank's (ECB) primary task. They leave open the exact numerical definition of price stability. In 1998 the Governing Council of the ECB defined price stability as a medium-term inflation rate of below 2%. In 2003 it provided additional clarification that it was striving for an inflation rate of below, but close to, 2%. Since mid-2013 inflation has been below 1% and, after months of negative rates of inflation, it stood at 0.2% in December. Critics who see the ECB's efforts to raise the current inflation rate as a change in its monetary policy strategy are mistaken. On the contrary: abandoning the inflation objective of close to 2% in the medium term would mark a change in its monetary policy strategy. At a time when achieving the objective seems harder, this would be opportunistic and would damage the ECB's credibility. It is precisely in turbulent times that the objective needs to be kept.

Too low inflation is damaging in the long term and deflation is dangerous

Since February 2013 inflation in the euro area has moved away from the ECB's medium-term objective. The persistently low inflation has also affected medium and long-term inflation expectations, which are significantly below the levels of previous years.

Low inflation in the longer term provides only a small buffer against sustained deflation. The expectation of falling prices delays purchases and investment. Rising real wages relative to productivity impose a burden on firms and employment. Added to this is the fact that the real value of nominal debt increases when there is deflation. Not least, deflation can limit the effectiveness of monetary policy, as the central bank can lose control over real interest rates.

Playing down the risk of deflation would be negligent, especially in times of persistently low inflation. Although falling oil prices have recently played a significant role in low inflation, the effect on inflation is not negligible or temporary. For example, falling oil prices quickly affect other sectors, such as transportation. They also foster second-round effects on inflation, e.g. through lower wage settlements.

The ECB's measures are effective

The ECB's monetary policy measures make a key contribution to ensuring price stability in the euro area. They also support growth and employment.

On 3 December 2015 the ECB expanded its asset purchase programme (APP) by extending it until at least March 2017 and reinvesting maturing bonds. At the same time, it cut the interest rate on the deposit facility by 10 basis points to –0.3%.

The decision to expand the existing measures provides continuity with the measures adopted since June 2014 and is based on the finding that the APP and the negative interest rates are extremely effective. In particular, the APP has helped to counter the fall in inflation expectations, as well as reduce the risk of deflation. More stable inflation expectations are a necessary condition for a return to medium-term price stability.

Added to this are the positive effects resulting from the transmission of monetary policy stimulus to the financing conditions for enterprises and households. For example, the financing costs for enterprises and households in the markets have improved considerably, while the

cost of credit at banks for enterprises has fallen. The positive effects were greater in those countries in which the monetary policy transmission mechanism was temporarily affected, with our measures also helping to create a more uniform monetary policy across the euro area. The volume of bank loans to enterprises and households has also begun to recover. For example, the most recent "Survey on the access to finance of enterprises" showed that it is precisely small and medium-sized enterprises that are finding it easier to access credit. In general, the improved financing possibilities have increased demand in the euro area, even though global growth and demand from emerging economies in particular have weakened.

The benefits outweigh the costs

Much of our work at the ECB is also concerned with quantifying and evaluating the costs of measures and their unintended side effects. We see no sign of doomsday scenarios, as the critics like to paint. Rates of increase in house prices, for instance, are lower in most euro area countries than before the crisis, and in all countries they are below the trend that could be considered normal on the basis of historical averages. Besides, price increases become particularly problematic when they are mainly driven by huge credit growth. In the euro area we are currently struggling more with restrained credit growth. In other markets too, such as those for corporate bonds or shares, developments are currently within the range of historically comparable processes.

Also, since the crisis the banking system has become significantly more resilient to negative shocks. The banks have strengthened their capital base. The ECB, since becoming the banking supervisor under the Single Supervisory Mechanism, has played a part in banks Europe-wide complying with high and uniform standards. Should problems arise however, macroprudential instruments are best positioned to counteract financial sector risks, enabling monetary policy to focus on its primary objective of maintaining price stability.

The ECB's measures are undoubtedly part of monetary policy

Traditionally, monetary policy works via changes in the key rates. In response to the financial crisis, the ECB, like other major central banks, has expanded its toolkit. The negative interest rate follows the traditional approach involving the key rate change, only with the special feature that it should make the holding of liquidity less attractive in order to stimulate bank lending in a targeted way.

In addition to that, the asset purchase programmes are necessary for monetary policy. By influencing longer-term interest rates, which are particularly important for investments and the purchase of consumer durables, monetary policy can therefore preserve its room for manoeuvre – in an economic environment in which traditional monetary policy is reaching its limits.

Special attention was paid in the design of the asset purchase programme to avoiding market distortions. Thus the purchases in that sense are market-neutral; on average they are spread uniformly across assets in the market. We are also constantly monitoring liquidity in the markets where we make purchases. It is important as well that the ECB only buys up to 33% of each bond to avoid having a market-dominant position in any security. Market participants can then freely set their prices and market-oriented premia can be established for credit and liquidity risks.

When, in January 2015, the Governing Council decided on the purchase of government bonds, there was consensus on the Council that such purchases in principle represent a legitimate monetary policy instrument for ensuring price stability. Bond purchases undoubtedly also have an influence on countries' refinancing costs. That, of course, changes nothing in respect of the monetary policy nature of the measures in the current situation of persistently too low inflation. And in any case, the traditional instrument of key rate changes influences countries' refinancing costs.

What matters is that governments at national and European level also play their part

Against this background, however, it is all the more important that governments continue their fiscal consolidation process. The common monetary policy can only be successful if, as the ECB has frequently stressed, the structural problems in the euro area are tackled at source. Here, governments bear the responsibility and have to do more. At national level, governments must consistently pursue the consolidation of their finances and increase growth potential. The necessary structural reforms on the labour and product markets should not be delayed either. But at European level, too, we need more from the political side. It is time to complement monetary union with deeper economic union. In the long run, it is very hard to imagine a complete monetary union without economic union. Further steps towards economic union will also make the task of monetary policy easier.