Peter Praet: Beyond monetary policy – on the importance of a proper alignment of economic policies in EMU

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the conference "Beyond Monetary Policy", organised by the US-Korea Institute at SAIS and Reinventing Bretton Woods Committee, Contribution to the Panel on Realignment of Economic Policy: Beyond Monetary Policy, Washington DC, 7 October 2016.

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I would like to thank Christophe Kamps for his contributions to this speech.

In my speech on monetary transmission in the euro area at the SUERF conference in New York yesterday, I stressed the constraints and challenges that central banks had to confront while operating for many years near the effective lower bound on interest rates. The challenges monetary policy had to confront in the euro area were in particular born of weaknesses in the institutional framework of our monetary union.

In my contribution today, I would like to address the topic from this particular perspective, and, starting with monetary policy, go beyond monetary policy by setting out the policy requirements for the smooth functioning of EMU.

First, I want to explain how ECB monetary policy has maintained price stability over recent years in the face of a series of adverse shocks, and despite an incomplete institutional environment.

Second, it is clear that monetary policy cannot be the only game in town for too long a period. I will thus stress the need for other policy areas to contribute to supporting the recovery and to fostering long-term growth.

Third, I will argue that we need determined progress towards deepening the institutional foundations of EMU if we want the euro area and its Member States to become more resilient to adverse shocks in the future.

I will conclude that 'secular stagnation' – one of the issues for discussion proposed by the organisers – is not Europe's destiny if we make sufficient progress along these dimensions.

The ECB's response to disinflationary pressures

Like the central banks of other advanced economies the ECB has since 2008 operated in an environment characterised by a sequence of adverse shocks exerting strong disinflationary pressures. And the ECB, like other central banks, has responded to these shocks with forceful and unprecedented monetary policy measures. These measures everywhere were taken with the objective to ensure price stability.

What is special about the euro area is that to reach this objective the ECB at times had to take complementary measures to ensure the singleness of monetary policy. As you will recall the period 2011-12 was characterised by extreme financial fragmentation along national borders, putting at risk not only monetary policy transmission and price stability but the very existence of EMU.

The ECB stepped in forcefully in the summer of 2012 with the Outright Monetary Transactions (OMT) programme, which proved highly effective in addressing tail risk, thus restoring market functioning and confidence in the integrity of the euro area.[1]

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[1] See Praet, P. (2014), "Current issues and challenges for central bank communication", speech at the ECB and its Watchers XV conference, Frankfurt am Main, 12 March 2014, and Coeuré, B. (2013), "Outright Monetary

Around the same time, euro area Leaders recognised that the institutional foundations of EMU were too fragile and called on the Presidents of major European Institutions to develop a specific and time-bound roadmap towards deepening EMU.[2]

I will return to this later.

By summer 2014, the ECB was confronting further risks to price stability linked to a too prolonged period of low inflation. Our ability to provide additional accommodation through standard measures was however constrained as policy interest rates approached zero. We have therefore gradually deployed three new, non-standard measures to secure medium-term price stability: a series of targeted long-term refinancing operations, a negative deposit facility rate, and an asset purchase programme including private and public securities.[3]

These measures have led to a very significant easing of financing conditions across the euro area, thereby providing considerably support to the recovery. ECB staff estimates suggest that in the absence of our policy package inflation would have been negative in 2015. We also estimate that our measures will raise the inflation rate by more than half a percentage point, on average, over 2016 and 2017. They will contribute to increasing real GDP growth by more than one and a half percentage points cumulatively between 2015 and 2018, which will support job creation.[4]

At present, the Governing Council of the ECB is very closely monitoring economic and financial market developments. While so far the recovery of the euro area economy has appeared resilient to the continuing global and political uncertainty, there are downside risks. Against this background, we will preserve the very substantial amount of monetary support that is necessary to secure a return of inflation to levels below, but close to 2% over the medium term. And if needed, we will not hesitate to act by using all the instruments available within our mandate.

The need for decisive action at national level

To reap the full benefits of our monetary policy measures, national economic and fiscal policies must contribute much more decisively.

Of particular importance are determined structural reforms to increase potential output and the resilience of the economy to shocks. At the beginning of the millennium Blanchard and Wolfers convincingly showed that the rise of unemployment in Europe since the 1960s could be explained by the interaction of adverse economic shocks with insufficiently flexible labour market institutions.[5]

Transactions, one year on", speech at the conference "The ECB and its OMT programme organised by the CEPR, the DIW and KfW, Berlin, 2 September 2013.

2 At the June 2012 European Council meeting the President of the European Council, in cooperation with the Presidents of the Commission, Eurogroup and ECB, presented a first report entitled "Towards a Genuine Economic and Monetary Union". Since then the Presidents have presented two follow-up reports, respectively submitted to the European Council meetings in December 2012 (again entitled "Towards a Genuine Economic and Monetary Union") and in June 2015 (entitled "Completing Europe's Economic and Monetary Union"), the latter with the additional cooperation of the President of the European Parliament.

3 For details on the ECB's monetary policy measures and their transmission see Praet, P. (2016), "The ECB's monetary policy response to disinflationary pressures", speech at the ECB and its Watchers XVII conference, Frankfurt am Main, 7 April 2016.

4 See Draghi, M. (2016), "Working together for growth in Europe", introductory remarks at Deutscher Bundestag, Berlin, 28 September 2016.

5 See O.J. Blanchard and J. Wolfers (2000), "The role of shocks and institutions in the rise of European unemployment: the aggregate evidence", *The Economic Journal* 110 (March), C1-C33.

If anything, the crisis has corroborated this finding. Now, it is sometimes argued that structural reforms should not be undertaken in a context of weak demand. Yet, the short-term effects of structural reforms depend a lot on the credibility and type of reform and their interaction with other policy measures.[6]

If reforms are well-targeted there is no justification to postpone their implementation.

At the same time, fiscal policies can and should contribute to the recovery. It is, of course, true that fiscal space varies widely across individual euro area countries. Those countries with fiscal space should use it to increase public spending in areas conducive to long-term growth, such as public infrastructure, education and research and development. Countries without fiscal space should not bend the commonly agreed rules, which by the way provide sufficient flexibility to address the short-term costs of structural reforms. Regardless of fiscal space there is ample room in all euro area countries to refocus public spending on productivity-enhancing items.

All what I just said, of course, applies much more broadly than just to the euro area context. It is very much in line with the three-pronged approach advocated by the IMF in the context of its Global Policy Agenda.[7]

The need for decisive action at European level

However, beyond the three-pronged approach, it will be necessary to fortify the institutional foundations of EMU. For the resilience of the euro area depends not only on structural reforms at the national level but also on effective risk-sharing mechanisms preventing the resurgence of financial fragmentation that plagued the euro area in the 2011-12 period.

The priority should be on strengthening the potential for private-sector risk sharing. Two key initiatives in this respect are the Banking Union and the Capital Markets Union. The Banking Union holds the promise to break the sovereign-bank nexus. The creation of the Single Supervisory Mechanism and the Single Resolution Mechanism are important steps in this direction. Further steps are under discussion, such as the creation of a fiscal backstop for the Single Resolution Fund and a European Deposit Insurance Scheme. These additional arrangements are inspired by similar institutions in the United States.

The 5 Presidents' Report of June 2015 also calls for further integration in the fields of economic union and fiscal union, with a view to increasing the resilience and shock-absorbing capacity of the euro and its member states. The rationale for economic union is to foster real convergence among euro area member states, while the rationale for fiscal union is to provide insurance against shocks that may overwhelm national budgets or overburden monetary policy. Going into this direction will require member states' willingness to make a leap forward in sharing sovereignty similar in scope to the one made when the Maastricht Treaty was signed.

Conclusion

Let me conclude.

The ECB has taken determined and unprecedented action to maintain price stability and to prevent the euro area from settling into a bad equilibrium. For the euro area and its member states to thrive it is important that member states individually and collectively contribute decisively to strengthening the recovery and the resilience of the euro area economy. I am

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[6] See Draghi, M. (2015), "Structural reforms, inflation and monetary policy", speech at the ECB Forum on Central Banking, Sintra, 22 May 2015.

[7] See IMF (2016), "The Managing Director's Gobal Policy Agenda: Decisive Action, Durable Growth", Washington DC, 25 March 2016.

convinced that if – as prescribed by the Treaty – “member states regard their economic policies as a matter of common concern”, they can take action conducive to increasing the euro area’s long-term growth potential and resilience to adverse shocks. In this sense Member States collectively control the destiny of the euro area and through well-aligned policies can make sure that “secular stagnation” will not take hold in the euro area.