Philip R Lane: European Central Bank monetary policy – an overview

Address by Mr Philip R Lane, Governor of the Central Bank of Ireland, to the New York University Stern School of Business, New York City, 27 September 2016.

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It is a pleasure to have the opportunity to address NYU Stern's Center for Global Economy and Business.[1] Today, my aim is provide an overview of the current monetary policy of the ECB's Governing Council.

As a reminder, the press statement following the most recent monetary policy meeting of the Governing Council on September 8th provided the following summary of the current policy stance:

"Based on our regular economic and monetary analyses, we decided to keep the key ECB interest rates unchanged unchanged. We continue to expect them to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases. Regarding non-standard monetary policy measures**,** we confirm that the monthly asset purchases of €80 billion are intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim."

The main elements of the policy package include:

- A deposit facility rate of minus 40 basis points. Since the banking sector collectively must hold considerable excess reserves with the Eurosystem, money market rates have been pushed down to deposit facility rate: hence this rate has become the most important policy rate in the current environment.[2] The deposit facility rate was cut from zero to minus 10 basis points in June 2014. It was further cut to minus 20 basis points in September 2014, minus 30 basis points in December 2015 and the current value of minus 40 basis points in March 2016.
- A series of targeted longer-term refinancing operations (TLTROs) that were initially introduced in June 2014, with a mark-II programme announced in March 2016. The design of the TLTRO series provides incentives to banks to expand credit provision to households and non-financial corporates, with the interest rate on the new TLTRO-II programme set at the deposit facility rate for those banks that exceed benchmark net lending targets.[3]
- A set of asset purchase programmes. In September 2014, programmes to buy asset-backed securities and covered bonds issued by private-sector entities were launched (termed ABSPP and CBPP respectively); the decision to launch a public sector purchase programme (PSPP) was taken in January 2015; and the introduction of a corporate sector purchase programme (CSPP) was decided in March 2016.[4] Taken together, these form the expanded asset purchase programme (EAPP): from March 2015 to March 2016, average monthly purchases were €60 billion; since then, the target has been raised to average monthly purchases of €80 billion.
- The Governing Council also provides forward guidance as to the future direction of monetary policy. As indicated above, the stated policy is that the key ECB interest rates will remain at current or lower levels for an extended period of time, and well past the horizon of the net asset purchases. In turn, it is guided that the monthly asset purchases of €80 billion are intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. Furthermore, the 8th September press statement also re-iterates the general determination of the Governing Council to attain its inflation target by stating: "If warranted,

we will act by using all the instruments available within our mandate."

The policy package that was initially launched in Summer 2014 was a response to the below-target outlook for the inflation rate and the subdued level of aggregate demand in the euro area.[5] There were also clear downside risk scenarios associated with destabilising feedback dynamics between elevated bank funding costs, significant premia in lending rates in those member countries most affected by the crisis and the legacy of high private and public sector debt levels. In addition, there was a clear risk of a de-anchoring of inflation expectations, especially if the Governing Council failed to respond to these adverse developments.

Since the shift in monetary policy in Summer 2014, financial conditions in the euro area have markedly improved: bank lending rates have declined and there has been a marked reduction in yields on bonds issued by sovereigns and financial and non-financial corporates. In turn, through mechanisms such as the easing of financial conditions and the positive impact of the accommodative monetary stance on confidence levels, it is estimated that the ECB policy measures have added 50 basis points both to the 2016 inflation rate and the projected inflation rate in 2017, while cumulatively adding 1.5 percentage points to euro area GDP over 2015-2018 (Draghi 2016a).

Still, the inflation rate remains below the target level, with inflation projected at 0.2 percent in 2016 and 1.2 percent at 2017. While the transitory impact of the sharp drop in the oil price between the middle of 2014 through early 2016 should be duly recognised, it remains the case that the level of aggregate demand remains subdued and the cumulative record of below-target inflation in recent years may also exert an adverse influence on the formation of inflation expectations. In addition, the assessment of the Governing Council is that risks to the growth outlook remain tilted to the downside, especially in relation to external developments. Taken together, these factors require continued close monitoring and analysis in assessing the likely future path for inflation and output.

Let me make a couple of points about the design of the policy package. First, it should be understood that there are significant complementarities among the different individual elements. Most directly, the TLTRO-II programme directly connects the funding of banks that meet the net credit growth targets to the deposit rate. The negative deposit rate reinforces the asset purchase programmes, with lower short-term rates further raising demand for longer-term securities.[6] In addition, even if the banking system collectively must hold the extra liquidity created by the ECB's accommodative conventional and unconventional monetary policies, the negative deposit rate provides an incentive for individual banks to recycle liquidity holdings through increased inter-bank lending, expanded lending to the real economy and the purchase of longer-term securities (Praet 2016).

Second, a proper assessment of the overall contribution of the negative deposit rate facility to the policy package should be comprehensive in nature.[7] An important component in this assessment is the impact of the negative deposit rate on the health of the banking system, especially in view of the feedback mechanism by which the current level of bank profitability may influence future credit growth through its impact on bank capital, both directly and indirectly through any impact on the market equity value of banks.

Of course, those banks that hold excess reserves face a direct cost from the negative deposit rate. In addition, to the extent that banks cannot pass through the lower rate to all types of depositors, the net interest margin of banks is also compromised if competitive pressures mean that lending rates fall by more than deposit rates.

That said, in the other direction, banks benefit from lower wholesale funding costs and the improved ability of customers and sovereigns to service existing debts, while also booking capital gains on holdings of fixed-income securities. The importance of the cash flow channel is

reflected the reduction since 2008 in the interest payments by households by three percentage points of disposable income and the net interest payments by corporates by seven percentage points of gross operating surplus (Praet 2016).[8] More generally, the positive impact of the accommodative monetary stance on macroeconomic prospects supports credit growth and thereby the capacity of banks to offset lower net interest margins through expanding volumes.

The relative importance of these different factors inevitably varies across individual banks and member countries, such that the aggregate picture may be obscured in analyses that have a narrow focus on particular countries or specific types of banks. It is also important to recognise that the relative strength of these factors may shift over time as macroeconomic and financial conditions evolve and the composition of the loan books and securities portfolios held by banks is turned over.[9] More generally, the assessment of the cyclical and structural forces shaping the banking sector is an important component in determining the appropriate stance of monetary policy, given its central role in the European financial system and the transmission of monetary policy.[10]

Side Effects

The accommodative monetary stance contributes to the current low level of interest rates across the yield curve, even if an array of underlying structural factors (including demographic factors and the rate of productivity growth) play a central role in the observed downward shift in equilibrium real interest rates in recent years.

A possible side effect of the low interest rate environment is that it may induce some asset and real estate market participants to engage in excessive risk taking. Excessive risk taking is most likely in those markets in which asset and real estate prices are already at elevated levels and/or rising quickly, tempting some participants to form optimistic beliefs on an extrapolative basis. Such behaviour is especially dangerous if it triggers a leverage cycle by which highly-priced assets are employed as collateral to back extra borrowing, which in turn further fuels price pressures in asset markets.[11]

In the European regulatory system, there are two mitigating factors that can address these risks. First, the lending practices of the 129 most important European banks (holding nearly 82 percent of bank assets in the euro area) are now directly regulated by the ECB's Single Supervisory Mechanism (SSM), providing a common, rigorous approach to banking supervision across the euro area.

Second, the post-crisis European financial reform programme has included the establishment of a national macroprudential authority for each EU member country, which *inter alia* is tasked with leaning against the financial cycle through the setting of a countercyclical capital buffer.[12] Moreover, the ECB is empowered to increase the national countercyclical capital buffer, if the level set by the national macroprudential authority is deemed inadequate. Furthermore, the national macroprudential authority in a number of countries is also empowered to employ borrower-based measures (such as loan-to-value ratios or loan-to-income ratios) to improve resilience and lean against the financial cycle.

In addition, national fiscal policies can also play a role in mitigating the financial cycle, both through macroeconomic and microeconomic channels (Lane 2016). Importantly, the recent quantitative model developed by Philippe Martin and Thomas Philippon demonstrates the complementary roles of macroprudential and fiscal policies in limiting macro-financial volatility in the euro area, with joint deployment more effective than if either instrument were used on its own (Martin and Philippon 2016).

In relation to the inter-relation between financial stability risks and low policy rates, it is important to appreciate that the more quickly inflation approaches the target level, the more quickly will

policy rates re-normalise, allaying fears of a “low for long” stagnation scenario vis-à-vis nominal interest rates. Put differently, forceful accommodative monetary policy in the short run is the best method to ensure that policy rates do not stay low for longer than is necessary.

Conclusions

In this speech, I have attempted to provide an overview of the Governing Council’s current monetary policy stance. The Governing Council is committed to preserving the very substantial amount of monetary support that is embedded in the ECB staff projections and that is necessary to secure a return of the inflation target over the medium term. If warranted, the Governing Council will act by using all the instruments available within its mandate. Meanwhile, the Governing Council has tasked the relevant committees to evaluate the options that ensure a smooth implementation of the purchase programme.

Finally, monetary policy is not the only policy instrument that should be deployed in the current euro area environment. The Governing Council routinely points out that fiscal policy also has an important role to play in supporting economic recovery through a variety of mechanisms, together with policy actions that would enhance medium-term growth prospects, improve resilience and strengthen the financial system.

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[1] The opinions expressed are personal and do not reflect the views of the ECB Governing Council.

[2] The interest rate on the main refinancing operations (MRO rate), which provide the bulk of liquidity to European banks, is currently set at zero, while the rate on the marginal lending facility is set at 25 basis points.

[3] Lending to households for house purchases is excluded under the definition of eligible net lending in the TLTRO series.

[4] Since there were also two covered bond purchase programmes during 2009-2012, the new 2014 version was labelled CBPP3.

[5] Draghi (2014) provides a comprehensive contemporary account of the mid-2014 situation.

[6] The PSPP buys bonds with remaining maturities in the interval of two years to thirty years. At the end of August 2016, the weighted average remaining maturity of PSPP bonds stood at 8.28 years.

[7] My focus here is on the conjunctural assessment about the role of negative rates in the current euro area environment; I do not address the longer-term debate about the implications of technological changes in payments systems for the setting of policy rates. Coeure (2016), Constancio (2016a) and Praet (2016) also provide analyses of the role of negative policy rates in the European context.

[8] The interest earnings of households have declined by a similar amount. However, the cash flow gain to indebted households supports deleveraging and boosts consumption growth.

[9] Some of the channels by which interest rate policy affects bank profitability are captured in the theoretical model developed by Brunnermeier and Koby (2016).

[10] The structural challenges facing European banks are covered in Constancio (2016b) and Draghi (2016b).

[11] See, amongst many others, Geanakoplos (2010) and Buttiglione et al (2014).

[12] The national macroprudential authority is also responsible for improving resilience by setting capital buffers for significant institutions and, where it is permitted under national law, a systemic risk buffer. In addition, macroprudential policy may also prompt increases in risk weights vis-à-vis specific types of lending (for instance, commercial real estate or mortgage lending). In some member countries, the central bank is the designated macroprudential authority; in other countries, the authority is jointly shared by the central bank, the finance ministry and other public stakeholders. Since systemic financial risks can also be generated in other sectors of the financial system, an expanded set of instruments to cover non-bank entities and market activities would add to the effectiveness of macroprudential regulations.