Benoît Cœuré: Outlook for monetary policy in the euro area

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, to the Association d'Économie Financière, Paris, 2 February 2017.

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Introduction

In my remarks tonight, I would like to discuss the outlook for monetary policy. As you will be aware, the Governing Council decided in December to extend the asset purchase programme with average monthly purchases of €60 billion from April this year until December 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. That decision was confirmed at our January meeting.

The decision to extend the asset purchase programme was based on our assessment of the current economic climate, and our view of the amount of stimulus required to reach our inflation objective. Before I discuss those points in a little more detail, allow me to refresh your memories of the events that have unfolded since the crisis. In particular, I'd like to briefly recount why unconventional monetary policy measures became necessary, and how the ECB has responded to the crisis.

Why unconventional measures became necessary

The need for unconventional policy measures in the euro area arose from the confluence of a number of factors. Broadly speaking, these factors fall into three categories: 1) weak domestic demand and the impairment of the monetary policy transmission mechanism arising from the financial and sovereign debt crises; 2) other factors weighing on inflation, notably energy prices; 3) the decline in equilibrium real interest rates.

Weak domestic demand and impairment of monetary policy transmission

Let me start with the financial crisis, which entered a particularly acute phase following the collapse of Lehman Brothers in September 2008. The ensuing severe recession across the euro area increased unemployment and, combined with falling real estate prices, caused large losses in many national banking sectors.

The financial crisis was exacerbated by the banking-sovereign nexus, sometimes called the diabolical loop. The large overhang of public debt in some countries, in part a result of the support provided to their banking systems, resulted in a marked widening of sovereign spreads. Markets began pricing in some risk of redenomination: in other words, the risk that certain countries would leave the euro area and revert to national currencies.

At the same time, bank holdings of sovereign bonds came under increasing market scrutiny. Interbank lending markets in the euro area became fragmented and certain national banking systems lost access to wholesale market funding.

The fragmentation of the interbank market and sharply rising yields in some countries impaired the transmission of monetary policy and threatened the unity of monetary policy throughout the euro area. Credit to the private sector contracted and the euro area entered a further recession, with unemployment peaking in early 2013 at just over 12%. The output gap – the difference between current levels of economic activity and its long-run potential – reached a position well into negative territory.

Additional factors weighing on inflation

Beyond the downward pressure on inflation from domestic sources, a number of other factors also weighed on inflation. In particular, energy and other commodity prices fell sharply from the middle of 2014. Headline HICP inflation turned negative in December 2014.

Our mandate is to maintain price stability over the medium term, so short-term movements in volatile components of the index do not necessarily require a monetary policy response. Indeed, the full transmission of monetary policy to inflation takes more than a year, but the initial impact of energy price changes no longer has an effect on the annual inflation rate after a year. So there is a real risk that any monetary policy action might only take effect when the main impact on headline inflation has already passed. As such, monetary policy could exacerbate volatility in inflation.

Conversely, there is a risk that movements in headline inflation caused by a succession of energy price shocks could become entrenched in wage bargaining and inflation expectations. Inflation expectations drifting away from our objective interferes with monetary policy's ability to meet that objective. As a result, monetary policy typically reacts to energy price movements by "looking through" their first-round, direct impact, but remaining vigilant regarding any second-round effects on expectations. This is certainly a description that fits the actions of the ECB at the time.

While the domestic recession and falling energy prices are the major underlying reasons for the low rates of inflation recorded since 2014, there are a number of additional contributory factors, including the flow-through of generally weak global demand and certain industry-specific factors. I won't detail them today, except to mention that the European System of Central Banks has carried out a significant body of research on the subject, which was published last week.[1]

Decline in equilibrium interest rates

Economists use a concept called, variously, the equilibrium real rate or the natural rate. It represents the interest rate at which there is neither upward nor downward pressure on economic activity and hence on inflation. Broadly speaking, when inflation is above the objective, central banks raise short-term real interest rates above the natural rate to bring inflation down. Symmetrically, when inflation is below the objective, central banks lower real interest rates below the natural rate.

While the equilibrium real rate is a useful concept in order to frame policy discussions, it is unobservable in the real world, and various models used to construct it provide different answers resulting in a range of uncertainty. What is more certain, however, from these models is that the equilibrium real rate has been falling, both here and across other major advanced economies. By some estimates, it might even currently be negative in the euro area.[2] As I have mentioned previously, potential reasons for this decline include demographics and falling productivity growth.[3]

Policy rates need to shadow this decline in the real equilibrium rate, otherwise monetary policy would be too tight, dampening activity and causing inflation to undershoot our objective.

How the ECB has responded to the crisis

With these factors in mind, let me briefly summarise how the ECB has responded to the crisis. We have taken action within our mandate to ensure sufficient stimulus is in place to return inflation to our objective over our medium-term horizon, and to repair the transmission of that stimulus across the whole euro area in order to preserve the unity of monetary policy.

In a conventional fashion, we gradually lowered our main refinancing rate to stimulate the economy, eventually reaching 0% in March 2016. However, the size of the stimulus required, combined with the lower equilibrium real rate, meant that this interest rate cut was not sufficient to bring inflation back to our objective. It was therefore necessary to introduce a number of unconventional measures.

First, we introduced forward guidance. We communicated explicitly to the market our expectation that interest rates would remain at, or below, the current rate until inflation had sustainably returned to our objective. In doing so, we were able to influence market views of our future interest rates, thereby reducing interest rates across the curve. Indeed, while economists tend to talk in terms of one natural rate, there is, in truth, a wide constellation of interest rates that are relevant for the consumption and investment decisions of businesses and households.

Second, we introduced an asset purchase programme. By buying bonds, including covered, sovereign and corporate bonds, we are reducing interest rates across a range of horizons. These lower interest rates encourage borrowing, either indirectly through banks or directly in terms of greater issuance of corporate bonds.

In terms of the transmission mechanism, we introduced full allotment for our monetary policy tenders, allowing banks to access all the liquidity they need. We also introduced measures to encourage banks to lend. We took the interest rate on our deposit facility into negative territory, meaning that banks have to pay to leave cash deposited with us. In addition, we introduced a range of targeted long-term repos designed to explicitly reward banks for increasing lending.

Evidence that our monetary policy is working

Let me now turn to the current economic situation in the euro area, and what it means for the monetary policy outlook. The monetary stimulus put in place by the ECB is clearly working, supporting a broad-based and resilient recovery in the euro area.

Since the beginning of 2015, euro area GDP growth has been solid in every quarter. The preliminary flash estimate for the fourth quarter of 2016 is 0.5%, with similar growth expected in the first quarter of this year. The December Eurosystem staff projections for GDP growth were 1.7% for this year, and 1.6% for both 2018 and 2019.

The Economic Sentiment Indicator rose in January to its highest level since 2011. Sentiment improved in industry, services and the household sector, mainly driven by improved sentiment regarding future economic conditions. New industrial orders increased in November, with a notable pick-up in new export orders over the past year. More broadly, global activity and trade gathered positive momentum in the second half of 2016.

The recovery has also supported employment growth in the euro area. The unemployment rate fell to 9.6% in December, its lowest rate since May 2009. Over four million more Europeans are employed now than was the case three years ago.

There are signs, too, that our measures to restore the monetary policy transmission mechanism and unblock the flow of credit to the economy are taking hold. Lending rates have steadily declined throughout the euro area and the dispersion of rates across countries has narrowed.[4] Credit provision continues to strengthen. Annual growth in credit to euro area households increased in December to 2.0% and growth in credit to businesses rose to 2.3% – the highest growth rates in more than four years. Lower lending rates and the recovery in activity have bolstered corporate profitability, with a consequent increase in investment.

Inflation has also increased. The flash estimate for euro area annual HICP inflation in January is 1.8%, 0.7 percentage points higher than the December final estimate. But most of the increase in headline inflation has come from energy prices; core inflation in the flash estimate remained subdued at 0.9%, the same as in December. As I discussed earlier, monetary policymakers have to look through the first-round, direct impact of energy prices on headline inflation, and instead focus on the second-round effects on inflation expectations. As a result, we will treat the current increase in energy prices in a symmetrical fashion to how we treated the fall in 2013.

Short-term inflation expectations have also increased in recent months, but still remain below our objective, while long-run expectations remain firmly anchored. Based on this, the Governing Council continues to expect interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases.

Outlook for monetary policy

Indeed, the Governing Council has said for a long time that appropriate stimulus will remain in place until inflation has converged sustainably towards our objective of below, but close to, 2%. What do we mean by sustainably? Well, it relates to our objective and how we have always carried out our mandate. Let me highlight the four criteria that the President set out at the January press conference.

Inflation needs to converge towards our objective over the **medium term**. As mentioned earlier, the relevant horizon for monetary policy is the medium term. We do not react to short-term fluctuations, particularly those caused by energy and other commodity prices. The convergence towards our objective needs to be **durable** – one swallow does not a summer make. We need to see clear evidence that once inflation returns to our objective, it will remain there.

The third criterion is that inflation needs to be **self-sustaining**. We have witnessed an increasingly resilient recovery in economic activity, but this has not as yet translated into a resilient increase in inflation. Inflation in the euro area is still reliant on the substantial amount of monetary stimulus provided by the ECB, and it would be inappropriate to withdraw the stimulus while that reliance remains.

Finally, the ECB's mandate covers the **whole euro area**, and our policy reflects that. What matters to us is the euro area-wide measure of inflation, not the outturns for individual countries.

Conclusion

In conclusion, monetary policy is currently set appropriately to ensure a return to our inflation objective in the medium term. Recovery in the euro area is resilient, but risks relating to the international environment remain elevated. We will continue to monitor closely the evolution of prices and costs in the coming weeks and months in order to assess any second-round effects of energy prices and also to judge the extent to which the increase in inflation represents a sustainable adjustment towards our objective.

And let me make one final point. For the past few years, growth in the euro area has been sustained by substantial support from monetary policy. Yet in the long run, growth is not determined by monetary policy, but by innovation and gains in productivity. Structural reforms are needed in the euro area, and in each member state to improve the economic resilience to shocks and to boost productivity growth. Higher productivity growth will raise equilibrium real interest rates and, more importantly, improve welfare for everyone in the euro area.

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[1] See Ciccarelli, M. and Osbat, C. (Eds.), "Low inflation in the euro area: causes and consequences", *Occasional Paper Series*, No 181, ECB, 2017, and accompanying discussion papers.

[2] Constâncio, V., "The challenge of low real interest rates for monetary policy ", lecture given at the Macroeconomics Symposium, Utrecht School of Economics, 15 June 2016.

[3] Cœuré, B., "Assessing the implications of negative interest rates", speech given at the Yale Financial Crisis Forum, Yale School of Management, New Haven, 28 July 2016.

[4] “MFI lending rates: pass-through in the time of non-standard monetary policy”, *Economic Bulletin*, Issue 1/2017, ECB.