Joachim Wuermeling: Keynote speech

Keynote speech by Prof Joachim Wuermeling, Member of the Executive Board of the Deutsche Bundesbank, at the Mandarine Gestion International Investment Conference, Munich, 18 September 2017.

* * *

1. Introduction

Ladies and gentlemen

I believe that most of your fellow passengers travelling to Munich did not come here for meetings, but for the “Oktoberfest". The “Oktoberfest” started two days ago – on the 16th of September. You can tell that people in Munich think ahead: they’re already celebrating October in mid-September.

Talking of “thinking ahead", you could draw a parallel between the “Oktoberfest” and monetary policy: celebrating the “Oktoberfest” in September is a kind of forward guidance. The Bavarians announce very early what they expect to happen in the future – October will be here soon.

So the Bavarians are acting just like the Eurosystem, which is made up of the national central banks of euro area countries plus the European Central Bank. Forward guidance is now a regular part of the statement of the ECB President after every Governing Council meeting. But forward guidance is not the only instrument that was implemented by the Eurosystem in response to the financial crisis: a whole package of non-standard measures was adopted. And these measures have an impact on financial markets and related investment decisions.

As portfolio managers and investment managers, you undoubtedly keep track of these developments and the statements made by central bankers. And thinking ahead, you will be probably wondering about the future implementation of monetary policy in the euro area.

Munich is located in a region of breath-taking mountain scenery, and regarding this future path a number of references to a mountain hiking tour can be made. I shall begin by sketching a general picture of the current financial conditions – in the same way that you would check what the weather is going to be like before going on a hiking tour. In the second part of my speech, I shall shine light on the implementation of monetary policy in the euro area and its instruments – or to continue with the image of a hiking tour – the equipment and path that brought us to where we are today. In my third part, I shall look at how things could unfold in the future. Note the use of the word “could” – after all, the third section of my speech today will take us well and truly into the realm of hypothesis, the world of “what ifs” – or, to continue our hiking tour metaphor, the time after the lunch break on the summit.

2. Financial markets: The current landscape

I would like to start with the current scenery in the financial markets.

As portfolio managers and investment managers, analysing the financial markets is your day-to-day business. The agenda for tomorrow’s conference gives you a great opportunity to exchange views on the outlook and trends in financial markets. Therefore, I shall keep my comments on how we as central bankers see the current financial setting as brief as possible.

For the most part, global equity markets have been developing positively lately, despite emerging geopolitical tensions. The US S&P 500 index, for example, is chalking up one all-time high after another. On our side of the Atlantic, the equity markets are currently also posting gains. Although the EuroStoxx50 and DAX recorded some losses in the course of the year, they were quick to recover from this setback.

The economic outlook for the euro area has improved and if the euro appreciation continues, the euro area will be more attractive to investors. Looking at the FX market, this segment is sensitive to the expectation of market participants regarding the future monetary policy. Notably, on 8 September – the day after the ECB press conference – a two-year-high was recorded with an exchange rate of USD 1.206 against the euro. Since then, the exchange rate has been fluctuating within a narrow corridor. But to be clear, the exchange rate of the euro is determined by market forces and it is not a policy target of the Eurosystem.

Activity in the bond market is also determined by the expectations among market participants concerning future monetary policy. The prospect that the monetary policy of the Eurosystem will remain very accommodative and the somewhat lowered expectations of a policy hike in the US are leading to declining yields on long-term government bonds at the current edge. The yield spreads between long-term Bunds and government bonds from the rest of the euro area have narrowed, as political risks have not materialised.

At the beginning of this year, uncertainty in the euro area was rated much higher. A turbulent year of elections in many European countries lay ahead. One indicator measuring the economic policy uncertainty in Europe[1] is currently moving around its long-term average – in spring, the indicator was nearly three times higher. The reason for this easing is that the elections in France, the Netherlands and Austria did not yield a positive outcome for Eurosceptic parties.

To sum up this first part we can say that financial markets are currently in quite good shape, driven by an improved economic outlook, benign political developments and an accommodative monetary policy stance.

3. The financial crisis: Monetary policy undergoing change

The mandate of the Eurosystem states quite clearly that maintaining price stability in the euro area is our overriding priority. That is why we conduct monetary policy.

In August, the euro area annual consumer price inflation (HICP) was 1.5%. This is still below the targeted inflation rate of less than, but close to 2% per year over the medium term. However, the risk of deflation is now universally considered to be very low. In 2014, things looked different: the euro area inflation was steadily declining and bottomed out at –0.6% in January 2015. But this risk has decreased – also supported by our monetary policy measures.

The ECB Governing Council has been pursuing an accommodative monetary policy stance for a while. Since June 2014, a move known as quantative easing has been implemented by the Eurosystem in order to bolster financing conditions for banks and the real economy. At the same time credit easing has been extended. The main measures were, briefly:

- targeted longer-term refinancing operations (also known as TLTROs) that provide financing to banks for up to four years, with the amount that an individual bank can borrow being linked to its loans and lending patterns to the private sector, at extremely favourable (in some cases, negative) interest rates;
- various asset purchase programmes, grouped under the umbrella acronym APP (expanded Asset Purchase Programme): an additional covered bond purchase programme (CBPP3); an asset-backed securities purchase programme (ABSPP); a corporate sector purchase programme (CSPP); and the large-scale public sector purchase programme (PSPP) as the main instrument to address weak inflation;
- the affirmation that full allotment in regular refinancing operations will continue at least until the end of 2017;
- and in terms of policy rates, a very low interest environment with the main refinancing rate,

which has stood at 0% since March 2016, and the negative deposit rate (negative since June 2014; currently –0.4%). These very low rates are expected to remain at their present levels for an extended period of time, and well past the horizon of net asset purchases under the APP.

Working in unison, the aim of these instruments is to improve financing conditions – which they have in fact achieved, to some extent. There has been a significant pick-up in lending since it hit its lowest point in early 2014, and the same can be said of monetary aggregates. What’s more, prices are rising more sharply once again – especially if you look beyond the fluctuations caused by energy prices.

But this comes at a price: all in all, the asset purchases made under the programmes launched in June 2014 currently total around €2 trillion, with government bonds accounting for almost €1.7 trillion of this. Since June 2014, the Eurosystem’s total assets have increased from €2.2 trillion to €4.3 trillion. Excess liquidity – in other words, surplus central bank money – currently stands at around €1.8 trillion.

These asset purchases mark a move deep into uncharted territory for European monetary policymakers. Eurosystem central banks are now the euro-area countries’ biggest creditors. The boundaries between monetary and fiscal policy, which are of such crucial importance in a monetary union, are becoming increasingly blurred. The financing conditions imposed on governments depend to a great extent on the actions of central banks.

You don’t need to be a naysayer to fear that there may be political pressure to pursue an accommodative monetary policy for longer than necessary from a price stability perspective.

4. Where could it go from here?

This part of my speech is about the future path of the monetary policy in the euro area: Where could it go from here?

The ECB Governing Council alone decides what path to take. It goes without saying that this includes the decision on whether and, if so, when it would be appropriate to normalise monetary policy. At its press conference earlier this month, ECB President Mario Draghi, has confirmed that the framework for this will be re-examined in autumn.

In any case, the current environment is opening up the prospect of no longer needing to further loosen the reins of monetary policy. Economic recovery is ongoing and risks have been broadly offset. Political risks in the euro area, at least, are lower and the banking system has become more stable. The Eurosystem finds itself surrounded by countries all over the world pursuing a less accommodative monetary policy. Furthermore, prices are going up and the risk of deflation is universally considered to be very low.

At the same time, the marginal benefit of further purchases is steadily declining, with market participants already bracing themselves for a certain degree of “normalisation".

It is for the ECB Governing Council to decide when and how such a course of normalisation will take place. I cannot, and would not wish to, speculate on this matter. But I would like to stick to outlining what could happen from a technical point of view if the ECB Governing Council were to decide that the time had come to normalise monetary policy.

This means that the Eurosystem in a first step would decrease its net asset purchases – not in one fell swoop overnight, but with clear prior warning and gradually.

Note that tapering net purchases isn't about scaling back the high level of excess liquidity that has been built up as a result of asset purchases and – mainly targeted longer-term – refinancing operations.

It's about curbing the growth rate of central bank money or, in other words, slightly reducing the monthly amounts additionally provided. Taken by itself, tapering net purchases is not a restrictive monetary policy tool. Quite the opposite: as long as additional net purchases take place, the already accommodative monetary policy is loosened even further. And even if net purchases were discontinued, monetary policy will remain expansionary.

Concerning the impact of the purchase programme, it is ultimately the stock of assets in the Eurosystem's balance sheet which is essential, and less the flow of monthly purchases. Given that reinvestments of the principal payments from maturing securities purchased under the asset purchase programme take place, the stock of securities held by the Eurosystem will not be reduced for the time being. As a consequence, and taking into account other monetary policy instruments in place, the monetary policy stance of the Eurosystem will be accommodative for a long time to come.

The banking sector would, all other things being equal, still have far more central bank money than actually needed for several years. Given the abundant supply of central bank money, it can't be the money market that is primarily to blame for many people's concerns about tapering. What is it, then?

Tapering is suspected of triggering greater volatility and yield increases in those capital market segments that are targeted by monetary policy purchase programmes, with the impact of this then potentially spilling over to neighbouring market segments, too. Some market participants are already anticipating that asset purchases by the Eurosystem will be scaled back in 2018.

That said, it's hard to predict just how the market will react to tapering. A certain amount of volatility is to be expected. But this is only natural when markets seek to rebalance themselves.

With careful communication, the Eurosystem can counteract major distortions and turmoil. Furthermore, market forces that were recently impaired by the Eurosystem may, to a certain extent, have a stabilising impact on interest rates as net purchases are tapered. We need to place more trust in such forces.

5. Closing Remarks

Ladies and gentlemen

To take up the mountain hiking metaphor I introduced at the beginning of my speech, there comes a time when every hiker wants to leave the most arduous part of the trek behind and see that mountain hut.

We haven't got that far yet, though. We are still on the mountain and our journey is far from over. What's more, the route that we will take remains unclear. But what we know is that the ECB Governing Council is our mountain guide. It alone decides which path to take.

In autumn, the ECB Governing Council will re-calibrate the monetary policy instruments beyond 2018. It has been already assured that this will not take place in one fell swoop overnight. And in any case, the monetary policy stance of the Eurosystem will be – due to the stock effect – accommodative for a long time to come. This should be considered when deciding on future investments.

---

[1] www.policyuncertainty.com/index.html.