# Modesty in times of uncertainty

## Monetary policy after the crisis

Business Economists' Annual Dinner (London, 29 November 2017)
Speech by Klaas Knot

**Introduction**

Good evening everyone. Thank you for inviting me here to share my thoughts on monetary policy. We stand at an important turning point, 10 years after the global financial crisis began to unfold. During the crisis, monetary policy stepped in with unprecedented measures. At each new turn of the crisis, we as the Eurosystem took action and designed new policy measures where necessary. These measures proved successful. Now, a broad-based economic expansion is taking hold across the euro area. As the economy is enjoying robust growth, it is giving us the opportunity to take a step back from the crisis mode.

Against this background, tonight I want to elaborate on the following. The current inflation outlook poses no threat to price stability. Despite undershooting its inflation aim in the near-term, the ECB is thereby fulfilling its mandate. This is thanks to a combination of monetary policy measures, including the Asset Purchase Programme, which has achieved what could reasonably have been expected. The slow inflation convergence towards our medium-term objective is due to global supply factors largely outside the realm of central banking.

In this situation, continued monetary expansion is not a free lunch. Unconventional monetary policy is more intrusive than conventional monetary policy. It creates deeper market distortions that can generate misallocation and financial stability risks. As long as the standard economic relation between domestic slack and inflation, the so-called Phillips curve, fails to assert itself, adding ever more stimulus makes our policy increasingly procyclical, reinforcing these risks.

I therefore want to argue for modesty in monetary policy-making. We need more emphasis on the medium-term orientation of our inflation objective. Patience is thereby of the essence. Absent deflation risk, a full phasing-out of net asset purchases from September 2018 onwards is warranted. Our communication will have to shift accordingly, from net asset purchases and incremental stimulus towards reinvestment and preservation of broadly accommodative financing conditions.

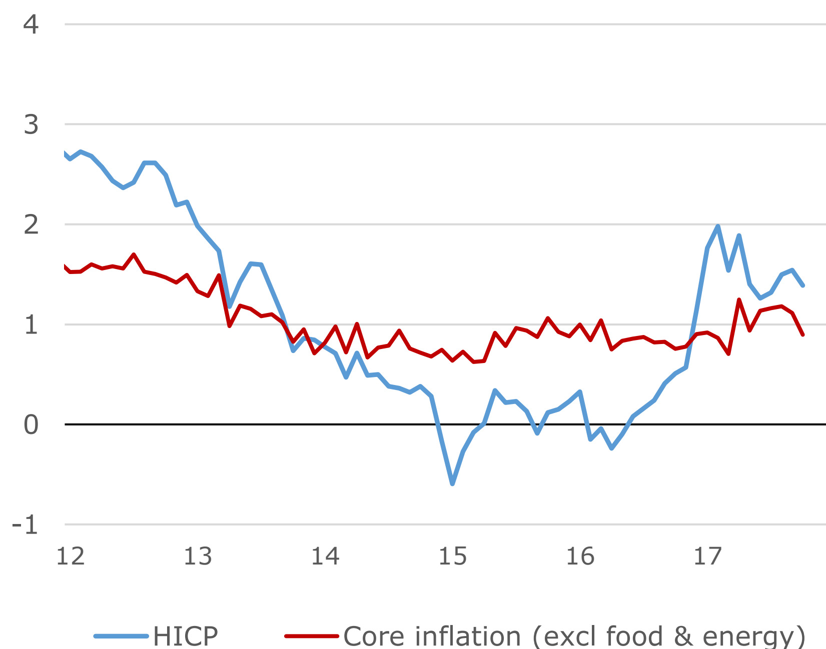
**A quick look back**

Let me begin by taking a quick look back. The euro area has endured some rough times. In the aftermath of the global financial crisis, the euro area weathered a sovereign debt crisis and a severe recession. These developments affected financial market actors, households, firms and governments. In an attempt to soften the impact of the crisis, the ECB took unprecedented monetary policy measures. Liquidity was provided in full allotment, and for longer periods than ever before. Interest rates were cut below zero, and several outright purchase programmes were set up. An indicator developed by the Dutch central bank shows that our actions were collectively equivalent to cutting short-term interest rates to around -4%.[1] Faced with severe challenges, the Eurosystem responded forcefully.

Being here in London tonight, allow me to highlight one crucial moment 5 years ago, when the functioning of sovereign debt markets in the euro area was severely undermined in the presence of redenomination risk fears. On July 26, 2012, our President Mario Draghi gave his famous “Whatever it takes” speech. Shortly after, the ECB announced its Outright Monetary Transactions (OMT) programme. Markets calmed down, in the knowledge that the central bank would intervene if needed. As they quickly realized the futility of speculating against the central bank in its lender-of-last-resort capacity, no purchases whatsoever were required under the OMT. This policy was successful on all accounts.

[1] Christiaan Pattipeilohy et al., “Assessing the effective stance of monetary policy: A factor-based approach”, November 2017.

Chart 1: Euro area inflation




Stemming a speculative attack on the integrity of your currency is one thing, controlling inflation is clearly a different ballgame. Whereas a central bank can credibly promise to do "whatever it takes" in lender-of-last-resort capacity, financial markets should not overestimate central banks' ability to fine-tune inflation.

Since the acute crisis abated, euro area inflation has been low and rising only slowly. As chart 1 illustrates, core inflation fluctuated slightly below 1% between 2014 and early 2017, and has yet to show more convincing signs of a sustained uptick. It is good to realize that stubbornly low inflation is not just a European phenomenon. Inflation in the US today, once corrected for imputed housing costs and thereby made comparable to our HICP measure, is actually lower than in the euro area, even though the economic and monetary policy cycles in the US are several years ahead compared to the euro area.

The universal nature of subdued inflation is increasingly linked to favourable supply-side developments such as technological advances and globalisation of product, labour and capital markets. The resulting disinflationary factors are global in nature and largely outside the realm of individual central banks. They have altered domestic inflation processes and have thus complicated the life of central bankers around the world.[2]

Chart 2: Euro area GDP growth

**The inflation outlook**

I would nonetheless argue that the current low inflation rates, despite falling short of our medium-term objective, do not constitute a threat to price stability. The current inflation outlook should be assessed against the background of a robust expansion of the eurozone economy. As chart 2 illustrates, the euro area is currently enjoying its fifth consecutive year of GDP growth. Since mid-2014 this growth can also be dubbed "reflationary", in the sense that quarterly growth readings have consistently outpaced potential growth rates.

[2] Claudio Borio, "Through the looking glass", OMFIF City Lecture, London, 22 September 2017.

Against the backdrop of a reflating economy, the inflation outlook is consistent with our aim of an inflation rate of below, but close to, 2% over the medium term. It should be emphasized that from the ECB's early days onward, the medium term has been defined as a flexible concept. It depends on the shocks hitting the economy and the efficacy of the monetary policy transmission that should bring inflation back on target. The global financial crisis was arguably much deeper than the average shock foreseen at the euro's inception, and the financial fragmentation it created within the euro area severely impeded monetary transmission. In a context of such widespread financial imbalances, the ECB's first chief economist, Otmar Issing, argued that "there is little sense in continuing to pursue an inflation forecast for consumer prices over a horizon of one to two years. In such circumstances it may instead be advisable to set interest rates with a view to a time frame extending well beyond conventional forecast horizons."[3]

Concerns have been voiced that a prolonged period of low inflation could lead to a de-anchoring of inflation expectations. While the conceptual relevance of this argument is beyond dispute, there are some challenging issues in operationalising it in the monetary policy process. Market-based and survey-based measures of inflation expectations exist, but they both come with a range of caveats and have often provided conflicting signals as to whether inflation expectations were anchored or not. Moreover, the mechanism by which inflation expectations affect actual price- and wage-setting behaviour is far from understood. I therefore sympathize with former Fed Governor Dan Tarullo, who recently argued that "inflation expectations are bearing an awful lot of weight in monetary policy these days, considering the range and depth of unanswered questions about them".[4]

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[3] Otmar Issing, "The ECB and the euro - the first five years", Mais Lecture at the City University Business School, London, 12 May 2004.
[4] Daniel Tarullo,"Monetary policy without a working theory of inflation", Hutchins Center working paper #33, October 2017, and "Fed has no reliable theory of inflation, says Tarullo", Financial Times, 4 October 2017.

All in all, I am confident that our monetary policy measures will continue to work their way through the transmission mechanism. Also at current low inflation rates the ECB is fulfilling its price stability mandate and successfully protecting the purchasing power of European citizens.

**Current policy stance**

So where does this assessment leave me in terms of the current monetary policy stance? After all, the crisis is several years behind us, the economy is enjoying solid expansion, price stability is not in jeopardy, yet many of our unconventional monetary policy measures are still in place. Liquidity operations are still conducted under fixed-rate full allotment, significant volumes of Targeted Longer-Term Refinancing Operations are still outstanding, and the deposit facility rate is still in negative territory. But the measure that has attracted most controversy in the recent years is our Asset Purchase Programme (APP). As you will be aware, the programme has just been extended until at least September 2018, albeit at a reduced pace of 30bn a month. As stated in our Introductory Statement, "The recalibration of our asset purchases reflects growing confidence in the gradual convergence of inflation rates towards our inflation aim."

Although at past occasions I have been sceptical about the APP's effectiveness with respect to raising inflation, the APP has contributed to four important achievements which I would like to recall here. First, the APP has further eased financing conditions across the euro area up to the point where borrowing costs are no longer an impediment to whatever spending decision. This also means that since monetary policy constraints have become de facto non-binding, the marginal benefits of further accommodation are negligible. Second, financial fragmentation between euro area countries has been reduced and monetary transmission has become much more homogeneous across Member States than was the case during the crisis. Third, the APP has supported the strong economic expansion I talked about earlier. Fourth, and perhaps most importantly, the tail risk of a 1930s type deflationary spiral has been averted. In doing so, the programme has achieved what could reasonably be expected from it.

With deflation risk clearly off the radar, the main rationale for employing the APP has therefore ceased to exist. Fear of relapse owing to an alledgedly premature discontinuation of net purchases seems rather overdone. The programme has simply run its course. Continuing the programme for the sake of fine-tuning inflation rates to precise values below, but close to, 2% suggests a degree of control over the inflation process that is at least debatable.

**Risks and side effects**

At the same time, continued monetary expansion is not a free lunch. Unconventional policy measures can have unconventional consequences that even professional economists cannot always oversee. A prolonged period of low interest rates, ample liquidity and prominent central bank intervention in markets has given rise to potential misallocation of credit and wider resources toward zombie firms.[5] Risk premia are compressed to a point where they no longer reflect the assets' inherent risk characteristics. The dynamics of preventing financial markets to adequately price risks for an extended period of time takes our economies into largely uncharted territory.

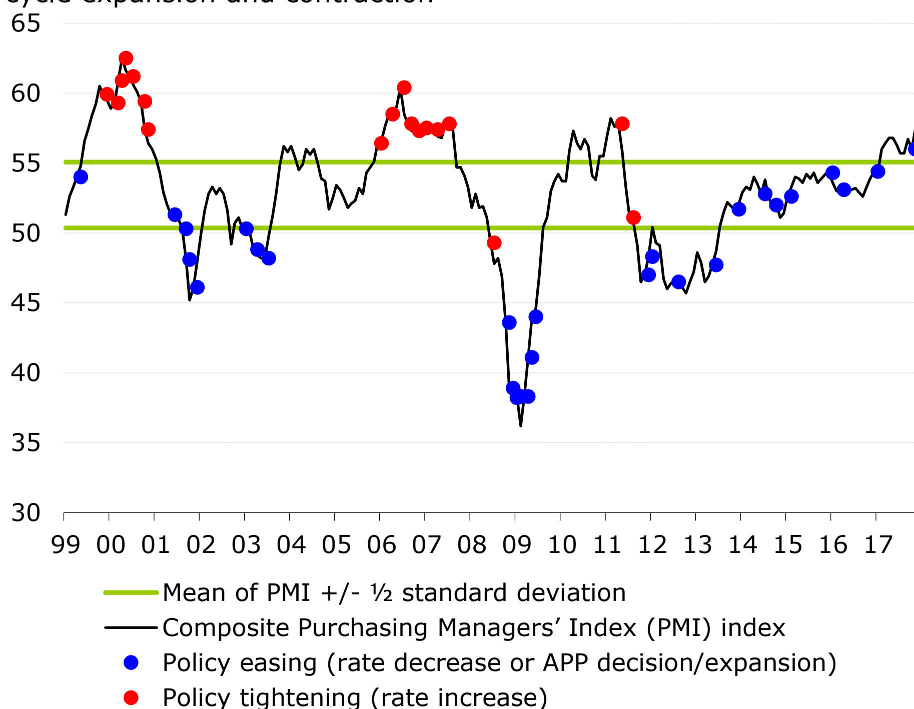
These financial stability risks also need to be considered when assessing our monetary stance. While some would argue that prudential and not monetary policies should address financial stability risks, I tend to agree with former Bank of England deputy Governor Charles Bean that there are "important qualifications to this somewhat Panglossian view of the ability to maintain both price stability and financial stability by assigning monetary policy to the former and macroprudential policy to the latter."[6] After all, only monetary policy sets "the universal price of leverage".[7] Conversely, materialization of financial stability risks can also become detrimental to price stability.

[5] Viral Acharya, Tim Eisert, Christian Eufinger, and Christian Hirsch, "Whatever it takes: The real effects of unconventional monetary policy", SAFE Working Paper Series, No. 152, 2017.
[6] Charles Bean, "The future of monetary policy", speech at the London School of Economics, London, 20 May 2014.
[7] Claudio Borio and Mathias Drehmann, "Financial instability and macroeconomics: bridging the gulf", September 2009.

**Procyclicality**

In the current context, financial stability risks interact with the issue of procyclicality. The failure of the traditional Phillips curve relation between the business cycle and inflation to thus far assert itself makes monetary policy increasingly procyclical. Economic growth in the euro area passed its cyclical trough in the first quarter of 2013, while core inflation bottomed out early 2015. Yet until at least September 2018 the APP will be adding stimulus. Not only in terms of length, but also in terms of magnitude of the expansion, the economy is in outstanding shape. With real GDP growth hitting levels above 2% year-on-year, the monetary policy stance is increasingly out of sync with the business cycle.

Chart 3: Euro area business cycle and monetary policy decisions




A simple historical comparison serves to illustrate this point. Chart 3 shows that during previous upturns, that is when the euro area composite Purchasing

Managers' Index (PMI) stood at similar levels above its long-term mean, policy was generally tightening instead of the current prolonged easing.[8]

Obviously, the main factor underlying this contrasting pattern is the weak and elusive character of the traditional Phillips curve relationship between cyclical conditions and inflation. Whether this is merely a temporary or a more permanent phenomenon is a topic for ongoing debate. My colleague Mark Carney, for example, has recently argued that "globalisation has been accompanied by a weakening in the relationship between domestic slack and domestic inflation, and by a corresponding strengthening between global forces and domestic prices"[9]. Also in the euro area, the strong recovery of the labour market has yet to translate into upward pressure on wages and prices.

**Communication**

Patience is therefore needed for our monetary stimulus to unfold. The reflating economy will ultimately translate into increased pressure on wages and prices. This may however take time. Central banks can only affect the price level with "long and uncertain lags". Consequently they cannot be over-ambitious and try to steer price developments in the short run, nor should they seek to precisely define the horizon of their action.[10] As we intend to reinvest maturing securities for an extended period of time, financial conditions will likely remain accommodative long after net asset purchases will have come to an end.

In view of the above, we have to adjust our communication. With a medium-term focus in mind, we need to highlight patience and confidence in the measures that we have already taken, while at the same time remaining realistic about what our measures can and cannot achieve. We will need to cater for the possibility that a sustained adjustment in the path of inflation (SAPI) can only be achieved well after net asset purchases will have come to an end. Fortunately, our

[8] Moreover, data since the 1960s show that once the recovery took hold, the first policy rate increase has typically taken place after 10 quarters in Germany and 11 quarters in the US, on average. As indicated earlier, the current euro area recovery is enjoying its 19th consecutive quarter of growth.
[9] Mark Carney, "[De]Globalization and inflation", 2017 IMF Michel Camdessus Central Banking Lecture, 18 September 2017.
[10] Otmar Issing, "Inflation targeting: a view from the ECB", "Inflation Targeting: Prospects and Problems" Symposium St. Louis, 16-17 October 2003.

monetary policy stance is more encompassing, and all our measures are geared towards this objective. The focus in communication therefore needs to shift to the other elements of our policy toolkit, such as forward guidance on key policy rates, together with the ongoing stimulus provided by the stock of our asset purchases.

**Conclusion**

Let me conclude. Our economy is in the midst of a strong cyclical upswing. Far-reaching policy measures have contributed to cement growth, avert deflation risk, and enhance the cohesion of the monetary union. Although raising inflation towards our aim is taking longer than expected, current inflation rates are not a threat to price stability. With actual growth exceeding potential and labour market slack falling, inflationary pressures will eventually unfold. At the same time, the longer the Phillips curve fails to assert itself, the more procyclical policy might become, and the greater is the likelihood of financial stability risks building up.

Patience and confidence should therefore replace suggestions of open-endedness in our communication. Absent deflation risk, a full phasing-out of net asset purchases from September 2018 onwards is warranted. Preservation of existing stimulus will be more than sufficient to reach our inflation objective, albeit at a medium term that may be further away than many of us are used to.

Let me then end with the more than relevant words of Augustus William Hare, *"True modesty does not consist in an ignorance of our merits, but in a due estimate of them"*. Let us be modest and take a realistic look at what our measures can and cannot achieve in our efforts to maintain price stability.

I thank you for your attention.