Peter Praet: Maintaining price stability with unconventional monetary policy

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Council of the European Union, Brussels, 29 January 2018.

* * *

Accompanying slides

I would like to thank F. Holm-Hadulla for his support in preparing this speech.

Responding to the crisis in the euro area

The crisis that erupted in 2008 sparked a sharp downturn in the global financial cycle. In the preceding years, over-optimistic growth expectations had taken hold in a number of advanced economies. Despite slowing productivity growth, agents overestimated future income growth and borrowed against it, accumulating excessive levels of debt. At the same time, financial liberalisation and deregulation encouraged financial leverage and rapid credit growth. The ten years since that eruption has been a changeable period of deleveraging and de-risking, with a number of different phases.

The first phase was the immediate liquidity crisis triggered by the turning of the global financial cycle and the subsequent collapse of Lehman Brothers. Market funding came to a sudden stop for many financial institutions. The ECB’s response was to lower its main refinancing rate to the then record low of 1% in May 2009, to expand the range of eligible collateral for our refinancing operations and to provide liquidity elastically to the banking sector, at both increasingly long durations and against a wider range of collateral.

The second phase was the sovereign debt crisis of 2011–12, which was intensified by the bank-sovereign nexus. Bank funding markets fragmented along national lines and banks in vulnerable countries lost access to wholesale funding. It led to a serious disruption of the monetary transmission mechanism and prevented our accommodative policy stance from reaching the economy.

Our policy response was twofold. First, we carried out two three-year refinancing operations at the end of 2011 and beginning of 2012. Second, we announced our conditional Outright Monetary Transactions in summer 2012, which acted as a powerful circuit breaker against self-reinforcing fears in sovereign bond markets. But the sovereign debt crisis nonetheless left the economy with a damaging legacy and paved the way for the third phase of the crisis.

As the euro area entered into a prolonged slump, banks in many parts of the euro area embarked on a slow process of deleveraging, mainly by reducing lending. A credit crunch was looming: by end-2013 loans to the private sector were falling by more than 2% per year. By mid-2014, the economic recovery was losing momentum and the weakness in aggregate demand was starting to depress inflation expectations. The sharp fall-off in oil prices that began in late summer exerted further disinflationary pressures.

Given the weak underlying trend in inflation, we saw a growing risk that low inflation could de-anchor inflation expectations and unleash a deflationary spiral. Short-term interest rates that were already close to zero hampered our ability to use conventional monetary policy instruments. The ECB had to resort to a new approach to ease its monetary stance, based more on directly influencing the whole constellation of interest rates that are relevant for the financing conditions of the economy. This strategy was articulated in three measures.

The first was the launch of a negative interest rate policy, as we lowered the interest rate paid on

our deposit facility to –0.1% in June 2014. The second instrument was our targeted longer-term refinancing operations (TLTROs), which are specifically designed to support bank lending to the private sector. The third instrument was our asset purchase programme (APP) involving private and public sector securities, which helped further depress the term structure of interest rates by compressing risk premia out along the yield curve.

These instruments were complemented by the use of forward guidance, where we started to communicate about our expectations of future policy, along with the conditions that would warrant a change in the policy stance.

A solid and broad-based economic expansion with subdued price pressures

Our monetary policy strategy has borne fruit. We have now seen 18 quarters of positive growth and the short-term economic indicators all point to a continued economic upswing with above-trend growth. The breadth of the expansion is notable: the dispersion of growth rates across both countries and sectors is at its lowest level for two decades.

The euro area recovery has so far been mostly home-grown, with monetary policy creating the conditions for a virtuous circle between rising income and spending in both the corporate and the household sector. Annual growth in employment has reached its highest level since before the crisis and the unemployment rate fell to 8.7% in November, the lowest rate for nearly nine years.

An important factor underlying the good performance of domestic demand is the very favourable financing conditions for firms and households, which are heavily influenced by our policy measures. Bank lending rates to non-financial corporations (NFCs) have fallen by around 120 basis points since June 2014, a large proportion of which can be attributed to the impact of our measures.

Moreover, the decline has been more marked in those countries that suffered more acutely from financial fragmentation during the crisis, showing that our measures have not only provided the necessary monetary accommodation, but also rehabilitated the transmission mechanism to ensure an even transmission of monetary policy throughout the euro area. Loans to NFCs – sharply down when we introduced our unconventional measures – are growing again, and reached an annual growth rate of 2.9% in December 2017.

Taking these factors together, the overall impact of the ECB's policy measures since mid-2014 are estimated to have contributed significantly to output growth – and by around half a percentage point in 2017.

While our measures have clearly played a decisive role in keeping inflation expectations anchored and have contributed to an improved inflation outlook, an ample degree of monetary accommodation remains necessary to secure a sustained return of inflation rates towards levels that are below but close to 2%, as reaffirmed by the Governing Council at last week's meeting. Despite the strong cyclical momentum, domestic price pressures remain subdued, as do measures of underlying inflation.

The evolution of the ECB's forward guidance

Our monetary policy stance is determined by the combination and mutual interaction of our asset purchase programme, our policy rates and our forward guidance on each of these tools. The stimulus provided by these policy tools is complemented by the TLTROs, which will remain outstanding for the next three years.

When our key policy rates reached exceptionally low levels, asset purchases became the main monetary policy instrument for calibrating our stance. This is why, since January 2015, when the APP started, we have been signalling the traditionally tight connection between the ECB's

monetary policy and our price stability objective by linking an assessment of the medium-term outlook for inflation to the size and duration of our net asset purchases. Accordingly, when communicating about net purchases, we have expressed our intention to continue with our chosen pace of monthly purchases until we see "*a sustained adjustment in the path of inflation consistent with our inflation aim*". This phrase describes the key contingency that has guided the course of our policy in the past few years and will continue to do so in the future. In addition, the pledge to re-invest the proceeds from the principal payments that accrue from the maturing securities in our portfolio should be seen as a necessary complement to the net asset purchases.

Central bank asset purchases ease monetary conditions primarily by taking long-duration bonds out of private hands. It is by withdrawing such assets from the market and holding them for a possibly lengthy period of time that the central bank spurs a rebalancing of private portfolios, and thus lowers term premia and eases financing conditions.

Forward guidance on both policy rates and the APP plays a key role in determining our monetary policy stance. Its function has evolved significantly over time. Before the APP was launched, our forward guidance related only to the expected path of our policy rates. When the Governing Council decided to start issuing statements on its expectations concerning the future evolution of the ECB's key interest rates, in July 2013, forward guidance was mainly intended to insulate the euro area from external tightening pressures, notably those originating from the global financial turmoil that had followed the "taper tantrum" a few weeks before.

As macroeconomic conditions deteriorated in the course of the following year, though, the statement that the Governing Council expected "*the key ECB interest rates to remain at present or lower levels for an extended period of time*" turned into a vehicle for easing the monetary policy stance.

With the adoption of our APP, forward guidance has been extended to key parameters of our purchases, and has helped investors form expectations about the size of APP and its duration. We have indicated a minimum horizon – an intentional end-date – until which time we plan to carry out net monthly purchases, while always retaining the option of extending the programme beyond that intentional end-date if the "sustained adjustment" condition has not been met. In October 2017, for example, as we extended our net purchases past the end of the year, we signalled that, starting in January 2018, we would "*continue at a monthly pace of €30 billion until the end of September 2018, 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*". Moreover, in view of the key role played by the accumulated stock of assets in our portfolio as an ongoing source of stimulus, we committed to "*reinvest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of its net asset purchases, and in any case for as long as necessary*."

Our instruments are configured in such a way that our forward guidance on policy rates has been reinforced by our forward guidance on net asset purchases. We have linked the expected path of our key interest rates to the intended horizon of the net asset purchases by saying that we "*expect them to remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases*". This sequenced guidance has served to exploit important complementarities between policy rates and asset purchases. On the one hand, having the horizon over which policy rates are expected to remain constant tied to – and longer than – the APP horizon has largely prevented the easing impact of our purchases on the yield curve from being countered by a destabilisation of short-term interest rate expectations. On the other hand, announcing that the APP would have a certain lifespan signalled that policy rates would remain at their present levels for longer. And this has reinforced the power of the statements concerning the evolution of the policy rate path. The forward guidance on policy rates acts as an enabling condition for the purchases to exert their full impact on term premia, and the

language on the intended horizon of our net asset purchases has reinforced the signalling power of our forward guidance on rates.

Looking ahead, the question is: how will our monetary policy toolbox evolve in the foreseeable future? Monetary policy will evolve in a data-dependent and time-consistent manner. The transition towards a normalisation will begin once we have established that there is a sustained adjustment in the path of inflation. Our assessment will be based on three criteria for the inflation outlook: *convergence*, *confidence* and *resilience*.

First, convergence: headline inflation will have to be on course to reach levels below, but close to, 2% by the end point of a meaningful medium-term horizon. Two things are noteworthy here: the salience of our inflation aim and the forward-looking perspective. There should be no doubt about our steadfast commitment to secure a sustained return of inflation rates towards levels that are below, but close to,, 2%. And the perspective should be forward-looking because our monetary policy framework directs us to shape monetary policy with a firm medium-term orientation. Since the start of Monetary Union, the ECB's monetary policy has always been formed with a view to stabilising medium-term headline inflation around levels that are most consistent with our price stability definition. Since 2003, we have said that those levels should be below, but sufficiently close to, 2%.

The second criterion on which our assessment is based is confidence, since meeting the first criterion – convergence – is a necessary but not sufficient condition for a sustained adjustment. The Governing Council wants to be sure that the expectation of an upward adjustment in inflation has a sufficiently high probability of being realised and is being met on a sustainable basis, i.e. not as the result of a transitory shock or measurement error. In other words, we need to build strong confidence in the accuracy of our baseline outlook for inflation: the range of possible outcomes around that baseline path should be reasonably contained. This is our second criterion for a sustained adjustment. At our last Governing Council meeting, we have communicated our increasing confidence that inflation will converge towards our inflation aim of below, but close, to 2%.

How can we substantiate today that inflation convergence has sufficiently strong legs to support its upward trajectory towards our aim? By looking at a broad range of indicators of price pressures, for example measures of inflation trends, notably including core inflation indices. As these underlying inflation statistics – available today – contain information that is valuable for predicting the level of headline inflation in the future, when short-term shocks that may influence its level today have faded away, we want to cross-check our medium-term projections for headline inflation with these measures. In parallel, an eye on capacity utilisation and the extent of unutilised resources can help reinforce our confidence in inflation convergence as a more robust real economy is likely to support a build-up of broad-based price pressures looking forward.

Our third criterion, resilience, measures the robustness of inflation convergence to a partial withdrawal of monetary policy accommodation. If the inflation outlook is overly dependent on monetary support, the upward adjustment cannot be considered sustained. So, we want to verify that the path would be maintained even in less supportive monetary policy conditions.

Today, we are still some distance away from meeting all three criteria at the same time. So, we still need *patience* and *persistence* in steering our policy conduct.

Patience is necessary because it takes time for price pressures to build up, and to be reflected in the information that forms the basis for our assessment of progress towards a sustained adjustment in the path of inflation.

Persistence is necessary because the recovery in inflation is, in itself, a consequence of the prevailing accommodative monetary policy stance. Even if incoming data were to validate the expectation of a gradual build-up of inflationary pressures, this would not be sufficient to affirm a

sustained adjustment, if even less supportive monetary policy conditions were to imperil the inflation trajectory.

Monetary policy will evolve in a data-dependent and time-consistent manner. Once the Governing Council judges that the three criteria for sustained adjustment have been met, net asset purchases will expire, in line with our guidance. From that point in time, the evolution of inflation will remain conditional on reinvestments continuing for an extended period of time and on policy rates remaining at their present levels well past the end of our net asset purchases. The stock of long-duration assets held in our portfolio will continue to put downward pressure on longer-term interest rates well beyond the end of our net purchases. Policy rates remaining at their present levels well past the end of our net purchases will contribute to holding the short to intermediate portions of the yield curve in check for as long as necessary, thereby ensuring that financial conditions remain consistent with a sustained adjustment of inflation.