Yves Mersch: Challenges facing monetary policy in the euro area

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, to the Schweizerisch-Deutscher Wirtschaftsclub, Frankfurt am Main, 19 March 2018.

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The euro area economy is recovering even faster than expected. Many people are hoping therefore that monetary policy will soon become again "more normal".

In that context, the procedure for exiting from our purchase programme is linked to a precondition: that inflation moves into line with our objective in a sustainable way. We have become more confident that inflation is on the right track. So it's only a question of time until we reach our goal. However, as we move in that direction we still need an expansionary monetary policy.

But that does not mean that our specific monetary policy measures have to remain completely unchanged. The gradual exit from the purchase programme is confronting us, however, with certain problems: on the one hand, a too abrupt ending could lead to excessive market reactions. On the other hand, the effectiveness of the purchase programme is declining over time; the side effects are increasing. To mitigate these risks, we need a credible exit scenario.

Background to the adjustment of the purchase programme

First, let us look back on our adjustment of the purchase programme. In October last year, the Governing Council decided to reduce the purchases. On 8 March this year, the Council confirmed that the net purchases, currently amounting to €30 billion per month, should be made until the end of September 2018. If necessary, the purchases can be extended beyond that until the Governing Council sees a sustainable correction of inflation in line with its definition of price stability over the medium term.

The purchase programme was adjusted because of the expected higher price pressure based on the euro area's strong and broad-based economic growth. Its economy has now grown continuously for 18 quarters, with the relevant indicators pointing to continued strong growth.

According to the projections made by ECB experts, the economy is expected to grow even slightly faster in the short term than previously expected. Annual real GDP will increase by 2.4% in 2018, by 1.9% in 2019 and by 1.7% in 2020. Compared with the December 2017 projections, the prospects for real GDP growth in 2018 have been revised upwards; the outlook for the two years thereafter remains unchanged.

Overall, the risks to the growth prospects of the euro area are regarded as being in balance. There are now global factors that could cast a shadow over the strong growth outlook.

First, the new trade measures announced by the US administration. ECB estimates indicate that the first-round effects of the proposed measures for the euro area are likely to be slight, even in the event of retaliation by US trading partners. The after-effects however could be stronger.

Second, developments in the foreign exchange and other financial markets. In this respect, I would like to point out though that the most recent volatility on stock markets had little impact on other asset classes in the euro area.

The strong economic growth is also having an impact on the labour market. The increase in employment since mid-2013 – almost 7.5 million jobs – has offset the total number of jobs lost overall during the crisis. The unemployment gap – a measure of labour market overcapacity – now seems to have closed , although it has again been revised downwards, and employment in the euro area is higher than it has ever been.

In short, our monetary policy has successfully boosted demand and returned slack resources back into productive use. In view of this, the path of inflation should, over the medium term, approach our inflation objective of below, but close to, 2%. And inflation is acceletating, albeit more slowly than we would like, but more clearly than expected in October, when we decided to scale back the purchases. The increase in trust that inflation is on the right path will also influence our reaction in the future.

Two additional factors play an essential role here: the first has to do with the declining impact of our net purchases over time. The holdings are becoming steadily more important than the growth. The second factor relates to the link between output and inflation.

In the past, a highly expansionary policy was needed to counter the economic downturn and to ensure that inflation remained consistent with our definition of price stability. Headwinds reduced the effectiveness of our monetary policy and they had to be resisted.

For example, deleveraging caused a greater inclination to save, the general uncertainty dampened investments and a long period of low inflation threatened to de-anchor inflation expectations. In addition, deflation was a real risk.

These negative factors have eased during the ongoing recovery. Deflation fears have been dispelled. And the assumption is that, under these circumstances, a policy of unchanged monetary policy is unduly expansionary.

In addition, there’s the fact that the effect of the asset holdings on our balance sheet will become greater over time: as the size of our portfolio grows, so does the additional effect of a given purchase volume. As our asset holdings are high, they have become much less widely held than at the start of our purchase programme. In this way, the relative share of our purchases on the market and thus the effect of these purchases for each billion euro spent goes up. In other words, a smaller purchase volume today has the same effect as a higher purchase volume in the past.

As our asset holdings go up, so does our need to reinvest, which is why we are having to increase our gross purchases – i.e. our net purchases in addition to our reinvestments. And this is happening in an environment of reduced new borrowing in most of the euro area countries. Even with a lower volume of net purchases, the Eurosystem retains a significant market presence. It is calculated that around €167 billion of cumulative repayments will be made between March 2018 and February 2019.

For all these reasons, we needed to adjust our monetary policy stance. We are in a position to adapt our monetary policy to the strengthening upturn in the future, without seriously harming growth or inflation. And the longer the recovery continues, the less the economy depends on special monetary policy measures.

The second factor behind our decision is: how quickly will stronger demand have an impact in the form of rising prices?

The euro area is by no means the only advanced economy with robust output growth and inflation rates below historical levels. It would be too much here to cover the various attempts made by economists to explain this. Frankly, I find none of them particularly convincing. However, I believe that these factors should not keep us from fulfilling our task in the medium term. We might need a bit longer to reach our goal, but we will reach it.

Let me briefly mention a theoretical explanation. The relationship between slack and inflation, the Phillips curve, has become so flat that changes in output have hardly any effects on inflation.

There are various reasons for this. Longer periods of low inflation can keep wage increases down, as wages are linked to inflation to a certain extent. In addition, job insecurity, digitalisation and high unemployment have led trade unions to prioritise employment over wages. And the crisis has led to more slack on the labour market – i.e. involuntary part-time and temporary work – which has to be absorbed again before wage pressures increase.

In practice, we are seeing positive signs: in fact, the difference between the overall unemployment rate and broader measures of slack on the labour market has declined somewhat over the past two years. The proportion of enterprises in manufacturing and services which say that labour shortages are limiting their output has never been so high. The result is stronger wage growth, which is contributing to an increase in inflation. Several measures of underlying inflation have apparently passed the turning point.

I say the word "apparently" as monetary policymakers should be cautious in their judgements[1].

The estimates of slack in the economy differ widely and are often corrected. Model results, as complex as they may be, should be treated with the requisite caution. In the end, assessments based on experience continue to be an essential part of monetary policy decision-making.

Monetary policy decisions should therefore not only be based on model results, but should also take into account the balance of risks. There are times when lack of action is much more dangerous than taking action and when resolute action is the most reasonable thing to do. For example, our purchase programme was necessary to avert the risk of deflation. However, there are also times when the balance of risks changes fundamentally and thus monetary policymakers should act more carefully.

Future challenges facing monetary policy

So now let's turn our attention to the future. I believe that the conditions for gradually ending the asset purchase programme are in place. However, it is up to the ECB's Governing Council to decide on the exact timing of such a move.

I'm not going to talk about the possible timing today. Let me instead touch on some of the risks we will face in implementing our monetary policy over the coming years. These risks are likely to grow the longer our asset purchase programme continues.

The first risk relates to the subsiding deflationary headwinds I have already mentioned. Could it be that our monetary policy is suddenly too expansive? In short, because of the uncertainties and imprecisions involved in measuring slack and inflationary pressure, we might find ourselves behind the curve without realising it. As a result of the long and variable lags of monetary policy, we could end up with inflation above the rate consistent with our mandate.

This would require a sharp correction of our monetary policy stance in years to come. Yet such a correction of interest rates would pose risks to the financial sector. Banks could be hit hard as funding costs rise faster than interest income on outstanding loans.

But it may also be the case that the impact of these factors has already been felt, and inflation could turn out higher than we expect over the course of the year. We would find ourselves behind the curve – and realise it – and we would have to adjust our forward guidance.

This forward guidance was put in place to stabilise market expectations and to enhance the effectiveness of our asset purchases. We do so by indicating that interest rates will rise only when we are well past the horizon for asset purchases. Prolonging asset purchases pushes out market expectations of a rate rise and pushes down interest rate expectations across the entire curve. Of course, the effectiveness of our forward guidance also relies on our credibility.

In effect, forward guidance is a promise not to react to short-term data outturns in the future so as to persuade markets to expect interest rates to remain low. But if we offer guidance that extends too far into the future, it risks unduly tying our hands.

This is a particular risk at present since, as I mentioned earlier, future increases in interest rates need to be gradual. Moving late could result in policy remaining too loose for too long. The time will come this year to make further gradual adjustments to our monetary policy stance in line with our confidence in achieving our objective; market expectations are appropriate in this regard. We should then certainly reflect at length on the degree to which we wish to pre-commit ourselves.

The second risk for monetary policy relates to the side effects of low interest rates. Our measures have considerably improved financing conditions for households and firms, and have unblocked the flow of credit.

Yet easier financing conditions may encourage investment in projects that are only profitable at low interest rates, and such loans risk turning sour as interest rates rise. Indeed, banks and investors may be tempted to "search for yield", without being adequately recompensed for the risk they are taking on.

Our mandate is to deliver price stability. Ensuring financial stability risks are adequately contained is the role of banking supervision and macroprudential policy. While there is no evidence at present of asset price bubbles in the euro area, there are some notable localised pockets, such as in commercial real estate, and signs of "search for yield" behaviour.

The financial crisis showed how such risks can interfere with the smooth operation of monetary policy through their effects on banks, which remain a key part of the monetary policy transmission mechanism in the euro area. We should therefore bear in mind that these risks may make it harder for us to implement our monetary policy.

There are also longer-term risks to monetary policy. Through low interest rates, monetary policy may indirectly permit inefficient firms to remain in business, and they may become so-called zombie firms. This blunts the productivity-enhancing function of downturns to bring about "creative destruction", whereby inefficient firms are forced out of business, freeing up resources to move to more efficient firms and boosting aggregate productivity. Indeed, there is evidence that creative destruction was weaker during the recession than in previous downturns[2] and that zombie firms have weighed on productivity growth in some euro area countries[3].

Productivity growth plays an important role in the conduct of monetary policy. Higher productivity growth spurs investment, and expectations of higher future income encourage consumers to spend more today. Thus slower productivity growth requires monetary policy to lower interest rates by more than would otherwise be necessary to stimulate the economy. Given that interest rates are currently low, and our stock of purchases is considerable, this would restrict our ability to respond to future downward risks.

I have just explained what the economic risks are. But there are also legal risks for the ECB regarding our Treaty obligations. Article 127 requires that we "act in accordance with the principle of an open market economy … favouring an efficient allocation of resources". In other words, we should only do as much as is necessary to fulfil our price stability mandate. And we should be aware of potential side effects from running expansive policy for too long.

An important principle of an open market economy is price formation in markets through the interaction of private sector agents. It should be those interactions that ensure correct pricing, and not the interactions that take place as a result of our asset purchases. And this also applies to credit risk.

Of course, with the large stock of assets it holds, the Eurosystem has become a big player in the market, bigger than ever before. We sometimes buy bonds from institutional investors, such as pension funds and insurance companies, which could push up the price we need to pay given the growing scarcity. We should avoid a situation whereby liquidity conditions in certain market segments are unnecessarily made more challenging by an unwarranted extension of the purchase programme.

So we have to be mindful not to exert an undue influence on price formation.

Another potential complication relates to our public sector purchases. A key safeguard that we have set up for these purchases is to operate so-called “blackout periods”, where we do not buy around the date of a new issuance. This facilitates price formation and ensures that Article 123 of the Treaty – the monetary financing prohibition – is fully respected.

Conclusion

The economic recovery in the euro area has been better than expected and employment has risen strongly. Both wages and underlying inflation appear to have turned the corner.

All the conditions are in place for a sustained adjustment in inflation towards our aim. So it’s just a question of time now. More haste, less speed, however.

The improving inflation trajectory means that we can gradually scale back our net purchases and keep monetary policy sufficiently accommodative to continue to support the convergence of inflation towards our aim.

We will continue to monitor developments in the economy and set policy in a way that remains consistent with our price stability objective.

In doing so, we must also take into account the balance of risks.

If we withdraw our monetary policy stimulus too early and too fast, asset prices could collapse and yields rise sharply, with negative spillover effects to the economy.

If our asset purchase programme continues for too long, the side effects will increase. And if we nourish a market belief that the exit might be permanently postponed, potential cliff-edge effects could be exacerbated.

We are pursuing a credible prospect for the exit to keep these risks contained.

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1 See Mersch Y., “Economic Policy and the Need for Humility”, speech at the conference “Banking and Financial Regulation”, Bocconi University, 9 October 2017.

2 Bartelsman E., López-Garcia P. and Presidente G., “Cyclical and structural variation in resource reallocation in Europe”, Mimeo.

3 See e.g. Gopinath G. et al, “Capital Allocation and Productivity in South Europe”, NBER Working Paper No 21453, 2015; Borio C. et al, “Labour reallocation and productivity dynamics: financial causes, real consequences”, BIS Working Paper No 534, 2016; Andrews D. and Petroulakis F., “Breaking the Shackles: Zombie Firms, Weak Banks and Depressed Restructuring in Europe”, OECD Economics Department Working Paper No 1433, 2017.