Peter Praet: Ensuring a sustained adjustment in inflation

Keynote speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the National Bank of Romania, Bucharest, 3 July 2018.

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Accompanying slides of this speech.

It is a great pleasure for me to be here in Bucharest today. Since Romania joined the European Union on 1 January 2007, the world has changed considerably. The global financial crisis has challenged the European Union and its Member States. Several of them, including Romania, have implemented significant macroeconomic and financial adjustments. The euro area sovereign debt crisis exposed the institutional weaknesses of our Economic and Monetary Union and notably led to the push for the banking union and the creation of the European Stability Mechanism.

Romania has achieved a lot since it joined the European Union. Starting from very low GDP per capita, the country has made significant progress in terms of real convergence, with real GDP per capita moving from about 40% to roughly 60% of the EU average. Further structural reforms are necessary to unlock the full potential of the economy and pave the way for continued sustainable convergence.

Further reforms are also indispensable to ensure the smooth functioning of our Economic and Monetary Union. Our monetary union is gradually becoming stronger. Last week the Euro Summit agreed to take further steps towards completing the banking union and to strengthen the European Stability Mechanism, including by providing the backstop to the Single Resolution Fund. This is not yet the end of the journey towards a genuine economic and monetary union, but the Meseberg Declaration maps out a path towards further institutional developments that will, over time, make our monetary union stronger, to the benefit of all Europeans.

As a European institution, the ECB responded forcefully to the challenges posed by the crisis. In doing so, it acted in complete independence and fully in line with its mandate to maintain price stability in the euro area as a whole. This independence, granted to central banks by the Treaties, is an invaluable asset, helping them to act as guardians of price stability in good as well as in challenging times.

I will first consider our monetary policy response to the crisis, before turning my attention to recent economic developments. I will then elaborate on the measures that we took last month.

Overview of the monetary policy response to the crisis

A drawn-out phase of overborrowing and leverage came to an abrupt end in 2008. This set in train a turbulent decade of challenges to both financial stability and to the macroeconomic performance of the euro area economy. Not least, significant deleveraging and de-risking were triggered over several phases, each requiring a distinct response from the ECB.

The first phase exposed banks and sovereigns. It started with the liquidity crisis triggered by the collapse of Lehman Brothers in September 2008. Funding markets for banks came to a sudden stop. In response, the ECB – in concert with its counterparts around the world – reacted swiftly. It lowered its main refinancing rate to 1% in May 2009 and, in order to facilitate banks' borrowing of central bank funds, it expanded the range of eligible collateral for its refinancing operations. It also provided liquidity to the banking sector elastically – with no ex ante limit. This caused overnight interest rates to drift down to well below the rate on main refinancing operations.

But the severity of the crisis was such that the banking sector remained under pressure. The resources of the public sector were mobilised, putting strains on the public finances of those countries whose banking sectors were large relative to their economies. As a result of this assistance to the financial sector, government debt in the euro area as a whole increased by more than five percentage points of GDP. At the level of individual countries, government debt increased in some cases by more than 10 or even 30 percentage points of GDP, not including further – very sizeable – contingent liabilities resulting from state guarantees to banks.

The second phase intensified the negative feedback loop between banks and sovereigns. This loop was a source of vulnerability for the euro area for two reasons: first, any impairment of the banking sector's liabilities – including capital − challenged fiscal sustainability in the eyes of investors; and, second, the value of bonds held as bank assets shrank as their market value eroded.

The main consequence of this negative feedback loop was a fragmentation of financial markets along national lines. A lack of liquidity, coupled with the erosion of capital due to losses on sovereign exposures, eventually led to entire national banking systems being unable to access market funding. Cross-border bank funding contracted, and has never really recovered since.

Financial fragmentation impaired monetary policy transmission. Markets started to price in redenomination risk for some sovereign bonds, which in turn prevented our accommodative policy stance from reaching businesses and households evenly throughout the euro area. Contagion eventually became an acute threat to price stability and to the economy as a whole.

The ECB's monetary policy response to these developments was twofold. First, to ensure that banks had access to longer-term funding, two three-year refinancing operations were undertaken at the end of 2011 and beginning of 2012. Second, in the summer of 2012, the announcement of Outright Monetary Transactions served as a powerful circuit breaker. However, by then, the sovereign debt crisis had already left a trail of destruction in its wake, paving the way for the third phase of the crisis.

In the third phase, banks in many parts of the euro area started to deleverage, substantially reducing their lending to the private sector. Towards the end of 2013 lending was falling by more than 2% per year and another credit crunch was looming. By mid-2014, the economic recovery was losing momentum and the weakness in aggregate demand was starting to depress inflation expectations. Additional policy accommodation was needed to maintain price stability, but the rate on the ECB deposit facility had already been reduced to zero in July 2012. To address this challenge, the ECB sought to affect the whole range of interest rates that are relevant for private sector financing conditions through a strategy consisting of three elements.

The first was the launch of a negative interest rate policy, which began with a cut in the deposit interest rate to –0.1% in June 2014. This provided additional stimulus, as it extended the scope of conventional monetary policy.

The second element was the introduction of a credit easing package, which included targeted longer-term refinancing operations designed to support bank lending to the private sector, a third covered bond purchase programme and an asset-backed securities purchase programme. These measures improved the pass-through of liquidity injected into the financial system to private sector borrowing costs.

The third was the addition of a public sector purchase programme to the ECB's asset purchase programme (APP) to reinforce the accommodative monetary policy stance, further compressing term premia all along the yield curve.

These instruments were complemented by the use of forward guidance, through which we started to communicate our expectations of future policy, along with the conditions that would warrant a change in the policy stance. Forward guidance was intended to make our measures as effective as possible, in particular by ensuring that the impact of asset purchases on term premia was not counteracted by false expectations of interest rate increases.

Over time, our measures have boosted the growth momentum of the euro area economy, thereby supporting a return of inflation towards our inflation aim. The euro area has now enjoyed five consecutive years of growth. This prolonged economic expansion is reflected in the labour market: around 8.4 million more people are employed now than at the bottom of the trough in mid-2013. The jobs lost during the crisis have been entirely recovered, and the unemployment rate stands at its lowest level in nearly nine years, despite an increase in the labour force of more than 2%. Recent business surveys point to a continued positive outlook for employment. Our monetary policy measures have thus been successful.

Progress towards a sustained adjustment in the path of inflation

In spite of the recent moderation in economic activity, economic conditions remain favourable. The moderation in the first half of 2018 is attributable to a pull-back from the high levels of growth in the previous year, compounded by some temporary and supply-side factors, as well as a weaker impetus from external trade. The pace of economic growth is expected to stay above potential in the coming years. Favourable financing conditions, a robust labour market and steady income and profit growth are expected to continue to support private consumption and investment. This outlook is contingent on a continued supportive business environment at the global level and on the pursuit of institutional and structural reforms in the euro area.

Headline inflation increased significantly in May, primarily due to higher oil prices, and stood at 2.0% in June according to Eurostat’s flash estimate. Eurosystem staff expect headline inflation to stand at 1.7% in each year over the period from 2018 to 2020, supported by the continuing economic expansion, high levels of capacity utilisation, labour market tightness and rising wage growth. This stable path of headline inflation conceals a decline in the annual rate for the energy component, offset by gradually rising HICP inflation excluding energy and food, as capacity constraints are expected to become increasingly tight. This expectation is consistent with the incipient increase in measures of underlying inflation from earlier lows.

The risks surrounding the euro area growth outlook remain broadly balanced. However, risks related to global factors, including the threat of increased protectionism, have become more prominent. Moreover, the risk of persistent heightened financial market volatility adds to the downside factors.

Against this backdrop, the ECB’s Governing Council carried out a thorough assessment of price and wage pressures and the inflation outlook at its June meeting. Its assessment of progress towards a sustained adjustment of inflation was guided by three criteria: convergence, confidence and resilience.

As for convergence, the June 2018 Eurosystem staff macroeconomic projections foresee headline and core inflation reaching 1.7% and 1.9%, respectively, in 2020. This confirms a pattern of convergence to levels closer to 2% that has become increasingly evident over successive projection rounds.

Concerning the second criterion, confidence, uncertainty about the inflation outlook has been declining significantly and the risk of deflation has vanished. Inflation expectations − both survey and market-based − have been gradually improving and are increasingly consistent with the Governing Council’s inflation aim. Moreover, domestic cost pressures are strengthening amid high levels of capacity utilisation, tightening labour markets and rising wages.

Finally, with regard to the resilience criterion, the projected inflation convergence towards our inflation aim has become progressively less reliant on further extensions of net asset purchases. This is also reflected in current market expectations.

Progress towards a sustained adjustment in inflation has been substantial so far. The underlying strength of the euro area economy, together with well-anchored, longer-term inflation expectations, provides grounds to be confident that the sustained convergence of inflation will continue in the period ahead, even after a gradual winding-down of net asset purchases.

At the same time, significant monetary policy stimulus is still needed to support the further build-up of domestic price pressures and to ensure the durable stabilisation of inflation around levels below, but close to, 2% over the medium term. Patience, prudence and persistence continue to be essential in determining the future course of monetary policy. The significant stimulus that is still needed for the continued sustained convergence of inflation will be provided by the additional net asset purchases until the end of the year, by the sizeable stock of acquired assets and associated reinvestments, and by the enhanced forward guidance on key ECB interest rates.

Patience, prudence and persistence are fully reflected in our latest monetary policy decisions. First, the anticipated end of net asset purchases remains conditional on incoming data confirming the medium-term inflation outlook. Second, we have reiterated our intention to maintain our policy of reinvesting the principal payments from maturing securities purchased under the APP for an extended period of time after the end of our net asset purchases, and in any case for as long as necessary. Third, we have clarified the expected future course of policy interest rates by enhancing our forward guidance through explicit date-based and state-contingent elements. The expectation is that policy rates will remain at their present levels at least through the summer of 2019 and, in any case, for as long as necessary to ensure that the evolution of inflation remains aligned with the Governing Council’s current expectations of a sustained adjustment path.

Beyond the end of net asset purchases, reinvestments will mean that the Eurosystem maintains a sizeable presence in euro area securities markets. Enhanced forward guidance on rates, in turn, supports financial conditions by anchoring policy rate expectations more firmly at their present low levels. Moreover, the conditionality embedded in forward guidance on all policy instruments ensures that the monetary stance will continue to evolve gradually and in a data-dependent manner.

The impact of our most recent decisions on financial prices was largely frictionless. Our enhanced forward guidance on the ECB’s policy rates underlines their pivotal role as the main tool for adjusting the monetary policy stance in the future.

Overall, the present configuration of policy instruments will preserve the monetary stimulus that underpins the economic growth momentum in the euro area and the evolution of inflation along a sustained adjustment path.