Yannis Stournaras: A retrospective on euro area monetary policy during and after the recent financial crisis

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the 23rd International Conference on Macroeconomic Analysis and International Finance, University of Crete, Department of Economics, Rethymno, 31 May 2019.

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Introduction

2019 marks the 20th anniversary of the euro, which ushered in a new era of European history. Over these past two decades, the monetary policy of the Eurosystem broadly succeeded in creating a low-inflation environment. Still, while the first decade, known as the "Great Moderation", was characterised by macroeconomic stability, the second was marked by severe challenges for policy makers:

- First, a major financial crisis spread from the US to the rest of the world, threatening financial stability and the macroeconomic outlook in the euro area.
- Second, doubts about sovereign and private debt sustainability in a number of euro area Member States exacerbated the crisis.
- Third, a protracted period of low inflation began in the second half of 2013, while risks of a de-anchoring of inflation expectations intensified.

In response to these challenging circumstances, the Eurosystem had to adapt its monetary policy to a significant extent.

In what follows, I will first focus on the monetary policy conducted by the Eurosystem during these three distinct phases[1], and then turn to the lessons learned and challenges for the future.

First phase of the crisis 2007–2010

In 2007, the turmoil in the US subprime mortgage market induced a general re-pricing of financial market risks. Financial tensions rapidly spilled over to the rest of the world, generating considerable uncertainty regarding the reliability of the banking sector. Concerns about the soundness of counterparties seriously impaired interbank and other short-term funding markets, leading to liquidity hoarding by some counterparties and to funding difficulties for numerous others. Financial market fragmentation increased markedly. The unrest in financial markets impacted on the real economy, leading to a severe contraction in international trade and, ultimately, to the "Great Recession" of the global economy.

In the euro area, the financial turmoil led to a collapse of bank intermediation, as evidenced by the sharp decrease of credit growth[2], the contraction of economic growth by more than 7 percentage points in just one year[3], and the sharp decline of inflation, which entered negative territory in the summer of 2009.

In order to meet the banks' strong demand for liquidity and to counter fragmentation by restoring the functioning of the monetary policy transmission mechanism, the ECB decided to:

o reduce its policy rates, bringing the rate on the main refinancing operations down to 1% in May 2009,

o offer unlimited liquidity at a fixed rate, against a widened pool of eligible collateral, through regular refinancing operations; and

o provide liquidity for longer periods (through longer-term refinancing operations –LTROs).

In 2009, the ECB also carried out, for the first time, an outright purchase programme, targeting covered bonds issued by banks, with the aim to stimulate activity in the covered bond market and to support credit intermediation.

These measures largely succeeded in improving the functioning of the financial markets. At the start of 2010, macroeconomic developments were encouraging, and inflation rose towards levels compatible with the ECB's price stability definition, with headline inflation reaching 1.7%.

Second phase of the crisis (2010–2013)

However, in early 2010, in the wake of a deep recession and expansionary fiscal policies in the euro area, several Member States began to face intensifying tensions in financial markets, on account of unsustainable public finances or a weak banking sector. These tensions were further amplified by the strong sovereign-bank nexus, and had their root in the concerns about the sustainability of sovereign and private debt in several vulnerable Member States, including Greece, Ireland, Portugal, Cyprus, Spain and Italy. The yield spreads of the government bonds issued by these countries vis-à-vis the respective German Bund soared to historic highs, reflecting a lack of confidence, as well as redenomination risk [i.e. the risk that euro area assets could be redenominated in legacy currencies].

The banking system was also confronted with financial fragmentation along national borders. As a result, monetary policy transmission was severely impaired – hindering the pass-through of the accommodative monetary policy stance to the stressed jurisdictions. Financial fragmentation in the euro area peaked in 2012, and still remains above pre-crisis levels[4]. The most vulnerable Member States lost market access and adopted adjustment programmes, which partly involved pro-cyclical fiscal consolidation measures. Against this background, the Eurosystem introduced the Securities Markets Programme in May 2010, purchasing sovereign bonds from financially stressed Member States.

In early 2012, financial tensions intensified, as the euro area economy slowed down again to a double-dip recession[5] and fiscal slippages re-emerged. Markets started to price-in redenomination risk in certain sovereign bonds. The adverse confidence effects triggered a further sharp increase in the spreads of government bonds. In response, the Eurosystem:

- lowered its policy rates with the deposit facility rate reduced to 0% by July 2012;
- offered longer-term refinancing operations, with maturities ranging from one to three years, in an aim to ensure long-term funding for credit institutions.
- following the implementation of these measures, the balance sheet of the Eurosystem almost doubled between 2007 and 2012, with monetary policy-related assets reaching €1.5 trillion by the end of 2012.

  Meanwhile, major steps were taken to address weaknesses in the architecture of the monetary union, as, among other negative consequences, the adverse effects of the incomplete architecture of Economic and Monetary Union on the effectiveness of monetary policy had become evident. Far-reaching measures were adopted to preserve financial stability in the euro area:

- In 2012, the European Stability Mechanism (ESM) was created to provide financial assistance to euro area Member States experiencing or threatened with severe financing problems.
- Another major step was the decision to implement a Banking Union with three pillars: a common banking supervision, a common resolution mechanism and a (yet to be established) common deposit insurance scheme. The decision to establish the Banking

Union contributed significantly to overcoming the debt crisis and to bolstering financial stability in the euro area, thereby enhancing the potential for economic growth.

- At the end of 2010, the European Systemic Risk Board (ESRB) was established as the main body for macro-prudential oversight and surveillance of EU financial markets with the aim of preventing systemic risk.

In the summer of 2012, President Draghi reassured markets that "the ECB is ready to do whatever it takes to preserve the euro" within its mandate, and announced the Outright Monetary Transactions (OMT) programme. Although OMT has never been implemented, the ECB's commitment to safeguard the effectiveness of the single monetary policy was instrumental in reducing the rise in yields and spreads and in bolstering confidence in the irreversibility of the euro. Sovereign bond spreads started to fall rapidly, reflecting the restored confidence of market participants.

However, the significant contraction in economic activity which had taken place in several euro area Member States, as well as the still weak confidence, left a damaging legacy for the economy and prepared the ground for the third phase of the crisis.

Third phase of the ECB's response to the crisis (2013-present)

In the second half of 2013, amid a weak euro area economic environment characterised by anaemic aggregate demand, inflation once again fell, by more than 2 percentage points[6], and remained in negative territory for several months in 2015 and 2016. Inflation expectations, which until then had remained anchored, declined significantly, reflecting downward pressures on prices and concerns about a protracted period of low inflation or even deflation. Deleveraging by banks in the euro area intensified, reducing credit to the real economy to a significant extent, while the monetary policy transmission mechanism remained impaired.

In July 2013, the ECB introduced forward guidance on the future path of its policy rates, in order to anchor policy expectations and guide the markets in their efforts to assess its reaction function[7]. Moreover, policy rates were lowered further, and in June 2014 the ECB went into negative interest rate territory when it lowered the deposit facility rate to below zero per cent.

Meanwhile, the steps towards the completion of the Banking Union continued:

- In 2014 the first pillar of the Banking Union, the Single Supervisory Mechanism (SSM), became effective with the ECB assuming responsibility for supervision of the larger banks of the euro area.
- That same year, the second pillar of the Banking Union, the Single Resolution Mechanism (SRM), entered into force, with the mission of ensuring the orderly resolution of failing banks, with minimal costs to taxpayers and the real economy.

In order to revive credit provision, the ECB introduced a series of targeted longer-term refinancing operations (TLTROs) on attractive terms, conditional on banks' lending behaviour to firms and households. Credit easing was complemented by Eurosystem programmes for purchases of covered bonds and asset-backed securities issued by banks, and later of bonds issued by public sector entities, international organisations, development banks and corporations.

Since the introduction of the Asset Purchase Programme (APP) in 2015 until the end of the positive net purchases in December 2018, total assets purchased by the Eurosystem exceeded €2.5 trillion. In addition, credit operations reached more than €0.7 trillion in December 2018. As a result, assets related to monetary policy on the Eurosystem's balance sheet expanded to unprecedented levels, at around €3.5 trillion, which corresponds to over a third of euro area GDP.

Quantitative easing, in combination with credit easing, drove up the prices of financial assets and lowered their yields, thereby reducing medium-to-longer term interest rates and enhancing the transmission of monetary policy. By providing ample financing and by easing funding conditions, the ECB successfully contributed to stimulating credit growth and supporting economic growth, with a view to achieving a solid economic expansion[8]. Furthermore, gradually rising prices supported the convergence of inflation to levels consistent with price stability[9].

However, according to the assessment of the Governing Council in the first half of 2019, in the face of a weaker-than-expected growth and inflation outlook, monetary policy accommodation is still needed to secure the path of inflation convergence. To this end, forward guidance on policy rates was strengthened earlier this year. Policy rates are now expected to remain at their present levels at least through the end of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term. Similarly, the forward guidance on reinvestment suggests that the sizeable stock of assets bought under the APP will be kept unchanged for even longer[10], continuing to provide an ample degree of monetary accommodation. In the same vein, a new series of targeted longer-term refinancing operations (TLTRO-III) was announced to help preserve favourable bank lending conditions and the smooth transmission of monetary policy. The relevant parameters of the TLTRO-III, to be decided in the near future, will reflect the evolving macroeconomic conditions. TLTRO may actually prove to be a more powerful monetary policy tool for the future than initially thought.

Lessons from the recent financial crisis and challenges for the future

The recent financial crisis was the most severe in seventy-five years. A key question now is: "Will it happen again?"

My answer is that − if and when it does happen − it will be different.

1) A valuable lesson is that, "while most of the time the economy works very well left in the care of the invisible hand, during panics, that hand seems to lose its grip", as Ahamed Liaquat wrote in his Pulitzer – award winning "Lords of Finance". Policy makers around the world have learned their lessons from the Great Depression: a financial system in distress requires active central bank intervention. Central banks this time acted quickly and forcefully. They developed their toolkit with a combination of more flexible, effective and innovative measures and enormous firepower. Given the success of these policies, some of these instruments may be permanently included in the new standard-framework, and thus equip policy makers with the tools to engage in proper and timely action. All in all, it seems that there is no strong case for a fundamental change in the monetary policy framework. Central banks are expected to continue to use the asset side of their balance sheets, as well as other tools such as forward guidance, in addition to their standard interest rate policies, as the effective lower bound will likely continue to be a binding constraint on interest rate policy in a low inflation, low interest rate environment. Going forward, central banks are likely to proceed to the downsizing of their balance sheets in gradual and cautious steps. In any case, even taking into account the hazards, sustaining the present high levels of central bank assets creates benefits for the economies and financial markets alike. These benefits relate to the maintenance of accommodative liquidity conditions for banks and the economy, as well as the avoidance of financial turbulence in the event of a sudden rise in interest rates in the markets.

2) We, as central bankers, have gained a much better understanding of how the financial system operates and how risks to the stability of the financial system may develop. A lot has been done to make the system much safer than it was 10 years ago and as resilient as possible. Such work has progressed in various directions, including not only more effective regulation but also higher capital and liquidity buffers for banks, early warning systems and the development of macroprudential tools to increase resilience to shocks when they occur. This was evident in the

results of the recent EU-wide stress tests which show that banks have become more resilient to financial shocks over the past two years.

3) Bold steps have to be taken to strengthen the eurozone. At the national level, euro area Member States have stepped up structural reform efforts in the labour and product markets to make them more flexible, which is necessary in a single currency area, and to boost productivity, and to make public finances more robust. The Banking Union (with a single supervisor, a Single Resolution Mechanism and – a yet-to-be-established but of utmost importance – common European Deposit Insurance Scheme) will help to create a better integrated, more efficient and well-capitalised European banking sector. Coupled with the completion of the Capital Markets Union, and a single rule book for banks and capital markets, it can support the single market and fund investment and growth. Increased risk sharing is highly desirable, but we should not forget that greater public risk sharing is only possible with less, and not more, sovereignty. Risk sharing, whether this takes the form of a safe asset, a central fiscal tool, a fund to insure against unemployment, or a truly European deposit insurance scheme, should proceed simultaneously with risk reduction, such as the reduction of non-performing loans or national discretions in supervisory and resolution rules for banks. It is only in this way that we can transform, what is in effect today in the eurozone, a non-cooperative zero-sum game into a cooperative, win-win one.

4) Many challenges remain and a lot still needs to be done. The financial system continuously innovates, and the work of regulators comes with a lag. In fact, certain large financial institutions that conduct activities similar to those of banks but have no banking license – what we call “shadow banks” – remain insufficiently monitored and under-regulated. Important challenges also remain outside the financial system, such as an escalating trade war, geopolitical risks and cyber-risks. As central banks, we have to be prepared for all contingencies.

5) Monetary policy alone cannot stabilise the economy in perpetuity. Fiscal policy should also be active, in those Member States where fiscal space exists and public debt remains sustainable. In addition, in a monetary union such as the eurozone, the adjustment of current account imbalances should be as symmetric as possible, implying that not only should the Member States with excessive current account deficits adjust, but, that the Member States with excessive current account surpluses should also adjust. Furthermore, the sequencing of domestic structural policies is important: for instance, goods and services market flexibility is best achieved before, or simultaneously with, labour market flexibility. Otherwise, large real wage reductions might occur, which are unnecessary both from an economic and a social perspective.

6) An important lesson is the need to safeguard the independence of central banks both from political influence but also from business interests, which sometimes try to capture the supervisory and other activities of central banks. Central banks also have a duty to speak the truth to the public, to explain the state of economies and to present their forecasts free from any outside influence.

7) Looking forward, allow me to briefly mention another aspect that is likely to become relevant to monetary policy in the future: climate change[11]. Climate change will be an increasingly prominent factor that influences monetary policy due to its potential for exerting multiple impacts on firms, households, banks and, eventually, the economy as a whole. Any assessment of risks, forecast or planning will ultimately be affected. It is therefore within the mandates of central banks and supervisors to ensure that the financial system is resilient to such risks. Central banks also need to establish access to sufficient high-quality data, in order to be able to assess the risk in the financial sector correctly, and to conduct relevant research. In addition, interaction is needed with other important players, who aim to define parameters of green finance and climate change risks and most importantly to establish global coordination. Having said so, I should also add that the main task for tackling climatic change remains with governments, with the use of the appropriate tax and subsidy policies as well as with other incentive mechanisms.

At present, several central banks, including the Bank of Greece and the ECB, participate in the Network for Greening the Financial System (NGFS), which was set up with the purpose to enhance the role of the financial system in managing climate and environmental risks, analyse the macro-financial impact of climate change and strengthen the global response to the threat of climate change. The Bank of Greece[12] is actively engaged and invests in climate change-related research. The interdisciplinary Climate Change Impacts Study Committee (CCISC) set up by the Bank in 2009 has been working on all aspects of climate change, from climate science to environmental macroeconomics, highlighting climate change as a key factor that should be horizontally integrated into policymaking as it affects almost all sectors of the Greek economy.

In conclusion, the monetary policy conducted by the Eurosystem has effectively tackled the crisis — flexibility and realism in the monetary policy framework have been pivotal in this regard. While such flexibility should be maintained in order to ensure that enough policy space will be available to address potential future adverse developments, several other avenues should be pursued in parallel, to further reduce vulnerabilities in the euro area, including prominently deepening European integration.

For those of us with a deep interest in economic history, it is clear that "those who cannot remember the past are condemned to repeat it". We need not only the ability to learn from the mistakes of the past, but also the vision to avoid repeating mistakes. At the same time, it is our duty to strengthen our safety net and build the tools to reduce the effects and length of downturns, should risks materialise.

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[1] See Constâncio (2018), Hartmann and Smets (2018)

[2] The annual growth rate of loans to the private sector in the euro area fell from 11.2% in December 2007 to –0.6% in January 2010.

[3] Euro area real GDP growth fell from 2.2% in Q1 2008 to –5.5% in Q1 2009, on an annual basis.

[4] ECB (2018)

[5] Euro area real GDP growth fell to –0.4% y-o-y in Q1 2012.

[6] Euro area inflation fell from 1.6% in July 2013 to –0.6% in January 2015.

[7] Praet (2013).

[8] ECB (2019).

[9] Hartmann and Smets (2018).

[10] See ECB Introductory Statement, April 2019: "We intend to continue reinvesting, in full, the principal payments from maturing securities purchased under the asset purchase programme for an extended period of time past the date when we start raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation".

[11] Lautenschläger (2019).

[12] Stournaras (2019).