EUROPEAN CENTRAL BANK

EUROSYSTEM

Ad van Riet *

Monetary Policy Challenges of the European Central Bank

*** Senior Adviser, European Central Bank (ECB).**

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Outline

Three challenges for the European Central Bank (ECB):

1. **Target of medium-term price stability**

   Address risk of inflation staying too low

2. **Toolkit of monetary policy**

   Focus on non-standard monetary measures

3. **Transmission of monetary policy**

   Activate all monetary channels to the real economy

Three challenges for the ECB

1. Target of medium-term price stability

The ECB's monetary policy objective

Legal mandate: **"…** the primary objective of the European System of Central Banks (ESCB) shall be <u>to maintain price stability</u>"

"Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union"

Treaty on the Functioning of the European Union, Article 127(1)

Operationalisation: **"…** the Governing Council will aim to maintain the euro area inflation rate below, but close to, 2% over the medium term"

Clarification of ECB strategy (2003) building on ECB definition of price stability (1998)

The ECB's monetary policy objective

Recent academic discussions on: what is meant by price stability?

Level of price stability benchmark:

- Some have argued 4% rather than 2% so as to give more space for lower interest rates when there is economic slack and inflation is relatively high.
- With persistent 'lowflation', others have stated that the benchmark could be well below 2% so as to avoid negative interest rates

➡ Central bank could be seen as opportunistic, if it were to change the benchmark

Horizon of price stability objective:

- Central bank cannot control supply-shocks affecting short-term inflation
- Sometimes the focus may have to on near-term financial stability

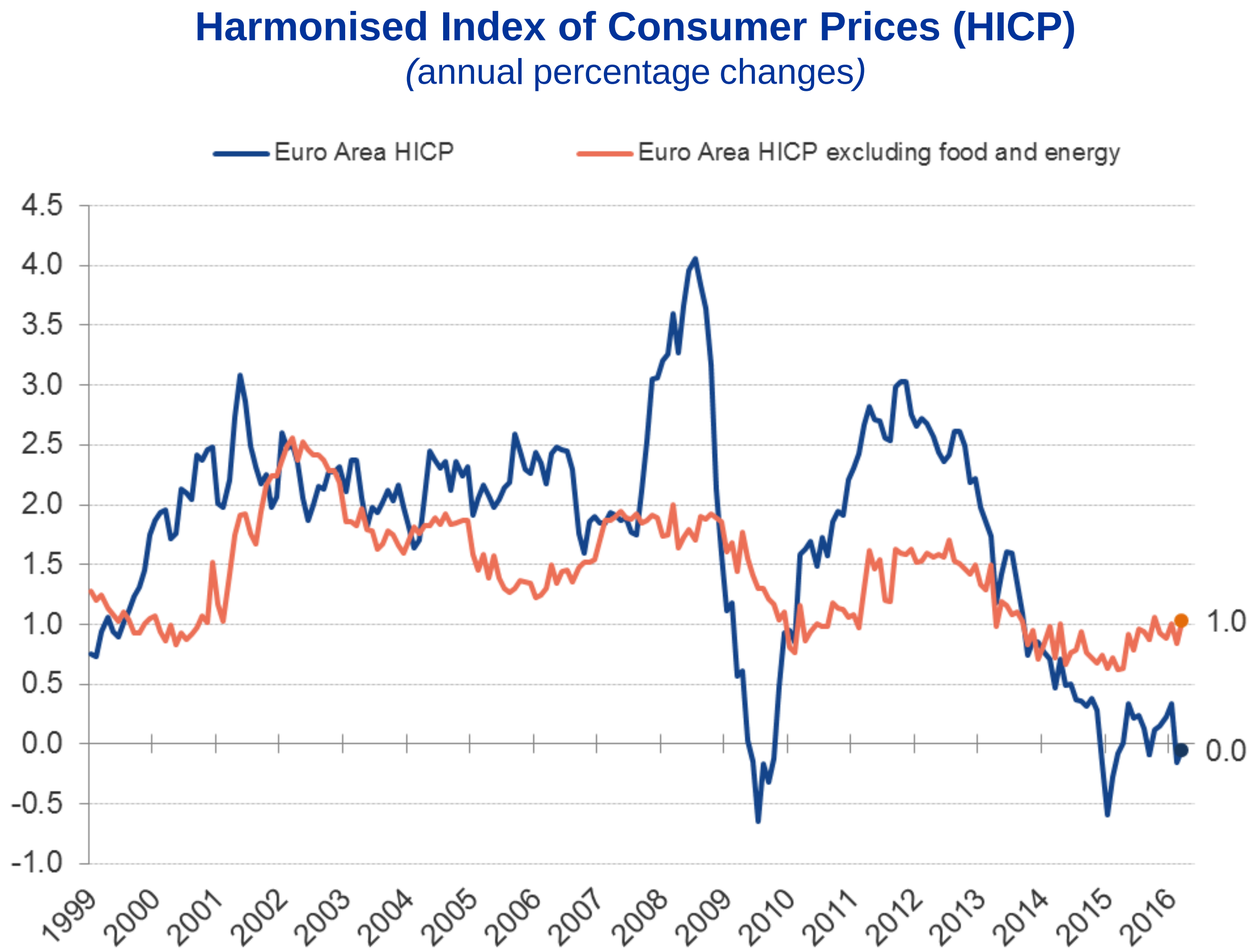
➡ Price stability can only be met over the medium term, this may take longer when the impact of shocks affecting prices is persistent or financial stability is at risk.

Focus on headline or core inflation:

- Exclude volatile prices, like energy and food? Focus on GDP deflator?
- All price information is relevant, there may be second-round effects in wages

➡ Core inflation helps to look through volatility and predict future headline inflation

Euro area inflation remains very low



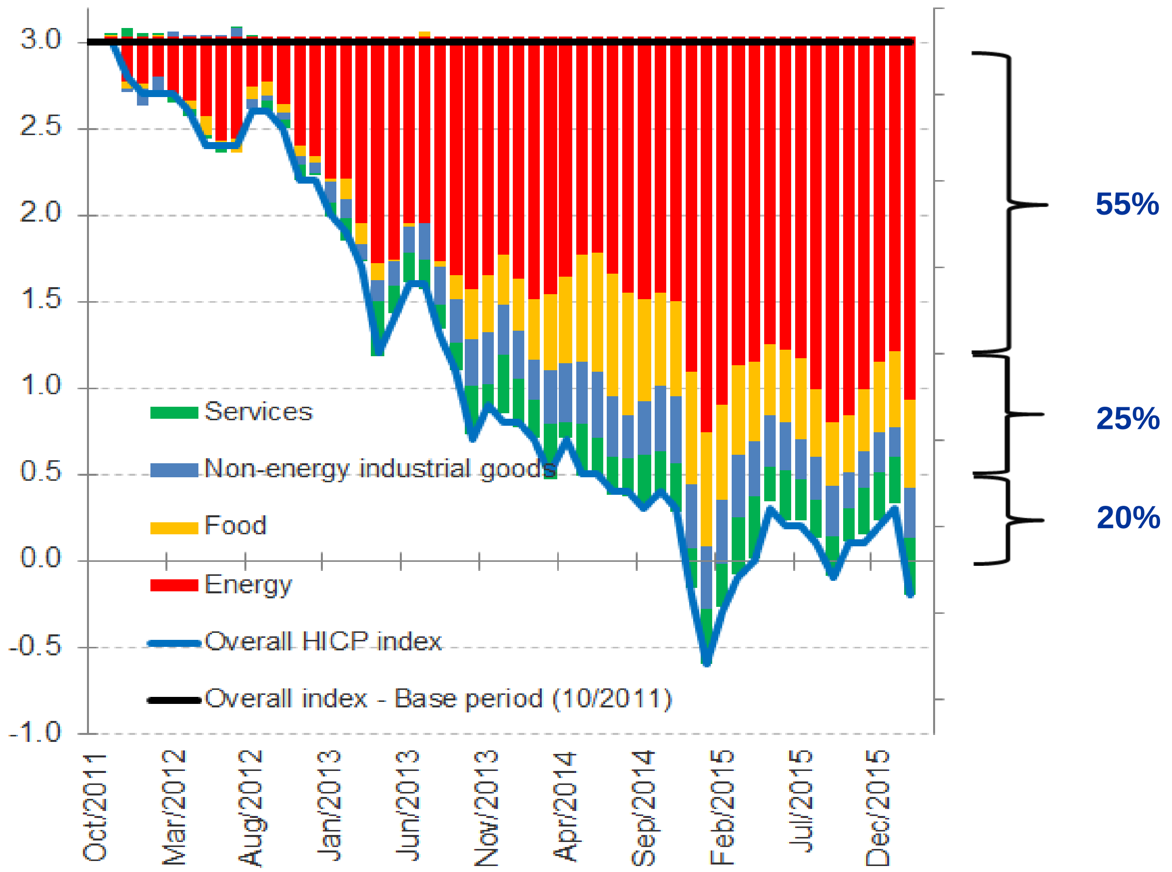
Source: Eurostat and ECB calculations.
Latest observations: March 2016.

Key to examine the factors behind the fall in inflation

Euro area disinflation reflected falling food and energy prices, but also slack in the economy. Also price/cost reductions to restore competitiveness in stressed countries

Composition of the change in HICP inflation since October 2011

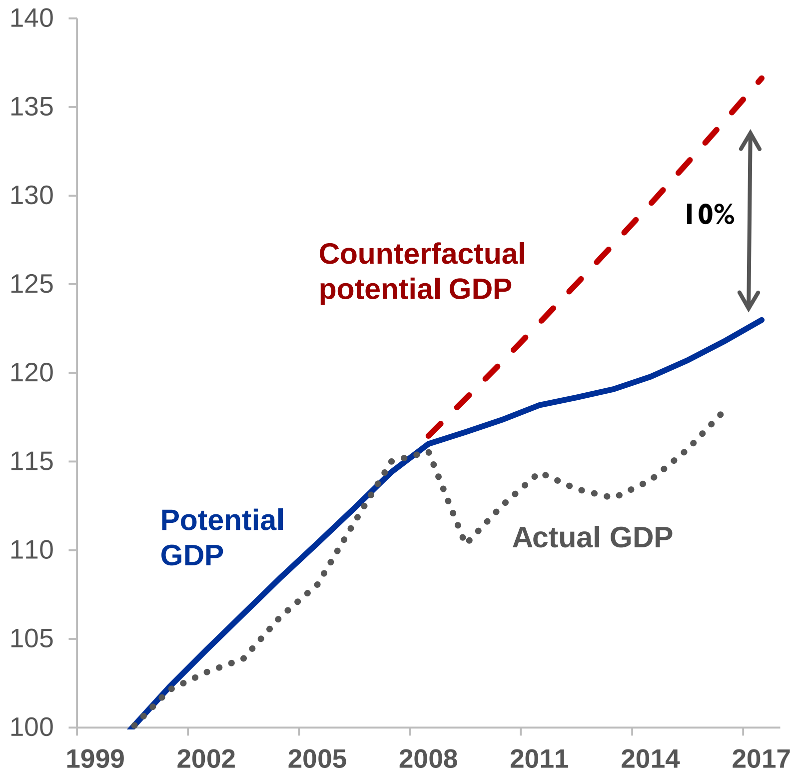
(annual change in % and contributions in p.p.)



Sources: Eurostat and ECB calculations.
Latest observation: February 2016.

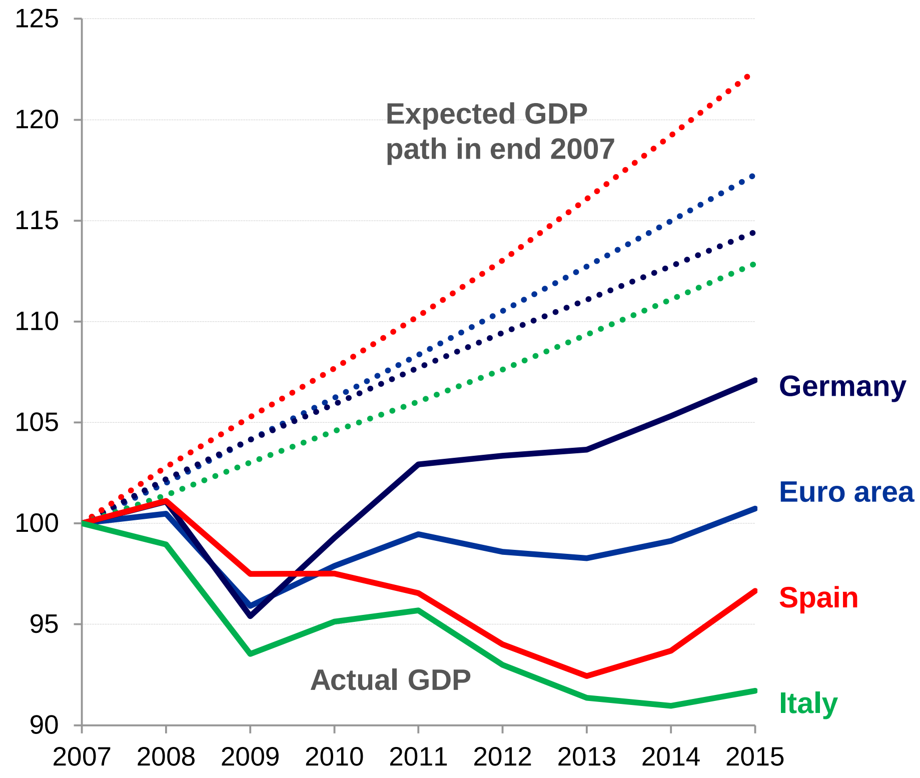
Euro area recovery continues, but slack remains significant

Actual euro area GDP well below potential
(index, 1999Q1 = 100)



Sources: European Commission, EPC Output Gap Working Group.
Note: Counterfactual potential GDP assumes that potential GDP continued to grow at its 2007 growth rate, i.e. it reflects that potential growth had already slowed down before the crisis.

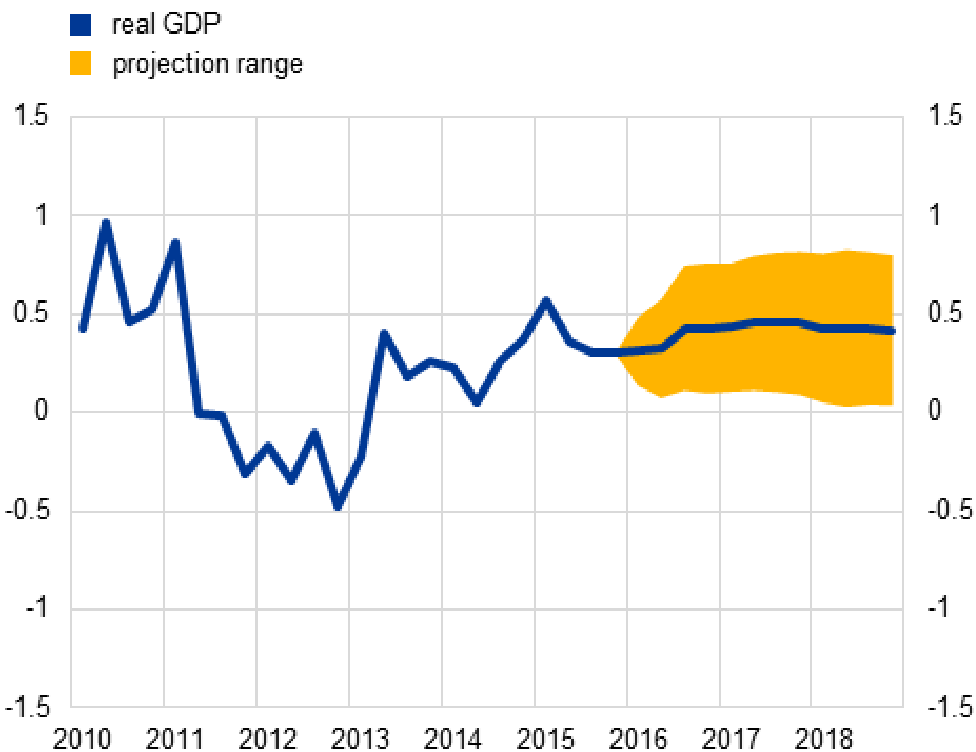
Actual GDP across the euro area
(index, 2007 = 100)



Sources: European Commission, Consensus Economics and ECB calculations.
Note: The dotted lines represent the GDP path based on private sector expectations in Consensus Economics of October 2007.

March 2016 ECB staff projections point to sluggish recovery

Euro area real GDP growth
(quarter-on-quarter percentage changes)



Annual rates: 1.5% 1.4% 1.7% 1.8%

Source: ECB, Economic Bulletin, Issue 2, March 2016.
Note: Working day-adjusted data

Key factors supporting demand:

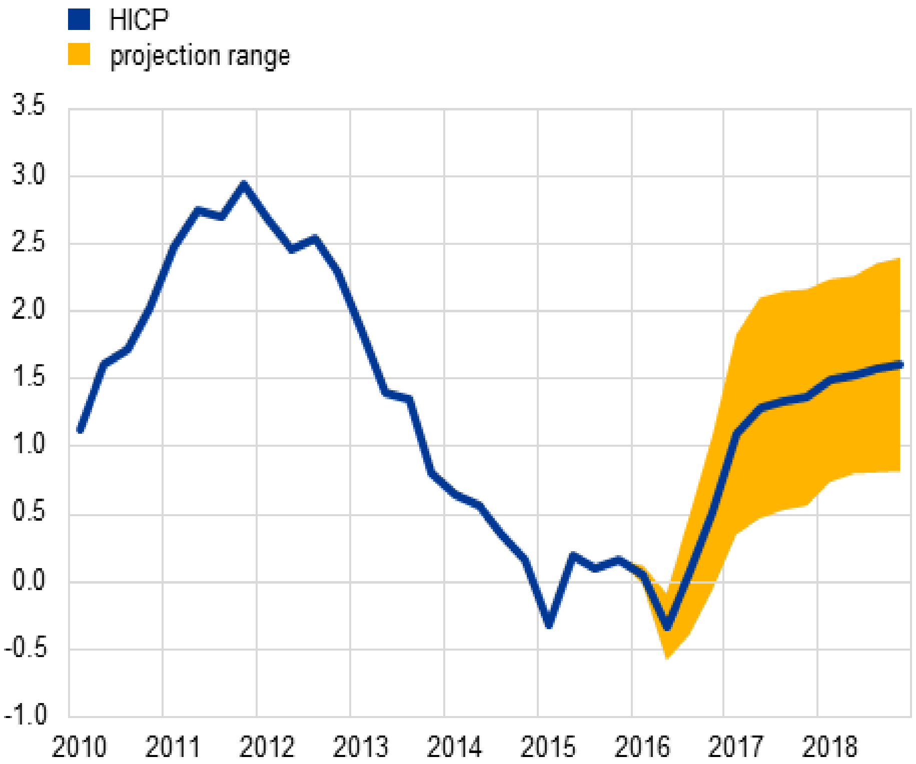
- Very accommodative monetary policy
- Improving credit conditions
- Slight fiscal expansion
- Improving labour market
- Fall in commodity prices
- Higher real disposable income
- Gradual pick-up in external demand

But some dampening factors:

- Still high unemployment rate
- Still sizeable unutilised capacity
- Need for further private and public sector deleveraging
- Uncertain growth in emerging markets
- Ongoing geopolitical tensions
- Strengthening euro exchange rate

March 2016 ECB staff projections point to subdued inflation

Euro area HICP inflation
(year-on-year percentage changes)



Annual rates: 0.0% 0.1% 1.3% 1.6%

Source: ECB, Economic Bulletin, Issue 2, March 2016.

Key factors countering low inflation:

- Very accommodative monetary policy
- Recovery of wage and profit growth
- Some indirect tax increases
- Upward base effects from oil price
- Pass-through from past euro decline

But some dampening factors:

- Overcapacity and labour market slack
- Pass-through of low oil prices
- Strengthening euro exchange rate
- Price and cost adjustments in the crisis-affected countries

Three challenges for the ECB

2. Toolkit of monetary policy

Since the crisis, ECB needed to dig deep in its monetary policy toolkit

Standard measures:

- **standard facilities** for providing/absorbing (excess) liquidity and steer bank reserves (main refinancing operations, marginal lending facility, deposit facility)
- reduction in the **three interest rates on these facilities** to levels close to or at zero
- narrowing of **interest rate corridor** around the main refinancing rate

Non-standard measures:

- **negative deposit facility rate**: increase incentives to use excess reserves for credit
- **ample liquidity at fixed-rate full allotment**: ease bank funding conditions in the money market in line with high demand for longer-term liquidity
- **enhanced and targeted credit support**: ease bank credit supply conditions and/or create market incentives to provide credit
- **increase scope of bank refinancing**: accept more eligible collateral/counterparties
- **cut required minimum reserves**: make more funds available to banks for collateral
- **improve monetary transmission**: selective private/public sector asset purchases to repair malfunctioning financial market segments and enforce the monetary stance
- **enlarge monetary stimulus:** large-scale private/public sector asset purchases

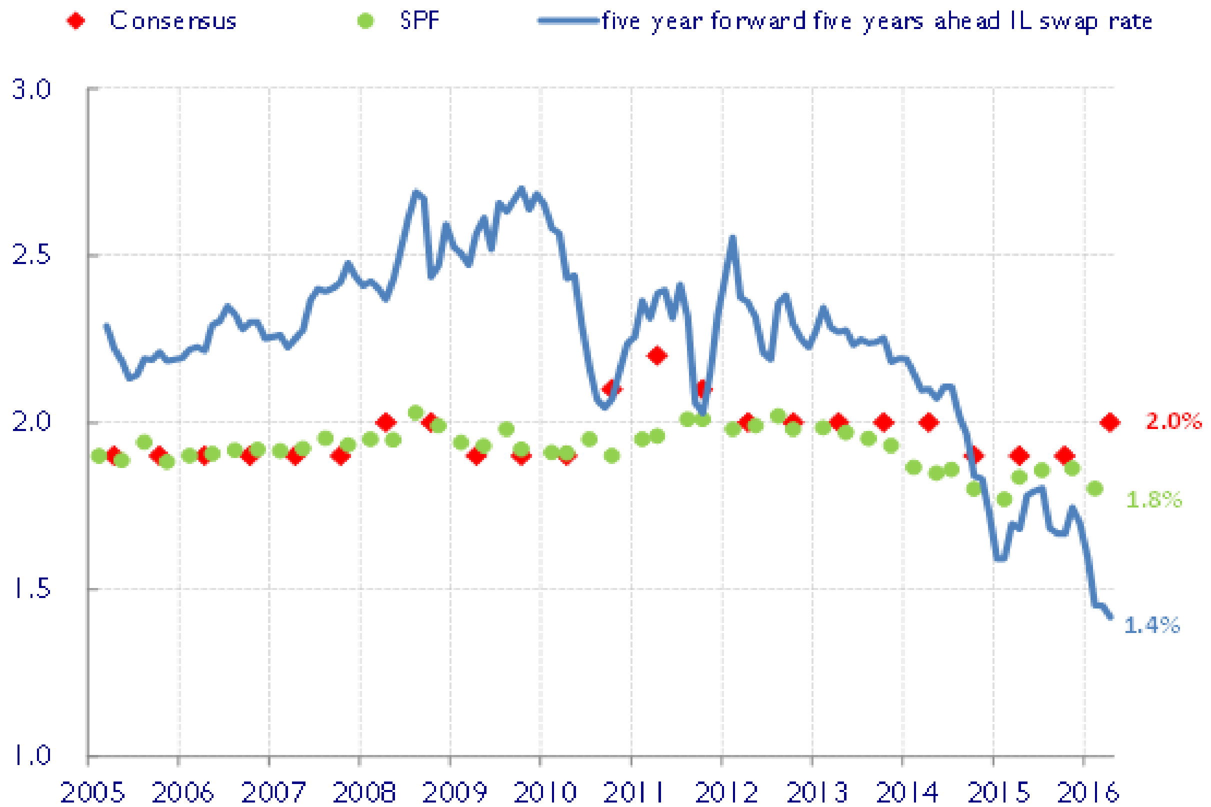
Communication:

- **forward guidance** about ECB's monetary policy stance and reaction function
- **publication of an account** of the Governing Council monetary policy meeting

Euro area inflation expectations were sliding below 2% in 2014

Survey- and market-based measures of longer-term inflation expectations

(percentages per annum)



Sources: Consensus Economics, ECB and Reuters.
Note: The survey-based measures of longer-term inflation expectations are taken every quarter from the ECB Survey of Professional Forecasters (SPF) looking 4 years ahead and twice a year from Consensus Economics for 6-10 years ahead. The market-based measure shows monthly averages of daily inflation-linked (IL) swap rates. The expected inflation rates are seasonally adjusted.
Latest observations: 14 April 2016 for daily data, April 2016 for Consensus Economics and 2016 Q1 for the SPF.

Coping with risks of a too prolonged period of low inflation

The Governing Council of the ECB decided to provide additional monetary policy accommodation and actively support lending to the real economy (monetary policy decisions of June and Sept. 2014, Jan., Sept. and Dec. 2015 and March 2016)

Monetary policy objective:

- secure a sustained return of inflation rates to levels that are below but close to 2%
- anchor medium- to long-run inflation expectations

Comprehensive measures:

- ECB key interest rates reduced in several steps close to or at the zero bound, deposit facility rate cut into negative territory
- Targeted longer-term refinancing operations (TLTRO I and from June 2016 TLTRO II) at a favourable interest rate with built-in incentives for banks to lend to private sector
- Private sector purchase programme of high-quality asset-backed securities (ABSPP), covered bank bonds (CBPP3) and (from June 2016) non-bank corporate sector bonds (CSPP)
- Public sector purchase programme of debt issued by euro area central, regional and local governments, public agencies, EU supranational institutions (PSPP)
- Forward guidance that key interest rates are expected to remain at the current very low or even lower levels, well past the horizon of the asset purchase programme – which itself was extended from Sept. 2016 to March 2017, or beyond, if necessary.

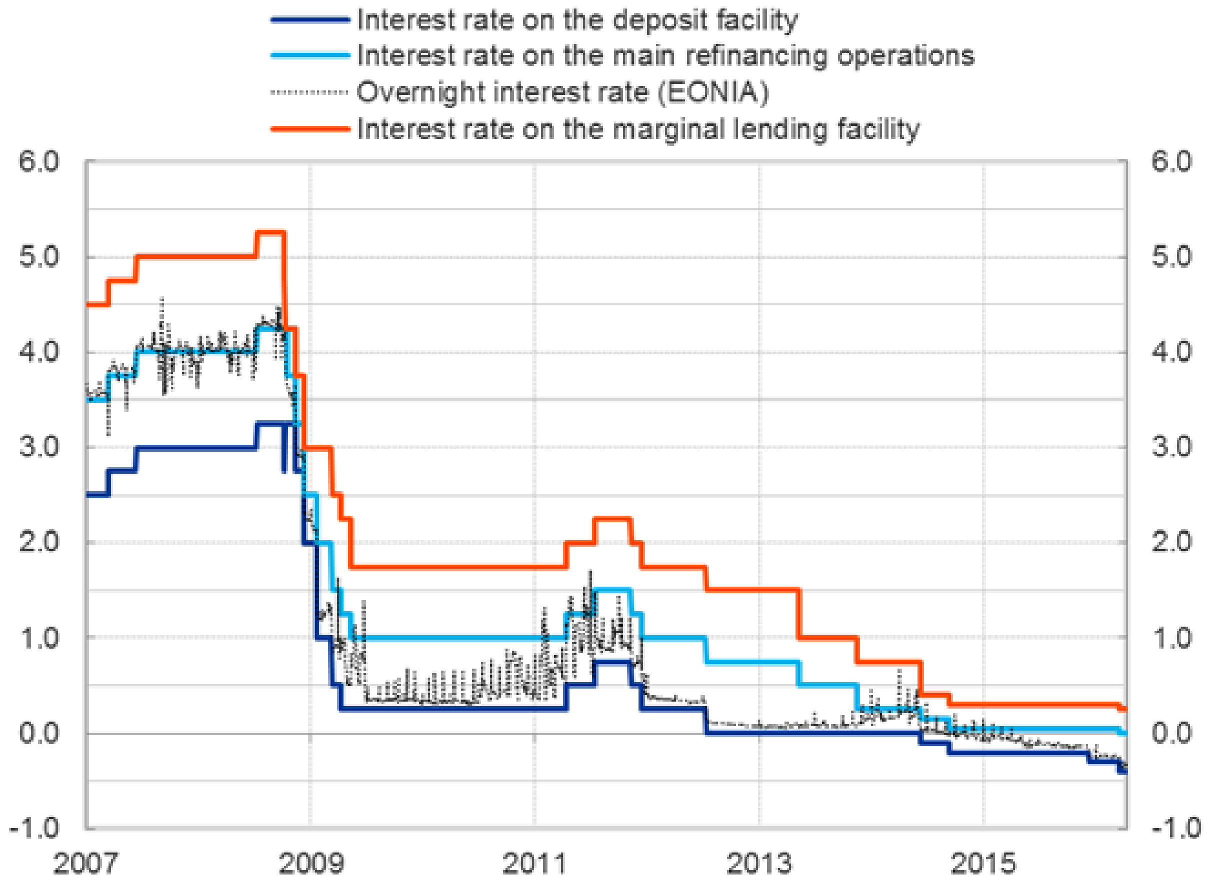
ECB monetary policy measures from June 2014 to March 2016

	June 2014	Sept. 2014	Jan. 2015	Dec. 2015	March 2016
Key interest rate cuts	MLF: 0.40% MRO: 0.15% DFR: -0.10%	MLF: 0.30% MRO: 0.05% DFR: -0.20%		MLF: 0.30% MRO: 0.05%: DFR: -0.30%	MLF: 0.25% MRO: 0.00% DFR: -0.40%
Targeted longer-term refinancing (TLTROs)	TLTRO I: - uptake depends on net lending - fixed rate (set at prevailing MRO) - up to 4-year maturity - mandatory early repayment				TLTRO II: - uptake depends on net lending - fixed rate (MRO or less if lending> credit benchmark min. rate = DFR) - 4-year maturity - no mandatory early repayment
Large asset purchase programme (APP)		Start of APP: - asset-backed securities - covered bank bonds	Extended APP: - euro area debt issued by central govt., agencies and EU institutions -€60bn monthly purchases until Sept. 2016 or >	APP recalibration - euro area local and regional government debt - purchases until March 2017 or > - reinvestment of principal - higher issue share limit*	APP recalibration - non-bank corporate bonds - €80bn monthly purchases - higher issue limit + issue share limit for certain issuers

* Higher issue share limit for central govt. was decided in Sept. 2015.

ECB reduced its key interest rates to levels at and around zero

Three ECB key interest rates and the euro overnight interest rate
(percentages per annum)



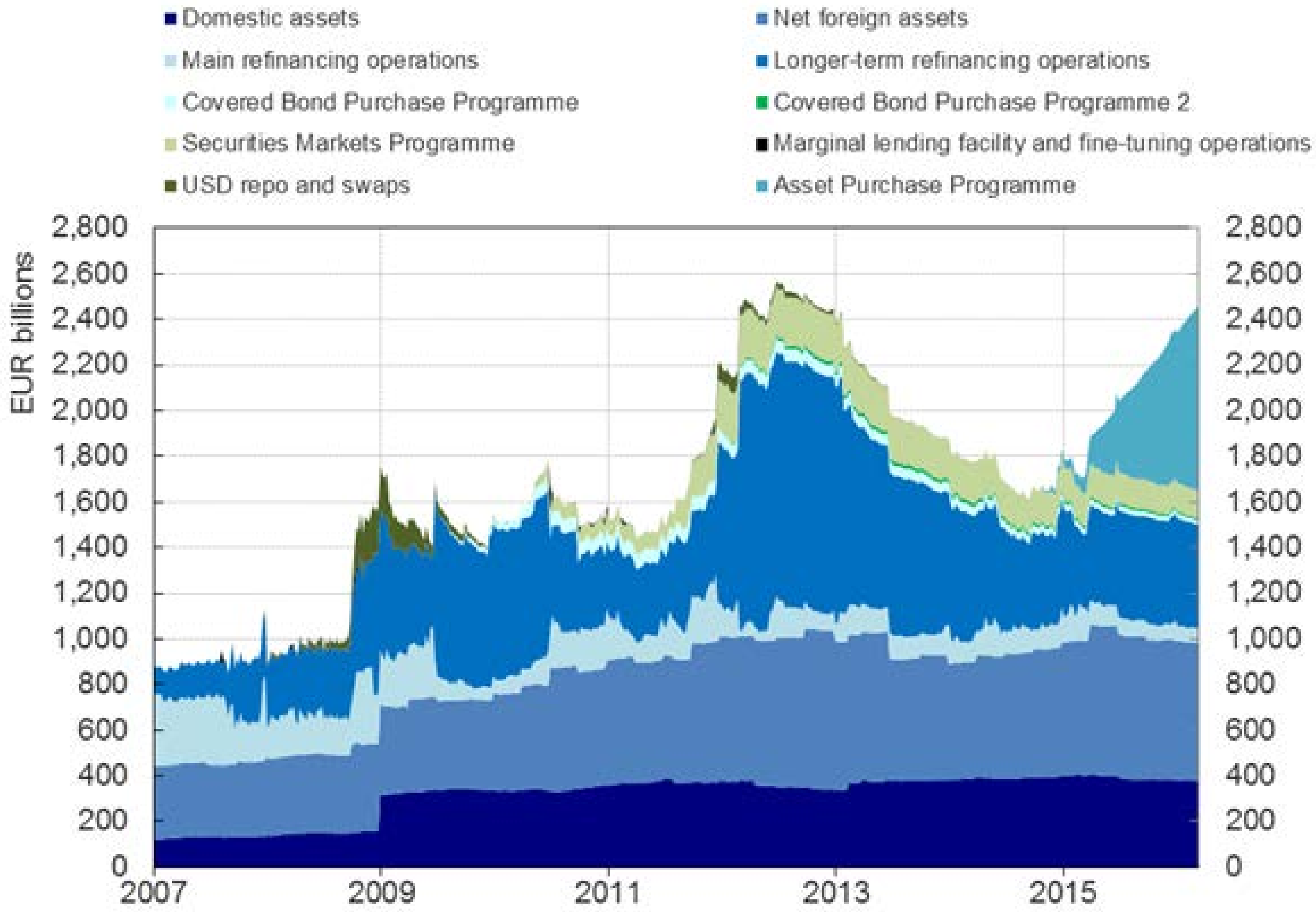
Latest:
MLR 0.25%
MRO 0.0%
DFR -0.4%

Sources: ECB, Thomson Reuters. Latest observation: 10 April 2016

Active large-scale expansion of Eurosystem's balance sheet since 2014

Simplified Eurosystem balance sheet: assets side

(weekly data from January 2007 to March 2015, € billion)



Source: ECB.

Three challenges for the ECB

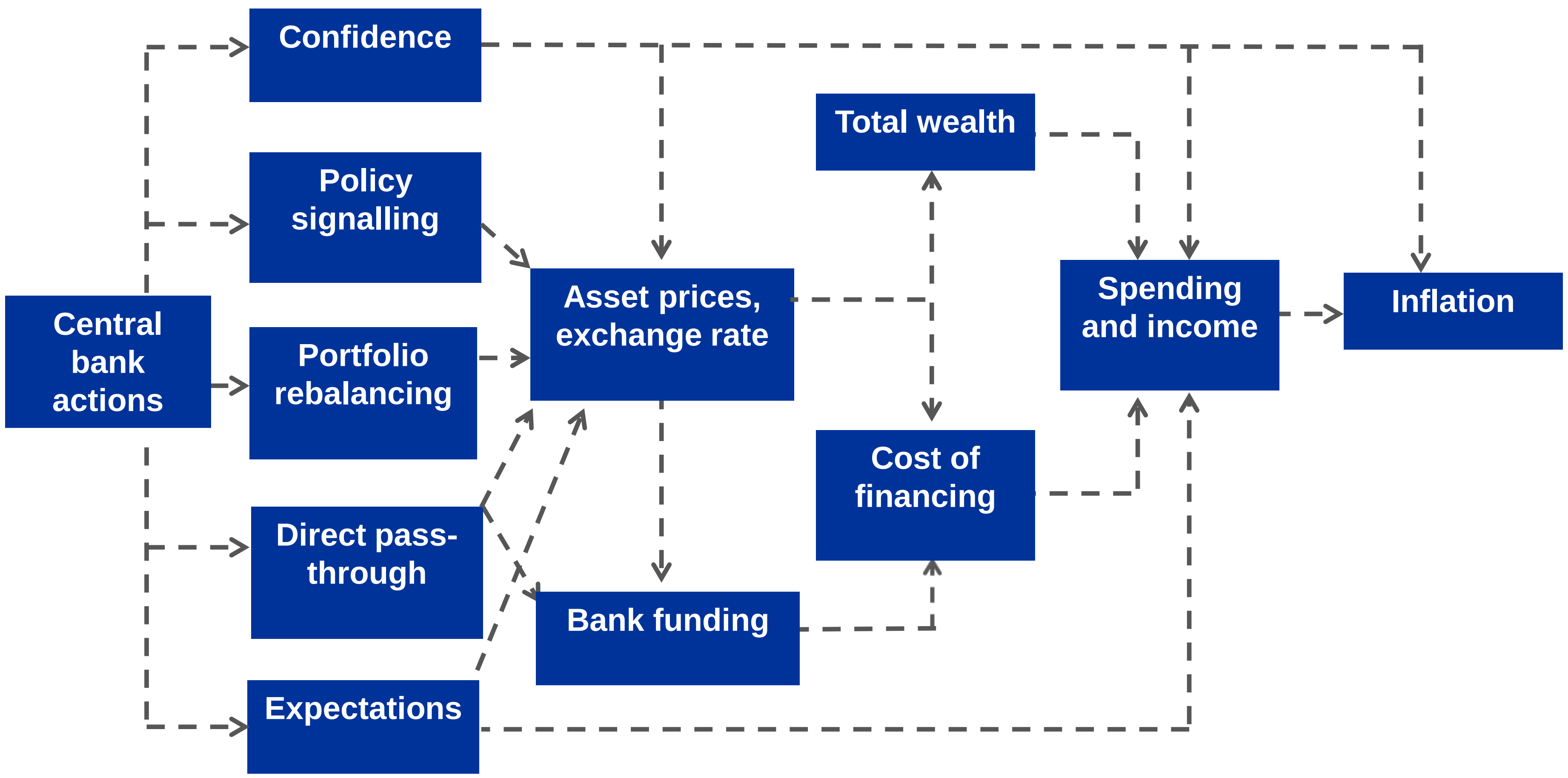
3. Transmission of monetary policy

Main transmission channels of monetary policy

Main channels of monetary transmission for the negative interest rate policy, targeted longer-term refinancing operations and large-scale asset purchases:

- **direct pass-through:** lowering key interest rates and offering cheap conditional liquidity directly reduces 1) the costs of bank funding and supports the pass-through of these benefits to bank borrowers, and 2) the costs for non-financial corporations that directly fund themselves in the bond and/or stock markets.
- **portfolio rebalancing:** buying of low-risk assets creates incentives for investors to rebalance portfolios towards higher-risk assets, which raises asset prices and wealth and indirectly supports capacity of banks to lend and creditors to borrow; negative interest rate on bank deposits with the ECB supports these portfolio rebalancing incentives.
- **policy signalling:** showing the ECB's determination to use all available tools within its mandate to address risks of too prolonged a period of low inflation lowers the risk-free yield curve and re-prices a large array of financial assets.
- **confidence and expectations:** raising inflation expectations reduces real interest rates and supports a euro depreciation, both of which ease financial market conditions which together with strengthening economic confidence increases incentives to spend rather than save.

Main transmission channels of monetary policy

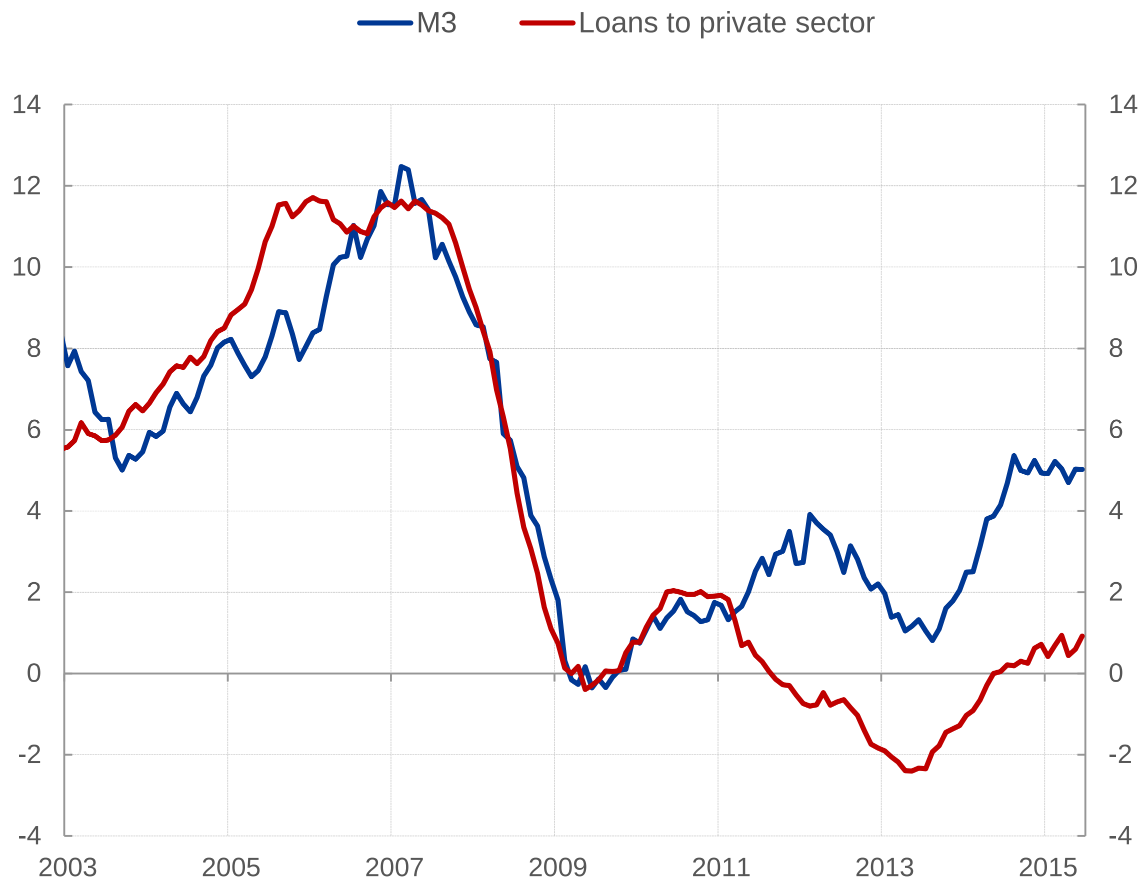


Source graphic: Joyce et al. (2011), Lemke and Winkler.

Evidence of a steady recovery of broad money and credit growth

Broad money (M3) and bank loans to the private sector

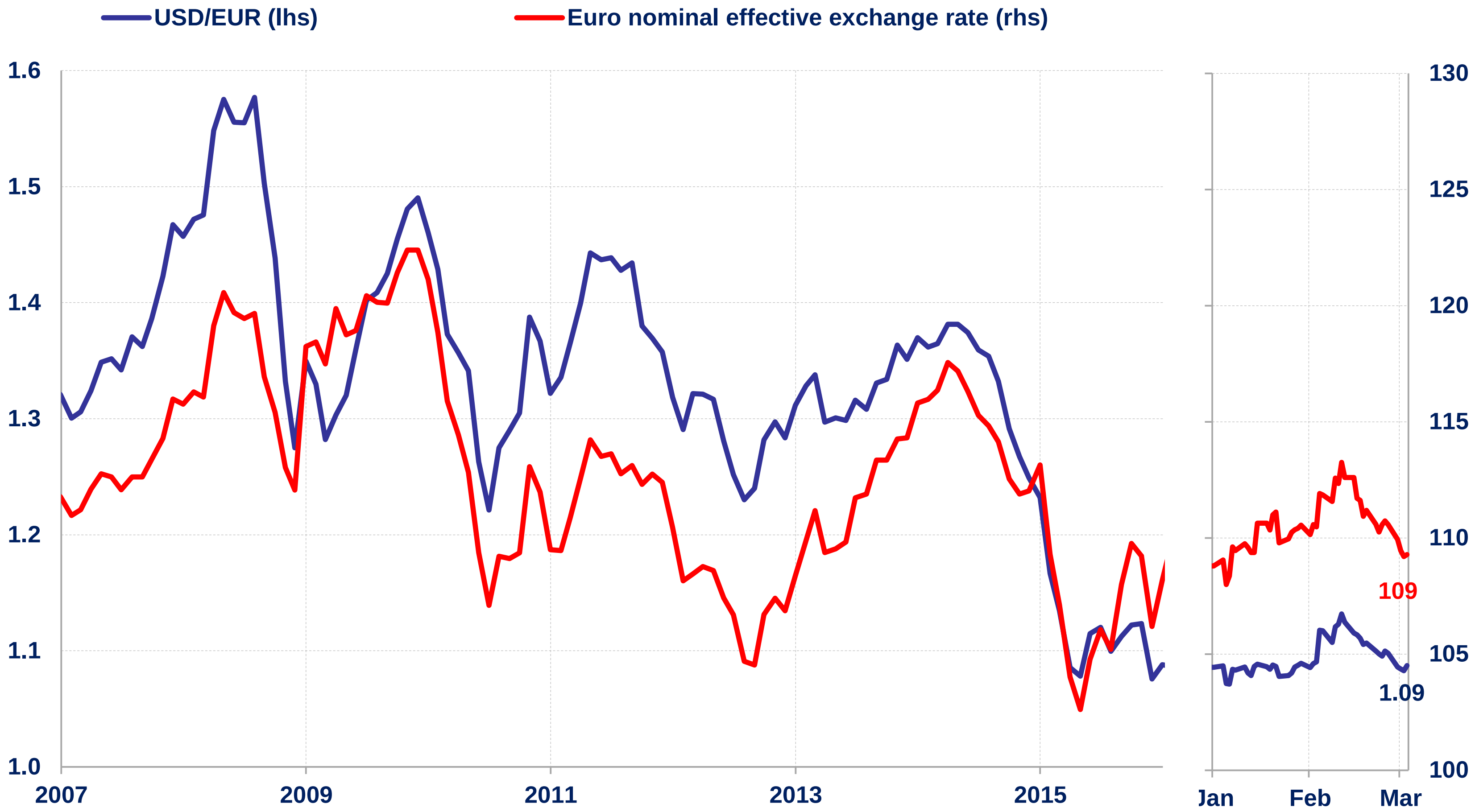
(annual percentage changes)



Source: ECB. Latest observation: February 2016.
Note: Loans to the private sector are adjusted for sales and securitisation.

Substantial depreciation of the euro, although partly reversed

Euro nominal effective exchange rate and USD/EUR
(index 1999Q1 = 100 (rhs); USD/EUR exchange rate on lhs)

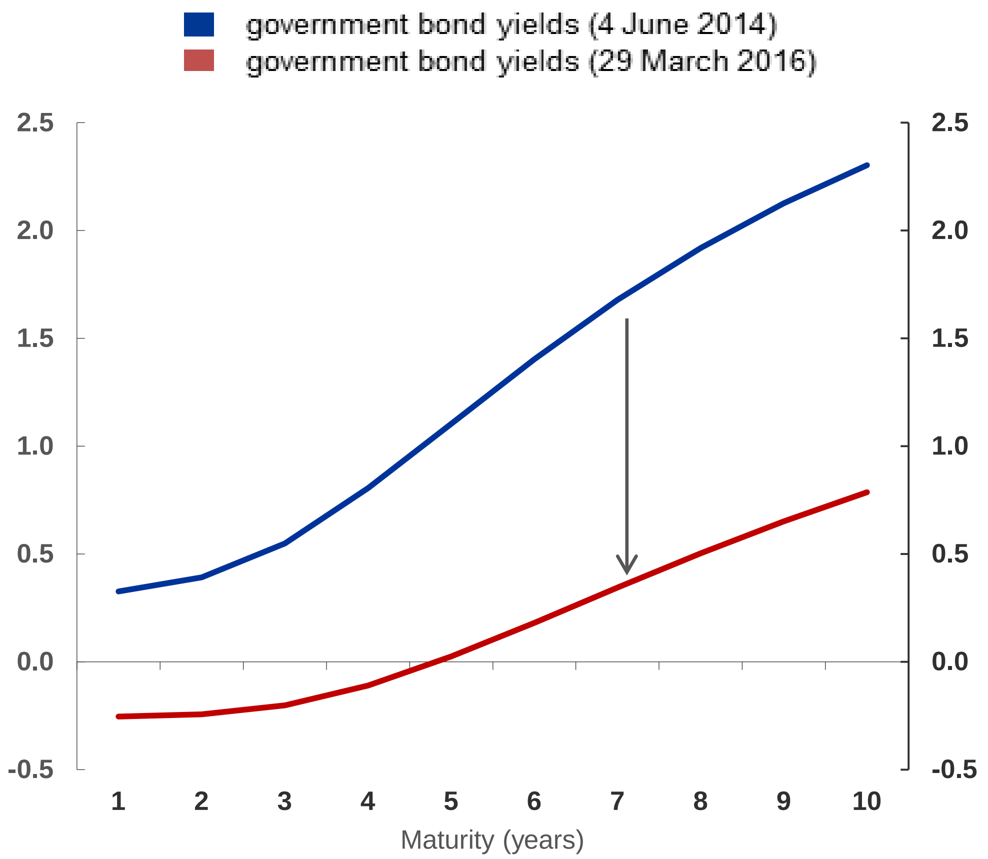


Source: ECB. Latest observation: 3 March 2016
Note: Effective exchange rate is for euro NEER-38.

Euro area yield curve has moved down and flattened

Euro area average government bond yield curve

(synthetic yields in percentages per annum and maturity in years)

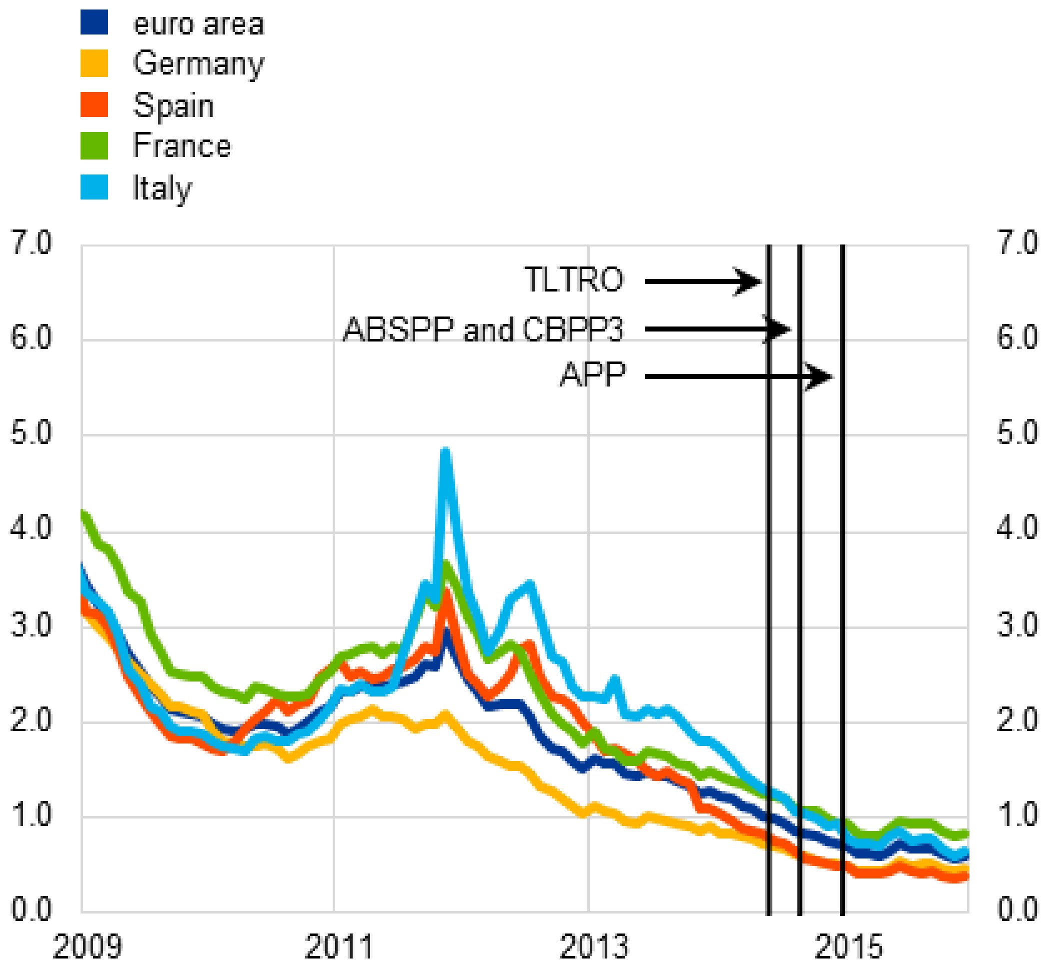


Source: ECB, Annual Report 2015 (updated).

Compression of the cost of bank funding

Composite cost of bank debt and deposit financing

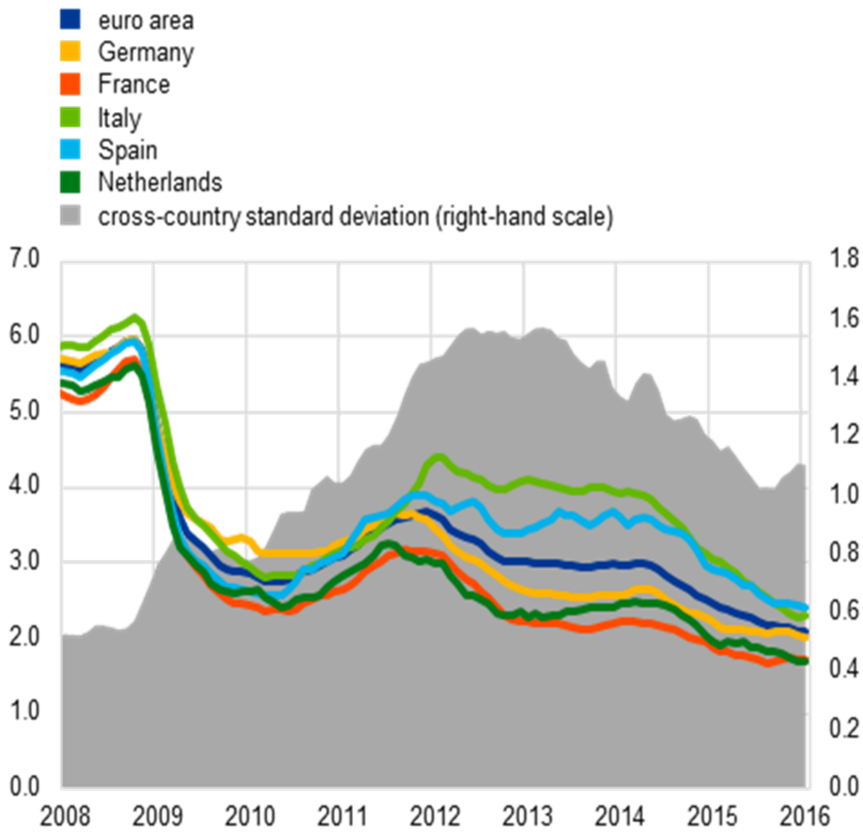
(in percentages per annum)



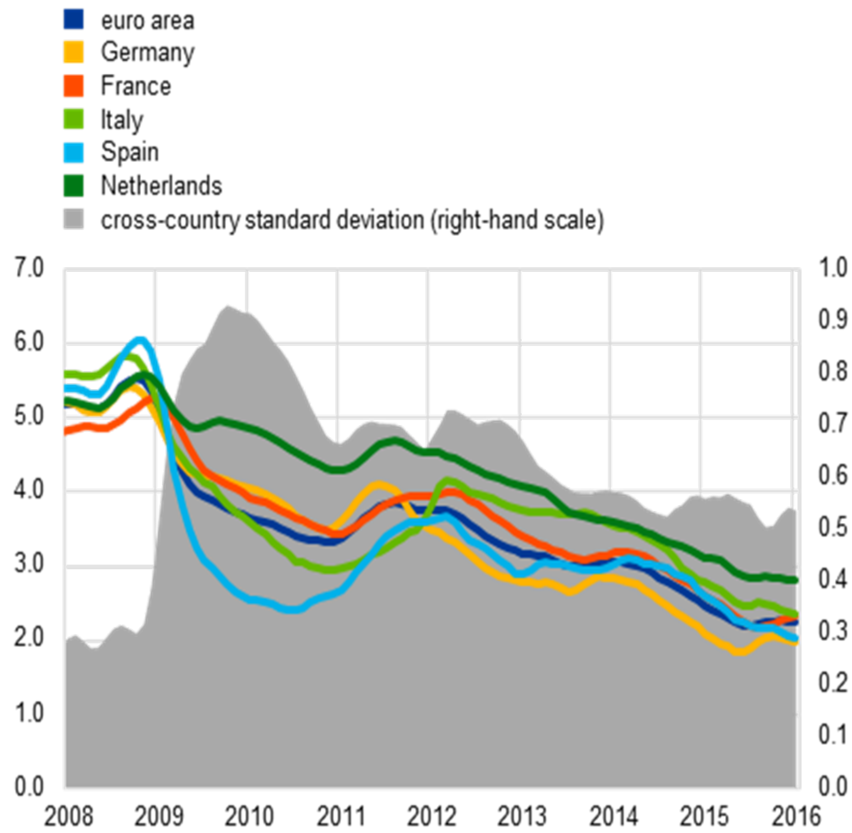
Source: ECB, Annual Report 2015.
Note: Bank debt and deposit financing comprises non-secured market debt and retail bank deposits

Costs of bank borrowing have been declining and converging …

Composite indicator of the cost of bank borrowing for non-financial corporations
(percentages per annum; three-month moving averages)



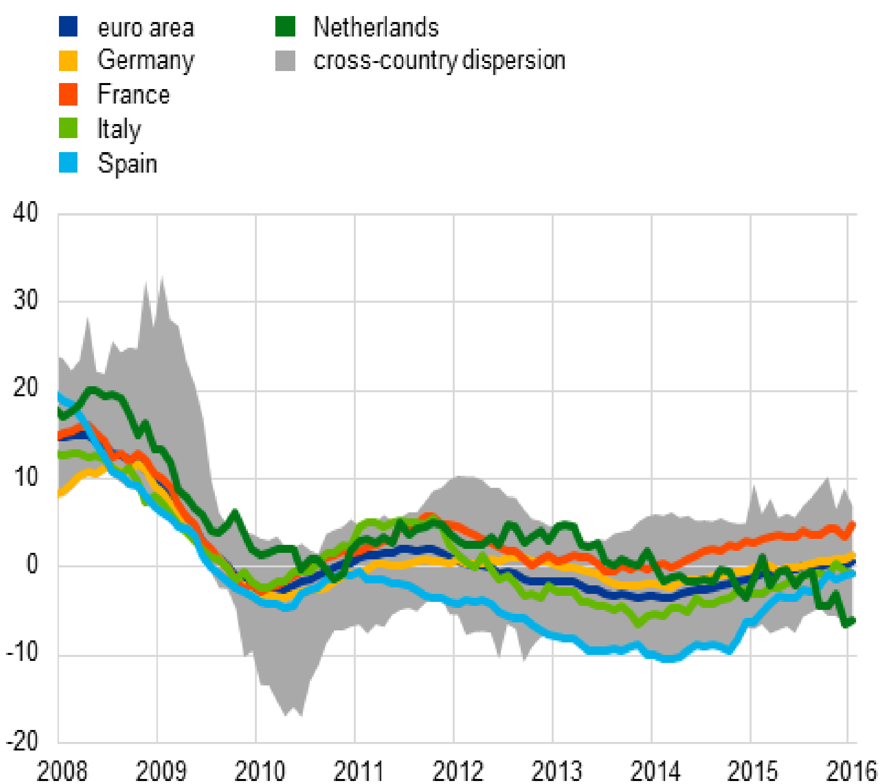
Composite indicator of the cost of bank borrowing for households for house purchase
(percentages per annum; three-month moving averages)



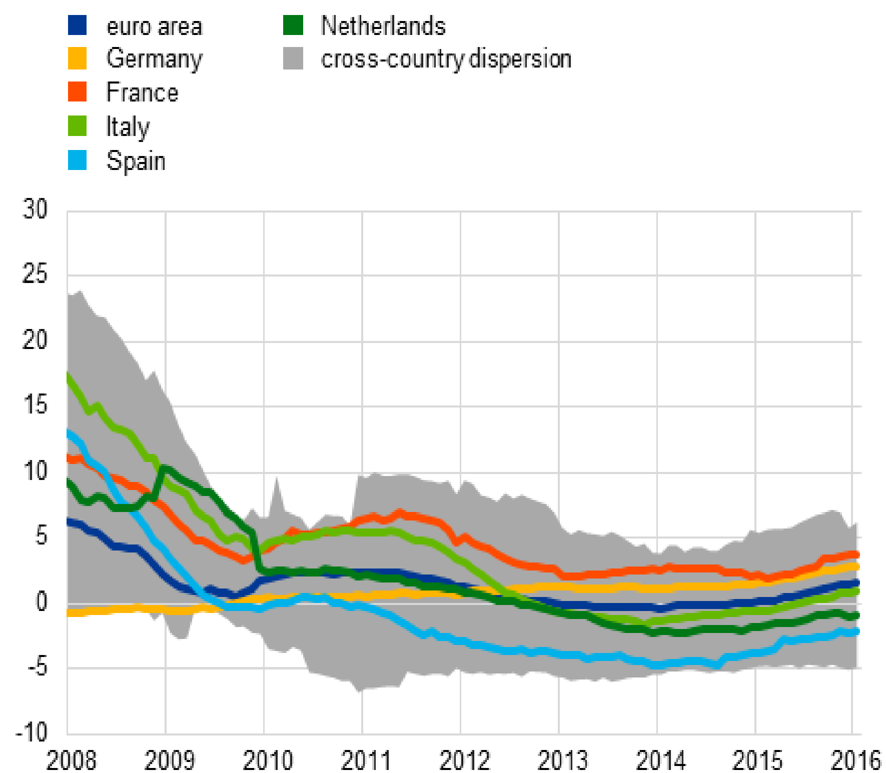
Source: ECB, Economic Bulletin, Issue 2, March 2016. Latest observation: January 2016.
Note: The indicator for the total cost of borrowing is calculated by aggregating short and long-term interest rates using a 24-month moving average of new business volumes. The cross-country standard deviation displays the minimum and maximum range over a fixed sample of 12 euro area countries.

… leading to a gradual recovery in bank lending

MFI loans to non-financial corporations
(annual percentage changes)



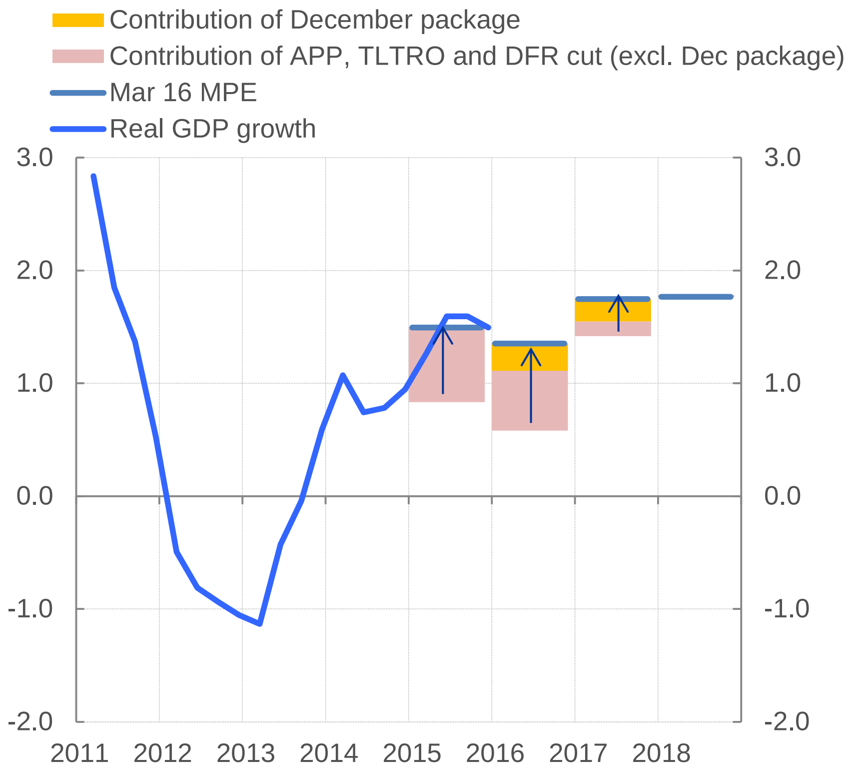
MFI loans to households for house purchase
(annual percentage changes)



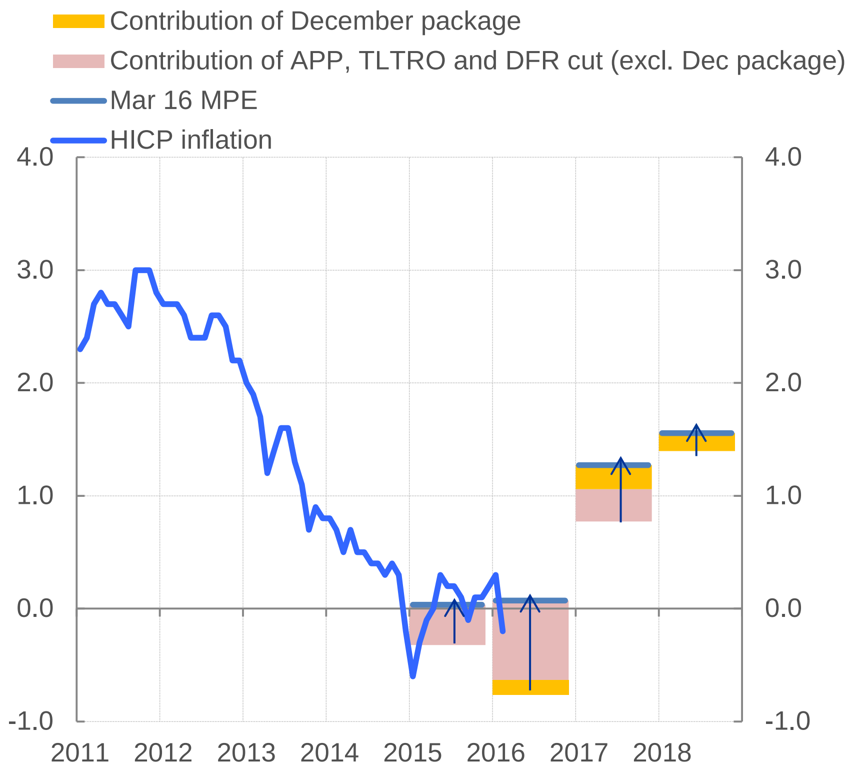
Source: ECB, Economic Bulletin, Issue 2, March 2016. Latest observation: January 2016.
Notes: Adjusted for loan sales and securitisation. The cross-country dispersion is calculated on the basis of minimum and maximum values using a fixed sample of 12 euro area countries.

Output growth and inflation: positive impact of ECB monetary easing

Actual and projected real GDP growth: DFR/TLTRO/APP contribution
(year-on-year percentage change)

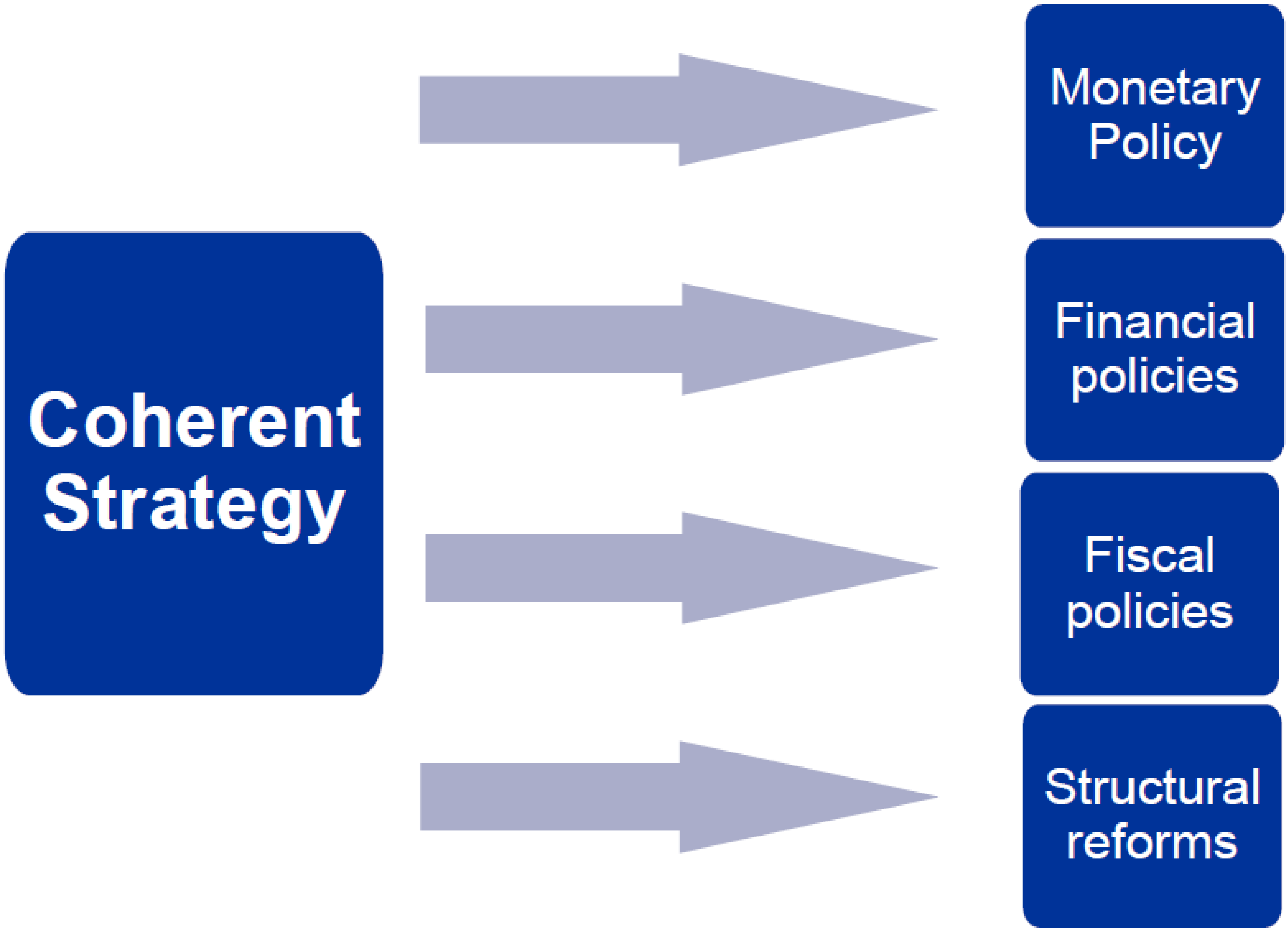


Actual and projected HICP inflation: DFR/TLTRO/APP contribution
(year-on-year percentage change)



Source: ECB computations, March 2016 staff forecast.
Latest observations: February 2016 for HICP inflation and 2015Q4 for real GDP growth.

Need for a comprehensive euro area policy strategy



Conclusions on challenges for ECB monetary policy

- Euro area inflation has fallen to a very low level and ECB is doing what it must do to secure a sustained return of headline inflation rate to below but close to 2% over the medium term
- ECB had to dig deep in its monetary policy toolkit, combining a range of standard and non-standard instruments in a flexible way
- ECB provided monetary accommodation and supported bank liquidity, credit supply and monetary transmission, while giving forward guidance on its policy intentions
- ECB is committed to cutting its key interest rates further and/or to using additional unconventional tools within its mandate, if necessary.
- Need for comprehensive policy strategy to complement monetary easing: the 19 euro area countries must underpin the recovery with structural reforms and growth-friendly fiscal policies, while coordinated prudential supervision needs to be prudent.

Thanks for your kind attention!

Background slides

Non-standard measures and type of impact on ECB balance sheet

	Conventional tools	Unconventional tools	
Non-standard measures using:	Special lending to relieve bank funding stress (passive balance sheet policy)	Market-making to repair monetary transmission (active balance sheet policy)	Quantitative easing to provide further monetary stimulus (active balance sheet policy)
A. Reverse lending operations[1]			
Ample refinancing (MROs + LTROs at fixed-rate full allotment, LTRO maturities up to 3 years)	X		
Targeted long-term refinancing (TLTRO1, 2 with maturities up to and of 4 years, respectively.)	X		X
B. Fine-tuning operations			
Foreign exchange repos and swaps (mainly in US dollars)	X		
C. Outright structural operations			
Selective and large-scale purchases of private sector securities (CBPP1, 2, 3, ABSPP, CSPP)		X	X
Selective and large-scale purchases of public sector securities (SMP, OMT, PSPP)		X	X

Source: van Riet (2017). Note: Outright Monetary Transactions (OMTs) were available for use, but never actually executed

Selected literature

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