A New Era for Monetary Policy: Challenges for the European Central Bank

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A. ECB Experience with Role and Limits of Monetary Policy

1. Crisis challenges for the ECB
   Monetary policy during the euro crisis

2. Current challenges for the ECB
   Risk of too low inflation for too long

B. Looking Ahead: A New Era for ECB Monetary Policy
A. ECB Experience with Role and Limits of Monetary Policy

1. Crisis challenges for the ECB
The evolving eurozone crisis from 2007 - 2014

- Financial turmoil
- Global financial crisis
- Great Recession
- Sovereign debt crisis
- Euro confidence crisis
- Sovereign-bank nexus
- Fear of deflation

Source: ECB.
ECB needed to dig deep in its monetary policy toolkit

- **Standard measures:**
  - reduction in the three **ECB key interest rates** to effective zero bound
  - narrowing of **interest rate corridor** around the main refinancing rate constituted by the rates on the marginal lending and deposit facilities
  - **standard facilities** for steering bank reserves and excess liquidity

- **Non-standard measures:**
  - **expansion of liquidity**: ease bank funding conditions in the money market in line with high demand for longer-term liquidity
  - **enhanced credit support**: ease bank credit supply conditions and/or create market incentives to provide credit
  - **wider range of eligible collateral**: lower minimum sovereign credit rating and accepting additional performing private-sector credit claims
  - **improve monetary transmission**: repair malfunctioning financial market segments in context of high risk premia, to enforce the monetary stance

- **Communication:**
  - **forward guidance** about ECB’s monetary stance and reaction function

ECB focused on maintaining price stability, while contributing to financial stability
ECB reduced its key interest rates effectively to the zero lower bound.

ECB key interest rates and EONIA
(in percent)

- deposit rate
- overnight interest rate (EONIA)
- main refinancing / minimum bid rate
- marginal lending rate

Source: ECB, Thomson Reuters.
Latest observation: 22 September 2014.
Euro area financial structure is predominantly bank-based

Breakdown of the sources of external financing of non-financial firms
(in percent, average 2002Q1 – 2008Q4 and 2002Q1 – 2014Q1)

Sources: ECB, Federal Reserve, ECB calculations.
1. Financial turmoil from summer 2007

High demand for liquidity as money markets froze
- ECB lent EUR 90bn overnight to banks (9 Aug. 2007)

2. Global financial crisis after Lehman Brothers’ collapse

This threatened the stability of the global financial system, the euro area economy and the outlook for price stability (Sept. 2008)

Beyond lowering its key interest rates, the ECB provided liquidity and enhanced credit support by easing bank funding conditions and supporting bank lending to households and firms:
- unlimited liquidity provision at fixed interest rate, against adequate collateral
- longer-term refinancing operations (LTROs) at longer maturities than usual (up to 1 year vs. 3 months normally)
- supplementary refinancing operations at maturities of 3 and 6 months
- expansion of list of collateral eligible for ECB refinancing operations
- liquidity provision in foreign currencies against euro-denominated collateral, notably US dollars through ECB swap facility with US Federal Reserve
- first Covered Bonds Purchase Programme (CBPP 1) of EUR 60bn to ease conditions in this key market for bank financing
Non-standard measures: focus on liquidity, credit, transmission

3. Great Recession

Enhanced credit support prevented a credit crunch
• As recovery began, phasing out of non-standard measures initiated, but aborted

4. Sovereign debt crisis

ECB conducted interventions on exceptional and temporary basis in euro area debt securities markets (Securities Markets Programme, SMP) to address malfunctioning sovereign bond markets, prevent contagion and restore monetary transmission
• purchases of sovereign bonds in volatile secondary markets from May 2010 until March 2012, for about EUR 220 bn
• without changing monetary stance: extra liquidity fully sterilised until June 2014

5. Sovereign-bank feedback loop

• second Covered Bonds Purchase Programme (CBPP 2) of EUR 40 bn
• two LTROs with exceptional 3-year maturity offered in Dec. 2011 and Feb. 2012
• required reserve ratio lowered from 2% to 1% to free up collateral
• further expansion of list of eligible collateral, e.g. including performing bank credit claims

6. Euro confidence crisis

ECB president, Mr Draghi: “Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough” (26 July, 2012)
• New, conditional tool: Outright Monetary Transactions (OMTs)
Large expansion of Eurosystem balance sheet, stepping up risk controls

Simplified Eurosystem balance sheet: assets

Source: ECB
Latest observation: 6 May 2014
Financial stress and fragmentation started to decline from mid-2012

Steps towards European Banking Union decided in June 2012
To break the doom-loop between vulnerable sovereigns and fragile banks:
• ECB as single bank supervisor from Nov. 2014 to ensure quality of bank balance sheets
• New single bank resolution mechanism with rapid build-up of single bank resolution fund
• Harmonised retail bank deposit insurance across Europe

Ongoing progress with macroeconomic adjustment in distressed countries
Market confidence in eurozone and in distressed countries returned but remains fragile
• Banks in Spain were stabilised and government required no further official support
• Ireland completed its EU/IMF programme and regained full access to the capital market
• Portugal is also back in the capital market and completed its EU/IMF programme
• Greece managed to borrow longer-term funds through syndicated loans
• Cyprus follows step-by-step plan to relax restrictions on bank deposits and capital outflows

Receding financial fragmentation within euro area
• currency redenomination risk has essentially vanished
• money markets more integrated, notably in secured segment
• bond markets more aligned at very low interest rates, equity markets more integrated
• bank borrowing costs still dispersed, especially in crisis-affected countries and for SMEs
Financial fragmentation in sovereign debt markets is receding …

Spread in sovereign bill and bond markets across euro area countries
(standard deviation)

Sources: Thomson Datastream and ECB calculations.
Note: Latest observation: 7 October 2014.
Total cost of borrowing for non-financial corporations in the euro area (percentages per annum)

Source: ECB, ECB calculations.
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. Latest observation: July 2014.
“The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time” (4 July 2013; since then reiterated).

Rationale:

• counter “excessive” volatility in euro area money market disconnected from euro area economic conditions and medium-term inflation outlook
• clarify ECB’s reaction function and acknowledge scope for further rate cuts
• anchor market expectations of ECB key interest rates more solidly, thereby: more effective implementation of the desired monetary policy stance

Modalities:

• consistent with subdued outlook for inflation extending into the medium term,
• given the broad-based weakness of the economy, the high degree of unutilised capacity, and subdued monetary growth and credit creation

Direct impact:

• decline in market uncertainty about the path of future short-term rates
• contained renewed dispersion across national sovereign bill and bond markets
• evidence of less sensitive market reaction to macroeconomic news
A. ECB Experience with Role and Limits of Monetary Policy

2. Current challenges for the ECB
September 2014 ECB staff projections point to weak recovery

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

Key factors supporting demand:
- Very accommodative monetary policy
- Improving financing conditions
- Less need for fiscal consolidation
- Support from past structural reforms
- Higher real disposable income
- Gradual rise in external demand
- Effective euro depreciation

But some dampening factors:
- High unemployment rate
- Sizeable unutilised capacity
- Need for further private and public sector deleveraging
- Ongoing geopolitical tensions

Note: Working day-adjusted data
September 2014 ECB staff projections point to subdued inflation

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

Key factors countering low inflation:
- Very accommodative monetary policy
- Higher wage and profit growth
- Some indirect tax increases
- Rising import prices in US dollars
- Effective euro depreciation

But some dampening factors:
- Remaining economic slack
- Stronger labour productivity
- Lower oil price in US dollars
- Price and cost adjustments in the crisis-affected countries

Subdued monetary and credit dynamics, may signal a turning point

M3 and loans to the private sector
(annual percentage changes, sa)

Loans to non-financial corporations
(annualised 3-month growth rates in percentages)


Source: ECB and NCBs. Latest observation: August 2014.
Coping with risks of a too prolonged period of low inflation

The ECB decided to provide additional monetary policy accommodation and support lending to the real economy (Governing Council decisions of 5 June and 4 Sept. 2014)

**Targeted credit easing:**
- ECB key interest rates effectively reduced to zero bound, negative deposit rate
- suspension of weekly operations to sterilise liquidity injected via SMPs
- targeted longer-term refinancing operations (TLTROs) at a fixed rate with built-in incentives for banks to lend to private sector (all maturing in Sept. 2018)
- targeted purchase programme of high-quality asset-backed securities (ABS)
- third Covered Bonds Purchase Programme (CBPP 3)

**Rationale of this package:**
- maintain high degree of excess liquidity and contain volatility in money market
- enhance bank-based transmission, restore impaired non-bank credit markets
- compress funding costs in targeted markets, ease general financing conditions

**Monetary stance:**
- achieve a sizeable, more controlled increase of Eurosystem balance sheet
- support ECB’s forward guidance on key interest rates and signal expansionary monetary stance over an extended horizon with key interest rates at zero bound
- anchor medium- to long-run inflation expectations
Long-term inflation expectations remain anchored around 2%

Market- and survey-based measures of long-term inflation expectations in euro area
(percent per annum)

Sources: Consensus Economics, Euro Zone Barometer, ECB Survey of Professional Forecasters, Reuters and ECB calculations.
Note: 5-day moving average of I/L swap rate and BEIR.
B. Looking Ahead: A New Era for ECB Monetary Policy
Europe has revamped financial governance since global financial crisis

- New European Systemic Risk Board since 2011 in charge of macro-prudential oversight of the financial system, may give warnings or recommendations

- New European Supervisory Authorities since 2011 for banking (EBA), pensions (EIOPA) and securities markets (ESMA) to more effectively coordinate national micro-prudential policies

- Single Supervisory Mechanism (SSM) from Nov. 2014 operational at the ECB to supervise – independently from monetary policy – the 120 most significant banks (about 85% of total banking assets in the euro area) after a solvency check, and to assume final responsibility for national bank supervision of the 6000 smaller banks

- New macro-prudential authorities at the national level since 2013-14; SSM may impose tighter (but not looser) macro-prudential rules than set at national level

- Single Resolution Mechanism for effective management of a banking crisis if, after a private sector bail-in, the national bank resolution fund is exhausted and the government has no fiscal capacity to step in

- A tightening of EU financial sector legislation in many areas, also following G20 agreements
These fundamental reforms in finance herald a new era for the ECB, as they should facilitate the conduct of the single monetary policy for a financially integrated, but heterogeneous monetary union:

- **Effective micro-prudential supervision**: supports stable (cross-border) banks, and supranational bank resolution breaks nexus between (cross-border) banks and their governments.

- **Effective macro-prudential supervision**: earlier identification, faster response and targeted instruments to deal with local systemic risks and prevent spill-overs to other countries (e.g. using countercyclical tools to dampen national credit cycles, structural measures to reduce regional financial vulnerabilities).

- **Tighter EU financial sector legislation**: reduces the chances of turmoil in financial markets, intermediaries and infrastructures.

This new architecture supports financial stability and reduces likelihood of financial fragmentation that hinders an even monetary transmission across the eurozone. Also helps to control risks from a prolonged very accommodative monetary stance.

As micro- and macro-prudential supervision are complementary and can directly and indirectly influence credit markets, a positive outcome assumes coordination with monetary policy.
A. ECB Experience with Role and Limits of Monetary Policy

1. Crisis challenges for the ECB

ECB faced a complex and evolving crisis-environment and had to dig deep in its monetary policy toolkit, combining standard and non-standard instruments.

ECB focused on medium-term price stability, while contributing to financial stability as lender-of-last-resort for banks and as market-maker-of-last resort.

2. Current challenges for the ECB

Transition from passive credit provision to more active management of central bank balance sheet. ECB is committed to using additional unconventional tools within its mandate to address risk of inflation staying low for too long.

But: the 18 national policy makers must also join forces to underpin the euro area recovery with structural reforms and growth-friendly fiscal policies.

B. Looking Ahead: A New Era for ECB Monetary Policy

Major reforms in European finance should support a sound banking system, deepen financial integration and secure financial stability.

This should ease the task of the ECB’s single monetary policy for the eurozone, assuming proper coordination among the relevant authorities.
ECB’s primary objective: keep euro area inflation below but close to 2%

Consumer price inflation (HICP)
(annual percentage changes)

Source: Eurostat.
Latest observations: August 2014.
Note: Long-term averages refer to the period from January 1999 onwards. Diamonds show annual forecasts for 2014, 2015 and 2016 from ECB staff projections of September 2014.
Selected literature


