20 years of EMU, 10 years in crisis mode: How may a future „new normal“ of monetary policy look like?

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Prologue:
The most simple EMU timeline: 2 decades completely different

The beginning: „10 golden years“

1999 - 2007

ECB

In crisis and in crisis mode...

2008 - now

ECB
Prologue:
The most simple EMU timeline: extended version

Preparatory Phase
EMI
1994 - 1998

The beginning: “10 golden years”
ECB
1999 - 2007

In crisis and in crisis mode...
ECB
2008 - now

The Future...
ECB
2019 - ????
Prologue:
Monetary policy exit as the pending challenge

In crisis and in crisis mode...

- ECB
- 2008 - now

The Future...

- WHEN?
- HOW?

WHERE TO?
Prologue:
By the way: What do Europeans think about the future?

Prologue:

European expectations for the future: More „Stefan Zweig“ than „Yuval Harari“

Stefan Zweig: „The World of Yesterday – Memories of a European“ (1942)

„…to sum up the time of my childhood and youth before the First World War, I hope I can put it most succinctly by calling it the Golden Age of Security.“ (The World of Yesterday, 1942)


„We don’t know how the world will look like in 2050, but we know for sure: It will be completely different from the one we are used to today.“ (Interview, March 2019)
Outline

● **Prologue**: The most simple EMU timeline

● **How** has monetary policy making changed in the course of the crisis?

● On the (forgotten) role of the **preparatory phase**

● **What** to expect for a future „new normal“ of monetary policy?

● **(Any)** Conclusions?
I. HOW HAS MONETARY POLICY MAKING CHANGED IN THE COURSE OF THE CRISIS?
All (big) Central Banks have reacted to the crisis in a very similar way

In short:
...cut interest rates to the ZLB (or below)
...expanded their balance sheet by various instruments
But: These reactions took place against a new economic background also...

...with very significant and lasting long-term changes in economic framework conditions like...

- structurally low inflation
- lower potential growth
- low interest rate environment
- globalization of financial markets
- increased financial market complexity
- higher systemic and contagion risk
- new regulatory environment
- ....

...resulted in
- significant changes in monetary policy implementation and operation
20 years of EMU in 4 pictures (I): ECB policy rates
20 years of EMU in 4 pictures (II): ECB overall liquidity provision
20 years of EMU in 4 pictures (III): Structural changes in ECB tender operations
20 years of EMU in 4 pictures (IV): The (E)APP – Quantitative Easing ECB style
Reminder: Eurosystem portfolio of non-standard monetary policy measures

**Road-map ex post**

- **Rate cuts**
- **TLTROs**
- **Private asset purchases**
- **Public asset purchases**
- **Forward guidance (FG)**

### Timeline:

- **TLTRO-I**
  - Max. maturity: Sept. 2018
  - Uptake depends on net lending. Mandatory early repayment

- **PSPP**
  - Purchases of public securities
  - €60bn monthly purchases until Sep. 2016, incl. ABSPP/CBPP3

- **APP**
  - Recalibration I
  - Extension to Mar. 2017
  - Reinvestment of principal payments

- **TLTRO-II**
  - No mandatory early repayment
  - Min. lending rate at DFR

- **CSPP**
  - Purchases of NFC bonds

- **APP**
  - Recalibration III
  - €60bn monthly purchases until Dec. 2017
  - Min. remaining maturity for PSPP eligible securities decreased from 2y to 1y
  - Purchases below DFR if necessary

- **APP**
  - Recalibration IV
  - €30bn monthly purchases until Sep. 2018
  - Starting from Jan. 2018

- **APP transition**
  - €15bn monthly purchases until Dec. 2018
  - Followed by end of net asset purchases

- **APP transition**
  - End of net asset purchases
  - ECB capital key to continue guiding PSPP during reinvestment

- **FG**
  - Expected rates to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases

- **FG**
  - …at present levels at least through the summer of 2019 and in any case for as long as necessary to ensure that evolution of inflation remains aligned with current expectations of sustained adjustment path

- **FG**
  - …intend to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP 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

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**Outright monetary transactions (OMT)** — announced in August 2012, yet to be activated

Transactions in secondary sovereign bond markets, subject to strict and effective conditionality

Aim: safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy
II. ON THE (FORGOTTEN) ROLE OF THE PREPARATORY PHASE
Determinants of the initial ECB „design“ and the evaluation of its strategy in 2003…

Result of strategy review in 2003 reflected basic building blocks of „good“ monetary policy design before crisis:

- Central Bank independence
- Price stability mandate
- Some sort of (flexible) inflation targeting (based on 2 pillars)
- Short-term interest rate setting
- Market-oriented policy implementation

ECB = youngest Central Bank = most modern „design“ of mandate and instruments

Some relevant factors at that time:

- Bundesbank – model
- Modern academic thinking on Central Bank design (independence, price stability objective…)
- Exchange rate crises of 70s and 90s
- …. 
Principles of ECB monetary policy operations as defined in 1997/1998

„…..the selection of the operational framework has been guided by the following general principles:

► conformity with market principles
► equal treatment
► simplicity and cost efficiency
► decentralisation
► continuity
► harmonisation
► and conformity with the setting of the ESCB’s decision-making.”
Harmonization: A joint monetary policy framework as a necessary „cultural compromise“…

11 (initial) participants + Sweden, Greece, Denmark, UK
…created an encompassing set of policy instruments stemming from different traditions

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<td>The deposit facility</td>
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Examples of „cultural differences:

- Minimum Reserve Requirements
- Acceptance of Credit Claims
- Outright transactions
- .....
III. WHAT TO EXPECT FOR A FUTURE „NEW NORMAL“ OF MONETARY POLICY?
Three areas of monetary policy to be looked at in more detail *(in 11 points)*

- **Interest rate policy:**
  From simple interest rate setting into negative territory and much more complex transmission

- **Liquidity provision:**
  From scarcity to (unlimited) balance sheet expansion

- **Forward guidance:**
  The (new) art of monetary policy making by expectation management

PRODUCT WARNING: Each of the following slides would warrant a lecture of its own
1. Interest rate policy: The Zero Lower Bound of (nominal) interest rates was newly defined.

Monetary policy interest rates worldwide in %

- Euro area
- USA
- Japan
- UK
- Sweden
- Switzerland
- China

Jän.07 Jän.08 Jän.09 Jän.10 Jän.11 Jän.12 Jän.13 Jän.14 Jän.15 Jän.16 Jän.17

Source: Macrobond.

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Zero nominal rate
- Negative rates empower other monetary policy instruments

"Economic lower bound"
- Detrimental effects on the banking sector dominate
- Negative rates have both a one-off and a persistent impact
- Rate cuts cease to provide stimulus to the economy
- Depends on banking structures and competition

"Physical lower bound"
- Large-scale hoarding of cash
2. Interest rate policy: The simple textbook model of monetary policy no longer applies

Policy interest rate setting by the ECB

- Marginal Lending Facility
- Additional Overnight Liquidity at a higher (penalty) rate
- Main Refinancing Operation (MRO)
  - Liquidity Provision to Banks for a Predefined Period of Time at the MRO-Rate
- Deposit Facility
  - Depositing liquidity with the Eurosystem at a lower rate

Liquidity provided against good collateral (e.g., securities) only
Amount of liquidity provision and MRO-rate determine money market rates
3. Interest rate policy: Today’s reality is characterized by a much more complex monetary transmission mechanism.
4. Interest rate policy: steering the entire term structure of the yield curve has become an accepted and important tool.
5. Interest rate policy: Structural liquidity surplus has established the floor system of interest rate setting.

- **Corridor system:** MRO rate steers Money Market rate
- **Floor system:** DFR steers Money Market rate

**Abbreviations:**
- MRO = Main Refinancing Operation
- DFR = Deposit Facility Rate
6. Liquidity provision: From peak liquidity to permanent high central bank liquidity volume

**Turnover in selected money market segments**

*(index: total volume in 2003Q2 = 100)*

**Sources:** ECB Euro Money Market Survey (until 2015Q2) and money market statistical reporting (MMSR, as of 2016Q3).
7. Liquidity provision: Balance sheet size has become an equally accepted monetary policy instrument
8. Liquidity provision: Historically very different operational traditions have become more and more similar

Composition of CB assets (Dec. 2006)

Source: Thomson Reuters.
9. Liquidity provision: Significant longer maturity of Central Bank liquidity supply

Almost all long-term liquidity, less than 6 bn MRO
10. Forward guidance: Talking to the markets and creating monetary policy expectations

First, we decided to keep the **key ECB interest rates** unchanged. We now expect them 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.

Second, 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.

Third, we decided to launch a new series of quarterly targeted longer-term refinancing operations (TLTRO-III), starting in September 2019 and ending in March 2021, each with a maturity of two years. These new operations will help to preserve favourable bank lending conditions and the smooth transmission of monetary policy. Under TLTRO-III, counterparties will be entitled to borrow up to 30% of the stock of eligible loans as at 28 February 2019 at a rate indexed to the interest rate on the main refinancing operations over the life of each operation. Like the outstanding TLTRO programme, TLTRO-III will feature built-in incentives for credit conditions to remain favourable. Further details on the precise terms of TLTRO-III will be communicated in due course.

Fourth, we will continue conducting our lending operations as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the reserve maintenance period starting in March 2021.
11. Forward guidance: How successful or how damaging may/will it be?

Bernanke’s Taper-Tantrum

Fed vs market expectations

FOMC members „Dots“

vs market expectations

10-year Government Bond Yields

+100 bps
(ANY) CONCLUSIONS?
(Any) Conclusions?

● Like Harari I think any future „new normal“ will very likely look (very) different from that before the crisis.

● I expect all the elements I have mentioned to stay with us and to be there also in a forthcoming definition of the „new normal“.

● Of course, the intensity of their effective use will vary depending on the respective economic situation…

● …but these new instruments or approaches have not only become part of our toolkit, they will be regularly used if found necessary and appropriate.

● However, WHEN we in fact will be able to approach this completely new „new normal“ still has to be seen….

● …unfortunately, even more than a decade after monetary policy went into crisis mode.
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