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The euro area's monetary policy in the context of economic recovery

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Ladies and gentlemen,

I would like to thank the Oesterreichische Nationalbank and my friend Governor Ewald Nowotny for having invited me today. A little more than one year ago, the full Governing Council of the ECB celebrated in this very place the 200th anniversary of the Oesterreichische Nationalbank (OeNB). Today, your country is on the eve of important national elections. Throughout history, Vienna has been one of the centres of Europe, and Austria a country that we love: on a more personal note, I am indebted to Austria for enabling me to improve my German during a lengthy stay in Graz, Styria, over 40 years ago. And the Austrian economy has been a strong performer in the euro area: a low unemployment rate of just 5.6% in August 2017, against 9.1% for the euro area as a whole. You are the proof, along with other countries, that our common European social model is compatible with economic success.

Today, you have invited me to speak about euro area monetary policy in the context of economic recovery. The prospect of a possible normalisation of our monetary policy gives rise to expectations and somewhat unduly to concerns. To be frank, this very gradual normalisation has already started. I will begin by focusing on the progress that our accommodative monetary policy has already achieved, before talking about prospects for the future, and then come to the necessary completion of non-monetary tools in Europe.

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I. The progress that we have already achieved

Economic recovery in the euro area is here [slide]. It is robust and broadly based across countries and sectors. Our latest ECB forecasts[ii] confirm this: growth should stand at 2.2% in the euro area in 2017, that is, a significant upward revision of 0.3 point compared with June's forecast of 1.9%. This means that for the second consecutive year, euro area growth will be comparable to that of the United States. And, according to Eurosystem calculations, the output gap will return to close to zero by the end of the year (-0.6%).

The non-standard monetary policy that we have been conducting since 2014 is contributing to this acceleration of growth in the euro area, by fostering very favourable financing conditions and by supporting domestic demand. In concrete terms, this acceleration results in more jobs – over 6 million jobs created in the euro area since the start of 2013 – and in a pick-up in investment. Corporate investment in particular, decisive for supply capacity, is clearly recovering: up 4.7% in 2015, 6% in 2016, and is expected to be up 4% in 2017 and 2018. [slide] This improvement in investment is underpinned notably by ongoing growth in lending to the private sector, at 2.5% year-on-year in August 2017 for firms and at 2.7% for households, with interest rates also remaining very low.

We are also observing favourable developments in **inflation**, which is gradually moving back towards our target of 2% over the medium term [slide]. After peaking at the start of 2017, the inflation rate stood at 1.5% year-on-year in September. This performance remains below our inflation aim, partly reflecting headwinds due to the past appreciation of the exchange rate. However, for 2017 as a whole, euro area inflation, at 1.5%, should be much higher than a year ago. For the next few years, we foresee inflation at 1.2% in 2018 and at 1.5% in 2019 – with a change in composition: less “energy” inflation, more underlying inflation. This represents a first success: our monetary policy measures have succeeded in warding off the risk of deflation which was still threatening the euro area last year – we mustn’t forget that inflation was declining in April 2016, standing at -0.2%.

That said, despite the progress made towards our target, it is still incomplete. Underlying inflation, excluding energy and food, has admittedly increased – rising from 0.8% in the first quarter of 2017 to 1.1% in September 2017 – but it still remains at subdued levels, despite the strong recovery in activity and employment.

A significant factor is the relatively low nominal wage growth. Among the cyclical factors, I would like to mention two in particular: first, persistent slack in the labour market – the unemployment rate has fallen sharply in the euro area, to stand at 9.1% in August 2017, but it is still too high; second, backward-looking wage bargaining, which means that low past inflation is feeding through to wages today. The influence of these two causes should nevertheless diminish with the recovery in economic growth and inflation.

Structurally, many studies [iii] suggest that the Phillips curve, that is the relationship between inflation and fluctuations in economic activity or unemployment, appears to have flattened since the 1980s [slide]. Inflation seems less responsive to changes in economic activity in advanced countries, notably because of globalisation,[iv] which appears to exert downward pressure on inflation via the decline in imported goods prices and competition from low-wage countries. But a flatter Phillips curve does not call into question this relationship: we are in no doubt about the **way** we are heading: the recovery and job creations will lead to higher wages and, ultimately, more inflation. But we remain, nevertheless, less certain as to the **speed** of this adjustment. We are both confident about the effectiveness of our monetary policy and willing to be patient regarding the time it will take.

II. The prospects: an adequate reduction of asset purchases, within an overall substantially accommodative monetary policy

Let me now turn to the implications of this for our monetary policy. You are well aware that we at the ECB's Governing Council will decide this autumn on the re-calibration of our policy instruments beyond the end of the year – and, to quote Mario Draghi, "probably the bulk of these decisions will be taken in October". We are now faced with a simple requirement, in line with our mandate to maintain price stability, and the progress towards our inflation target: we have to reduce the intensity of our net asset purchases, while maintaining overall a substantially accommodative monetary policy.

As regards our **asset purchases**, we have to reduce their intensity in a pragmatic manner, as we already decided successfully in December 2016. “Pragmatic” because, while keeping the current rules – we shouldn’t change any of the parameters, including the issuer and issue limits –, we can on the one hand exploit the margins of flexibility of the programme and we must on the other hand hold in reserve an additional purchasing capacity – if needed. So, there is no reason to be worried by the prospect of an adequate reduction of our net purchases, which would be perfectly compatible with maintaining a substantial degree of monetary accommodation.

Indeed, **QE is not limited to net asset purchases, and monetary policy is not limited to QE**. Our monetary policy is based on a set of instruments [slide]: **it is not a solo, but a quartet**. On top of QE, we perform with our policy interest rates, our forward guidance and the provision of liquidity to financial institutions.

1/ On **QE**, the academic literature provides consistent evidence that the impact of asset purchase programmes on the yield curve and asset prices is primarily driven by the total **stock** of assets held by the central bank (the so called “stock effect”), rather than by the flow of transactions conducted over a given period (“flow effect”) [slide]. Banque de France studies of the effects of the PSPP find that holding a stock of bonds equivalent to 10% of GDP lowers the 10-year yield by about 45 bps in the euro-area. [v] These results imply that our current programme lowers the 10-year euro-area government bond yield by about 100 bps. These estimates are of similar magnitude to results obtained for evaluations of the programmes conducted in the United States and the United Kingdom.[vi]

In any case, the Eurosystem will remain a major buyer of euro-denominated bonds over the coming years, thanks to our reinvestment commitment, which we took in December 2015 and which was perhaps not widely enough noticed: the repayments that we will obtain when bonds reach their maturity date will be fully reinvested, thus keeping the size of our asset holdings unchanged and at a high level. In addition, the maturity of such reinvestments can be calibrated, if need be, to support the duration that we will extract from the market. This implies that we will continue to exert downward pressure on the yield curve by keeping our stock of asset holdings at a high level for a prolonged period of time, and we could specify it in our communication.

2/ Perhaps the most unconventional policy tool is the use of **negative interest rates**. Negative interest rates have their limitations; I have already stressed them in the past.[vii] And at our Governing Council's meeting in Tallinn last June, we clarified these limitations in our forward guidance stating that we do not intend to lower our deposit facility rate below its current level of -0.40%. But slightly negative interest rates have their virtues. First, by removing the zero lower bound constraint on expectations of future short-term interest rates, they contribute to easing financial conditions by lowering rates along the curve, with a positive impact on the demand for credit by firms. Second, the negative deposit facility rate (DFR) positively interacts with asset purchases. Indeed, the portfolio rebalancing effect of QE is reinforced by the negative DFR, as banks with excess liquidity holdings have a stronger incentive to put their reserves to work. And, so far, we have not seen significantly detrimental effects of negative rates on the profitability of banks, notably thanks to the favourable fact that the slope of the yield curve has remained positive.

3/ Our **forward guidance** provides further indications as to the future path of our monetary policy; and by steering expectations, it has an impact on the yield curve. Our forward guidance is clear as to the sequencing: "we expect [the key ECB interest rates] to remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases." There is no doubt within the Governing Council about this sequencing. In all events, we should not consider raising interest rates until we have reached a sustained adjustment in the path of inflation.

4/ The fourth instrument is the provision of **liquidity** to financial institutions. In October 2008, we introduced the fixed-rate full allotment policy in all our regular refinancing operations. The maturity of this liquidity provision was then extended with the launch of 3-year longer-term refinancing operations (LTROs) and, later, targeted longer-term refinancing operations (TLTROs). In September 2017, a total of EUR 760 billion is still lent to euro area banks through TLTROs, which at over 7% of euro area GDP is substantial.

III. Supplementing monetary policy in Europe

For the future, we can be confident, because our monetary policy is effective and recovery is robust. But our confidence must be without complacency, because monetary policy cannot be the only game in town: it must be supplemented by national reforms, and by a strengthening of the euro area. We have been saying this for a long time, but **now is the time to act**.

Now is the time to act in France, where stepping up reforms is a priority, with a focus on two main areas: on the one hand, sustainably consolidating our public finances, and on the other, aiming to achieve an overall transformation, with and a major simplification effort in both labour market and the goods and services market, and large-scale investment in education, vocational training and apprenticeships. Even though we must pursue this course, this is what the new government appears to be doing with the labour market reform underway since this summer, and efforts to bring the government deficit down to 2.6% in the 2018 budget, well below the threshold of 3% of GDP for the first time in 11 years.

Now is the time to act in Europe, above all. We cannot both overburden monetary policy – our German friends are right in this respect – and refuse Economic Union which is the prerequisite for a sounder Monetary Union. So we must not let ourselves be slowed down by sterile debates or false suspicions: there is no question of implementing a “transfer union”, which would only benefit certain countries; we must not get bogged down by considerations about methods either, between intergovernmental and community methods. It is now urgent to make concrete progress on substance, and to move up a gear, by triggering four accelerators of the Economic Union:

- **A macro accelerator**: the French President, Mr. Macron, in his speech about Europe ten days ago at the Sorbonne, started by talking about the "coordination of economic policies". In this widely-discussed speech, I believe that this was not sufficiently remarked upon. In my opinion – as an independent central banker – we should aim to achieve a genuine collective economic strategy; a mutual commitment between the Member States of the euro area, for more reforms in countries where they are required, and more fiscal support in countries with leeway for this. This collective strategy could be prepared and adopted as of 2018. It could be supplemented by the creation of a common stabilisation fund, aimed at supporting, through lending, Member States facing asymmetric shocks. This could be part of a European Monetary Fund, provided that its scope of action is extended beyond the current European Stability Mechanism.
- **A micro accelerator**: i.e. a Financing Union for Investment and Innovation. The aim is to mobilise the EUR 350 billion savings surplus of the euro area, notably to shore up equity which is the key to an innovation economy, and also to foster synergies, thanks to an integrated steering mechanism, between the Juncker investment Plan, the Capital Markets Union and Banking Union. Here too, progress could be rapid.
- **A fiscal accelerator**, once we have increased trust between Member States and made headway towards greater economic convergence: the euro area budget could be used to finance, for the benefit of **all** countries, certain "European common goods" such as digital technology, energy transition, security, migration controls.
- **An institutional accelerator**: i.e. first and foremost a euro area Finance Minister, President of the Eurogroup and member of the Commission, backed by a European Treasury; but also a euro area Parliament group, in order to ensure the democratic legitimacy of the institutions and decisions.

The latter two accelerators, fiscal and institutional, would require Treaty changes, unless they were to be very limited. But this must not stop us from making progress straightway on the first two, in order to breathe new life into Economic Union.

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I would like to conclude my speech today by quoting Stefan Zweig, one of the most famous Austrian authors. He wrote a beautiful text after his visit to the Banque de France in Paris in 1932.[viii] But he above all paid tribute to his home town in the following words: “For the genius of Vienna — a specifically musical one — was always that it harmonized all the national and lingual contrasts. Its culture was a synthesis of all Western cultures. Whoever lived there and worked there felt himself free of all confinement and prejudice.”[ix] I admire this Viennese spirit, which combines audacity and liberty, and which was the cradle of the greatest minds of our contemporary era. Today, as Europe’s time may be here again, I hope that this spirit will continue to inspire us. Thank you for your attention.

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[i] I would like to thank P. Andrade, P. Antipa, G. Cette, M. Dujardin, O. Garnier, A. Lojschova, B. Mojon and B. Rudelle for their help in preparing this speech.

[ii] Eurosystem staff macroeconomic projections for the euro area, September 2017.

[iii] See e.g. Blanchard (O.), Cerutti (E.), and Summers (L.) (2015) “Inflation and Activity - Two Explorations and their Monetary Policy Implications,” *National Bureau of Economic Research Working Paper* No. 21726, November.

[iv] Guilloux-Nefussi (S.) (2016) "Globalization, Market Structure and Inflation Dynamics," *Banque de France Working Papers* 610.

[v] See e.g. Andrade, Philippe, Johannes Breckenfelder, Fiorella De Fiore, Peter Karadi, and Oreste Tristani (2016) “The ECB's asset purchase programme - an early assessment” ECB Working Paper No. 1956 and Arrata, William and Benoît Nguyen (2017) “Price Impact of Bond Supply Shocks: Evidence from the Eurosystem's asset purchase program” Banque de France Working Paper No. 623.

[vi] See e.g. D’Amico Stefania and Thomas B. King (2013) “Flow and stock effects of large-scale treasury purchases: Evidence on the importance of local supply” Journal of Financial Economics Volume 108, Issue 2, Pages 425-448 for evidence associated with programmes conducted in the US and Joyce et al. (2010) in the UK.

[vii] See speeches of August 2016 (Handelsblatt conference), September 2016 (annual CERS conference) and April 2017 (conference at Columbia University).

[viii] Stefan Zweig, *Visiting the billions (Besuch bei den Milliarden),* 1932.

[ix] Stefan Zweig, *The World of Yesterday, Memories of a European*, 1944.