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Bank of Finland

Monetary Policy

Global Interdependence Center
Central Banking Series: Helsinki
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Growth and inflation outlook in the euro area



The uncertainties are in part economic ...

Europe
Risk of
deflation?

Oil and other
commodities
Price developments

United States
Gradual
normalisation of
monetary
policy?



China
Slowing of
economic growth
and structural
change

Emerging economies
Condition of balance sheets
Commodity prices



... but it is difficult to assess the economic importance of some risks

Europe

BREXIT

Refugee situation

Near East

Geopolitical risks



Global

*Consequences of
climate change*

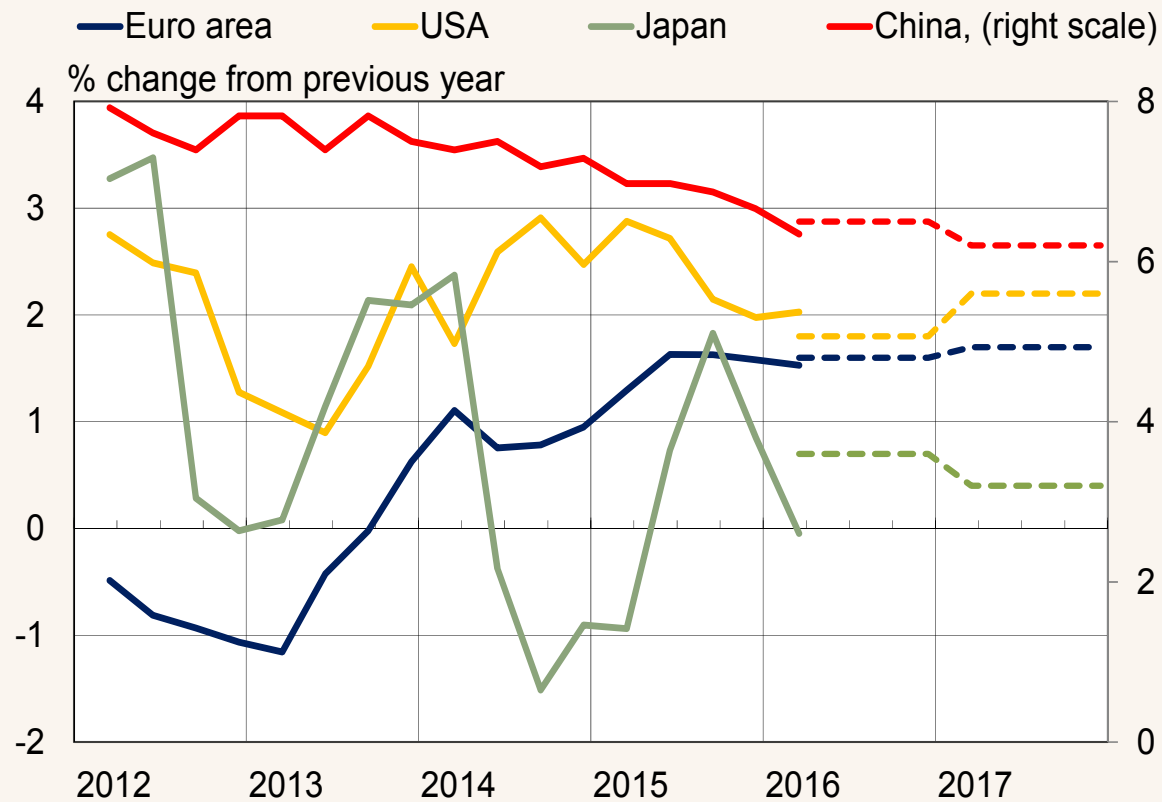
United States and Europe

Opposition to free trade

Risk of introversion



GDP recovery broad-based in the euro area



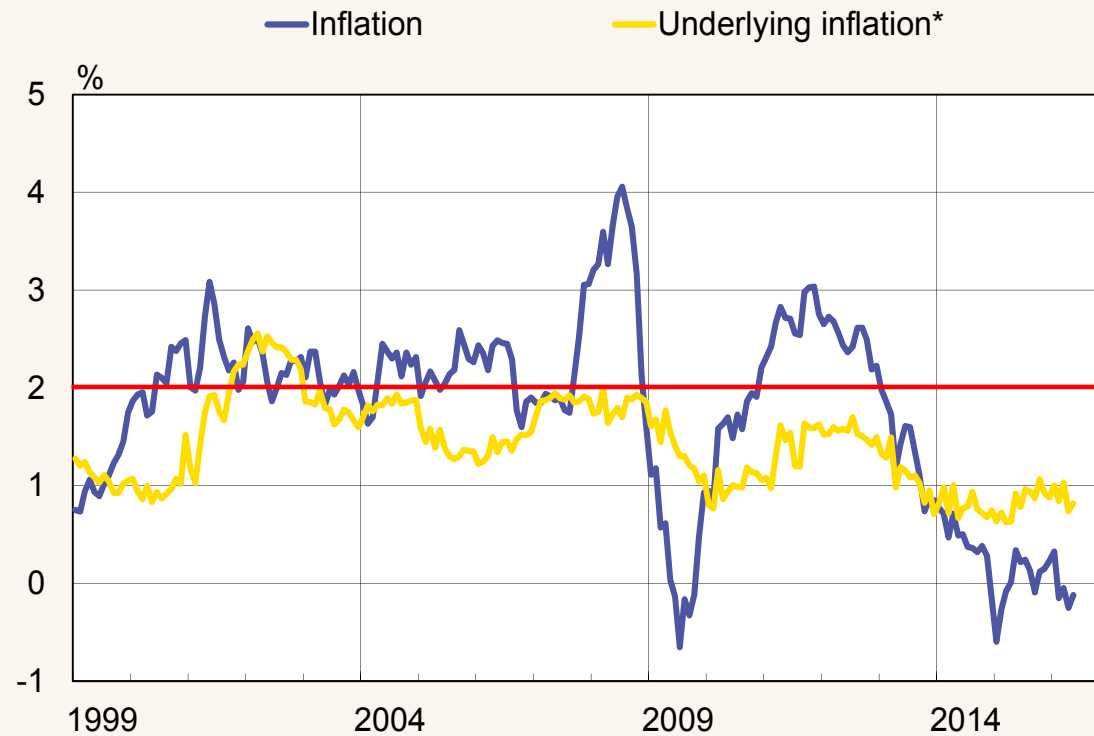
Sources: Eurostat, ECB and OECD.

Euro area ECB BMPE June 2016 projection. USA, Japan, China OECD June 2016 forecast. 32709



But consumer price inflation still subdued

Euro area consumer price inflation (HICP)



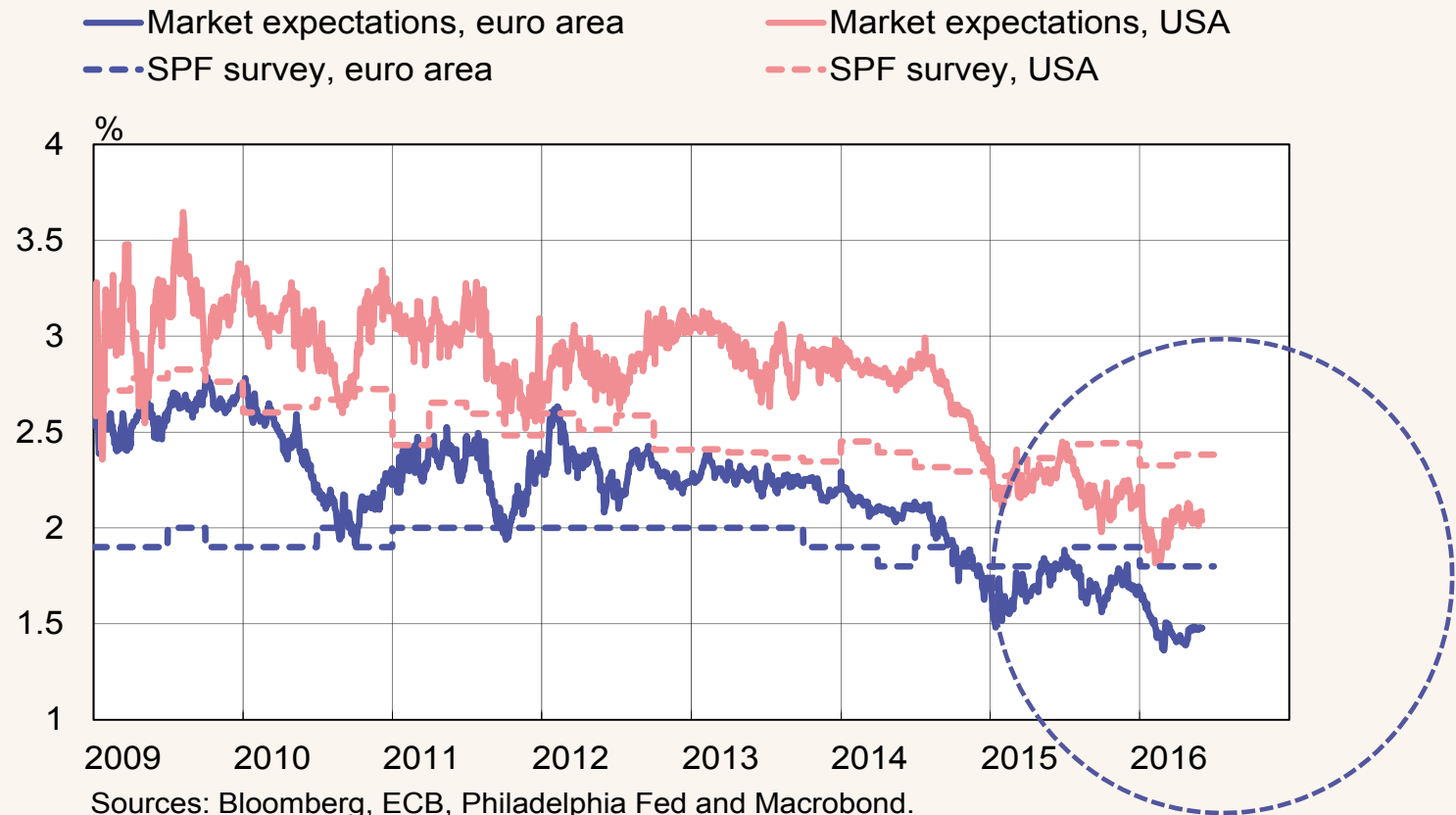
* Underlying inflation = inflation excluding energy, food, alcohol and tobacco.

Sources: ECB and Bank of Finland.

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Long-term inflation expectations low in the euro area



Sources: Bloomberg, ECB, Philadelphia Fed and Macrobond.

Market expectations are based on 5-year and 10-year inflation-linked swap rates. The SPF survey horizon extends five years ahead.

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Growth and inflation forecasts: Eurosystem macroeconomic projections, June 2016

(change from March 2016 ECB staff macroeconomic projections)

- **GDP:**

2016: 1.6% (+0.2%)

2017: 1.7% (-)

2018: 1.7% (-0.1%)

- **Inflation:**

2016: 0.2% (+0.1%)

2017: 1.3% (-)

2018: 1.6% (-)



Monetary policy exceptionally accommodative for a prolonged period



Eurosystem non-standard monetary policy

- ***Outright Monetary Transactions (2012-)***
- ***Forward Guidance (2013-)***
- ***Targeted Long Term Refinancing Operations (2014-15 and 2016-17)***
- ***Covered Bond Purchase Programme (2014-)***
- ***Asset Backed Securities Purchase Programme (2014-)***
- ***Public Sector Purchase Programme (2015-)***
- ***Corporate Sector Purchase Programme (2016-)***



An important new step was taken in January 2015

- ***Expanded asset purchase programme***
 - ***Bonds issued by euro area governments, government agencies and European institutions as a new target for purchases***
 - ***Combined monthly asset purchases under the three programmes of EUR 60 billion from March 2015 until at least September 2016***

- ***Forward guidance***
 - ***Purchases are intended to be carried out until end-September 2016 and will in any case be conducted until we see a sustained adjustment in the path of inflation consistent with our inflation aim.***



Monetary policy was further eased on 10 March 2016 with the adoption of a comprehensive monetary policy package.



ECB Governing Council decisions in March 2016

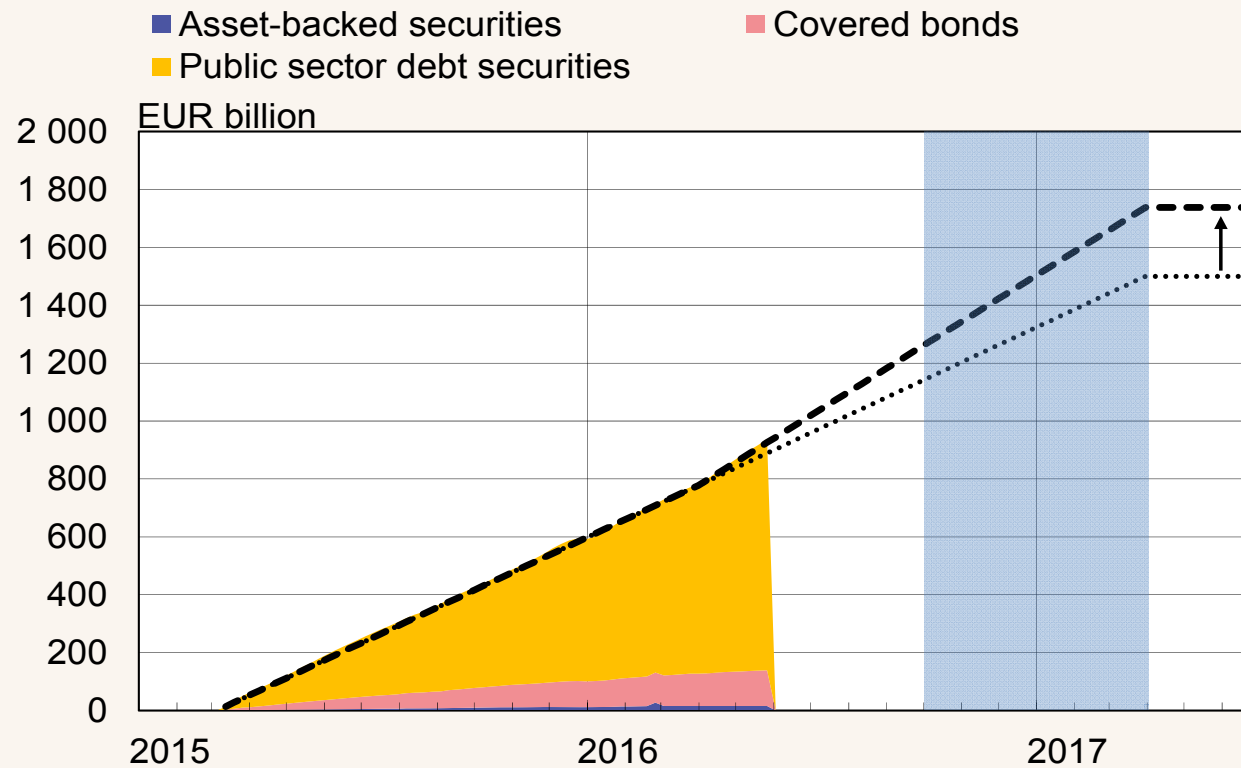
- ***Monetary policy rates were lowered***
 - Key interest rate to 0.0%
 - Deposit facility rate to -0.40%

- ***Monthly purchase volumes in the expanded asset purchase programme (EAPP) were expanded to €80 bn as of 1 April 2016***
 - Investment-grade bonds issued by non-banking-sector corporations included

- ***A second series of targeted longer-term refinancing operations (TLTRO 2) will be launched in June 2016.***
 - These will enhance the transmission of monetary policy measures to the economy by encouraging banks to increase lending to the real economy.
 - Each operation will have a 4-year maturity, and the interest rate can be as low as the rate on the deposit facility.



Monthly purchase volumes increased from EUR 60 billion to EUR 80 billion



Sources: ECB and Macrobond.

The dashed line shows target path announced in March, the dotted line shows the previous target path announced in December 2015.

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ECB Governing Council on 2 June 2016 confirmed its forward guidance on monetary policy

- ***Purchases are intended to run until at least the end of March 2017, or beyond, if necessary, until inflation is on a sustained path towards a level below, but close to, 2%.***
- ***In view of the current outlook for price stability, the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of the asset purchases.***



ECB Governing Council on 2 June 2016

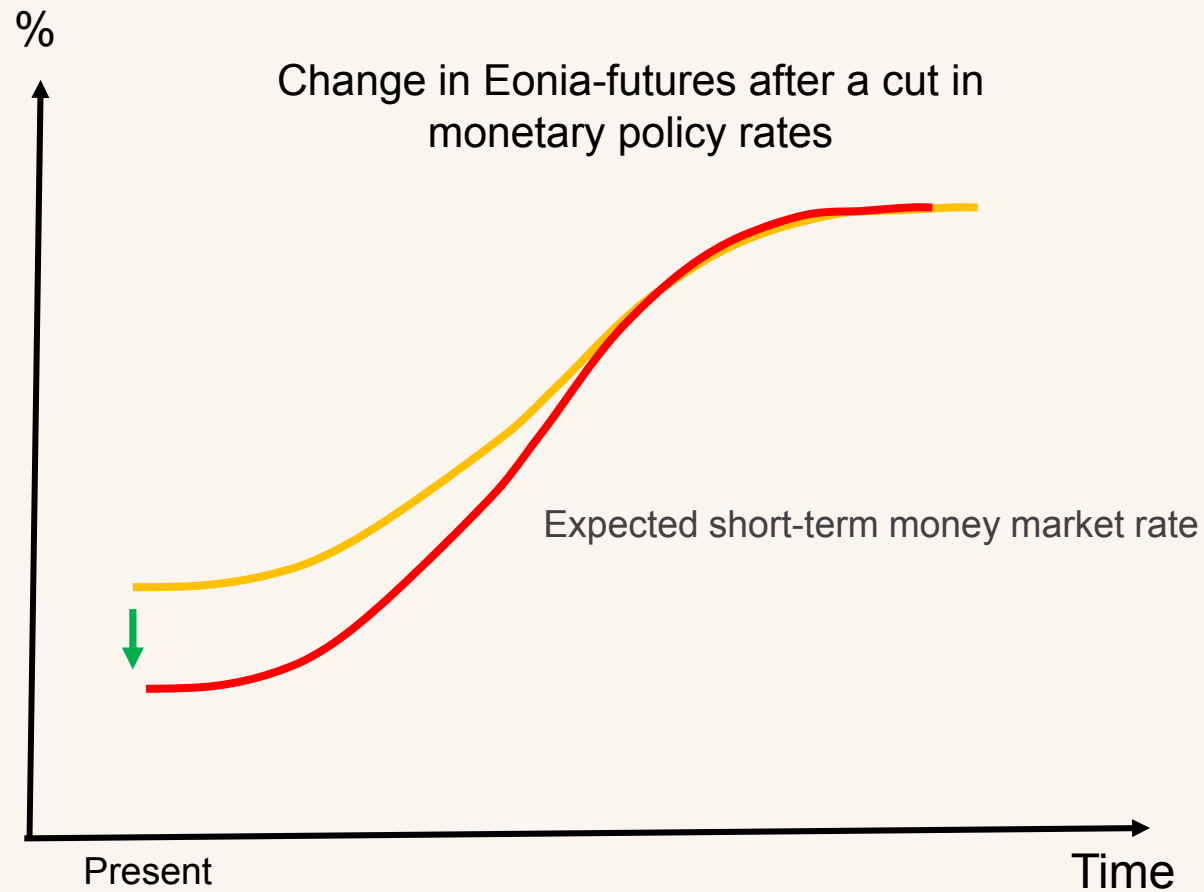
- ***In the current context, it is crucial to ensure that the very low inflation environment does not become entrenched in second-round effects on wage and price setting.***
- ***The Governing Council will closely monitor the evolution of the outlook for price stability and, if warranted to achieve its objective, will act by using all the instruments available within its mandate.***



Monetary policy transmission channels

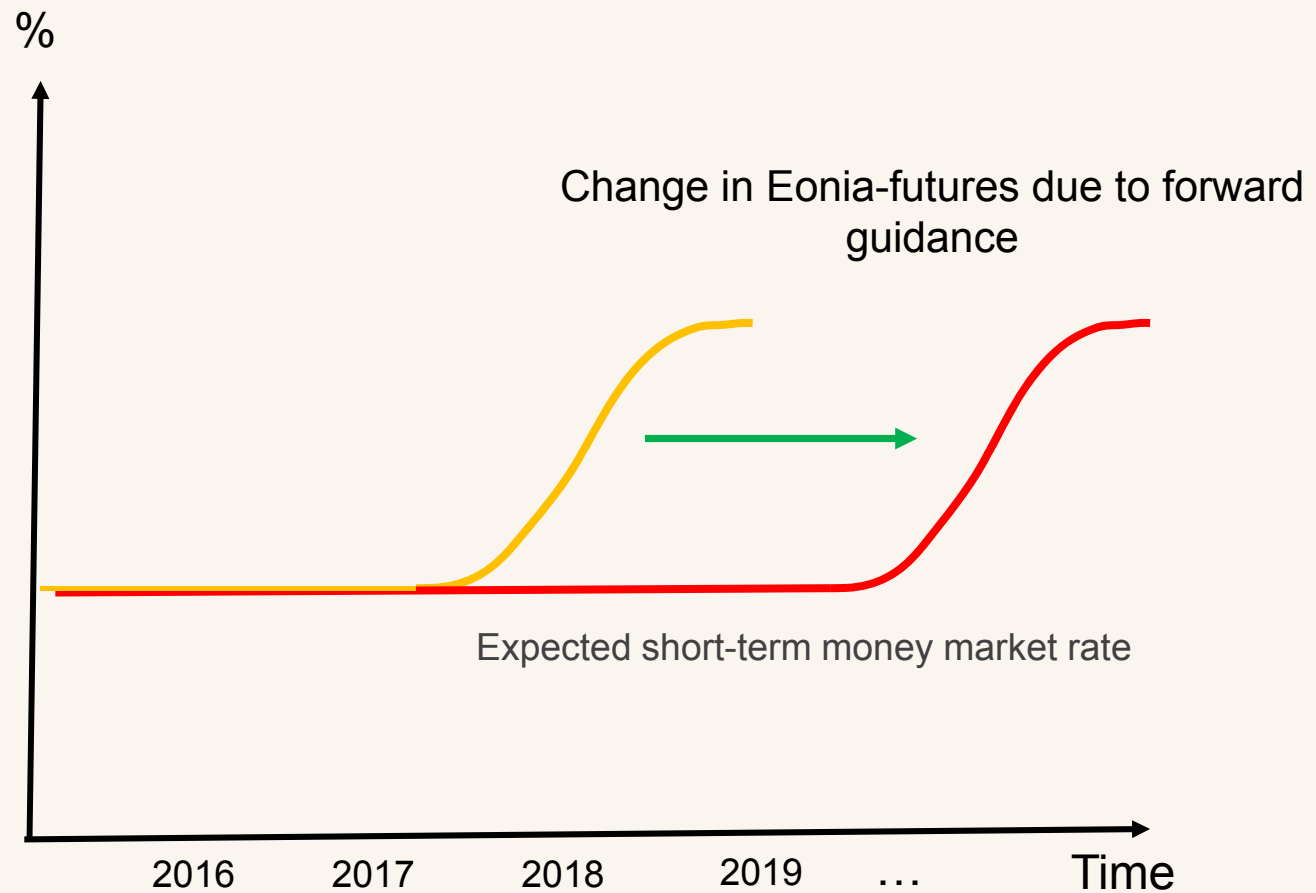


A cut in monetary policy rates lowers short-term money market rates...



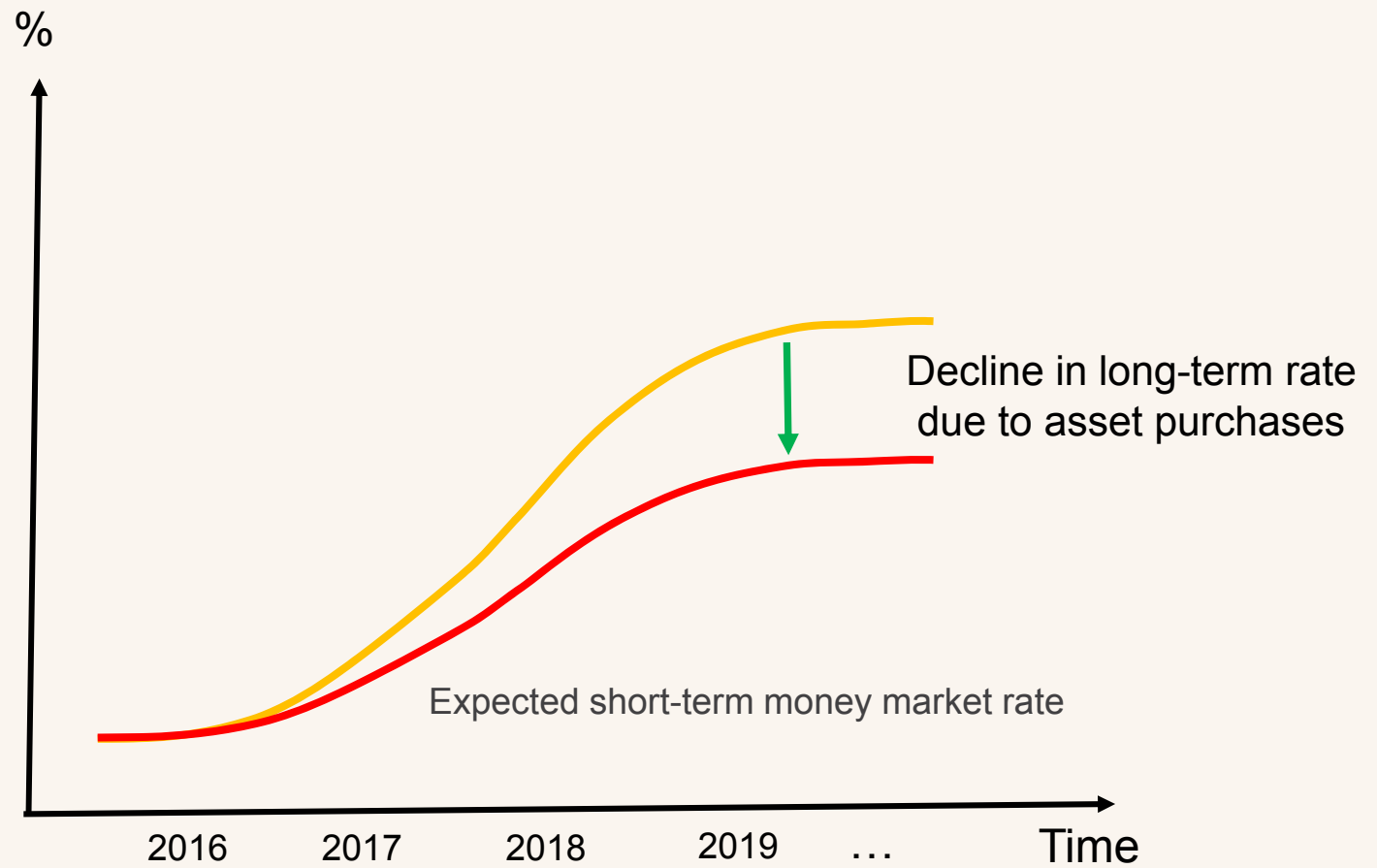


... forward guidance postpones expected tightening of monetary policy...





... and asset purchases depress long-term interest rates





Negative deposit rates

- ***The Governing Council of the ECB introduced negative deposit rate in June 2014, with three further reductions in September 2014, December 2015 and March of this year.***
 - *In March the deposit rate was lowered to -0,4 %.*

- ***The main objectives of this measure are twofold:***
 - *to further lower money market rates and the longer end of the yield curve via expectations effects*
 - *to increase the velocity of circulation of excess reserves in the interbank market towards banks that need liquidity to sustain or expand their credit portfolios*



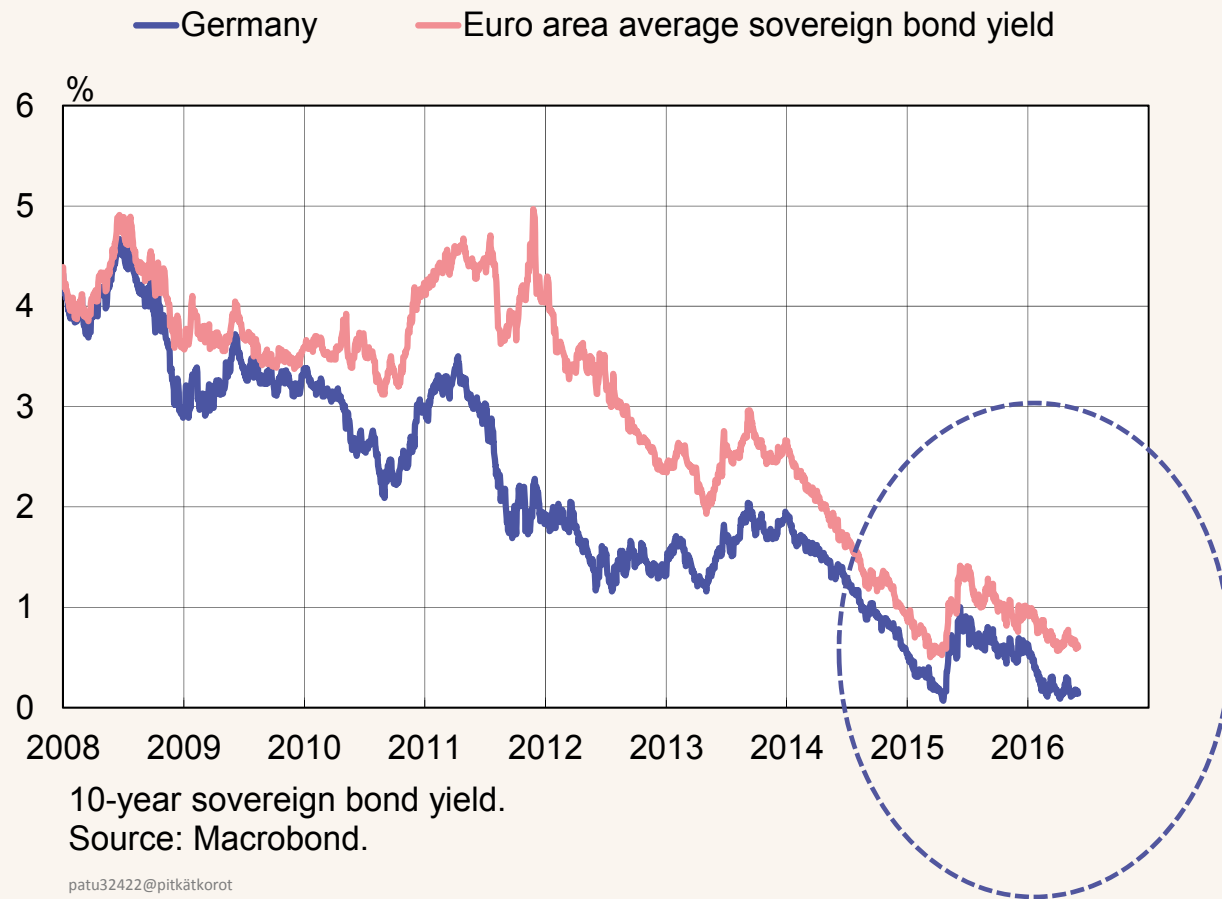
Channels of influence of a more accommodative monetary policy

- ***Lowers real interest rates and eases financial conditions in the economy***
 - *interest rates at the longer end decline, financial conditions for companies and households become easier, securities prices rise*
 - *higher inflation expectations mean lower real interest rates*
 - *corporate and household confidence improves*

- ***Increases demand and boosts inflation***
 - *consumption and profitability of investments increase*
 - *external value of the euro depreciates*

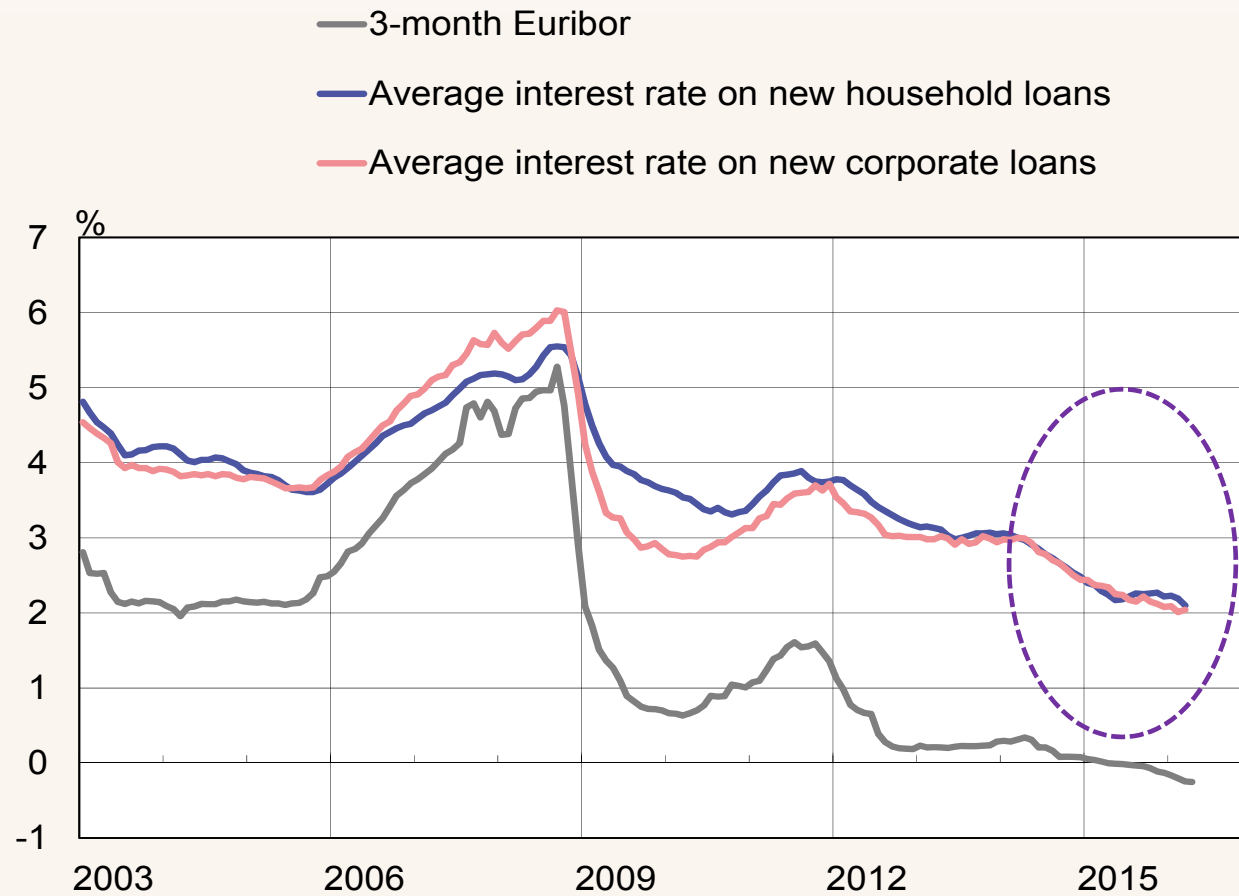


Euro area sovereign bond yields at low levels





Bank lending rates on household and corporate loans have decreased



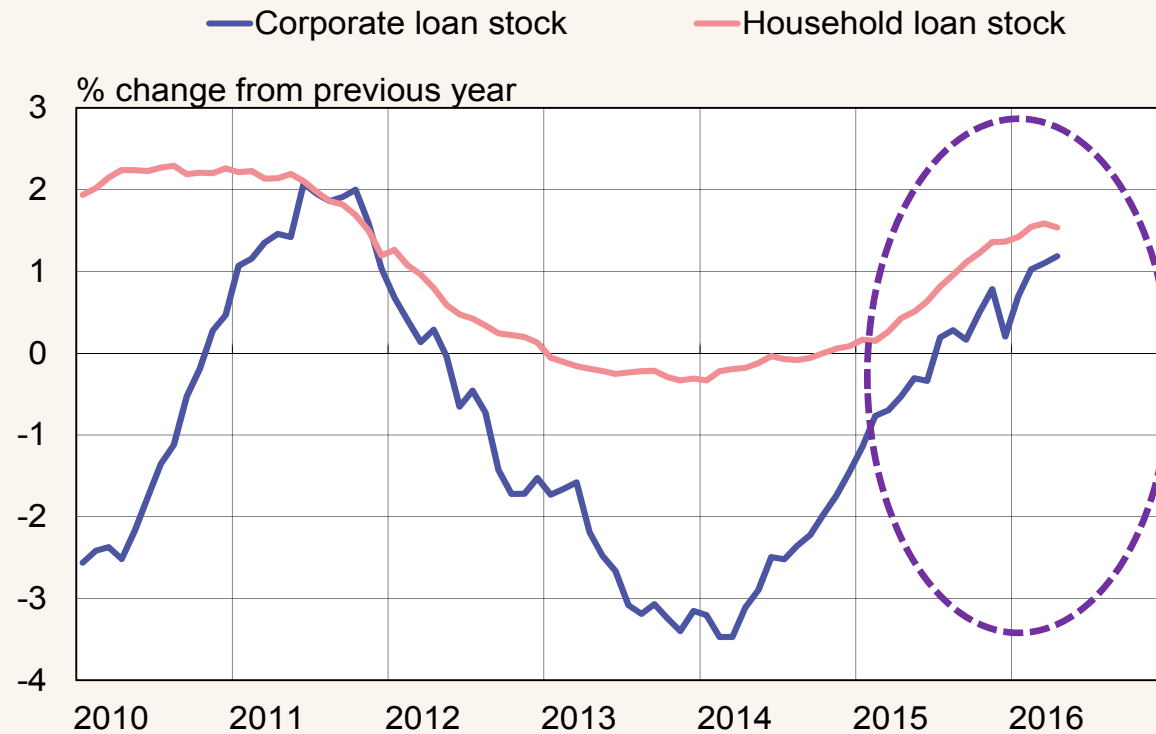
Sources: ECB and Macrobond.

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Growth in bank loans has accelerated

Annual growth in loan stocks



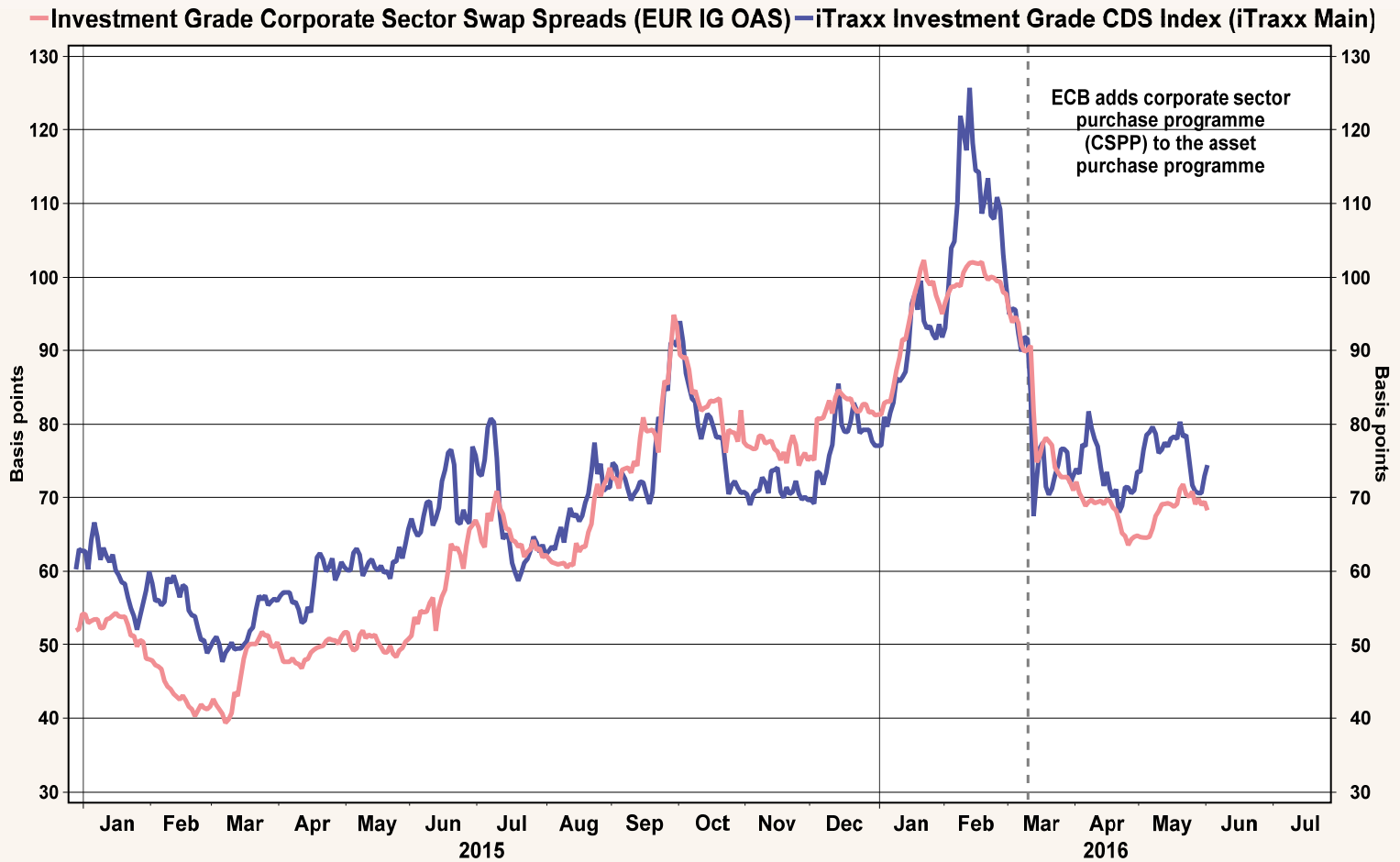
Loan stocks adjusted for balance sheet transfers and securitisation.

Sources: ECB and Macrobond.

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Corporate bond spreads have declined

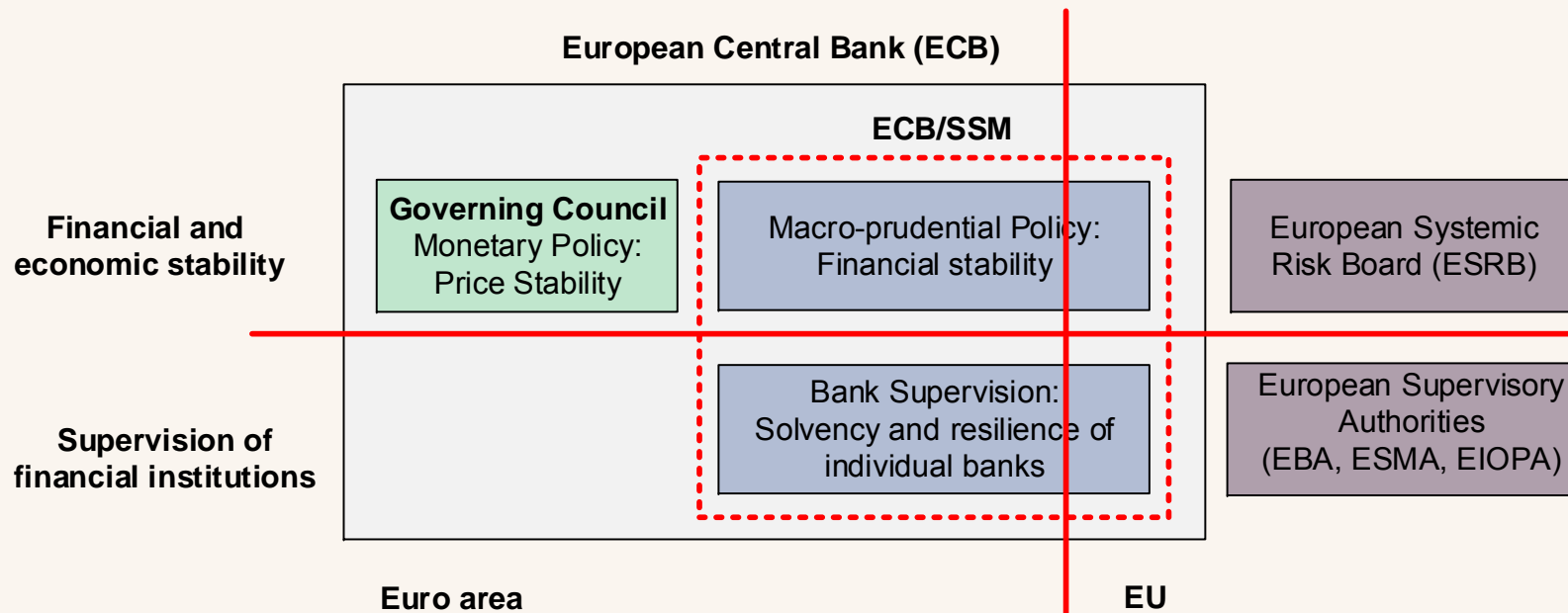




On the Banking Union and the new responsibilities of the ECB



ECB's role in the new supervisory architecture

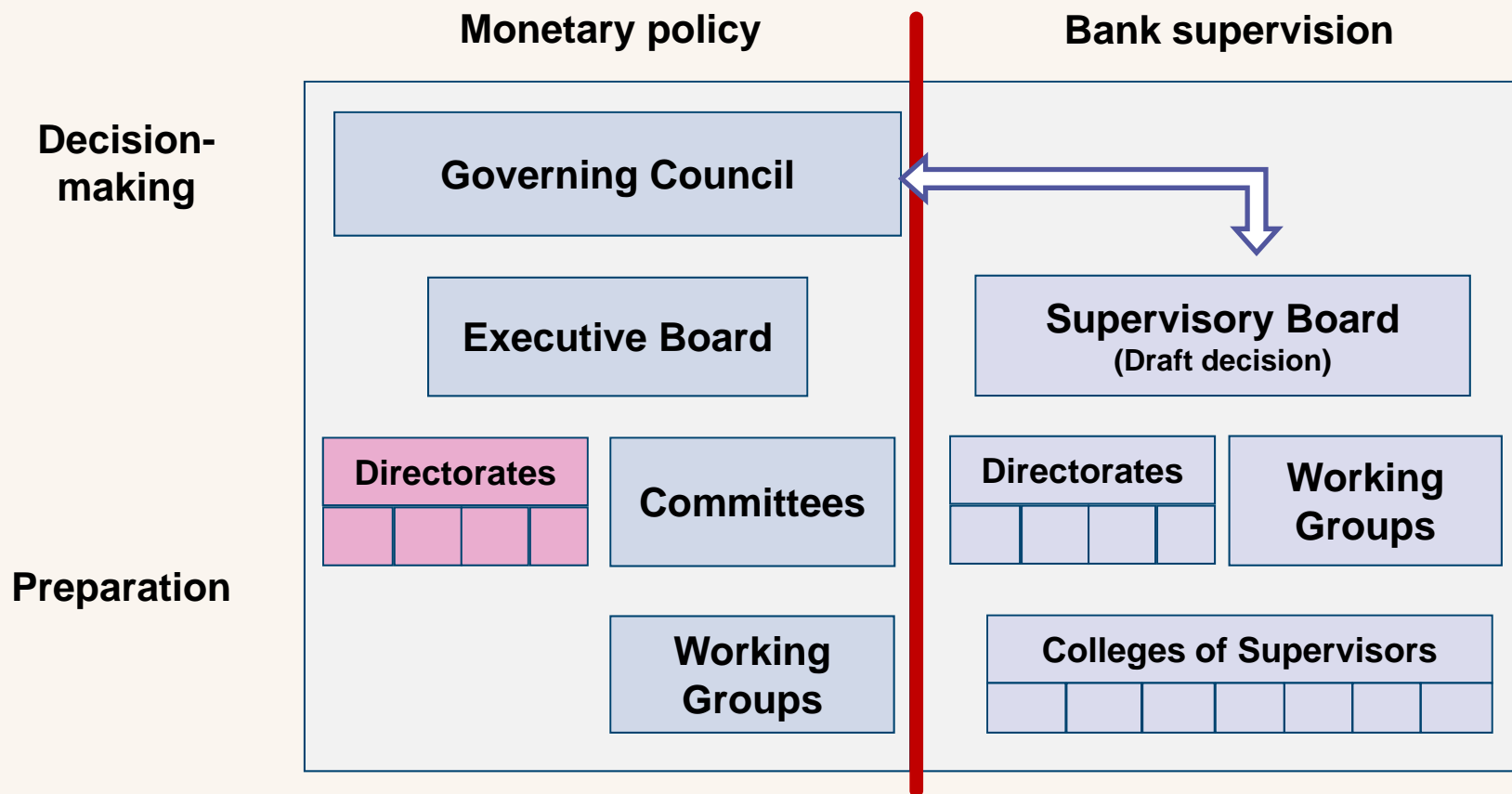


Sources: Smets (2013) and Bank of Finland.



ECB's monetary policy and bank supervision separated

European Central Bank (ECB)





ECB reinforces but cannot substitute for national macroprudential policies in the euro area

- ***National macroprudential authorities bear the main responsibility for detecting systemic risks and taking appropriate macroprudential action***
- ***National macroprudential action should be timely, bold and intrusive***
- ***The ECB can reduce the inaction bias inherent in national macroprudential policies***
- ***European Systemic Risk Board (ESRB) provides EU-level guidance to prevent and mitigate systemic risks***



European Systemic Risk Board (ESRB) oversees the EU financial system

- *In response to the global financial crisis, the ESRB was established as a Union-level body to prevent and mitigate systemic risks*
- *The ESRB monitors and assesses systemic risks, collecting views of both central bankers and supervisory authorities*
- *To pursue its macroprudential mandate, the ESRB may issue risk warnings and policy recommendations*



Two main groups of macroprudential tools

- **1) Tools directed (mainly) at financial institutions:**
 - *Countercyclical Capital Buffer*
 - *Capital buffers for Systemically Important Financial Institutions*

- **2) "Borrower-based tools": tools directed (mainly) at borrowers and terms and conditions of loans:**
 - *Loan-to-value cap , Loan-to-income cap, Debt-service-to-income cap, Amortisation requirements,...*

- ***In several countries, borrower-based tools automatically apply to loans made by branches of foreign banks***



New financial regulatory architecture and monetary policy transmission



The mandate of the ECB

- **Maintaining price stability is the primary objective of the ECB.**
- **Without prejudice to price stability, the ECB shall support the general economic policies in the EU, including balanced economic growth.**
- **Financial stability is key to realizing this mandate.**
- **The SSM regulation assigns macroprudential responsibilities to the ECB, with power to apply tighter macroprudential requirements than the designated national macroprudential authorities.**



New financial regulatory architecture and monetary policy transmission

- ***Monetary policy transmission more immune from disruption***
 - *Banks more resilient to future shocks*
 - *New macroprudential instruments designed to improve the stability of the financial system as a whole*

- ***Interaction of micro- and macroprudential policy can enhance the effectiveness and efficiency of monetary policy***
 - *Effective regulation protects monetary policy from financial dominance*

- ***Euro area less vulnerable to fragmentation***
 - *The SSM creates the conditions and incentives for deeper integration of the European banking market*



Thank you!