Executive summaries of the papers prepared by the Monetary Expert Panel


Topic 1: Central bank communication at times of non-standard monetary policies

Karl WHELAN (University College Dublin)

Communications about plans for future monetary policy are one of the key tools through which central banks can affect the economy. The addition of non-standard policies such as quantitative easing has complicated communication for central banks and there have been some lessons for the ECB to learn from communications mistakes made by other central banks in recent years. The ECB has so far done well in handling the communications issues relating to the ending of its Asset Purchase Programme but it faces a number of communications challenges as it seeks to normalise monetary policy.

- Communications about plans for future monetary policy are one of the key tools through which central banks can affect the economy.
- In particular, the yields on long-term financial instruments depend on expectations of future monetary policy and are sensitive to guidance from central banks.
- For many years, central banks were highly secretive about their decision-making procedures, fearing that revealing too much information would restrict their flexibility.
- Central banks around the world have gradually accepted that transparency in communicating their goals and strategies to the public helps to make policy more effective.
- Experience over the past two decades with periods in which policy rates are at or close to zero has highlighted the importance of providing forward guidance on the likely length of time that interest rates will remain very low.
- The Federal Reserve and Bank of England’s experiences with using specified numerical values of the unemployment rate as a trigger to raise interest rates were not successful. These central banks kept policy rates at zero after the “trigger” level of unemployment was reached because of the absence of inflationary pressures. The ECB should not use this tactic of specifying a specific level of unemployment (or any other indicator) as dictating the end of its zero interest rate policy.
- The addition of non-standard policies such as quantitative easing (QE) has complicated communication for central banks. The public will expect interest rate increases to come after a QE programme has ceased so the central bank can provide additional information on the future path of interest rates by signalling whether it is planning to continue its assets purchases at its current rate or planning to reduce them and also by signalling a timeline for the end of the programmes.
The 2013 “taper tantrum” event shows how central banks can mishandle their communications strategy in ending a QE programme and trigger unwanted financial tightening.

The ECB has so far done well in handling the communications issues relating to the ending of its Asset Purchase Programme but it faces a number of communications challenges as it seeks to normalise monetary policy, most notably in relation to how high policy rates will go in the next cycle.

Over the longer term, the ECB faces a communication problem in establishing its commitment to a symmetric 2 percent inflation target because it has undershot this target for so long.

Perhaps the key communications issue facing the ECB is the need to replace Mario Draghi with someone who agrees with his approach to monetary policy and who will provide continuity rather than a sharp change in policies.

Lukasz JANIKOWSKI, Andrzej RZONCA (CASE, Centre for Social and Economic Research)

Communication is an important monetary policy tool, as central banks can use it to manage the expectations of economic agents. Communication becomes even more important in times of non-standard monetary policies due to increased levels of uncertainty and the introduction of new policy tools. In this paper, we summarise the literature on central bank communication in times of non-standard monetary policies, with a particular focus on forward guidance.

The Global Financial Crisis (GFC) that began in 2007 was followed by the Great Recession. In 2009, for the first time since the Second World War, the world economy shrank, which was the result of an economic downturn in advanced economies.

In reaction to the outbreak of the GFC, major central banks (the Federal Reserve, the European Central Bank, the Bank of Japan, the Bank of England, and the Swiss National Bank) reduced their interest rates to zero or even below, reaching the effective lower bound (ELB). After this, traditional monetary policy instruments became ineffective and central bankers had to come up with ideas on how to provide additional monetary stimulus to the economy. Two types of non-conventional instruments were used: quantitative easing (QE) and forward guidance.

QE, broadly defined, covers all forms of liquidity provisions by central banks to the financial sector, which have a purpose other than keeping short-term interest rates at a certain level. Central banks provide liquidity to the financial sector by buying financial assets. As a result, their prices rise and their yields decrease. By lowering medium- and long-term interest rates and increasing the wealth perceived by economic agents, QE stimulates aggregate demand in the economy.

Forward guidance is a communication tool. It provides information about a central bank’s intentions with regard to future monetary policy. Initially, it referred to the expected path of a central bank’s interest rates; however, it was later expanded to include QE. Forward guidance is aimed at managing economic agents’ expectations of how borrowing costs are likely to develop in the future relevant to their economic decisions. By lowering medium- and long-term interest rates, forward guidance can boost aggregate demand.

Communication can be used as a monetary policy tool. Since economic agents make their decisions based not only on the current situation but also based on their expectations regarding future economic developments, a central bank can increase the efficiency of monetary policy by managing their expectations. Central bank communication is especially important in times of non-conventional monetary policies due to elevated levels of economic...
uncertainty and the introduction of new policy tools, the functioning of which needs to be properly explained to economic agents.

- Central bank communication is also important due to the duty of central banks to explain both their actions and the thinking that underlies their actions to the general public. The accountability of central banks is a prerequisite for their independence in democratic societies. A need for accountability is even greater during times of non-standard monetary policies, due to their side effects, including effects on the distribution of the national income.

- Communication regarding the future normalisation of monetary policy will be a significant challenge for the European Central Bank. The normalisation of monetary policy encompasses terminating QE (which has already started), increasing interest rates above the ELB observed prior to the GFC, and downscaling the European Central Bank’s balance sheet to the pre-crisis level. The experiences of the Federal Reserve highlight the importance of precise communication. Ineffective or imprecise communication can result in an increase in financial market volatility. The American experience suggests that central banks should be very explicit about the state-dependency of monetary policy normalisation.

Christophe BLOT, Paul HUBERT (OFCE, Observatoire Français des Conjonctures Économiques)

Central banks have intensified their communication strategy since the mid 1990's and it has become an important instrument of central banks’ policymaking toolkit. A large empirical evidence suggests that central bank communication has effectively enhanced the transmission of monetary policy before and during the financial crisis. Nevertheless, the use of communication as a policy instrument is fragile since it depends on economic agents’ perceptions and beliefs. It is crucial that central bank communication be consistent with policy decisions.

- Central banks communication has been crucial during the crisis, but the increasing trend in central bank communication preceded the financial crisis. It has been certainly motivated by the request of increased transparency and accountability of independent institutions in charge of the conduct of monetary policy. Beyond the institutional argument, central banks communication is also instrumental to enhance the transmission of monetary policy as it conveys information on the present and future stance of monetary policy.

- All indicators assessing central banks communication show a steady increase since the mid 1990's indicating that it has become a major issue. The financial crisis has reinforced this trend.

- Communication matters as it makes central banks decisions more transparent. On the one hand, transparency of monetary policy is needed to make independent central bank accountable of their decisions. On the other hand, communication may enhance the transmission of monetary policy.

- There is a large empirical evidence suggesting that communication provides central banks with an instrument to influence economic agents’ expectations of future monetary policy decisions, strengthening central banks’ ability to achieve their goals.

- The role of communication has been reinforced during the financial crisis when the policy rate has been constrained by the zero lower bound. Central banks have sought to influence asset prices and interest rate expectations through the announcement of several non-standard measures.

- The “forward guidance” policy implemented by the ECB was a major change, following years of “we never pre-commit”, a usual mantra by Jean-Claude Trichet.
Non-standard monetary policy measures adopted during the financial crisis worked mainly through the confidence and signalling channels, so through central bank announcements of these policies. One key example of the powerful effect of communication on sovereign yields has been the famous “whatever it takes” announcement by ECB President.

There is a large evidence of sizeable effect of central banks communication on financial market variables such as asset prices, yields and exchange rates.

Nevertheless, the use of communication as a policy instrument is fragile. Imperfectly controlled communication may trigger adverse effect or mitigate the expected impact of an announcement. Central banks need to implement consistent communication, which shall also be consistent with their policy decisions.

Daniel Gros (CEPS, Centre for European Policy Studies)

Non-standard policy measures are intended to work via financial markets. Their effectiveness thus depends on how ECB communication affects the expectations of market participants far into the future. Communication has become as important as the details of the policy measures itself. The success of communication is often measured by short term market reactions, increasingly using advanced statistical techniques to interpret them. But this ‘policy making by the markets’ lacks a strong anchor because financial markets often anticipate policy and the assessments of investors change all the time, often independently of monetary policy actions.

The ultimate aim of the ECB is to safeguard price stability. Until the financial crisis, it pursued this goal by setting short-term (policy) interest rates. When its rates reached zero, the ECB had to switch to ‘non-standard’ policy measures, with the aim of influencing financial markets in other ways.

But measuring the success of ‘non-standard’ measures is difficult and sometimes their communication is more important than the details of the policy itself. This was the case for the so-called ‘forward guidance’, which has been largely abandoned. But new policy measures like bond purchase programs also require special communication to establish their effectiveness.

Central bankers themselves often measure the success of their policies and their communication by the short-term reaction of financial indicators, such as long-term interest rates, stock prices, exchange rates or financial market based measures of inflation expectations. This is to some extent unavoidable, but has disadvantages, mainly because asset prices change all the time, and for many reasons, unrelated to monetary policy.

The tendency to measure the impact of communication by the immediate reaction of financial market to ECB announcement has disadvantages. First of all, it remains always difficult to judge whether a policy has achieved its purpose if the immediate reaction was as expected, but markets later reversed.

Second, sometimes the reaction of financial markets might not be due to the (announcement of) policy measures, but because market participants infer new information about the state of the economy from the very fact that the central bank deems non-standard measures necessary.

In principle, the ECB should mainly focus on medium term inflation expectations as they measure the degree to which financial market participants believe that the ECB will reach its price stability target. In the run-up to the PSPP decision, the ECB has indeed done this, but this focus was lost during the implementation phase. The focus on longer-term inflation expectations has returned only more recently with the discussion on the end of the bond...
purchases. In the meantime, the ECB has tended to focus on the improving state of the economy.

- This is how the ECB has been very successful in communicating the idea that the PSPP has been instrumental in the overall improvement of the euro area economy over the last years; although medium term inflation expectations (measured by five year forward rates) are today at the same level (around 1.7%) as they were in 2014/5, at the start of the PSPP.

**Topic 2: Abundant liquidity and banks’ lending activity: an assessment of the risks**

**Kerstin BERNOTH, Alexander HAAS (DIW Berlin)**

While negative interest rates stimulate the real economy by enhancing credit supply and improving the wealth situation of firms and households, they might come with side effects with regard to banking and financial stability. In an assessment of the trade-off between the ability of a central bank to use negative policy rates to signal lower future deposits rates, against the potential costs on bank profitability, we find that the signalling effect dominates. Thus, a negative interest rate policy is an effective monetary policy tool, even when deposit rates are bound by zero.

- Confronted with below target inflation, sluggish growth, and increasing financial market uncertainty, on June 5, 2014, the ECB’s Governing Council decided to decrease its deposit facility rate into negative territory. Since then, it has pursued a negative interest rate policy.

- Due to a zero lower bound constraint on returns to retail deposits, this policy has created a wedge between reserve and deposit rates in the euro area. Despite this, banks hold record levels of excess liquidity. This can be attributed to demand as well as supply factors.

- The banking system plays an important role for the transmission of monetary policy to the real economy. Our analysis suggests that negative interest rates have a significant impact on this transmission by changing the relative importance of the classic transmission channels.

- While in aggregate, negative interest rates seem to stimulate the real economy by enhancing credit supply and improving the wealth situation of firms and households, they might come with side effects with regard to financial stability.

- Our analysis of the impact of negative interest rates on financial stability yields the following results for the euro area: (i) empirical evidence suggests only a limited amount of additional risk-taking by banks; (ii) private sector inefficiencies due to the large provision of liquidity cannot be ruled out, even though there is no consensus on their quantitative extent; (iii) so far, there is little empirical evidence for excessive cash hoarding; and (iv) there is only very limited empirical evidence for adverse effects of the ECB’s negative rate policy on bank profitability.

- To quantitatively weigh the costs and benefits of the ECB’s negative interest rate policy, we use a macroeconomic model by de Groot and Haas (2018). In this model, a novel signalling channel of negative interest rates complements the classic transmission channels, highlighting one additional benefit of negative rates: Even with classic monetary policy transmission constrained by the zero lower bound on deposit rates, a cut of the policy rate into negative territory can be expansionary as the central bank signals that it will hold deposit rates lower for longer, which lowers interest rate expectations and stimulates economic activity.

- In an assessment of the trade-off between the ability of a central bank to use negative policy rates to signal lower future deposits rates, against the potential costs on bank profitability, we
find that the signalling effect dominates. In this modelling framework, a negative interest rate policy is an effective monetary policy tool, even when deposit rates are bound by zero.

- A negative interest rate policy stimulates bank net worth. Significant capital gains and a more favourable economic environment, that induces banks to increase credit supply to the real economy, outweigh the costs of negative rates. A simple welfare analysis yields that under reasonable conditions, negative interest rates might constitute an optimal crisis response.

- We conclude that the ECB’s negative interest rate policy has most likely been an effective monetary policy tool and a complement to its rate forward guidance policy.

- An effective banking regulation and an alert banking supervision are crucial to ensure that the benefits of the ECB’s current negative interest rate policy continue to outweigh its costs.

Andrew HUGHES HALLETT (Copenhagen Business School), Addilyn CHAMS-EDDINE (School of Public Policy, George Mason University)

This paper assesses the risks facing the euro area banking system, as it returns to normal financial conditions without ECB support. In the first part we argue that risks to bank lending mainly stem from the transmission of external monetary policy effects that may not be aligned with ECB policies. The second part of the paper therefore offers some ideas on the need to moderate spillover effects from outside monetary policies or events. We also review how far new prudential policies, regulatory measures and/or policies can be used to mitigate those unfavourable risks.

- Much work has been done since the Great Financial Crisis (GFC) in 2008-12 to create new prudential and surveillance techniques to protect financial markets, financial institutions and the euro-area banking system from the consequences of excessive risk taking, financial instability and destabilising behaviour.

- The new prudential system includes a variety of different prudential or regulatory metrics which the ECB or other policymakers can use to ensure sufficient liquidity cover their lending and to underpin the stability and safety of the banks; to influence the growth of credit (up or down); to promote recovery without excessive lending; to steer interest rates and the cost of credit; to stabilise financial markets (including insurance, pensions); and to rule out asset price bubbles.

- Now, as we emerge from the GFC and a long period of excess debt (public and private), it is important to check on how well bank lending in the euro area is shaping up to these prudential safety measures. There is no doubt that liquidity in the financial system has increased a great deal. Has it increased enough? Almost certainly yes: as measured by the required liquidity cover ratio using the most recent data.

- But has it increased by too much? Apparently not: bank lending has either not materially increased, or has increased no faster than income growth. Yet deposits flow in at a sufficient rate and private indebtedness is falling rather than rising. This suggests that the euro-area banks are in sound enough shape as monetary policies gradually become less accommodating.

- But that analysis concerns only internal stability and internal risks in euro-area banking activity. The real risks may be external to the euro area, for example the impact of outside monetary policies or a global financial cycle that is not synchronised with that in the EU.

- This paper therefore offers an analysis of the need to moderate spillover effects from outside monetary policies/events (as opposed to internal risks). We focus on new prudential policies or regulatory ratios. We review how far the new regulatory ratios and/or policies can be used to mitigate those risks and how they might best be implemented.
These new metrics provide the ECB and other policymakers with a series of non-standard financial measures to be used for regulatory purposes and to moderate unfavourable shocks. Some of these measures had been present before the GFC. But they were seldom used or used systematically. Moreover they were poorly understood, which is what happens when prudential regulation is kept as a low priority.

Overall conclusions: prudential regulation supplies a number of nonstandard monetary measures that might be used as pro-active policy instruments. But they depend on a stable or well regulated banking system and the availability of high quality collateral.

Corrado MACCHIARELLI (Brunel University London & London School of Economics)

With the Asset Purchase Program, the European Central Bank has supplied significant amounts of liquidity into the financial system starting from 2015, resulting yet into a new upswing in excess liquidity. The expanded asset purchase programme (APP) program broadly coincided with further cuts in the ECB’s deposit facility rate, which currently stands at -0.4%. Against this background, this note assesses the ECB policy of negative rate on the deposit facility and discusses the associated risks in the context of an excess liquidity overhang for the euro area, including risk-appetite for banks.

- The rise in excess liquidity between 2008 and 2012 was the result of at least three factors: banks’ higher demand for central bank liquidity; the ensuing change in the auction procedure in the Eurosystem refinancing operations to fixed rate full allotment; and the stretch of long-term refinancing operations (LTROs) to longer-maturities.

- As parts of the first 3-year LTROs being repaid, excess liquidity has been on a declining trend for the period 2013-14.

- With the expanded asset purchase programme (APP), the Eurosystem has supplied significant amounts of liquidity starting from 2015, resulting yet into a new upswing in excess liquidity. In the case of the APP, however, excess liquidity is essentially supply-driven rather than demand-driven. This created a situation where asset purchases have become the dominant central bank operation and driving factor of excess liquidity over time.

- The growth in excess liquidity since 2015 should not be seen as a reflection of high demand in the Eurosystem refinancing operations by a banking sector under stress, as it was the case during the financial and the sovereign debt crisis. The available empirical evidence suggests that risk aversion has played a less important role in explaining the liquidity concentration observed since 2013/4 than it did at the time of the “flight-to-safety” crisis in 2010/11.

- When the ECB cut the deposit rate to zero, first, and then progressively into negative territory – currently standing at -0.4% – banks felt less and less the need to move money to the deposit facility, as money yielded zero interest or even it became costly to hold deposits. The implication of this policy was that banks started to pay a charge for their excess deposit holdings. Banks were generally unable to pass this cost to retail depositors, resulting into lower profit margins.

- With negative rates, individual banks had therefore to try to minimise this charge by reducing their excess liquidity holdings through active portfolio rebalancing and balance sheet adjustments, exchanging very safe assets such as central bank reserves for riskier assets such as loans or bonds.

- The empirical evidence suggest these measures amplified the effect of the bank-lending channel, which, in turn, exacerbated the home-bias in banks’ assets holding. According ECB
data, this was particularly the case for banks with a high share of retail deposit funding and/or located in lower-rated countries.

- When looking at the distribution of excess liquidity currently, data suggest the latter is the result of at least three factors: the interaction of remaining risk aversion, the investment opportunities created by yield differences across the euro area (versus the negative rate on the deposit facility) and the incentives created by new regulations. All together, these leave liquidity in much the same countries as before, with banks in lower-rated countries finding more attractive to invest liquidity in home bonds or assets with higher yields (foreign assets and repos against domestic collateral) rather than deposit them with the Eurosystem. At the same time, banks in higher-rated countries or institutions anyway facing stricter internal risk limits often found excess liquidity holdings more attractive, in the light of the low yields on own domestic bonds and repos.

- Banks’ profit margins differ widely between ‘core’ and peripheral euro area countries and there is still evidence of interbank market fragmentation. Recent evidence suggests high non-performing loan (NPL) ratios in the ‘periphery’ may still hinder banks’ access to the interbank market.

- According to the ECB Bank Lending Survey, banks’ risk aversion has declined since 2014, as the ECB ultra-accommodative monetary policy has compressed risk premia. Still, banks report that their decisions remain subject to internal risk limits and new regulations.

- Regarding the impact of ongoing regulatory or supervisory changes, the banks surveyed by the ECB reported a further strengthening of their capital positions and a reduction in risk-weighted assets predominantly related to riskier loans. This means that the easing of financial conditions and enhanced regulation seem to be going hand in hand.

- The EBA (2017) Risk Assessment Questionnaire suggests banks’ lending especially to small and medium sized enterprises is growing. Similarly, the low general level of interest rates is supporting net demand for consumer credit, household lending, in turn boosting, consumer confidence and spending on durable goods.

- In the euro area as a whole, there is little evidence of increased banks’ risk appetite (risk-taking), even though credit standards have clearly loosened.

- Going forward, excess liquidity is expected to moderate in tandem with the normalisation of ECB monetary policy.

Zsolt DARVAS, David PICHLER (Bruegel)

*Low interest rates and excess liquidity in the euro area, which exceeded €1,900 billion in September 2018, might create financial stability risks. We clarify the notion of excess liquidity and highlight that its current level is primarily the result of European Central Bank asset purchases. Overall, we conclude that financial stability risks in the euro area are low, but increased home bias and housing prices necessitate full attention from macroprudential authorities. Monetary policy tools are anyway ill-suited to fostering financial stability objectives.*

- Excess liquidity was practically zero before September 2008, and has fluctuated since then, with a peak of close to €1,000 billion in 2012 followed by a major reduction, and an even more significant increase starting in March 2015. The reason behind the 2008-2012 increase was banks’ demand for liquidity because of the break-down of normal interbank market operations and heightened risks. This demand was satisfied by the ECB and even incentivised by the ECB’s
generous lending facilities. Since March 2015 the ECB’s expanded asset market programme (APP) automatically creates excess liquidity, unless it is converted to cash or compulsory reserves because of an increase in banking activities;

- We do not find increased conversion of excess liquidity to cash, probably because the cost of holding cash is higher than the negative interest rate to be paid after excess liquidity;

- Excess liquidity is highly concentrated in a few countries, and in a few banks within countries, highlighting that it is not a widespread issue throughout the euro area;

- Excess liquidity in the euro area is in fact much lower than related indicators in Japan, Switzerland and the United States, and also somewhat lower than in the United Kingdom;

- While the direct marginal impact on bank profits of the ECB’s negative deposit rate levied on excess liquidity is negative, the overall impact of the negative rate and other monetary policy measures, such as asset purchases, could be positive. Monetary policy measures can increase asset prices and improve the economic situation, which enhances the credit quality of bank assets, thereby improving bank profitability. Empirical research has found that the overall impact of monetary policy on bank profitability has been positive;

- Most euro-area banks are still in the deleveraging phase of the financial cycle, implying that their risk appetites might be limited;

- Risk-weighted assets relative to total assets are declining (implying lower riskiness) or remain broadly stable in most euro-area countries, suggesting that bank balance sheets have not become riskier. Compositional changes, upgrades to bank client credit ratings, fewer non-performing loans (NPLs), the deleveraging process, cautious internal risk limitation measures and stricter financial regulation might contribute to the decline in risk-weighted assets;

- Home bias in loans granted and securities purchased by banks has increased in most countries, highlighting that banks have become more exposed to developments in their home countries, which is a risk factor;

- Bank lending growth remains subdued with the exceptions of Belgium and Slovakia, suggesting that in the majority of euro-area countries, the expansion of housing loans remains well below values observed during earlier housing booms;

- House prices have started to pick up in a number of euro-area countries, but to a lesser extent than house price increases during earlier housing booms, with the exception of Ireland. However, the acceleration in house prices requires attention from macroprudential authorities;

- Our overview of macroprudential reports issued by relevant authorities suggests that the overall risk to financial stability remains low, but in certain countries the accelerated increase in house prices is already in the spotlight;

- We argue that monetary policy tools are ill-suited to fostering financial stability;

- Finally, we note that while the winding down of excess liquidity is a remote prospect at the moment, when this happens, banks that rely heavily on excess liquidity to meet the Liquidity Coverage Ratio (LCR) requirement might face problems, which could have financial stability implications.