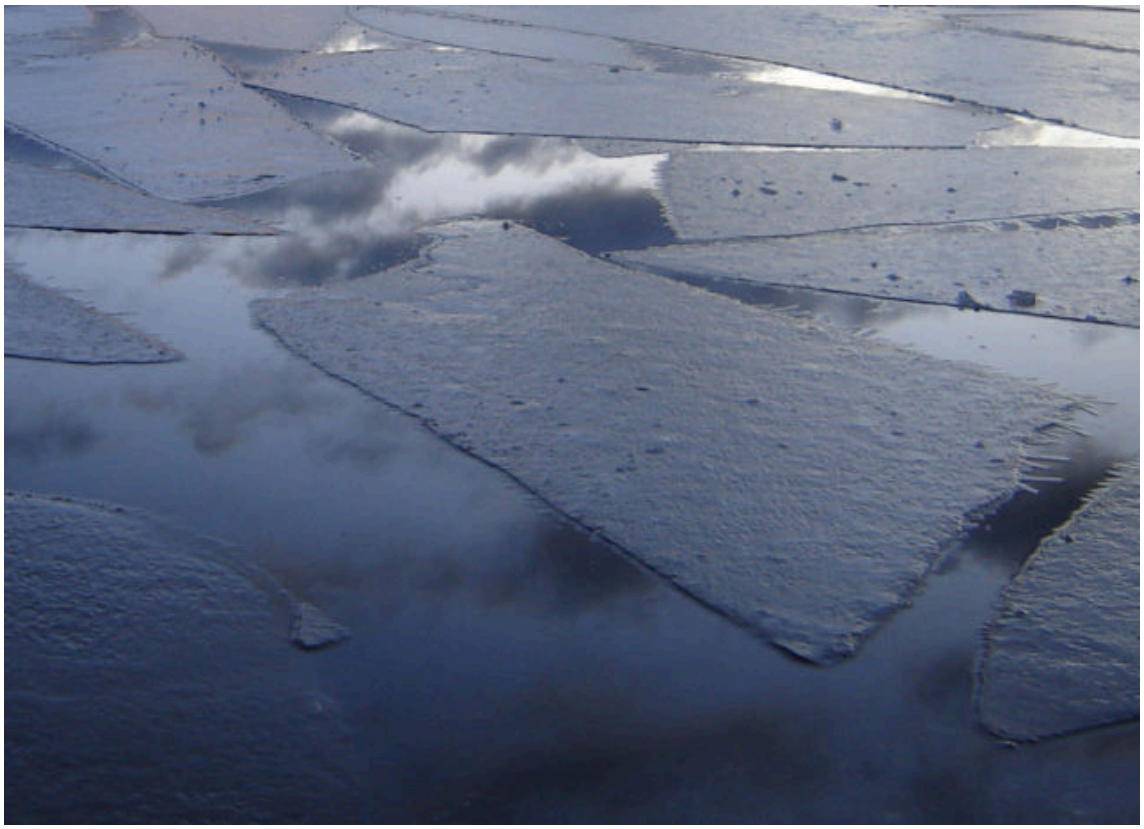
Monetary Policy Review

Monetary policy supports euro area recovery from the crisis

Monetary policy | 18 May 2015

The decision by the ECB Governing Council to ease monetary policy through an expanded asset purchase programme will boost demand and accelerate inflation via a number of different channels. Completion of the comprehensive assessment of banks allied to the steps taken by the ECB will improve monetary policy transmission to the real economy via bank lending. More relaxed financing conditions for non-financial corporations and the reasonable level of indebtedness in the euro area's corporate sector provide fertile ground for recovery in investment. Households' large debt-servicing costs and low net assets will sustain the pressures in many euro area countries for a reduction in debt levels and weaken household demand. Although the exceptionally accommodative monetary policy is justified in order to safeguard price stability, negative side-effects cannot be entirely ruled out. The channelling of the accommodative monetary policy into fixed investment rather than the housing market can be supported through macroprudential policy.

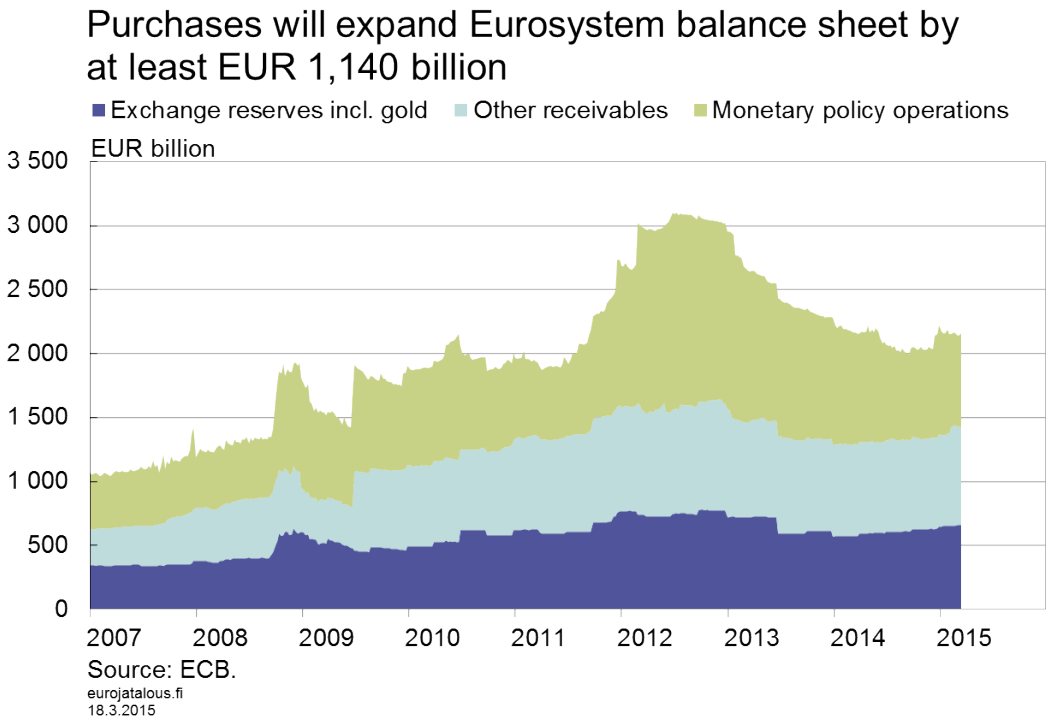


The new purchases will be continued until the price stability objective has been achieved

In January, the Governing Council of the ECB decided on an expanded asset purchase programme (EAPP). Purchases will be continued until inflation is sustainably on a path leading to a level close to 2%. Through the EAPP, the Eurosystem will extend its purchases to also cover bonds issued by euro area governments, government agencies and European institutions. The purchases of private securities (banks' covered bonds and asset-backed securities) that commenced in October/ November are still ongoing. Securities will be purchased to a total value of EUR 60 billion per month as from March 2015 until at least September 2016. Thus, the total value of purchases will be a minimum of EUR 1,140 billion, with the majority being euro area government bonds.

Forward guidance indicating the Governing Council's commitment to securities purchases in order to drive inflation into alignment with the price stability objective is a key component of January's monetary policy decisions. During the current phase of slow inflation there is a danger that inflation expectations will begin to diverge from their medium-term anchor. With monetary policy interest rates already at the zero lower bound, fading inflation expectations would push up real interest rates, effectively tightening monetary policy. In January 2015, the Governing Council judged that there was a need for an additional easing of the monetary policy stance, as the inflation outlook had weakened further. Extensive securities purchases allow a substantial relaxation of monetary policy in a situation where there is no longer any room for standard reductions in interest rates.

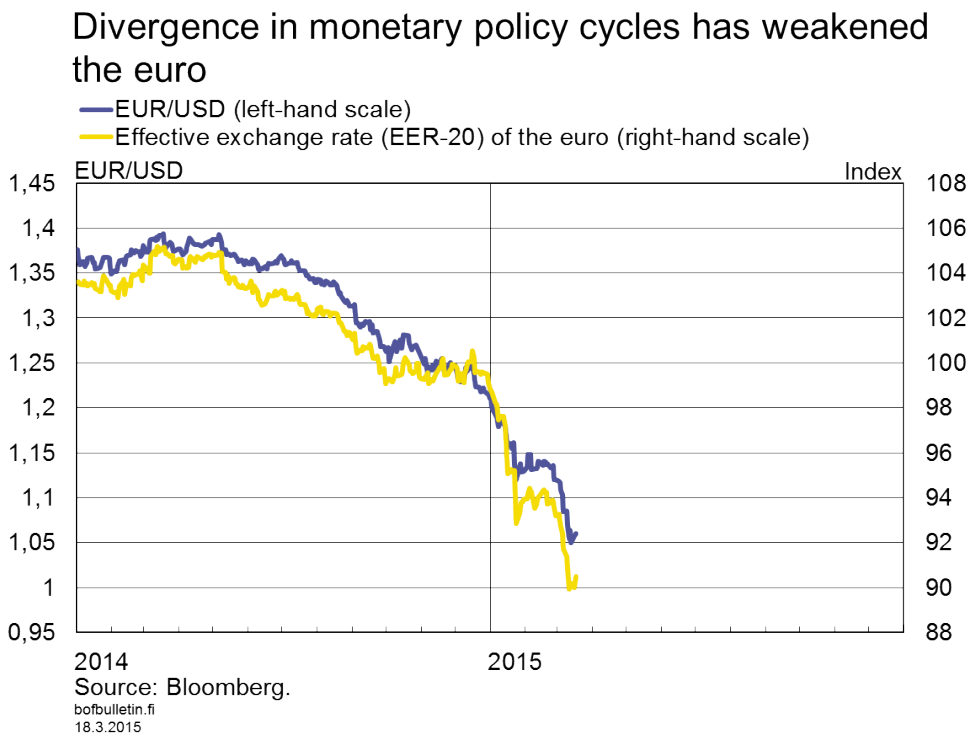
Chart 1.



The additional easing of euro area monetary policy through the purchase of government bonds differs from the actions taken by other major central banks in that, in the euro area, the bonds to be purchased are from more than one country. Euro area government bonds are to be purchased on the secondary market in amounts relative to the size of the country (the capital key). Purchases will focus on euro-denominated investment-grade government bonds with a maturity of 2–30 years. Bonds of governments implementing EU/IMF debt adjustment programmes that are not investment grade are subject to slightly tighter eligibility criteria, and purchases will be suspended while the programme is assessed. Moreover, purchases will be limited so that the Eurosystem will have in its possession at most 33% of each issuer's bonds and at most 25% of each issue.

The Governing Council also decided that any possible credit losses from purchases of the bonds of international and supranational institutions (with their 12% share of all new-type purchases) will be shared. Moreover, the ECB's share of purchases is 8%, whereby 20% new-type purchases will involve risk-sharing arrangements.

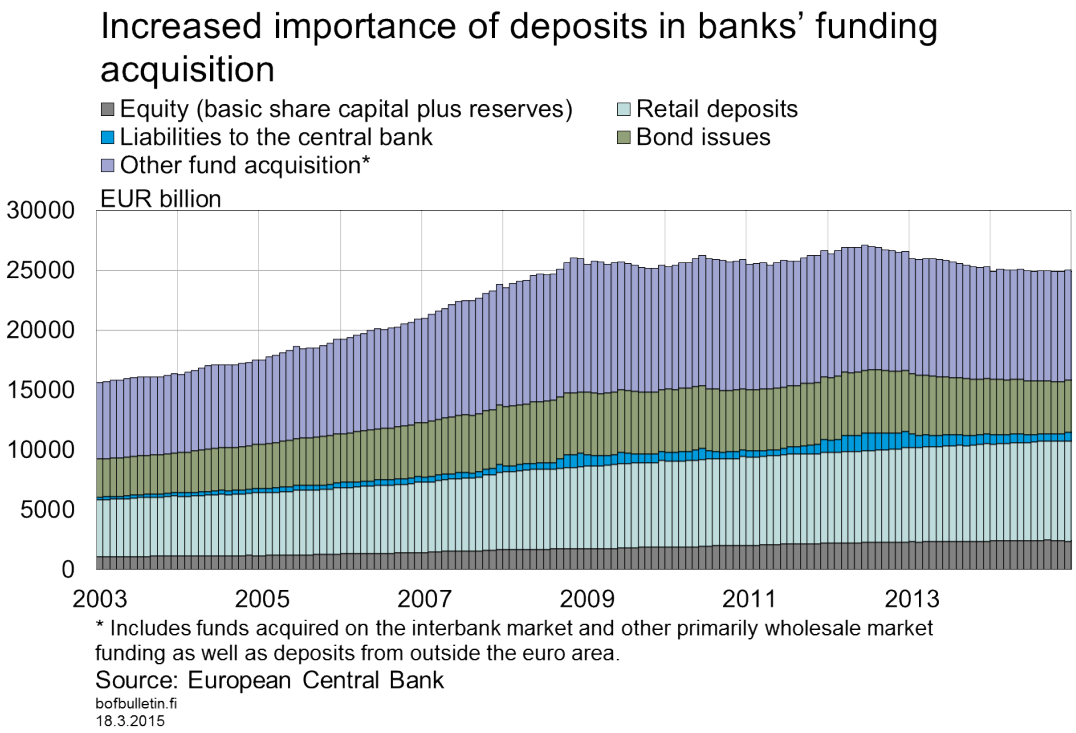
Chart 2.



Expanded purchase programme will stimulate both demand and inflation via a number of channels

The EAPP will lead to lower interest rates, more relaxed financial conditions for non-financial corporations and households (lower interest on loans and improved access to finance) and higher securities prices. Monetary policy easing with the help of a purchase programme linked to the inflation outlook will raise inflation expectations, thereby lowering the real interest rate. The drop in the real interest rate and general relaxation in financial conditions will impact the economy in such a way as to boost demand and drive faster inflation. The overall effects of quantitative easing on the economy will operate largely via the same channels as a normal cut in interest rates.

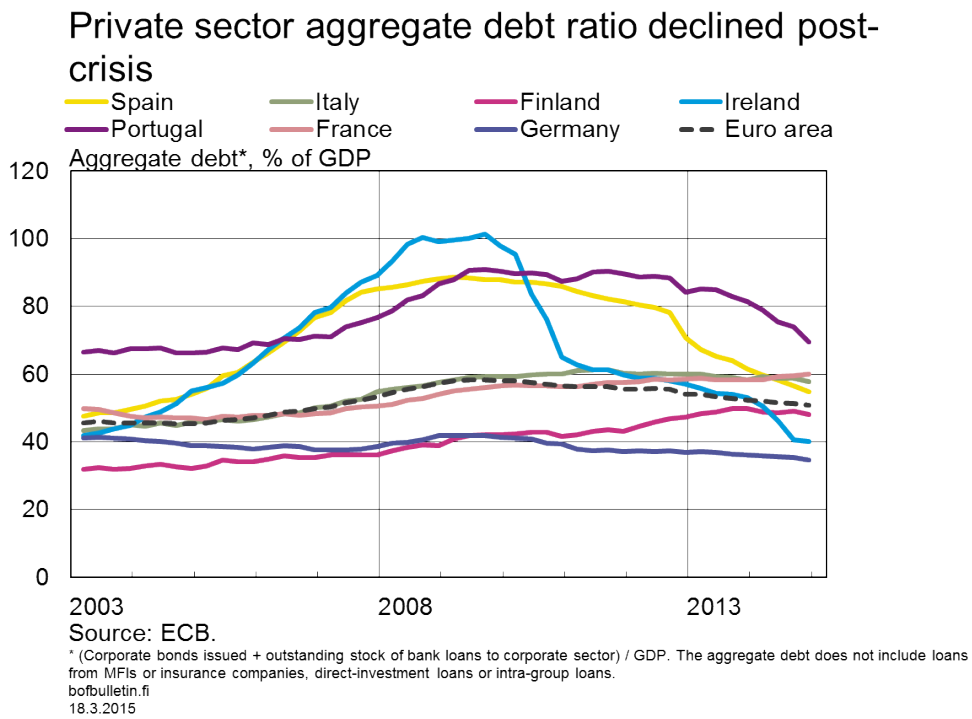
Chart 3.



The central banks of the United States, United Kingdom and Japan have experience of extensive programmes of securities purchases, and we already have information available on the effects of the programmes in these countries. Research estimates vary regarding the scale of impact these programmes have had, but it is clear that monetary policy forward guidance relating to the purchase programme will play a considerable role in the overall impact. The inflation impact of the monetary policy measures will, however, be apparent only later, and the drop in the price of oil that has already occurred could keep euro area inflation negative for several months ahead.

In the United States, the impacts of the first two purchase programmes (in 2008 and 2010) were possibly amplified by the fact that government bond yields at the outset were higher than they are in the euro area at the present moment. In the euro area, government bond yields declined substantially in 2014 as confidence in the management of public finances in the area remained strong and expectations over ECB purchases of government bonds strengthened towards the end of the year. In early 2015, 10-year government bond yields have stabilised at a very low level, and in many countries yields on the shortest government bonds have even entered negative territory.

Chart 4.



In the United States and the United Kingdom, the economic situation and the outlook have both improved, and the markets expect the US Federal Reserve, in particular, to begin raising interest rates already during the course of 2015. In such a situation, the Eurosystem decision for additional easing of monetary policy will weaken the external value of the euro.

The Eurosystem decision to expand its securities purchases has been reflected in the euro area's near neighbours. A few days before the Governing Council decision, the Swiss National Bank had already decided to suspend the lower threshold it had set for the value of the Swiss franc relative to the euro. It has also lowered the interest on its deposit facility to -0.75%. Meanwhile, in order to dampen pressures for a revaluation of the krone, the Danish central bank has also been forced to lower the interest on its deposit facility to -0.75%. The Swedish Riksbank has in two steps lowered its key policy rate into negative territory, at -0.25%, while also indicating its intention to purchase Swedish government bonds to a total value of SEK 30 billion.

Macroprudential tools can be deployed to counteract negative side-effects of monetary policy measures

Although an exceptionally accommodative monetary policy is justified in the current economic situation in the euro area, it could also have unwelcome side-effects. These could include

increased risks to financial stability or effects on income distribution.

Prolonged low policy interest rates and the additional relaxation from the securities purchases could in some euro area countries or in some sectors of the economy accelerate the pace of debt accumulation and also increase other risks to financial stability.

The Eurosystem's primary objective is to maintain price stability, and monetary policy decisions are based on assessments of the risks to price stability in the euro area. Higher risks to financial stability should be met primarily through macroprudential policy in order to prevent significant growth in risk.

From the perspective of macroprudential policy, the euro area is now in a substantially better position than a few years ago. With the launch of single banking supervision in November 2014, the European Central Bank received new macroprudential powers, and the requirement for a counter-cyclical capital buffer will have to be introduced in all euro area countries by the beginning of 2016 at the latest. The ECB has the right to tighten the counter-cyclical capital buffers of individual countries and other macroprudential tools provided in the Capital Requirements Directive and Regulation in excess of the levels set by national authorities.[1]

A significant part of the euro area's macroprudential policy is, however, still the responsibility of national authorities. In the operating environment of the single monetary policy, euro area countries can use a robust national macroprudential policy to underpin the stability of both their own economy and the entire euro area economy, and to enhance the capacity of the financial system to withstand a crisis. It is important that member countries make comprehensive use of macroprudential tools in accordance with their own national interests to target macroprudential measures optimally. There is a need for both effective tools to moderate lending growth and an understanding of the risks involved in excessive lending growth, if macroprudential policy is not to be overly passive.

The prolonged period of low interest rates combined with non-standard monetary policy measures has raised the question of the possible effects of the extremely accommodative monetary policy on the distribution of income and wealth. Monetary policy can affect the distribution of income and wealth in several ways, of which some can increase and some reduce the differences. Research outcomes suggest that extensive securities purchases may increase income and wealth differences. As high-income households typically own more securities and a greater proportion of their income is capital income, a rise in securities prices benefits them more than low-income households. On the other hand, low-income and indebted households benefit from low interest rates. Moreover, the demand-stimulating effect of accommodative monetary policy can boost employment more in low-pay than in high-pay sectors of the economy.

Monetary policy transmission via bank lending is improving

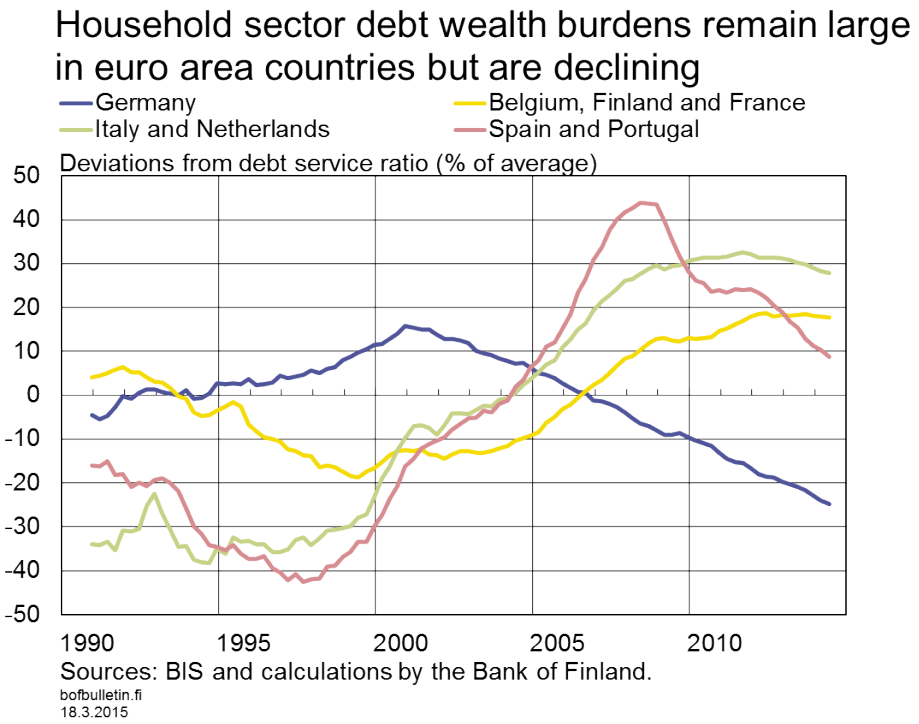
In 2014, the ECB conducted a comprehensive assessment of the balance sheets of banks in the euro area. Immediately prior to this assessment, and particularly at the end of 2013, euro area banks reduced the level of risk on their balance sheets both by reducing their size and by improving their capital adequacy. According to the comprehensive assessment, which was completed in October 2014, most of the significant banks in the euro area are strong enough to withstand serious shocks from the international financial markets or the real economy.

It is of key importance to the stability of the financial system that banks be adequately equipped to deal with risks. However, monetary policy transmission via the banks additionally requires that banks have sufficient capital to increase their lending, and hence risk-taking. Statistics for 2014 would seem to indicate that balance sheet consolidation at aggregate level has come to an end. The aggregate risk-weighted assets of euro area banks has begun to rise, which is positive from the angle of monetary policy transmission. This has not, however, weakened banks' capital adequacy, which has remained more or less unchanged.

Although the condition of the banks has improved, their operating environment remains challenging. The biggest problem for the euro area banking sector remains weak profitability. Profitability is undermined by the weak performance of the economy as a whole and the consequent large amount of impairment losses, the poor quality and development of credit and a flat interest curve, which is a problem for the pricing of credit.[2] Moreover, the profitability of individual large banks is burdened by an increase in legal costs and sanctions imposed by the authorities.

The weakness of the economy means banks are also suffering large credit risks, particularly in the countries of southern Europe. Growing geopolitical risks and their negative effects on the real economy have also increased the vulnerability of those banks with significant operations in many countries of eastern and central Europe and other emerging economies, such as those in Latin America. In addition, the rapid appreciation of the Swiss franc in January 2015, when the Swiss National Bank unpegged the franc from the euro, could increase loan losses in countries where loans are to a significant degree tied to the Swiss franc.

Chart 5.



Banks could still avoid increasing high-risk corporate lending

The ECB's monetary policy measures will enhance financial intermediation in a number of ways. The targeted longer-term refinancing operations (TLTROs) and the purchase programmes for banks' covered bonds will lower funding costs for banks and hence the costs of lending, while boosting the volume of lending. Moreover, the EAPP, which was launched in March 2015 and involves the purchase of public sector bonds, is aimed at channelling the additional liquidity provided through ECB bond purchases from the banks into the real economy via a growth in lending.

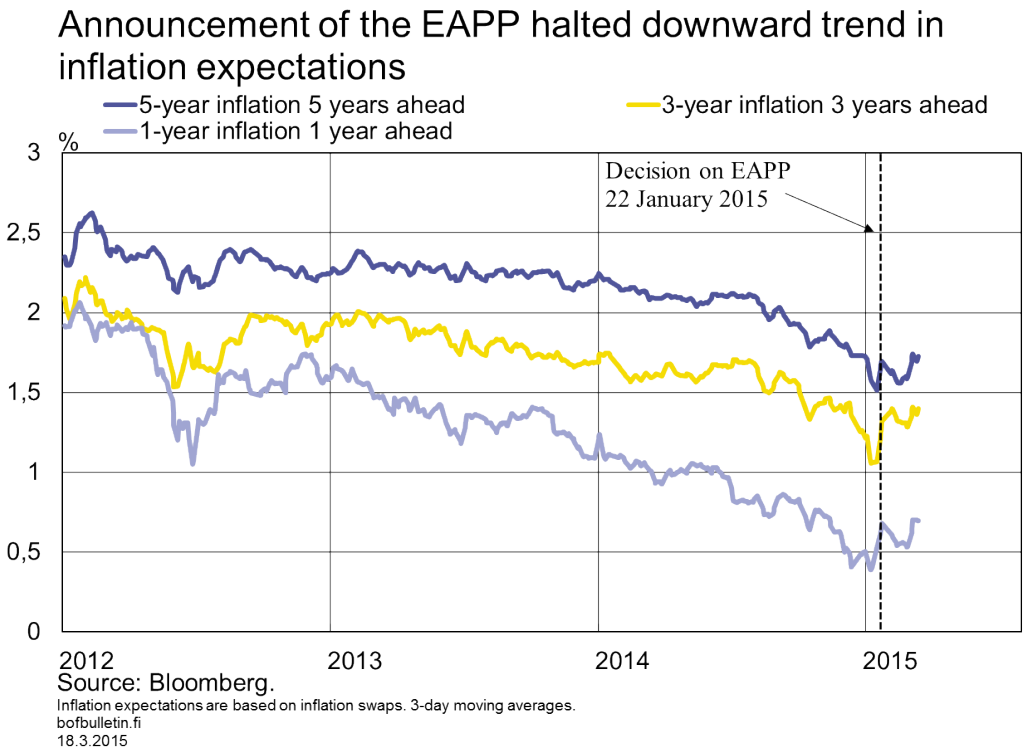
Monetary policy transmission via the banks is, however, still beset with challenges. Although the need to reduce the risks on bank balance sheets has for the most part been met, it is by no means clear that the banks are significantly more ready to take on more risk in the near future. As well as monetary policy measures, banks' ability and readiness to take on risk are also influenced by regulatory reforms and the prevailing situation in the economy.

Banks require low-risk bonds as collateral in central bank operations and other activities. Regulatory reforms will compel banks in future to also maintain larger liquidity buffers. Increased higher-risk lending will similarly require additional capital, the acquisition of which in a time of weak profitability could prove problematical. Moreover, the direct effects on the banking sector of

the Eurosystem's government bond purchases will differ between countries, as the amount of government bonds on banks' balance sheets varies.

The impact of lower funding costs as a channel for monetary policy transmission could be limited. It will be eroded by factors such as a general reduction in the need for funds due to shrinking balance sheets and the pressure from regulatory reforms to increase the share of deposits in funding acquisition. Increased investor responsibility will also serve to increase banks' funding costs. On the other hand, although the average funding costs of euro area banks have already fallen to a low level, in some countries there is still room for a further reduction.

Chart 6.



Banks will also benefit from the ECB's measures indirectly, via the positive impacts on the real economy. An improving real economy will be reflected in the banks in expanding balance sheets and improved profitability, as, for example, the share of non-performing loans in the loan stock declines. At the same time, banks' credit risks will decline, making it easier for them to increase their lending.

Over the longer term, it is conceivable that the structure of the euro area banking sector will change. If banking profitability remains weak for a prolonged period, this will force banks to increase efficiency and develop new business models. It could also increase the importance of market funding for non-financial corporations in the euro area financial system.

Accommodative monetary policy will support investment in the euro area

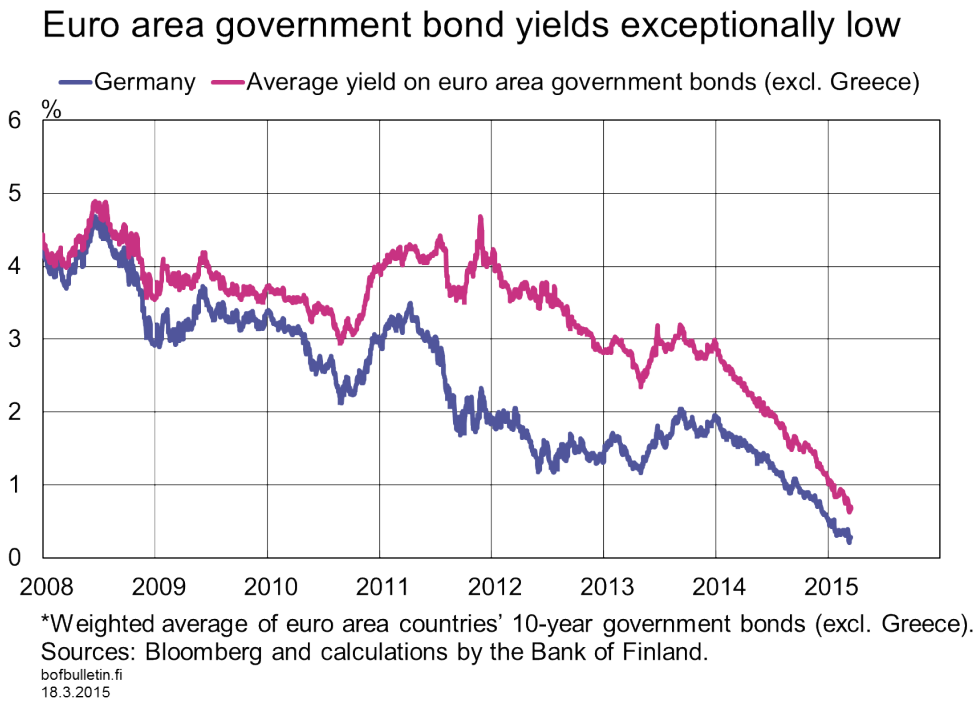
The financing conditions for non-financial corporations in the euro area became considerably easier during the course of 2014. The ECB's measures to support lending and the EAPP launched in March 2015 are expected to further reduce both the interest non-financial corporations pay on their bank loans and the costs of their future acquisition of funding on the capital markets.

The availability and costs of corporate funding are monitored through both the ECB's Survey on the Access to Finance of Enterprises (SAFE) and the Eurosystem's Bank Lending Survey (BLS). According to the SAFE survey, non-financial corporations in the euro area estimate that access to funding was already less of a problem in the half-year period ending in September 2014, while according to the BLS, corporate demand for credit picked up in the final quarter of 2014 and credit terms were eased, particularly via a decline in margins. Businesses estimate their own capital positions have improved. Banks, too, see the economic position of borrowers in the final quarter of 2014 as having contributed positively to the easing of credit terms.

The credit terms for both SMEs and large corporations have eased, and the differences between countries have become less evident. Besides the narrowing of margins, credit terms have also been eased by lengthening the average duration of loans and increasing their size. Moreover, collateral requirements have been eased and companies have been given more opportunities to run overdrafts. The change has been less with regard to more risky loans, suggesting banks are still very cautious in taking on additional risk. There are, however, positive signs in the development of the corporate loan stock, as the prolonged contraction appears to be slowly coming to an end.

The share of market funding in the loan stock for large non-financial corporations has grown at the same time as costs have fallen to a record low. MFIs' share of large corporations' external funding has declined, while the share of market funding in aggregate debt has grown in the euro area by an average 5 percentage points since 2008 and in the third quarter of 2014 stood at around 12%. The growth in the share of market funding is also partly explainable by the fall in the cost. The yield requirements on corporate bonds reached a record low in the euro area in early 2015. The EAPP supports the corporate bond markets in that investors selling government bonds are expected to switch to higher-risk investments such as corporate bonds.

Chart 7.



Although corporate emissions have partially compensated for the decline in bank lending in the case of large corporations, SMEs do not have the same alternative sources of funding and are therefore still highly dependent on bank lending. Moreover, market funding's share of corporate funding differs greatly between countries. For example, in Spain and Ireland issues of corporate bonds have remained very low even during the crisis relative to bank lending, whereas in France and Portugal the relative share of market funding has traditionally been larger and has also grown during the crisis.

Euro area corporate sector debt not a significant brake on investment

The improved availability and lower costs of funding are not yet reflected in investment growth. Fixed investment in the euro area is still around 10% lower than in 2008, and the GDP share has contracted by around 4 percentage points. There are, however, clear signs of a revival in corporate credit demand. According to the Bank Lending Survey, there was a clear quickening of euro area demand for corporate loans at the end of 2014, and the trend is expected to remain positive in the early months of 2015.

Research suggests that improved terms of credit and growth in credit demand anticipate growth

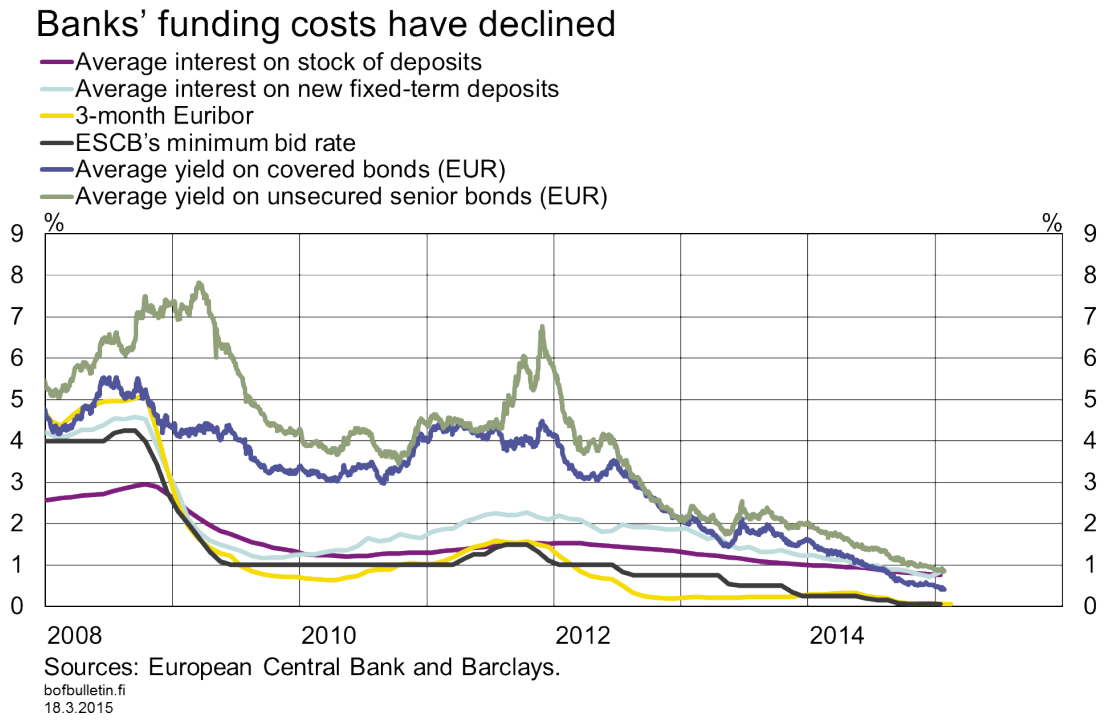
in the real economy 3–4 quarters ahead. Thus the recent easing of financial conditions means we should expect a start to investment growth sometime in 2015.

Another factor underlying the weak trend in investment could be uncertainty over the future course of the economy and a consequent reduction in the appetite for risk among non-financial corporations. Euro area confidence indicators do, however, suggest heightened expectations for the economy, and the most recent statistical data on the real economy have been better than the market expectations.

The accommodative monetary policy could boost corporations' willingness to invest indirectly, too, as the EAPP will probably also push up share prices. As these rise, so will the market value of the corporations, while their funding costs will decline further. This will make it more worthwhile for corporations to issue new capital, which will be reflected ultimately in a growth in their investment opportunities. Share prices have in fact moved in parallel with investment developments in both the United States and the euro area.

On the other hand, the low price or improved availability of credit will be insufficient to restore more vigour to the economy if overindebted corporations opt to reduce their debt instead of investing. The debt ratio of non-financial corporations in the euro area (aggregate debt relative to GDP) has come down from the heights of 2009, albeit there are very large differences between countries.

Chart 8.



For example, in Germany the aggregate debt ratio of the corporate sector has over the past 15 years been well below the euro area average, whereas in Ireland and Spain the debt ratio grew rapidly until the outbreak of the crisis. Over the past couple of years, however, non-financial corporations in the latter countries have significantly reduced their debt ratio, and the euro area corporate sector in general cannot be considered to be particularly indebted. Even so, higher-than-average debt ratios in some countries may still be a partial cause of the weak developments in corporate borrowing and investment.

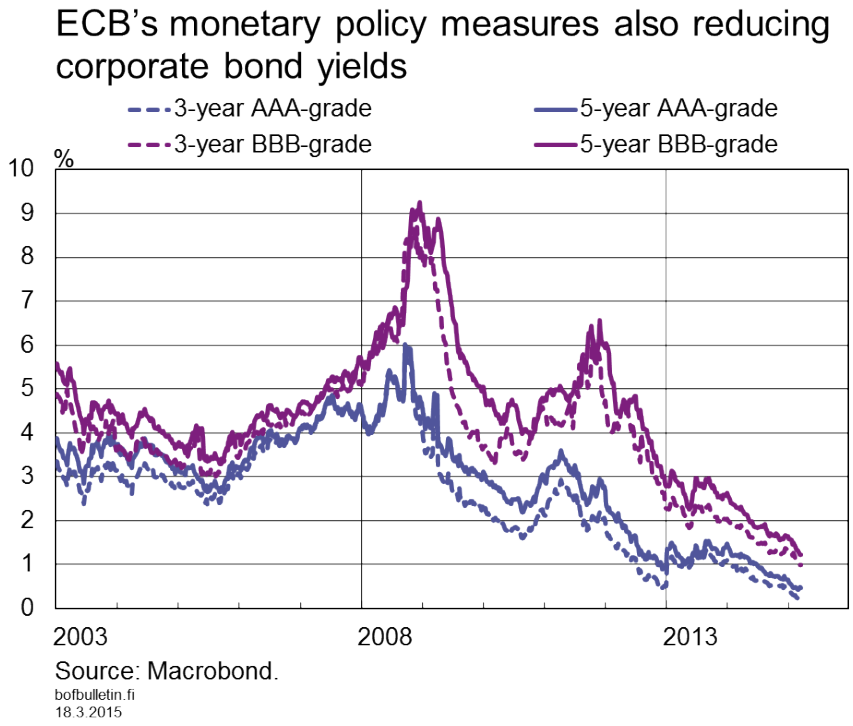
Process of reducing household debt burden hampering consumption in euro area

From the perspective of achieving price stability it is vital that monetary policy measures have a positive effect not just on investment, but also on consumption. By the third quarter of 2014, private consumption in the euro area had risen more or less to the level prevailing prior to the financial crisis. It is also important that the measures taken do not cause any new financial imbalances, such as a housing bubble. The risk of this is nevertheless fairly slight at the moment, as housing prices have fallen in most euro area countries since the financial crisis.

The new monetary policy measures are also expected to further reduce interest rates on

household loans. The Euribor rates typically used as reference rates for housing loans declined throughout 2014 under the influence of falling monetary policy rates. The impact on the average interest on new housing loans has been more moderate. There are, however, differences between countries in how much housing loan interest rates can come down.

Chart 9.



Euro area households are still fairly heavily indebted. Household debt ratios (debt relative to income) are more or less at the same levels as before the global financial crisis. This could hamper monetary policy transmission to the real economy, as demand for new credit will remain subdued if households continue to consolidate their balance sheets. The fall in real house prices of approximately 15% between the early phase of the financial crisis and the present lends further support to this view.

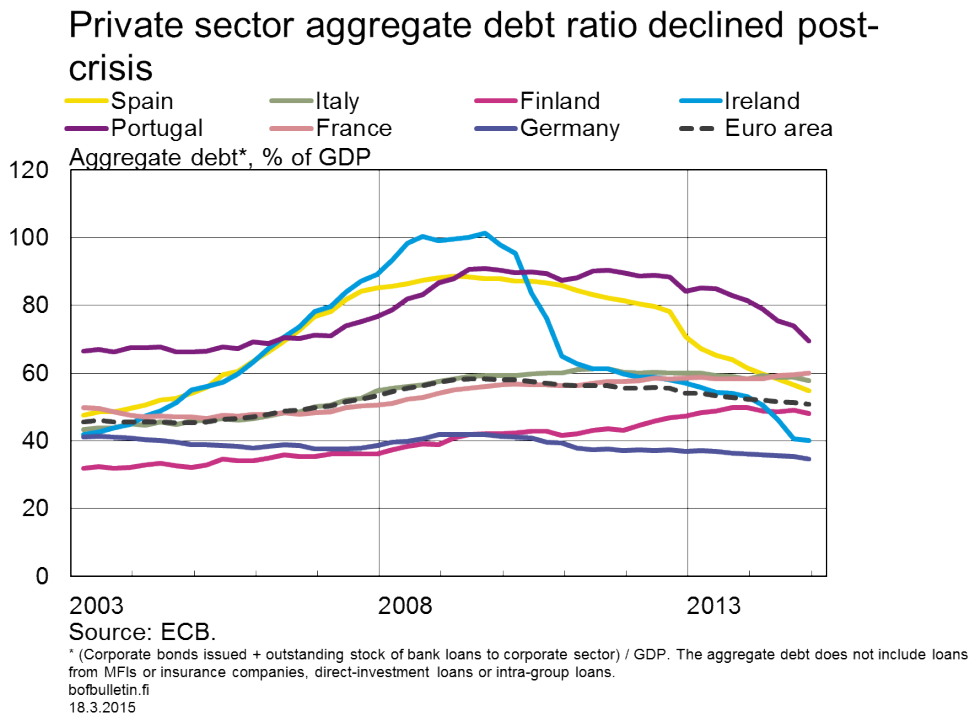
An over-simplistic focus on the debt ratio could, however, be misleading, as in many countries the household sector debt ratio relative to e.g. GDP has been growing for over 30 years. This makes it hard to assess what level of debt ratio is a sign of over-indebtedness, and what is not.

We can get a more precise picture of the current level of household indebtedness by looking at the debt service ratio, i.e. the costs of debt-servicing (interest payments and repayment of principal) divided by net income. This indicator does not grow over time, and deviations from the long-term average are inversely related to growth in private consumption.[3] However, deviations in the debt

service ratio do not tell the whole story, as it is possible to bear large debt-servicing costs – at least for some time – by taking out additional loans. This is possible for as long as households' net wealth remains substantial. Correspondingly, when net wealth is low, households lack collateral for new loans and are forced to reduce their stock of debt. Thus deviations of net wealth from the long-term average generate a picture of households' tendency to increase or reduce their debt burden.

Household debt service ratios are well above their long-term average in all large euro area countries with the exception of Germany. Net wealth is, in contrast, below average. Taken together, these factors will probably weaken household demand going forward and generate pressure for reducing the amount of debt.

Chart 10.



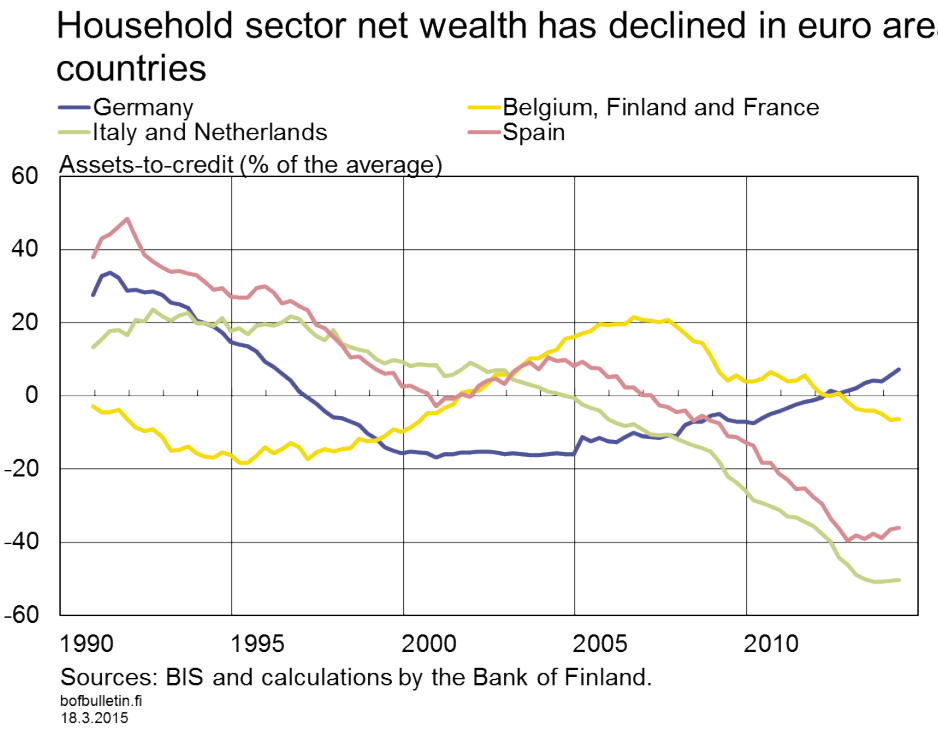
The accommodative monetary policy stance can help with unravelling household debt. Insofar as the measures reduce debt-servicing costs, they can in a best-case scenario assist balance sheet adjustment. The average interest on the euro area loan stock has already come down to around 3%, but it can be expected to fall somewhat further still. On the other hand, in a worst-case scenario, the new measures could artificially bolster asset prices, thereby slowing the natural adjustment of balance sheets.

Household demand for new loans is likely to remain subdued over the short to medium term. On

one hand, this will hamper monetary policy transmission into private consumption, but at the same time prevent the relaxed monetary policy from strongly affecting the housing market. This means that the accelerating effect of the measures on consumer price inflation could be less than expected, while on the other hand there is unlikely to be a strong rise in house prices.

There are, however, large differences between euro area countries in the transmission of monetary policy via households to the real economy. One contributory factor is the level of household indebtedness, which varies greatly from one country to another. In this respect, euro area countries can be roughly divided into four groups.

Chart 11.



The first group contains countries that experienced a violent domestic financial boom and systemic crisis in connection with the global financial crisis. The affected countries include Spain and Portugal.[4] Rapid debt accumulation in these countries pushed the debt service ratio to a record high just before the crisis. In the post-crisis environment, these countries have, however, managed to reduce their debt burden. The single most important factor in this respect has been a collapse in house prices, which also led to a collapse in net wealth and hence a rapid contraction in the supply of credit. The decline in interest rates also eased debt-servicing pressures, thereby improving households' ability to repay their loans.

The second group consists of Italy and the Netherlands. In these countries, households' debt-

servicing pressures prior to the crisis grew in almost the same manner as in Spain and Portugal, if not quite as strongly. The upward trend in debt-servicing pressures has been prolonged in these countries, and there has been a decline in net wealth. This unfavourable trend has only recently begun to turn around. A reduction in the amount of debt will presumably take a long time still, and recovery will be slow.

The third group contains countries that experienced a short period of recovery after the financial crisis, but where there are currently clear signs that increasing debt-servicing pressures are undermining economic growth (Belgium, France and Finland). House prices in these countries did not collapse in the same way as in the other groups, so net wealth remained high and households continued to accumulate debt. This trend was further fuelled by the reduction in loan interest rates in response to the accommodative monetary policy. Net wealth in these countries has recently turned negative, which suggests that a long phase of debt reduction lies ahead, during which economic growth will be slow.

The only significant exception in household debt trends in the euro area is Germany, which on its own forms the fourth group. In Germany, real house prices were falling for a prolonged period before the financial crisis, keeping net wealth low. As a consequence, German households reduced their debt burden, meaning the debt service ratio is currently below average. The deviations in net wealth have also turned positive recently as a consequence of a recovery in house prices. Against this background, we can expect an improvement in the growth figures for private consumption in Germany in the near future.

Notes

1. Other macroprudential tools that can be imposed by the ECB include the setting of additional capital requirements on MFIs that are systemically important to a national financial system (O-SII requirements) and minimum risk weightings for housing and real estate-mortgaged credits in banks' capital adequacy calculations. ↑
2. A bank's net interest income consists of the difference between the interest it receives from (long-term) loans and the interest it pays on (short-term) deposits. ↑
3. Drehmann, Mathias – Juselius, Mikael (2012) Do debt service costs affect macroeconomic and financial stability? BIS Quarterly Review. September 2012. ↑
4. Ireland also belongs to this group, but the statistical data needed to calculate the debt service ratio and deviations in net wealth is not available. ↑

Keywords

euro area, macroprudential stability, monetary policy