Challenges for monetary policy in the euro area

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Outline

A brief preamble:

• From the global financial crisis to the sovereign debt crisis
• Challenges faced by the Governing Council of the ECB and measures undertaken: 2011-2013

Main focus:

I. Current challenges for monetary policy in the euro area

II. The need for further reforms of European governance and for a better policy mix
The global financial crisis marked a new era of central banking

Before the crisis:

- Great Moderation
- Steering short-term rates considered sufficient for price stability

In the aftermath of the crisis:

- More complex financial world: more instruments needed
- ZLB and frictions in asset markets: scope for balance sheet measures and enhanced management of expectations
- Financial stability as a pre-requisite for price stability
The sovereign debt crisis and the ECB

✓ In the euro area the **financial crisis morphed into the sovereign debt crisis**

✓ Confidence in the euro related to
  - concerns over some countries’ **long-term growth prospects** and **public finance sustainability**
  - incompleteness of the European architecture

✓ **Challenges** for the ECB have suddenly increased, with the **need for prompt responses** tailored to the specificities of the euro area
  - Institutional setup (one monetary policy, many fiscal players)
  - Bank-based economy and monetary policy transmission
Key challenges and ECB measures: 2011-2013

✅ Between the most acute phase of the sovereign debt crisis (second half of 2011) and the end of 2013:

- Weak economic conditions
  - MRO rate from 1.5 to 0.25%

- Threat of a credit crunch due to disruptions in banks’ funding markets
  - LTRO with 3yrs maturity
  - (fixed rate-full allotment)

- Impairment of the transmission mechanism of monetary policy due to disruptions in sovereign debt markets
  - • Enhancement of SMP
  - • Announcement of OMT

- Market expectations not in line with ECB intentions
  - Forward guidance
Rationale for OMT

✓ Sharp increase in government bond yield spreads
  o **sustainability risk**, from fiscal imbalances and weak growth prospects in some euro-area economies
  o **redenomination risk**, from the incompleteness of the European architecture and fears of a break-up of the monetary union

✓ Fiscal consolidation and structural reforms by **national governments** and **reform of European governance**

✓ But **reforms require time** – meanwhile, tensions on sovereign debt continued jeopardizing the transmission of monetary policy

✓ The OMT
  o countered a surge in sovereign yields due to the redenomination risk, improving the homogenous transmission of monetary policy
  o fully within the Eurosystem mandate
The OMTs announcement was effective

- Market segmentation along national borders has decreased, yield spreads have narrowed

![Graph showing government bond spread with German bond, 10yrs horizon](image)

*Graph note: Government bond spread with German bond, 10yrs horizon (daily data; basis points)*
Current challenges to monetary policy in the euro area
A weak outlook ...

euro area and main member countries GDP levels
(quarterly data; indices, 2005=100)

€-coin coincident cyclical indicator and euro-area GDP growth
(percentage changes)
...with subdued and heterogeneous credit dynamics...

Bank loans to non-financial corporations
(3-month annualized growth rates)

Interest rates on new loans to NFCs
(percentage points)
...and protracted low inflation ...

Inflation in the euro area and contributions of the components
(monthly data; 12-month percentage changes and percentage points)

Inflation in the euro area and the contribution of crisis/no-crisis countries
(monthly data; 12-month percentage changes)

✔ Inflation low not only because of energy prices ...

✔ ... and not only in countries hardest hit by sovereign debt crisis
... which is de-anchoring inflation expectations ...

Long-term inflation expectations
(percentage points)

Consensus 5-10 years
Inflation swap 5yrs forward-5yrs ahead (15d moving average)
Inflation swap 1yr forward-2yrs ahead (15d moving average)
Too low inflation for too long is costly and dangerous

- detrimental to financial stability (especially with high public and private debt and low growth)
- relative price adjustments more costly
- risk of sudden shifts of inflation expectations (non-linear process)
- strong credibility concern

Need to act pre-emptively
ECB’s response has been wide-ranging

✓ Further easing of the monetary stance
  o rate cuts in June and September (to the ZLB); negative rate on the deposit facility

✓ Measures to support credit
  o TLTRO
    • lower funding costs conditional on new lending
    • “fixed rate” of operations strengthens forward guidance
  o Outright purchases of ABSs and covered bonds (ABSPP/CBPP3)
    • revive important funding markets
    • positive spillovers to other markets
  o Measures “expected” to have a sizable impact on the Eurosystem balance sheet (but uncertainty large)
Too early to assess effectiveness, but there are already some positive results

**Implied yields on 3-month Euribor futures**

*percentage points*

**Euro exchange rate**

*(daily data)*
The ECB is ready to take further action if needed

✓ Should the current measures be insufficient or the medium-term outlook for inflation expectations worsen, the “Governing Council is unanimous in its commitment to using additional unconventional instruments within its mandate”

✓ The Governing Council tasked ECB staff and relevant Eurosystem committees to prepare further measures to be implemented, if needed

✓ Need to take into account:
  o Treaty provisions: **price stability mandate; prohibition of monetary financing**
  o Balance sheet risks: **market/counterparty risks vs. macroeconomic risks**
A challenge is **overcoming the zero lower bound**

**Large scale purchases of public sector assets (QE)**
- impact on longer term yields from experience of other monetary jurisdictions overall positive
- quantitative impact on the economy difficult to estimate, but qualitatively it goes in the right direction

In the euro area, a QE would work through the **banking channel** and a **number of other channels**
- exchange rate
- inflation expectations (especially now)
- confidence
Financial stability considerations played a critical role in the design of unconventional monetary policy.

Financial stability an explicit objective alongside price stability?
- No, clear benefits from current ECB mandate and risks of blurring responsibilities
- But preserving financial stability lies fully within central banks’ responsibilities
Monetary Policy and Financial Stability (II)

✓ Monetary policy, macro- and micro-prudential policies entail policy and governance complementarities and trade-offs
  ○ Should they all be within central banks?

✓ The ECB, by ensuring euro area-wide coordination in the application of these policies, provides a **concrete case of an institutional setting aimed at addressing interactions between them**

✓ The decision-making framework within the Single Supervisory Mechanism takes into account:
  ○ **Synergies between macro-prudential policy and monetary policy**
  ○ **Strict interrelation of macro-prudential policy with micro-prudential policy**
The need for further reforms of European governance and for a better policy mix
The Banking Union is an important step forward...

- The Banking Union is an important advancement in the process of European governance reform
- In November, the Single Supervisory Mechanism was launched
- The completion of the comprehensive assessment of banks’ balance sheet provides greater transparency and should improve credit conditions
- Unified European supervision and resolution paramount in achieving the benefits of the single market
Reforms should not stop at the Banking Union; still a long journey towards a genuine economic and monetary union

- Integration of financial services must be completed (e.g. changes to company laws, bankruptcy procedures, harmonisation in the taxation of financial products)

- Prospect of Fiscal Union and, ultimately, elements of Political Union (e.g. European judiciary framework, common policies to support education, research and innovation)

- Necessary to shift from intergovernmental peer review of national policies to formulation of truly common policies
Low growth in the euro area has structural causes

- Many countries are still struggling to adapt to the radical global changes (e.g. globalisation, ICT, population ageing)
- Need for structural reforms to help the transition from the old to the new economy and increase growth potential

But no denying that cyclical conditions are critical

- Fiscal policy must join monetary policy
Fiscal policy should play a greater role

✓ After the needed adjustments during the crisis, national authorities may now have room to calibrate the fiscal stance to cyclical conditions
  ○ need to “make best use” of the flexibility built into the SGP, for both the deficit and the debt rule

✓ “Blind implementation” of debt rule risks pro-cyclical effects
  ○ pursuit of excessively ambitious targets can be self-defeating

✓ Need for coordinated European action to support demand
  ○ isolated measures by countries could trigger adverse market reactions
  ○ common action – especially to sustain public investment, tapping all sources of finance – would demonstrate cohesion and capacity to act

✓ Open issue: debate on the size of public debt
In the euro area the Governing Council of the ECB made bold decisions during the sovereign debt crisis, but new challenges have emerged: deflation is a material risk.

We are committed to adopt further measures, if needed.

But to solve the low growth problem of the euro area – which reflects structural and cyclical factors – monetary policy is not enough.

We need further progress towards a genuine economic and monetary union and a contribution from fiscal policy, at both national and European levels.