



BANCA D'ITALIA
EUROSISTEMA

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 and monetary policy





- ✓ 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

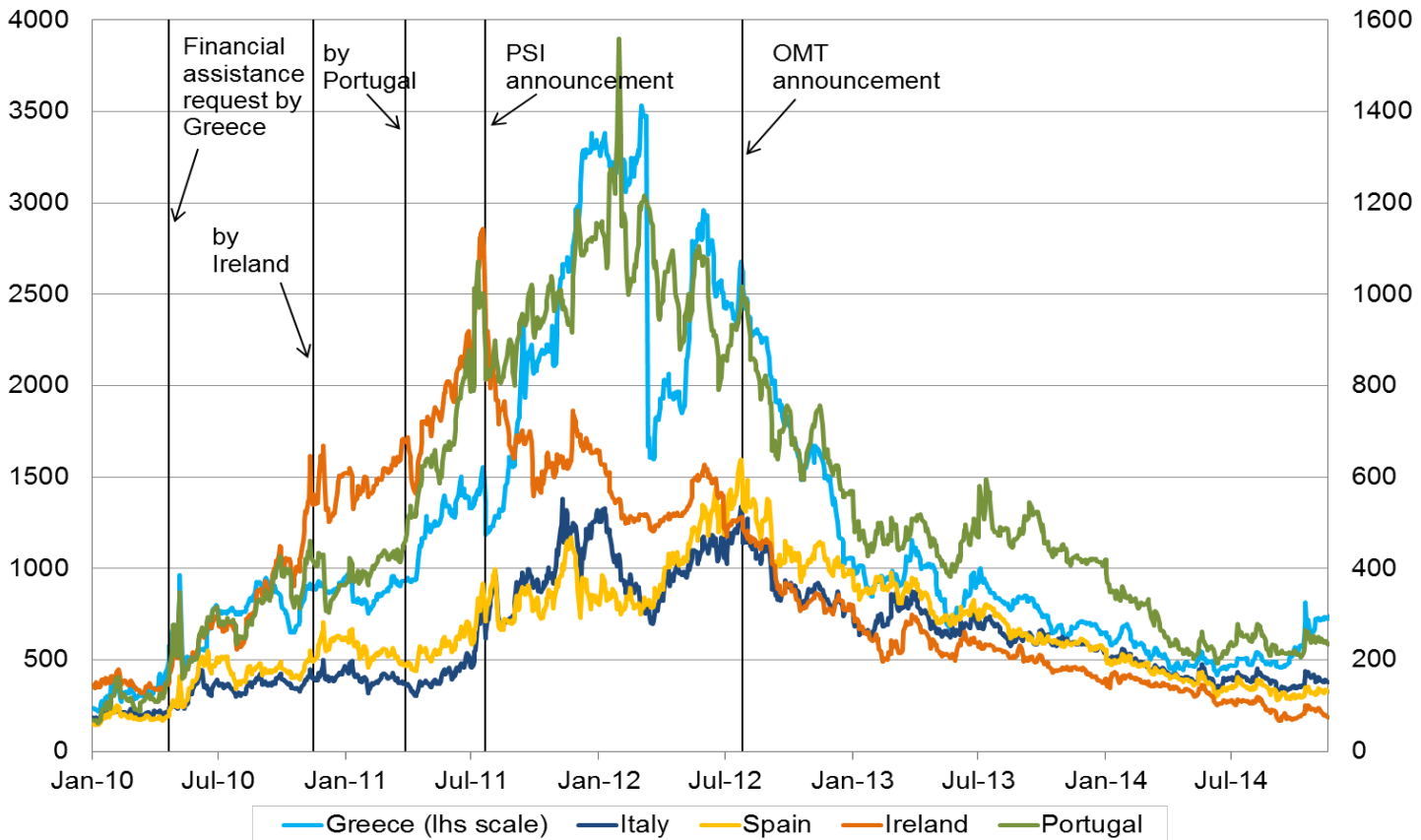
- ✓ Sharp increase in **government bond yield spreads**
 - **sustainability risk**, from fiscal imbalances and weak growth prospects in some euro-area economies
 - **redenomination risk**, from the incompleteness of the European architecture and fears of a break-up of the monetary union
- ✓ Fiscal consolidation 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**
 - countered a surge in sovereign yields due to the redenomination risk, improving the homogenous transmission of monetary policy
 - fully within the Eurosystem mandate

The OMTs announcement was effective

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

Government bond spread with German bond, 10yrs horizon

(daily data; basis points)

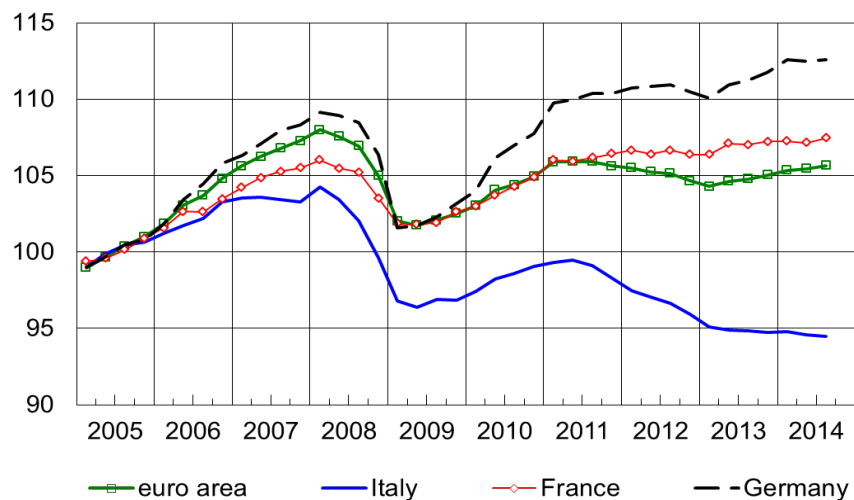


Current challenges to monetary policy in the euro area

A weak outlook ...

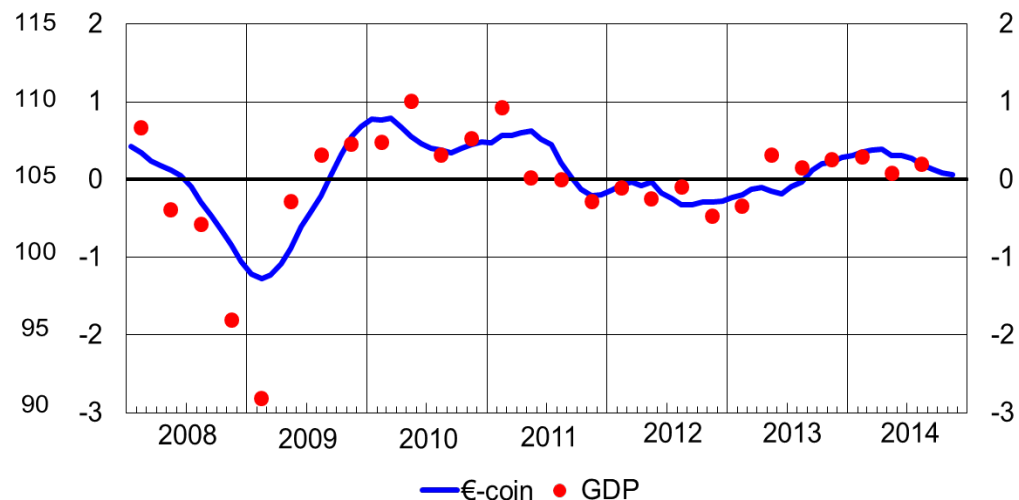
euro area and main member countries GDP levels

(quarterly data; indices, 2005=100)



€-coin coincident cyclical indicator and euro-area GDP growth

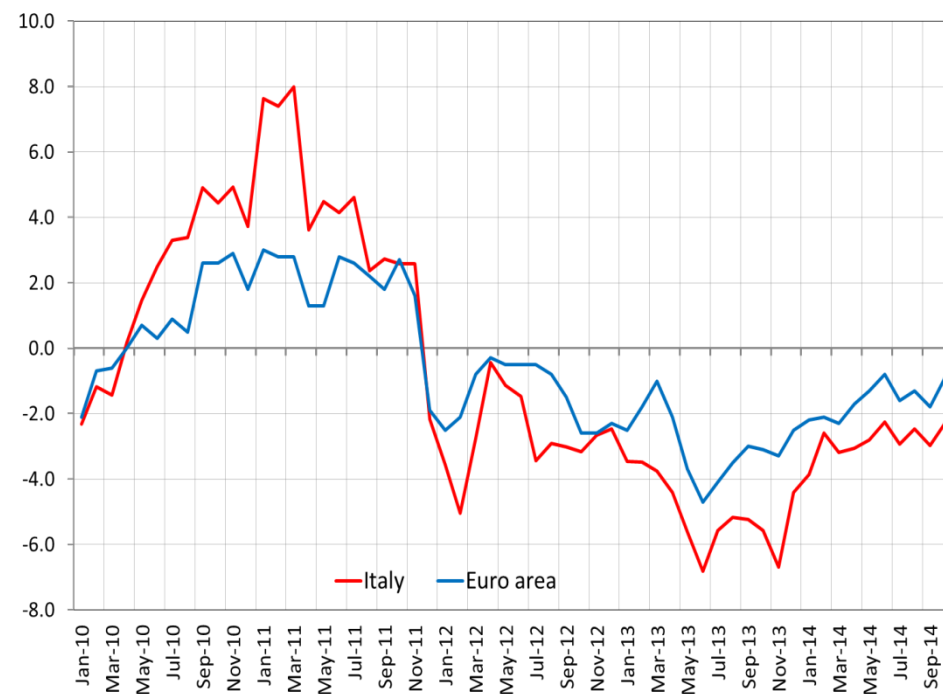
(percentage changes)



...with subdued and heterogeneous credit dynamics...

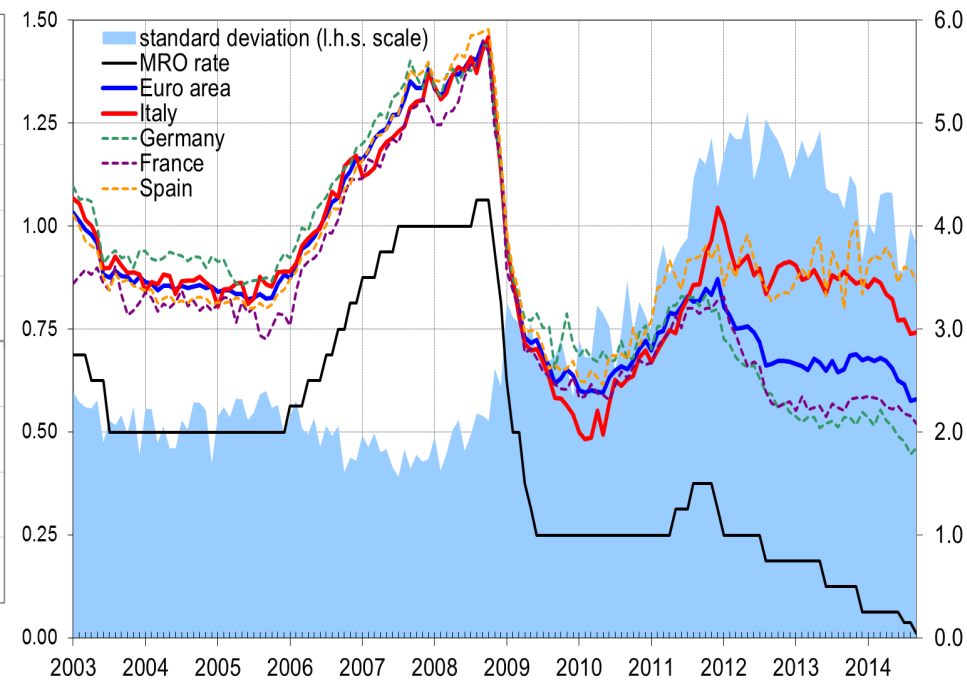
Bank loans to non-financial corporations

(3-month annualized growth rates)



Interest rates on new loans to NFCs

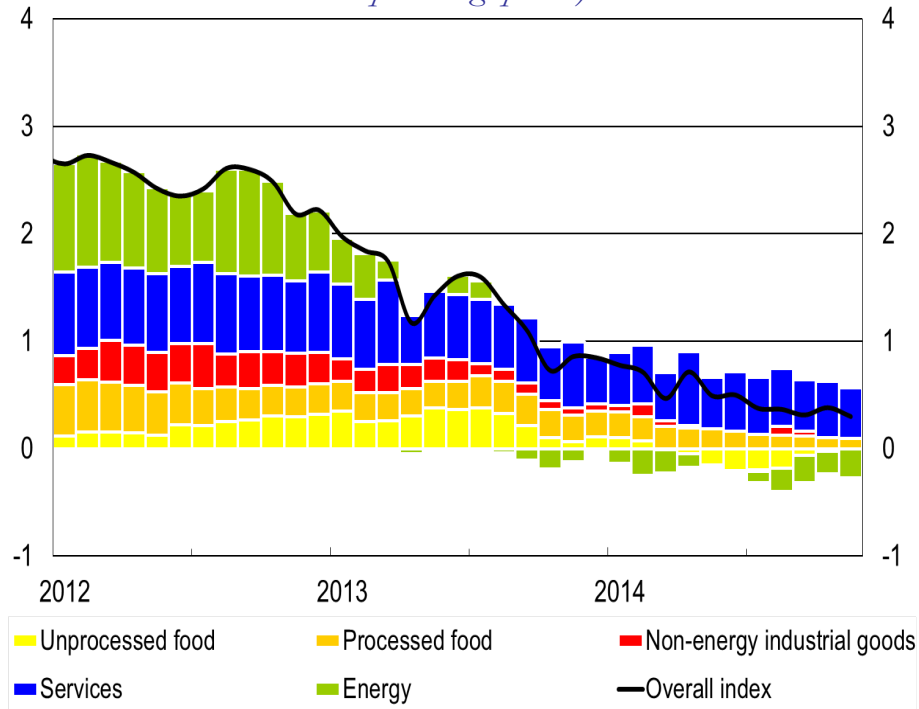
(percentage points)



...and protracted low inflation ...

Inflation in the euro area and contributions of the components

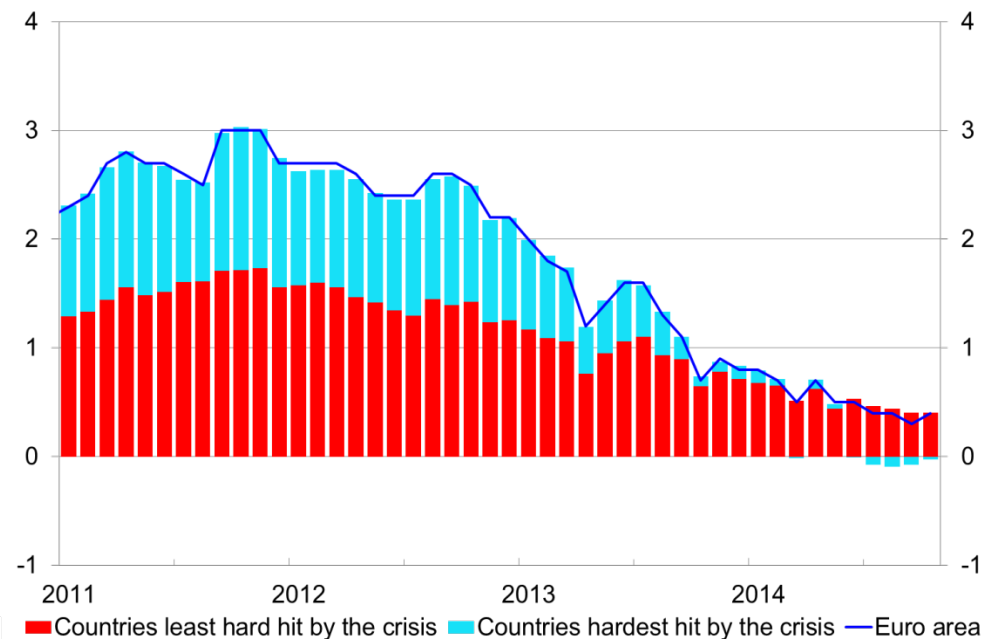
(monthly data; 12-month percentage changes and percentage points)



- ✓ Inflation low not only because of energy prices ...

Inflation in the euro area and the contribution of crisis/no-crisis countries

(monthly data; 12-month percentage changes)

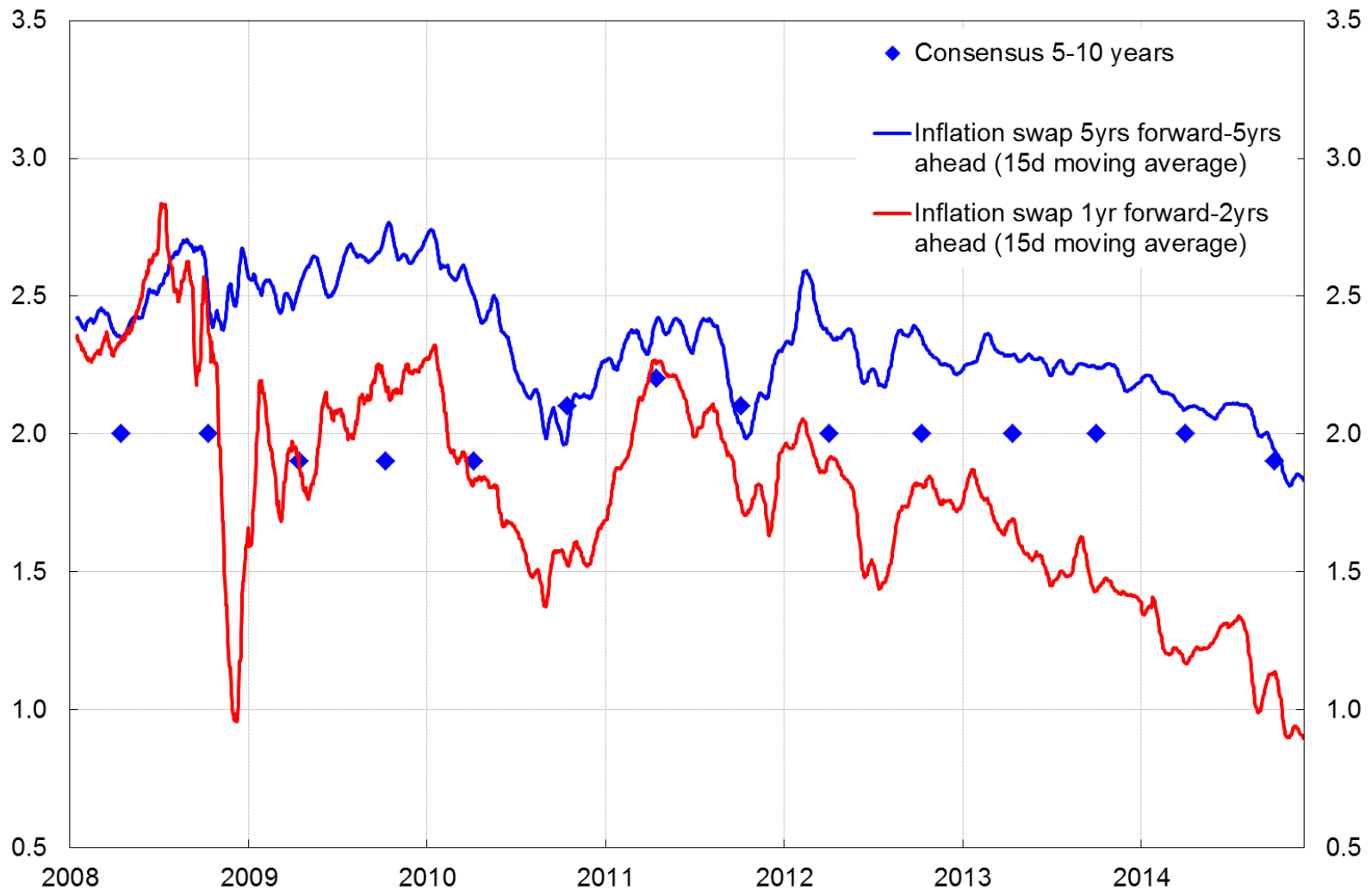


- ✓ ... and not only in countries hardest hit by sovereign debt crisis

... which is de-anchoring inflation expectations ...

Long-term inflation expectations

(percentage points)



...and poses great risks

- ✓ **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

- rate cuts in June and September (to the ZLB); negative rate on the deposit facility

✓ Measures to support credit

○ TLTRO

- lower funding costs conditional on new lending
- “fixed rate” of operations strengthens forward guidance

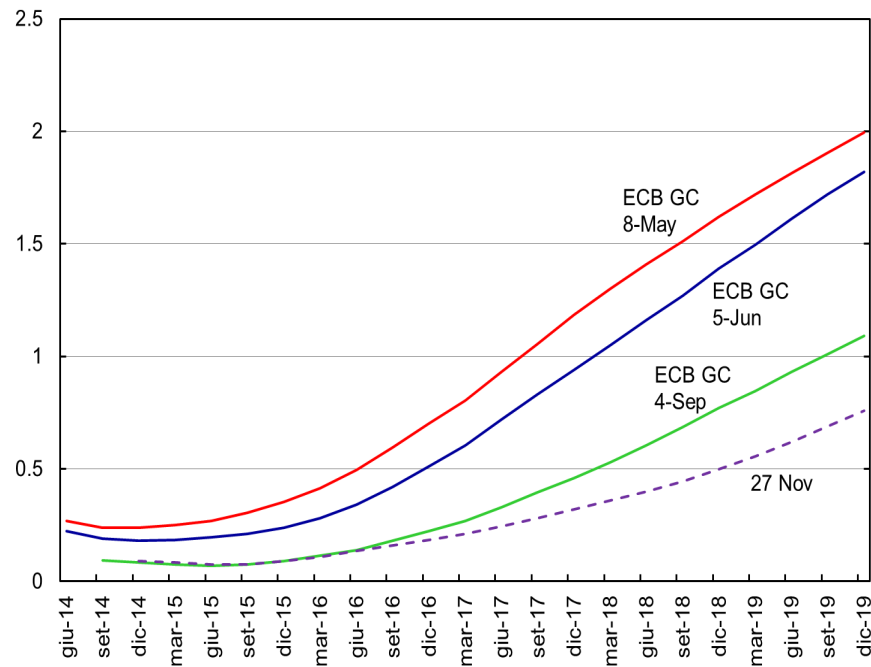
○ Outright purchases of ABSs and covered bonds (ABSPP/CBPP3)

- revive important funding markets
- positive spillovers to other markets

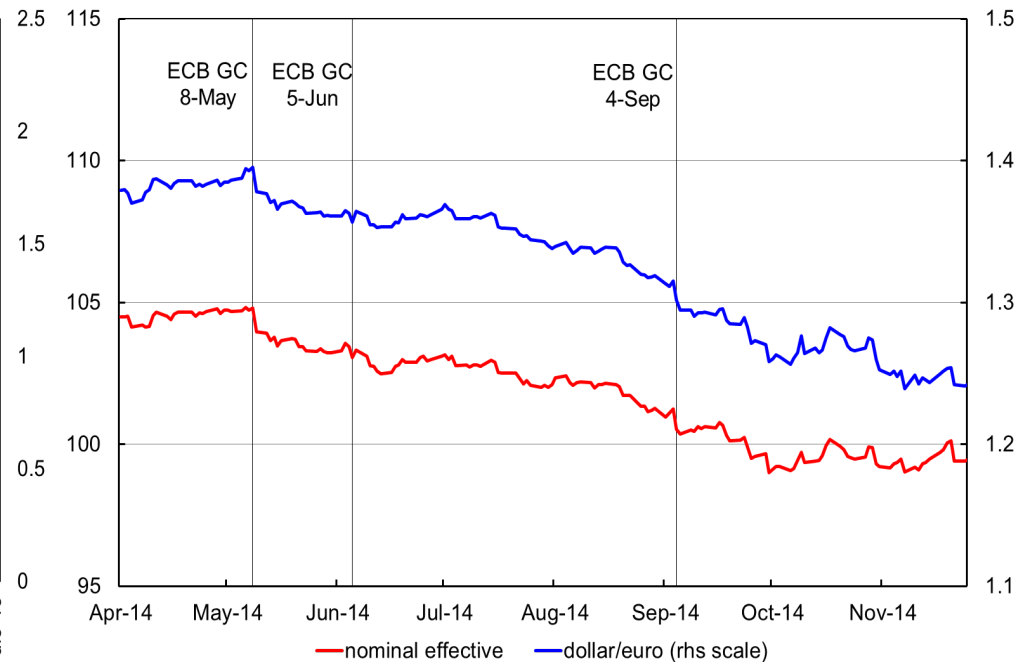
- Measures “expected” to have a **sizable impact on the Eurosystem balance sheet** (but uncertainty large)

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:**
 - Treaty provisions: **price stability mandate; prohibition of monetary financing**
 - Balance sheet risks: **market/counterparty risks** vs. **macroeconomic risks**

Quantitative Easing: other experiences and euro area

- ✓ 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

Monetary Policy and Financial Stability (I)

- ✓ 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

...but further reform of European governance is needed...

- ✓ **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**

... and a joint response to low growth is essential

- ✓ **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**

Conclusions

- ✓ 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