



BANCA D'ITALIA  
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# Challenges for monetary policy in the euro area

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Geneva, 2 December 2014

# 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

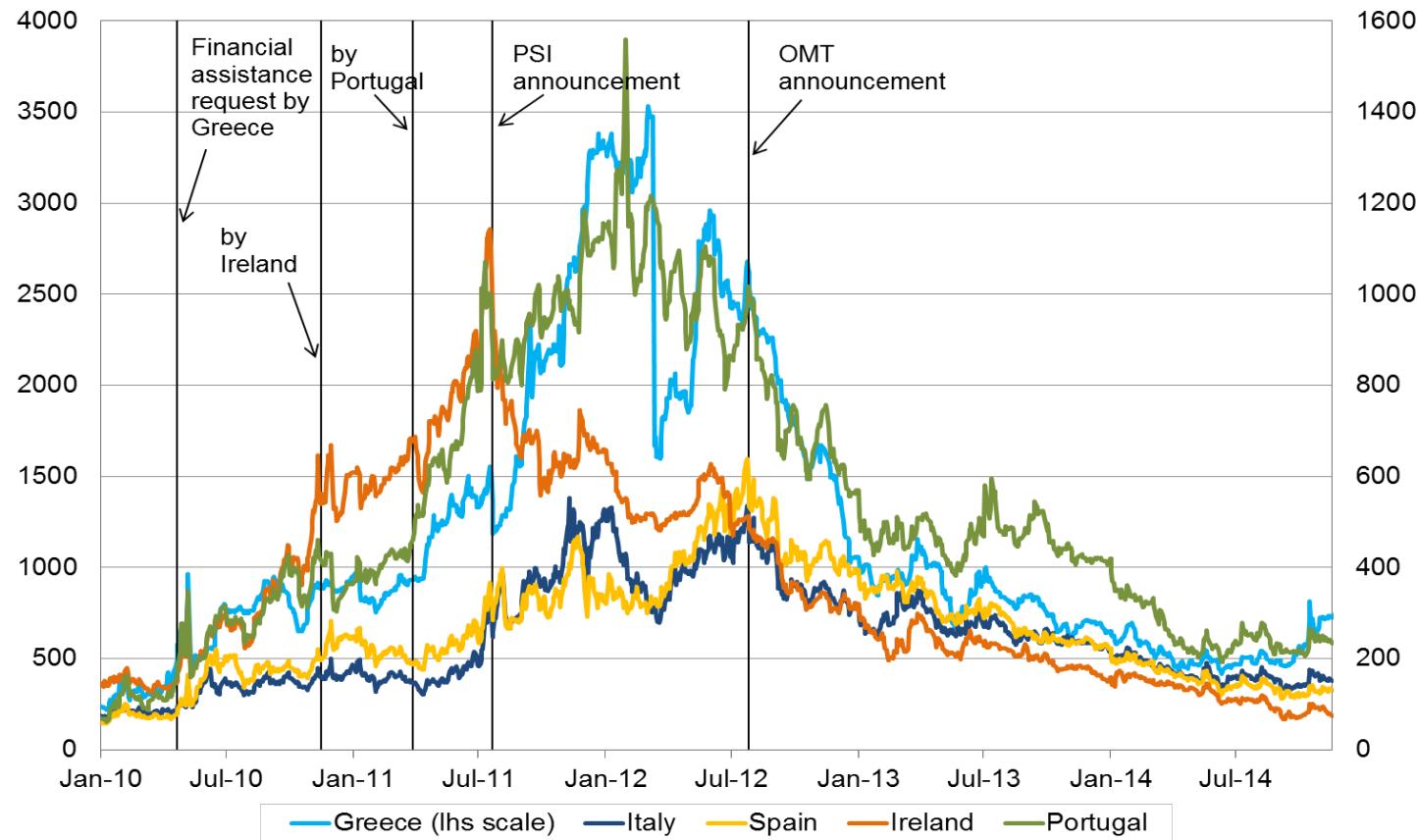
- ✓ Sharp increase in **government bond yield spreads**
  - **sustainability risk**, from fiscal imbalances and weak growth prospects in some euro-area economies
  - **redenomination risk**, from the incompleteness of the European architecture and fears of a break-up of the monetary union
- ✓ Fiscal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

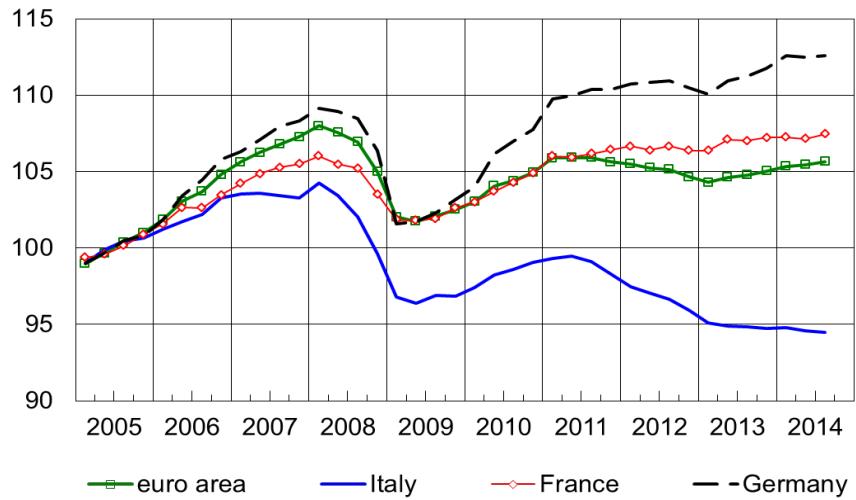
(daily data; basis points)



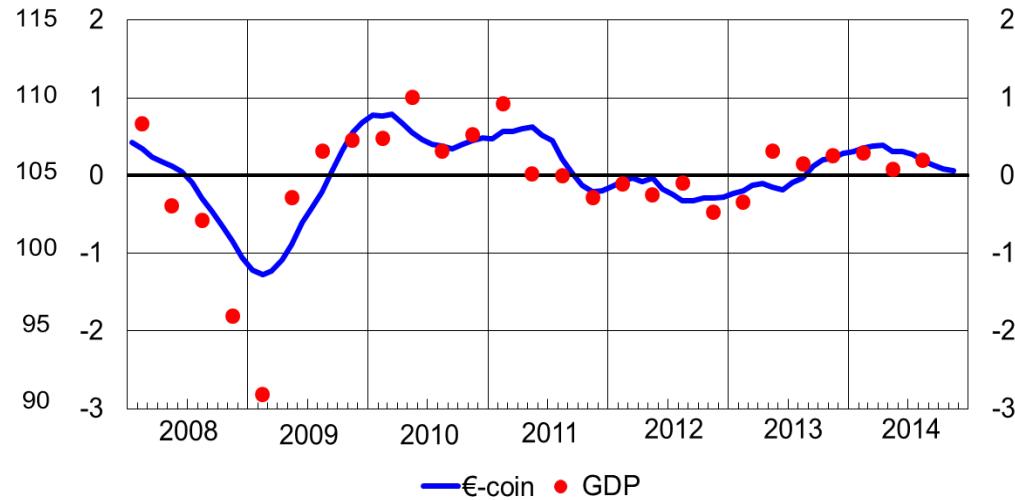
# Current challenges to monetary policy in the euro area

# 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)

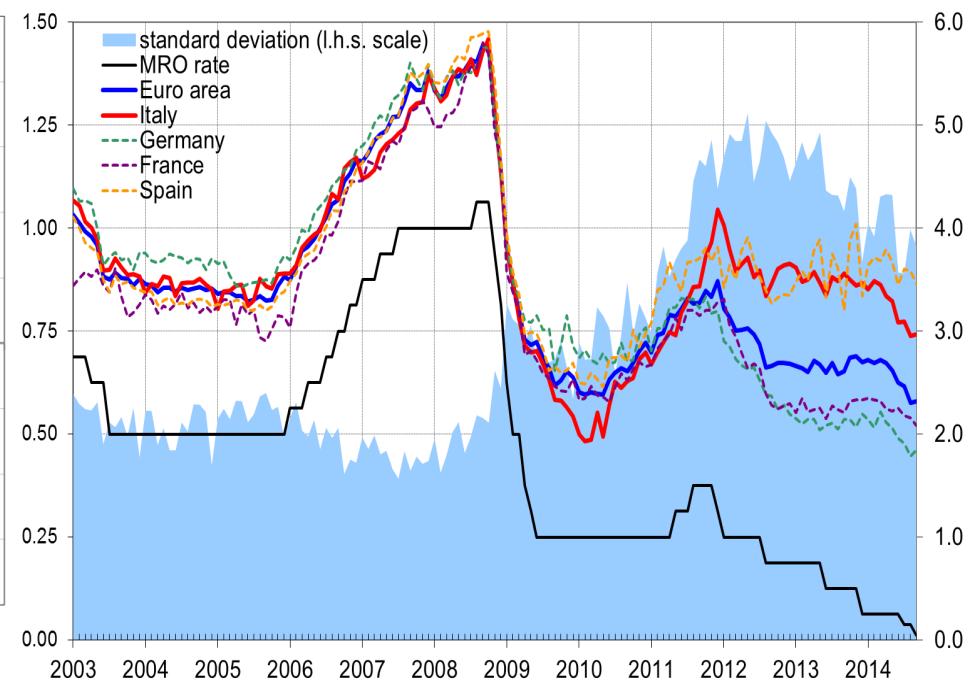


# ...with subdued and heterogeneous credit dynamics...

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

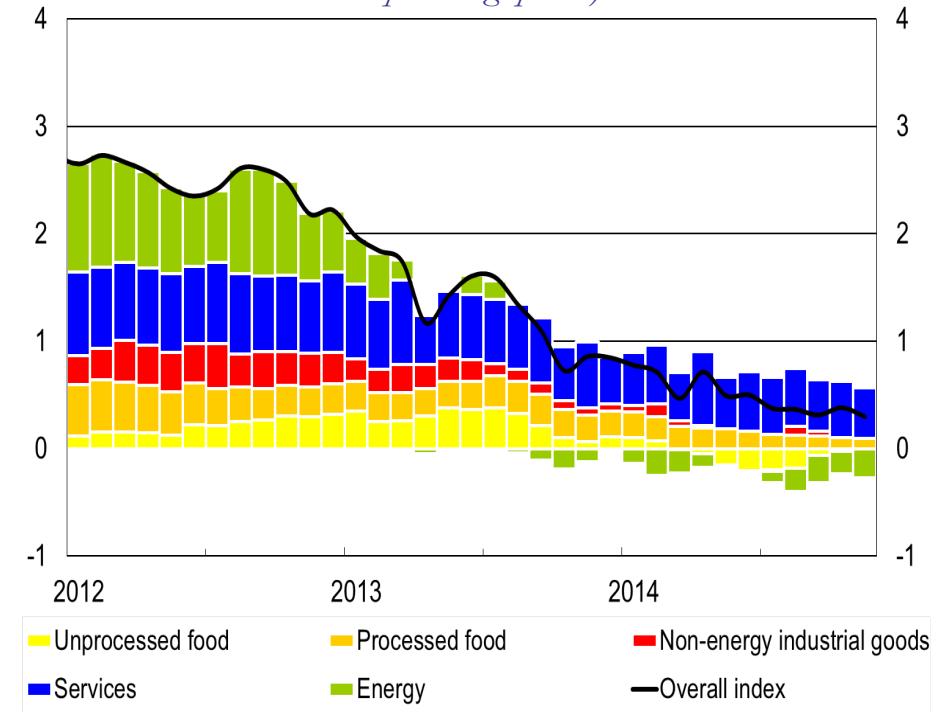


**Interest rates on new loans to NFCs**  
(percentage points)

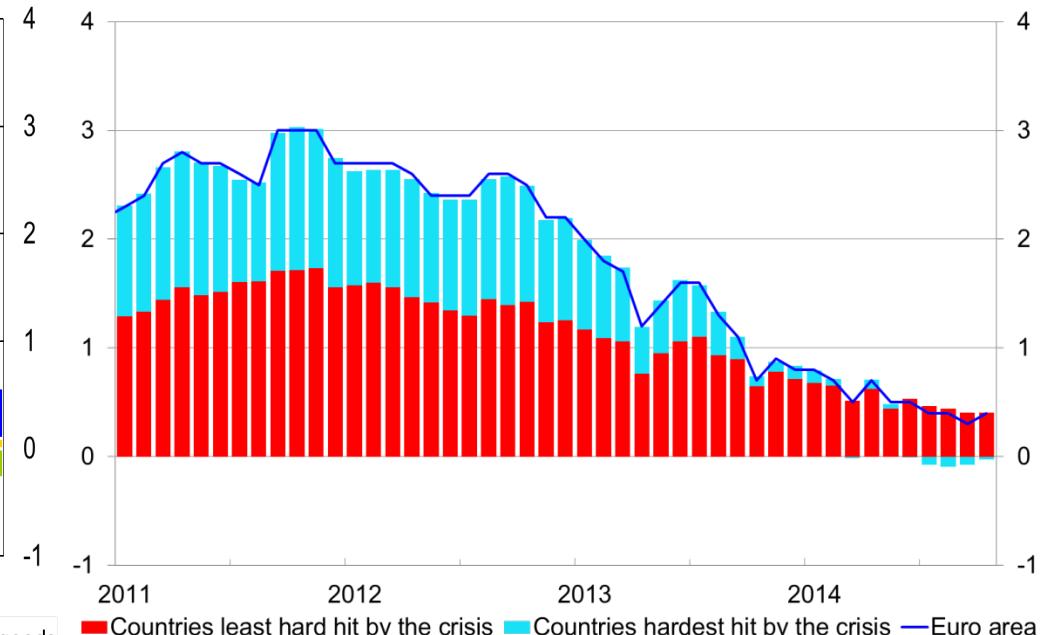


# ...and protracted low inflation ...

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



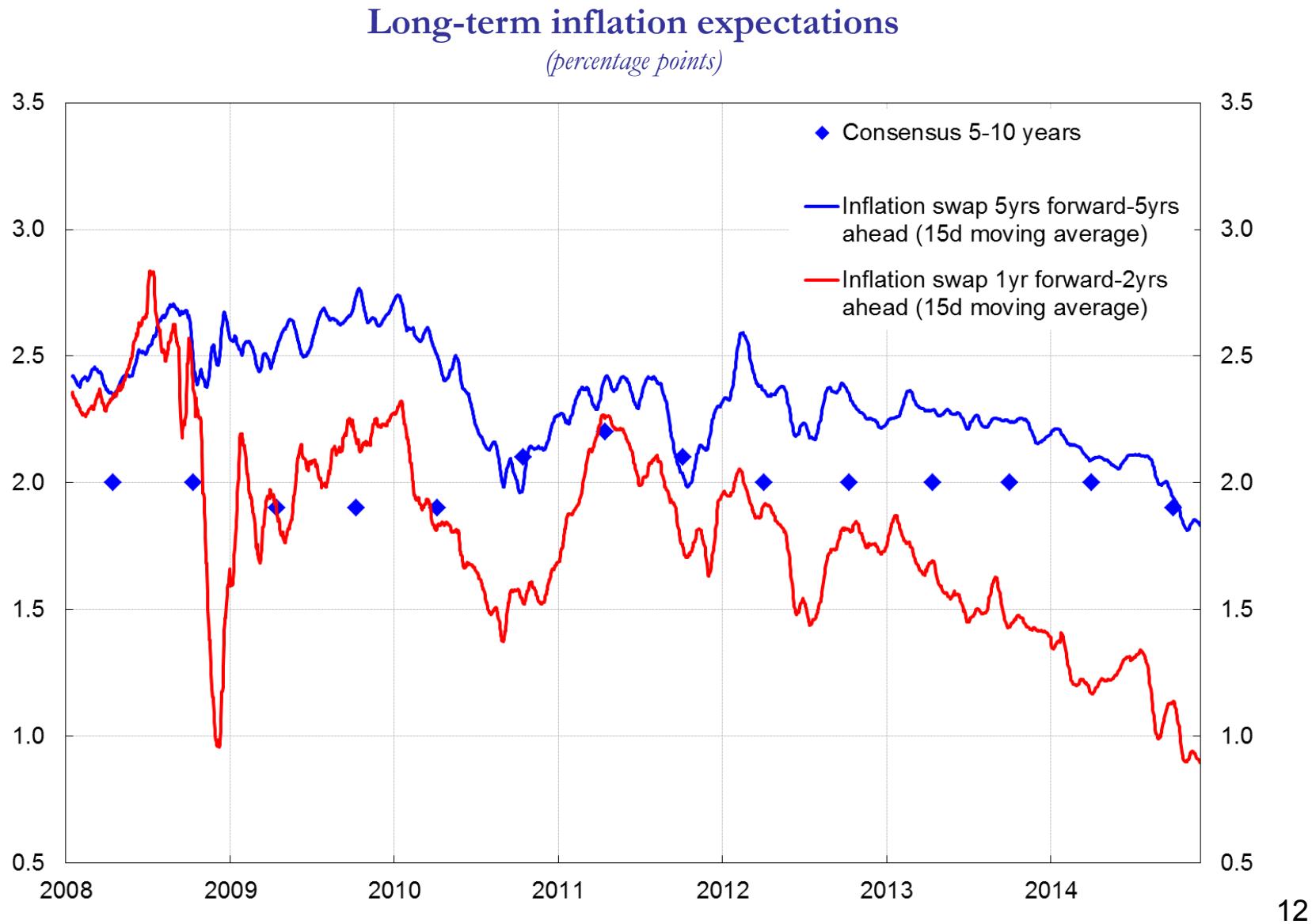
**Inflation in the euro area and the  
contribution of crisis/no-crisis countries**  
(monthly data; 12-month percentage changes)



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

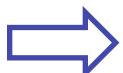
✓ ... and not only in countries hardest hit by sovereign debt crisis

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



# ...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**

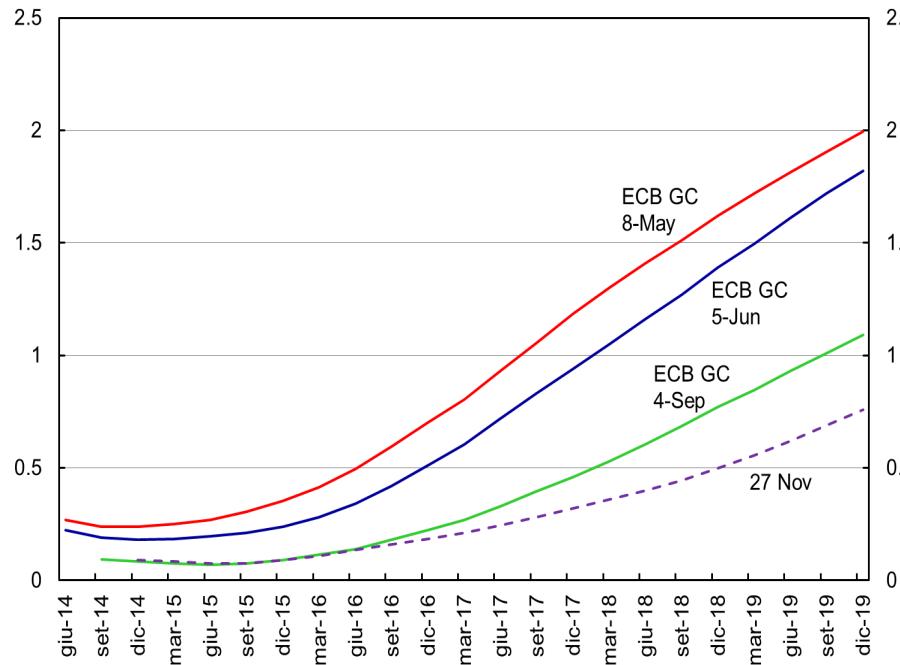
 Need to act pre-emptively

# ECB's response has been wide-ranging

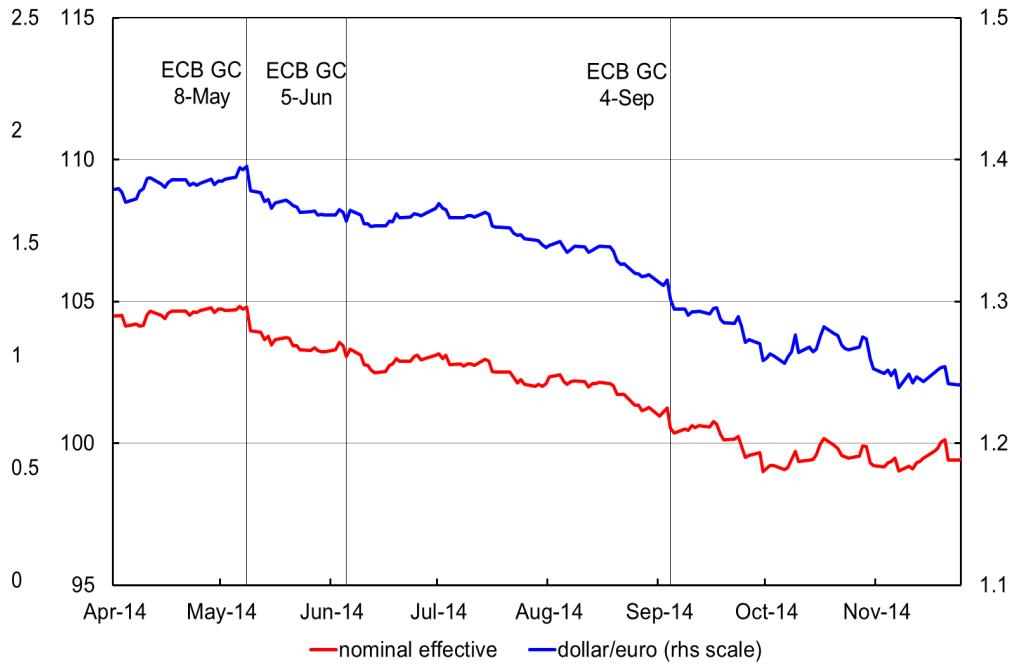
- ✓ **Further easing of the monetary stance**
  - rate cuts in June and September (to the ZLB); negative rate on the deposit facility
- ✓ **Measures to support credit**
  - **TLTRO**
    - lower funding costs conditional on new lending
    - “fixed rate” of operations strengthens forward guidance
  - **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