Monetary policy beyond maintaining price stability

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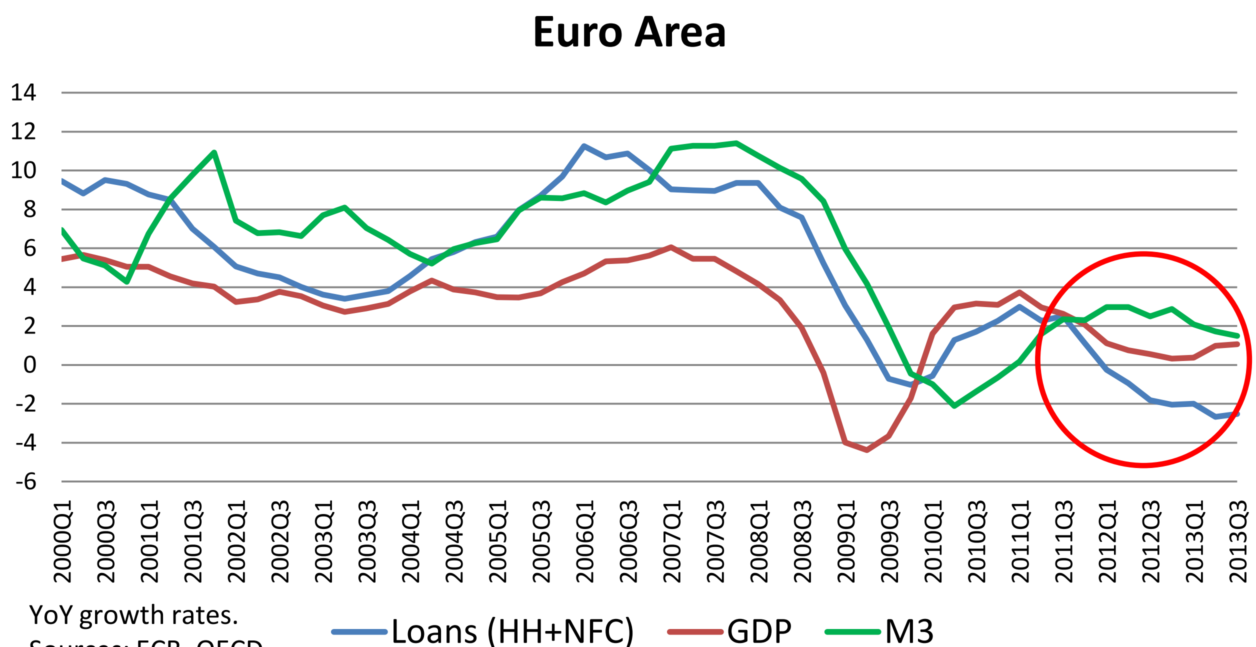
Key problems in the euro area today

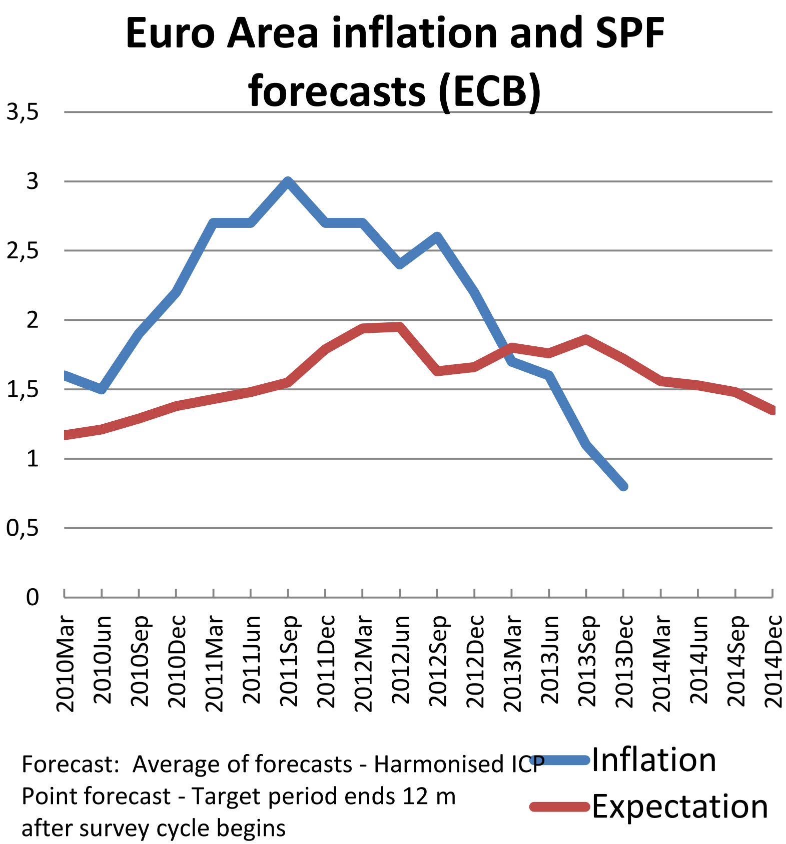
- Inflation: declining, expectations below target, ECB forecast negative surprised
- Banks’ fragility and in the process of deleveraging (AQR)
- Legacy debt (banks and sovereigns)
- Financial segmentation causing heterogeneity in financial conditions and impairment of monetary policy transmission
- Finally the recovery is there but nominal GDP weak
- Weak M3 and credit

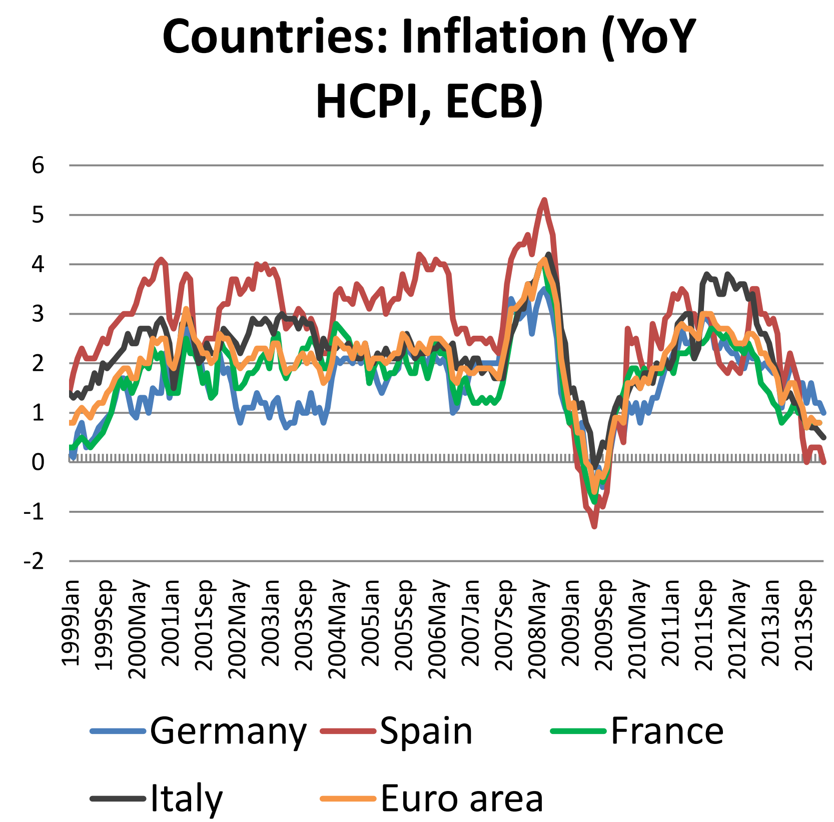
Nominal GDP, credit and M3



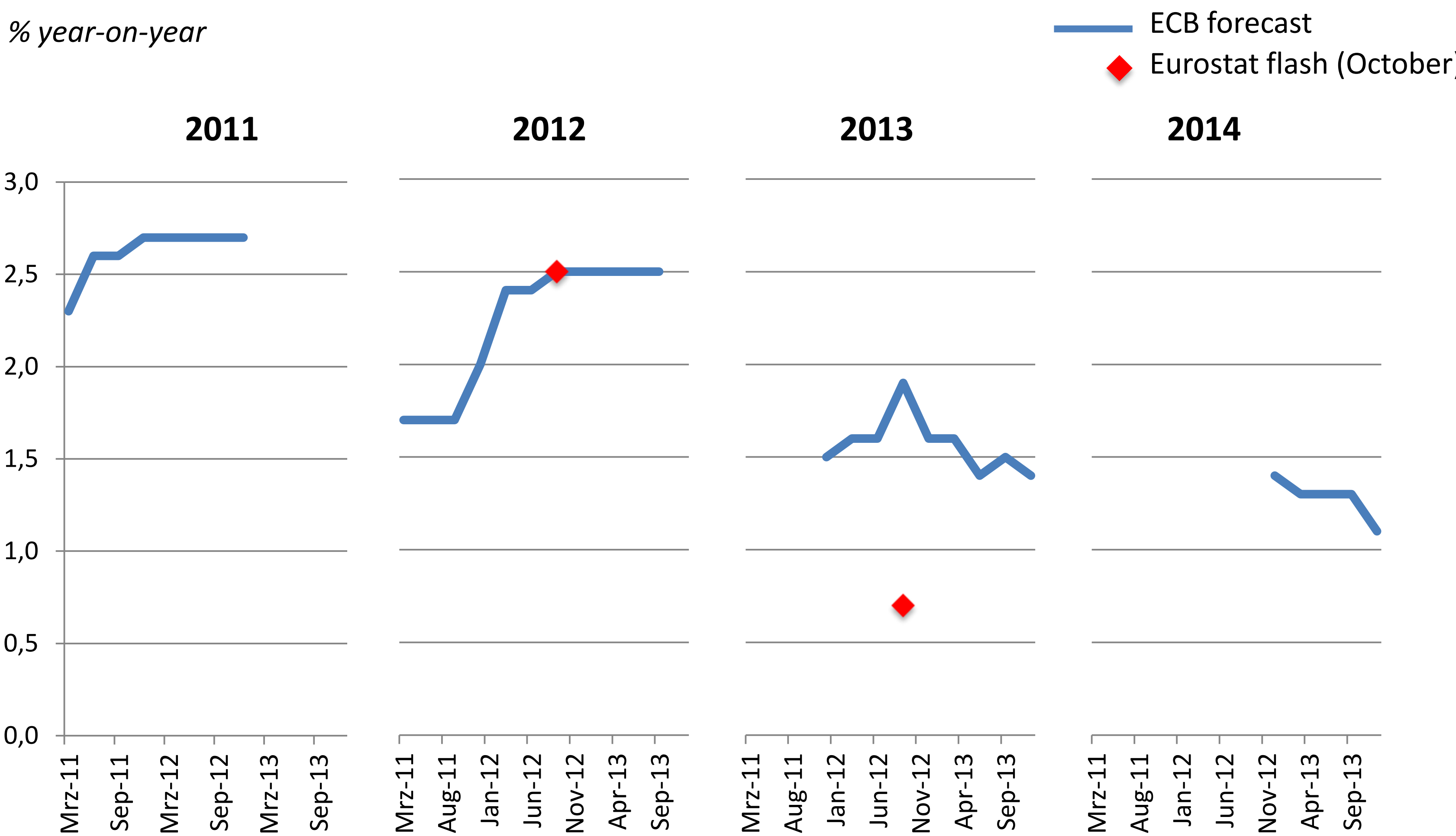
YoY growth rates.
Sources: ECB, OECD

Inflation


Euro Area inflation and SPF forecasts (ECB)
3,5
3
2,5
2
1,5
1
0,5
0
2010Mar
2010Jun
2010Sep
2010Dec
2011Mar
2011Jun
2011Sep
2011Dec
2012Mar
2012Jun
2012Sep
2012Dec
2013Mar
2013Jun
2013Sep
2013Dec
2014Mar
2014Jun
2014Sep
2014Dec
Forecast: Average of forecasts - Harmonised ICP
Point forecast - Target period ends 12 m
after survey cycle begins
Inflation
Expectation

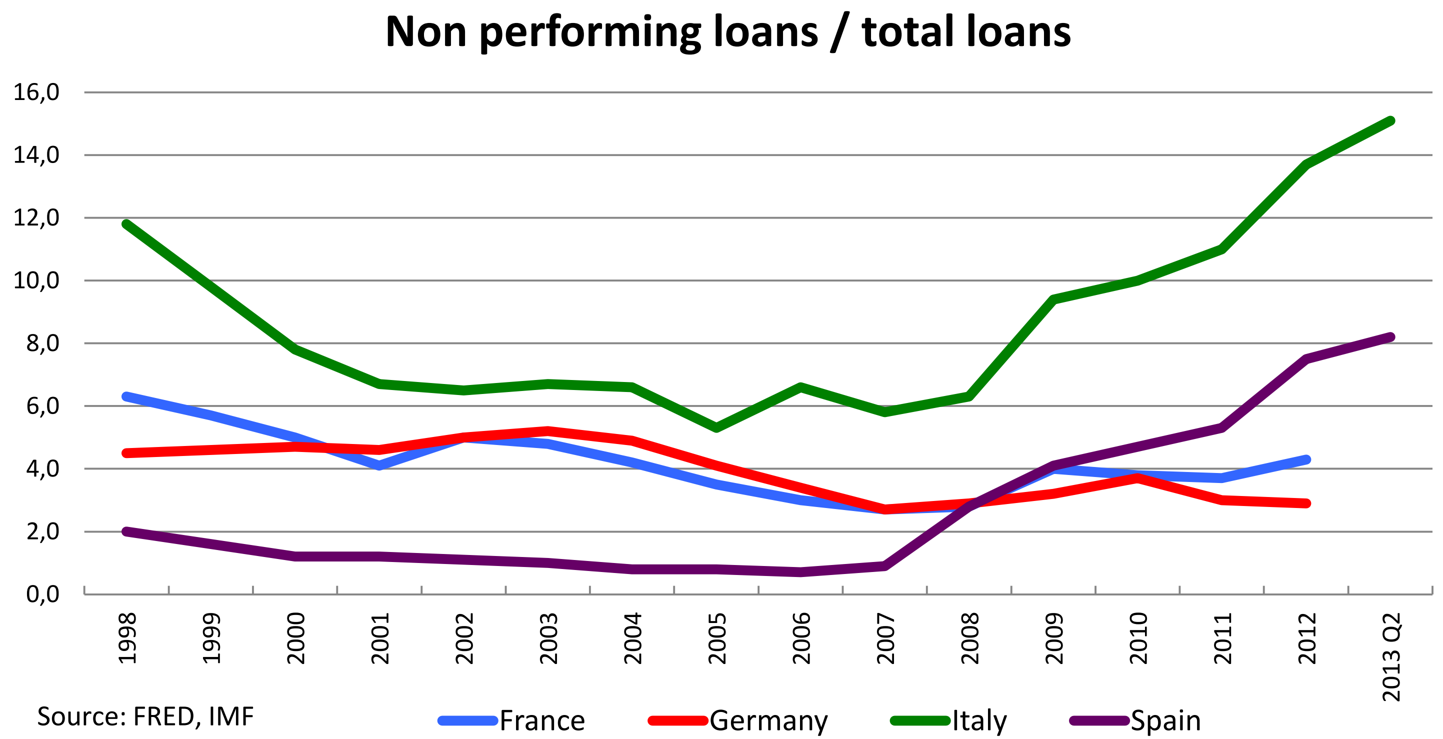

Countries: Inflation (YoY HCPI, ECB)
6
5
4
3
2
1
0
-1
-2
1999Jan
1999Sep
2000May
2001Jan
2001Sep
2002May
2003Jan
2003Sep
2004May
2005Jan
2005Sep
2006May
2007Jan
2007Sep
2008May
2009Jan
2009Sep
2010May
2011Jan
2011Sep
2012May
2013Jan
2013Sep
Germany
Spain
France
Italy
Euro area

ECB systematically surprised

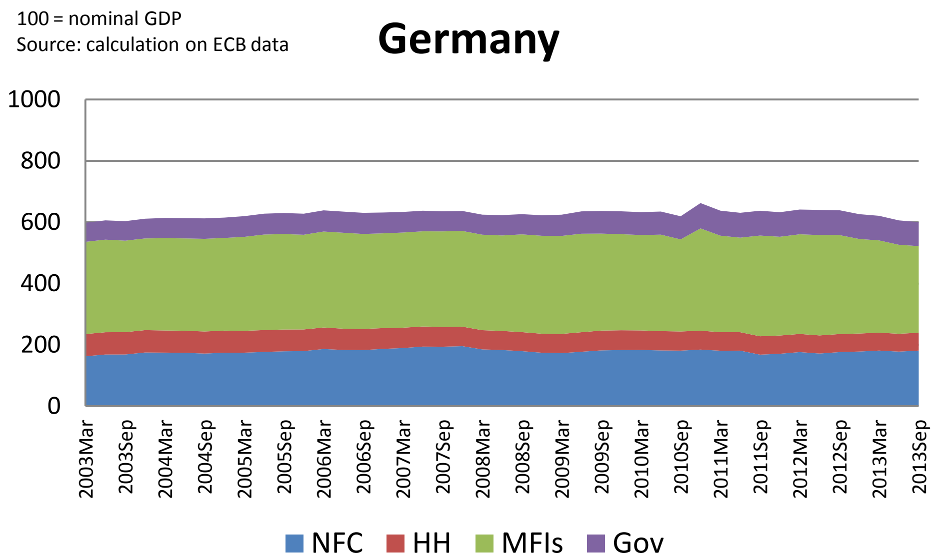


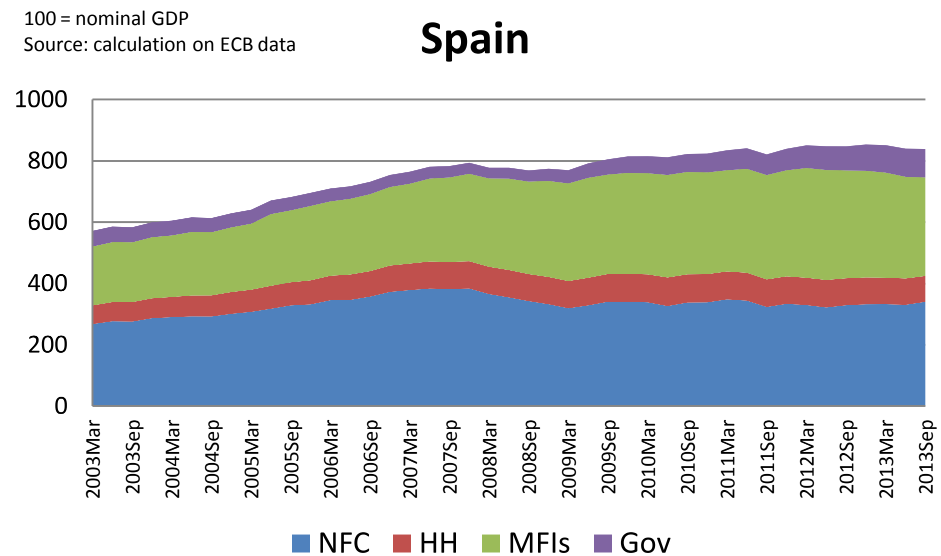
Sources: ECB, Eurostat

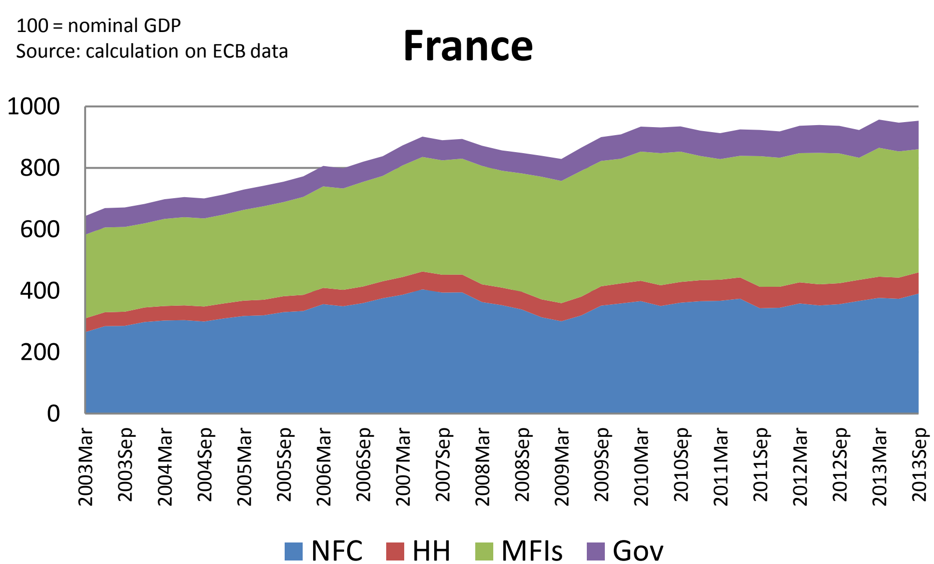
Growing non performing loans

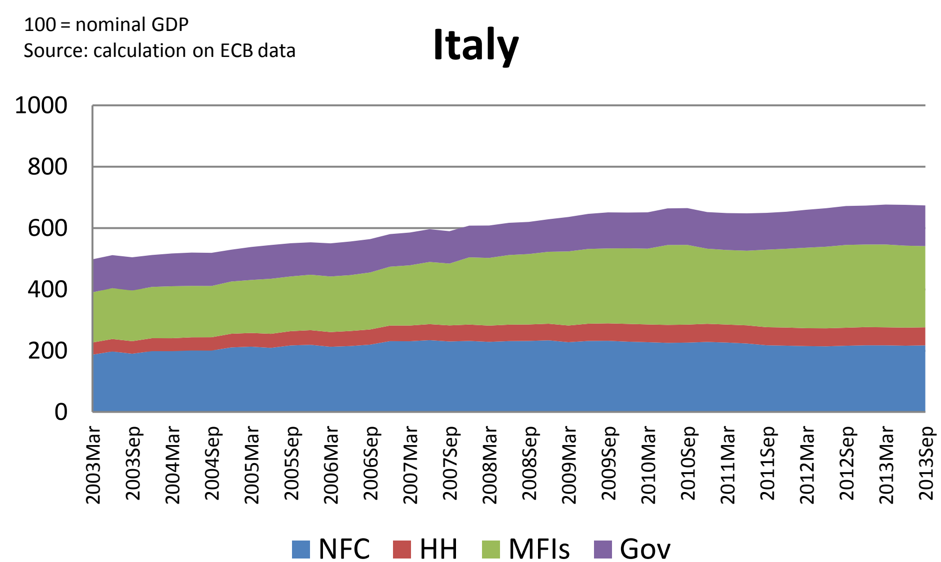


Total liabilities as % GDP not declining









In this situation ….. divine coincidence

Achieving price stability would help financial stability as well by easing the debt burden and facilitating the macro adjustment

Problems:

-- how to do it at the ZLB

-- the fundamental problem of the adjustment in the euro – financial balkanization in response to shocks – is the key problem for both price and financial stability … **the euro area is facing a specific problem which has to be addressed creatively but it is facing difficult tradeoffs between stability and moral hazard … the ECB has to experiment with new tools and clarify its view on those tradeoffs**

HOW HAVE THESE TRADEOFFS BEEN DEALT WITH BY THE ECB EXPERIENCE SINCE THE CRISIS?

ECB since the crisis
non-standard tools

PHASE 1:

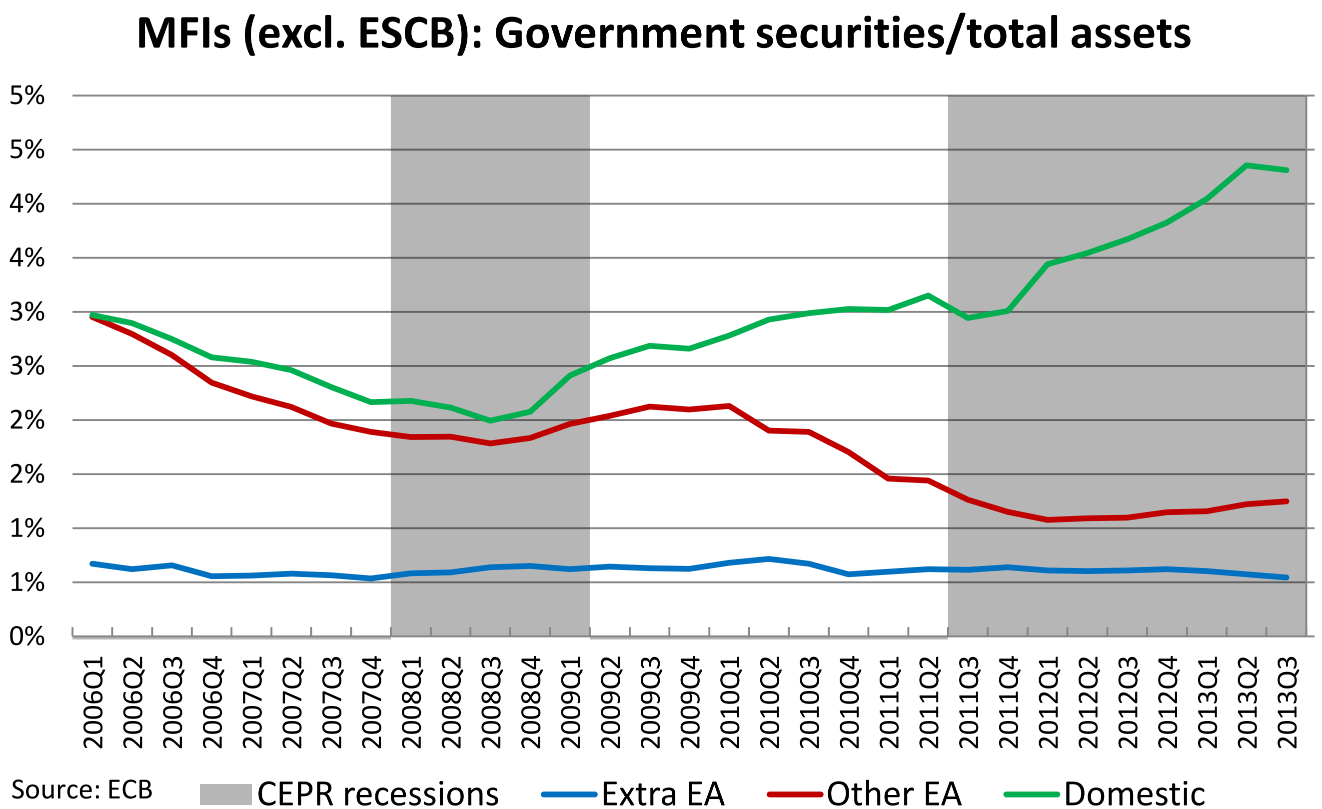
- First wave of market segmentation drying up of the non domestic inter-bank market
- The ECB responded by substituting for intra-euro area market transactions via the LTRO (financial stability and price stability objective)
- *Successful on both grounds (loans resilient, financial sector survived) but increasingly clear that insolvent banks were kept artificially alive*

ECB since the crisis
non-standard tools

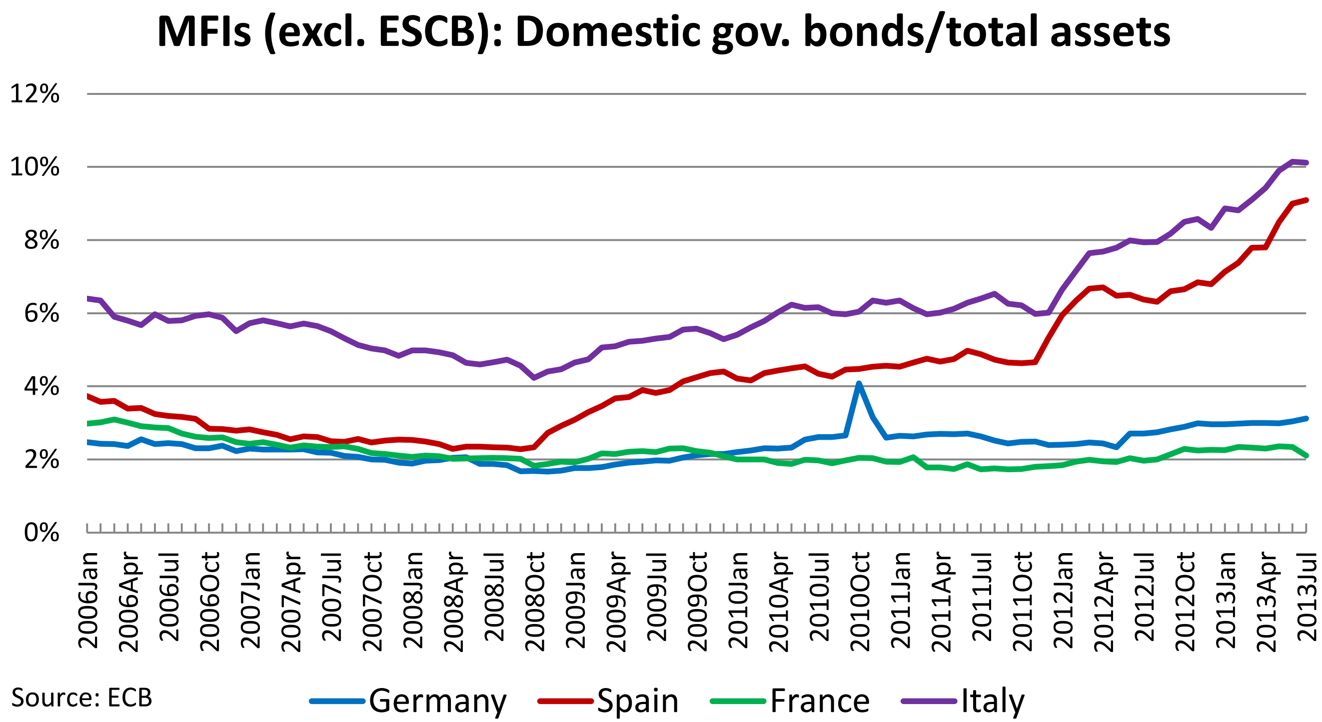
PHASE 2:

- As the euro crisis developed, the flight to quality took the form of non domestic investors withdrawing financing to either sovereign or banks.
- This led to a situation in which sovereigns had to intervene to save the banks while domestic bank took increasingly more domestic sovereign debts.
- The link between the sovereign and banks was exacerbated by the emergence of redenomination risk which led banks to hold domestic assets to match their increasingly domestic liabilities combined with side effects of the LTRO which created incentives to hold government bonds to use as collateral

Increasingly banks become holder of domestic government bonds



Effect is larger in the periphery but home bias is pervasive



Source: ECB

ECB since the crisis non-standard tools

… PHASE 2:

- The consequence was the banks-sovereign “vicious loop” leading to correlation between banks and sovereign risk
- This, combined with delayed banks’ deleveraging in view of the AQR and the accumulation of non-performing loans …

lead to both price stability and financial stability problems

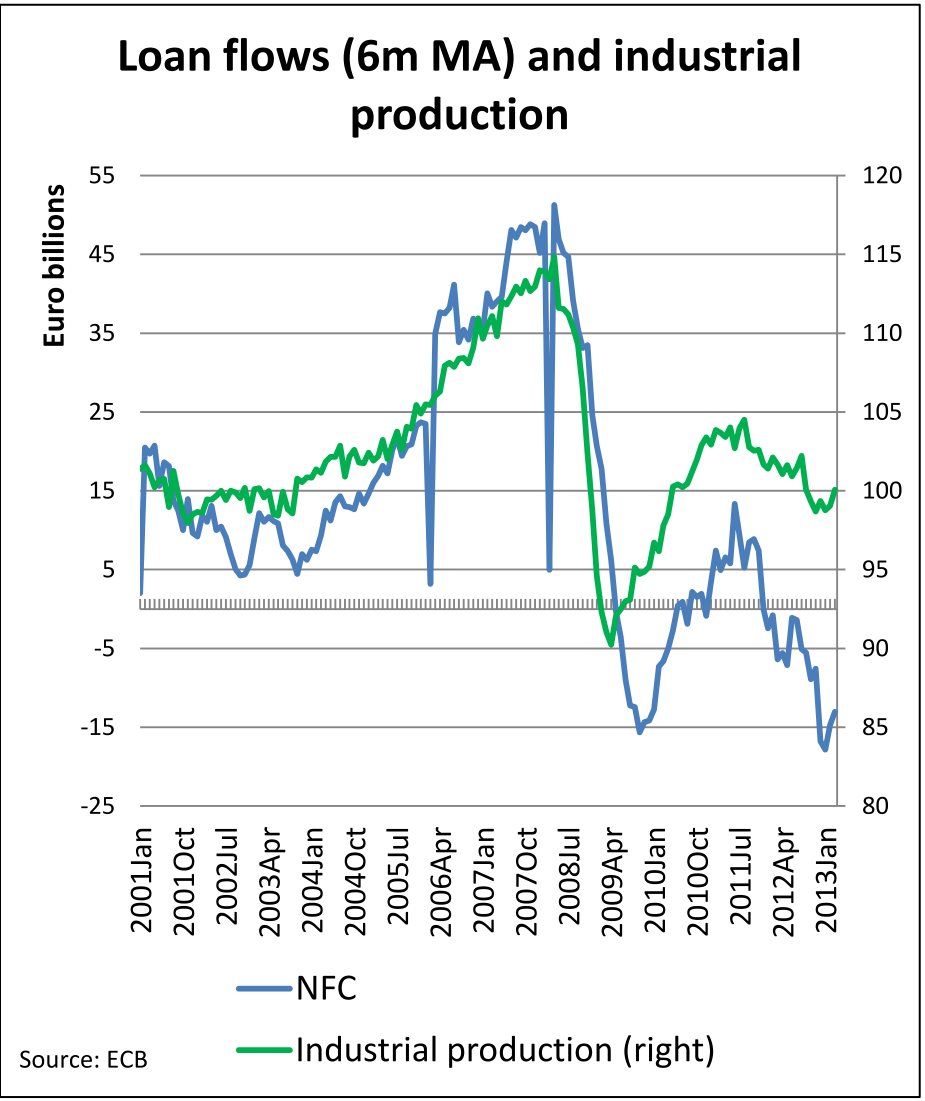
ECB since the crisis non-standard tools

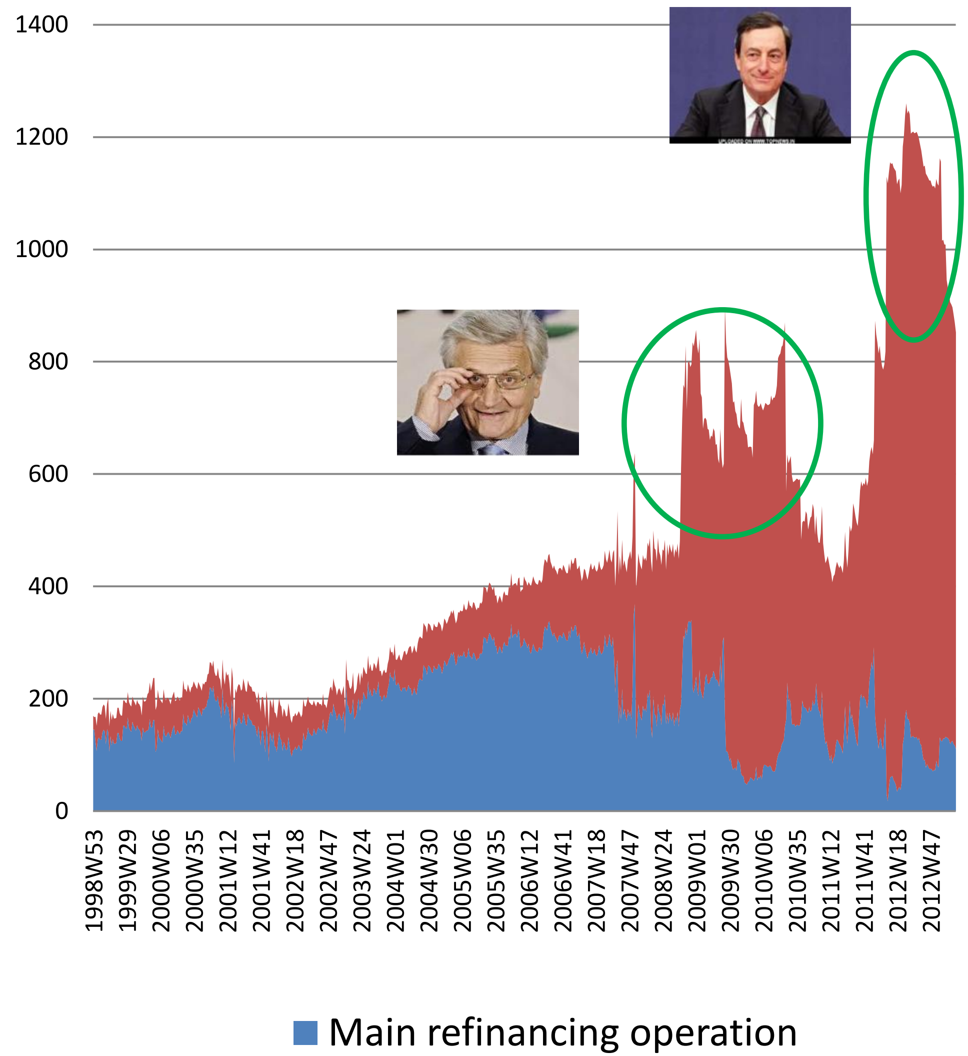
… PHASE 2:

In this situation LTRO2 was less effective than LTRO1 both for stimulating the economy via supporting bank lending and for dealing with financial stability issues essentially driven by solvency issues (not dealt with) and disruption of geographical financial diversification

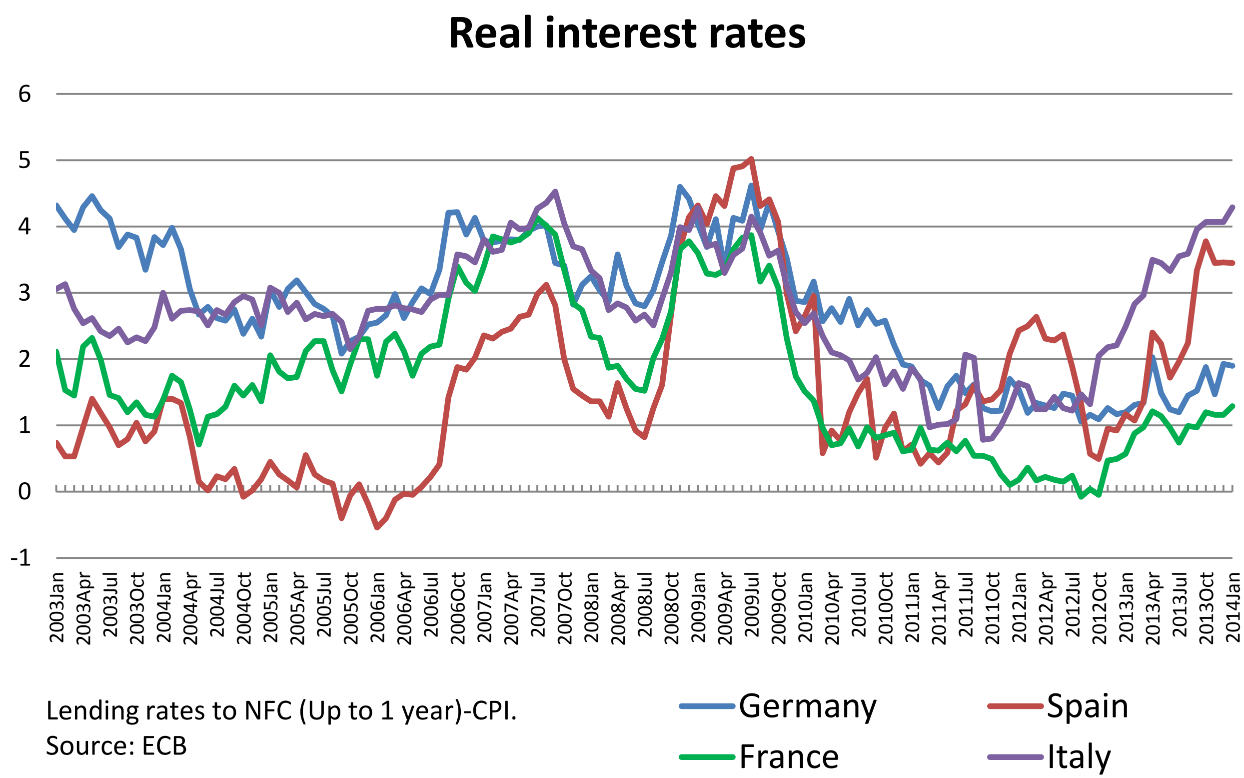
…. FEW OBSERVATIONS

1. Weak loans: a puzzle given aggressive ECB action?





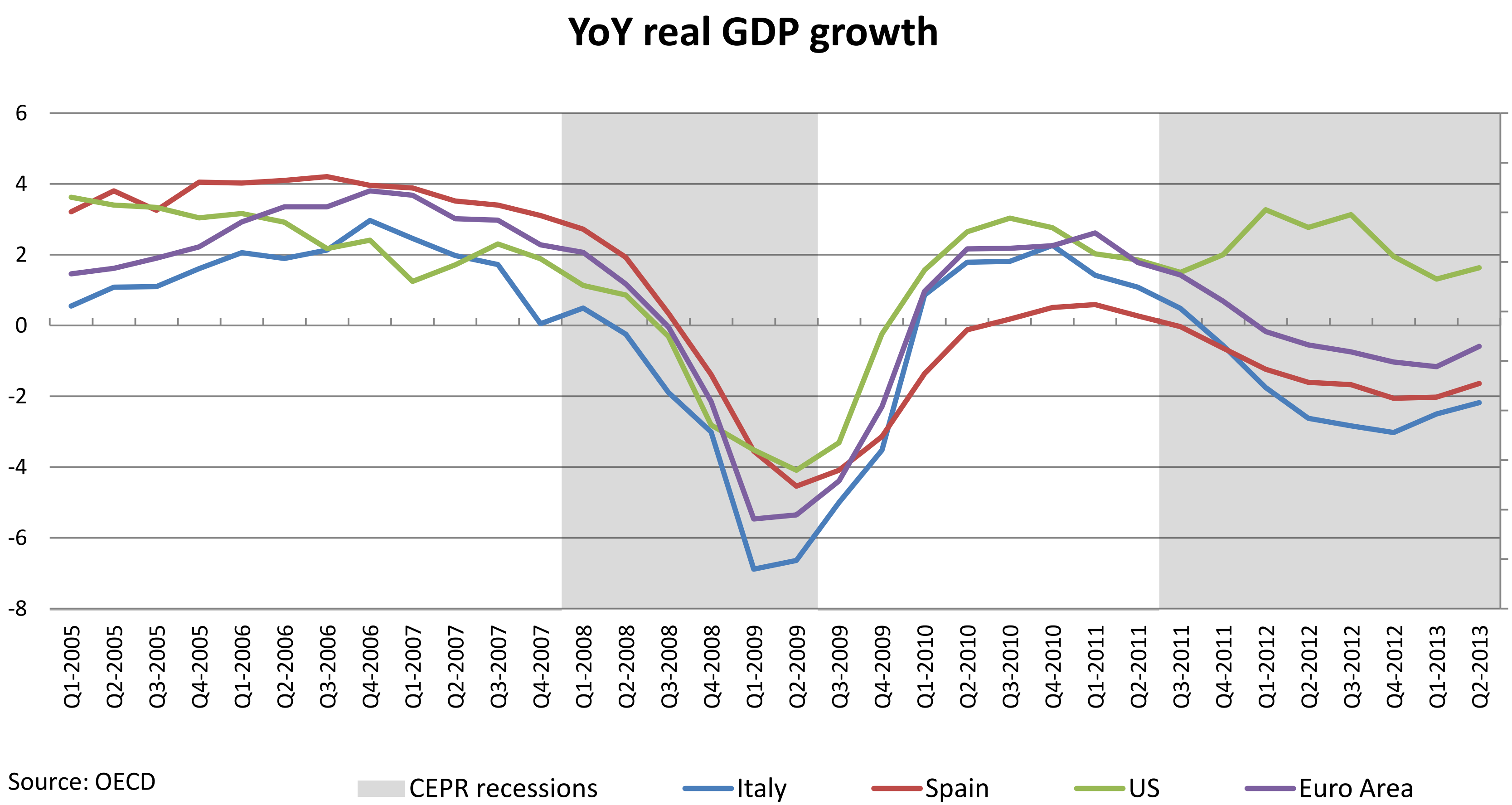
2. Although liquidity was provided especially in the periphery, nominal and real lending rates remain heterogenous



Lending rates to NFC (Up to 1 year)-CPI.
Source: ECB

3. The second recession was specific to the euro area – the US avoided it

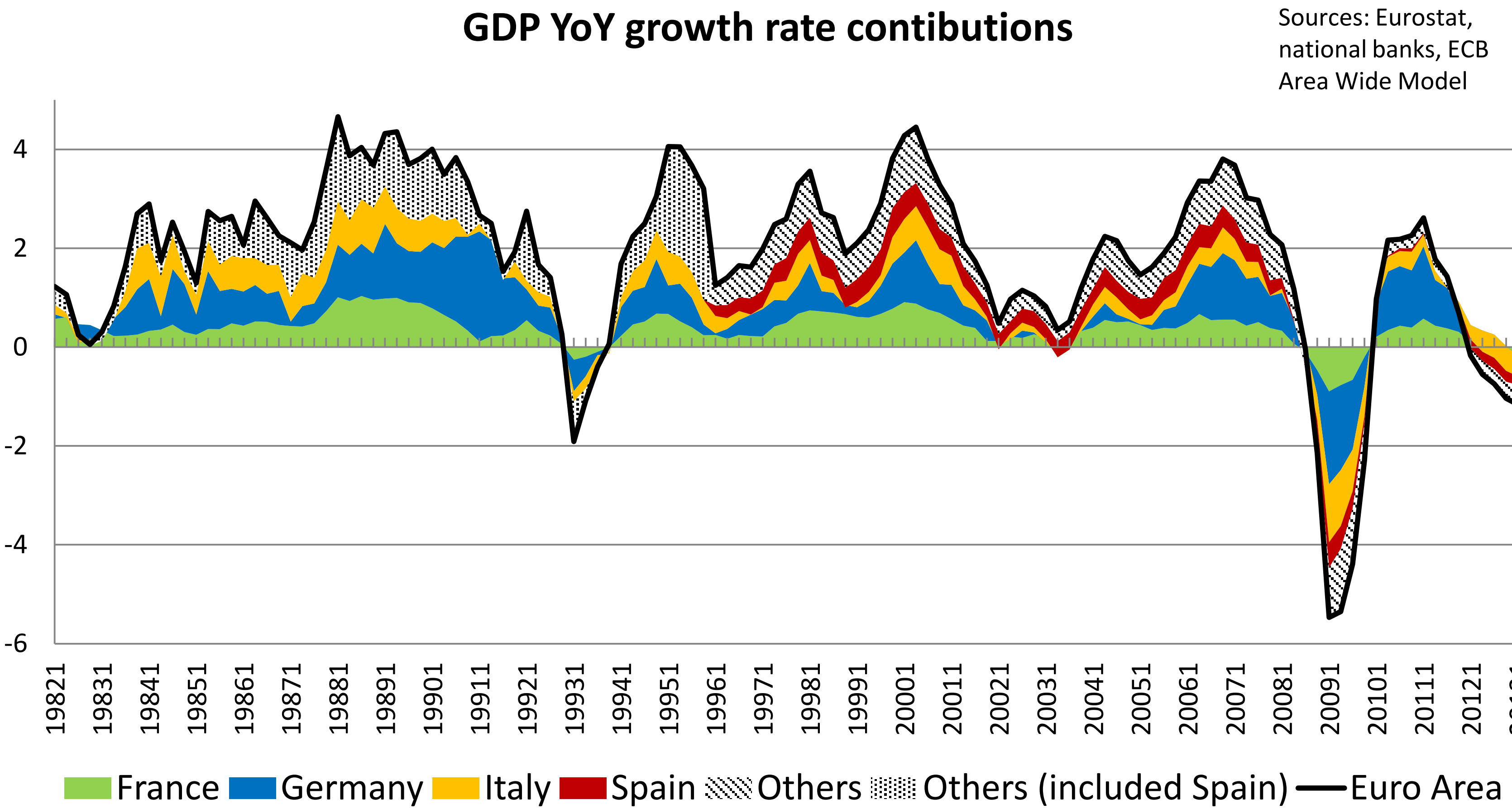
The Euro Area had a second crisis – not the US



Source: OECD

4. And, unusually in historical experience, the second recession was driven by the periphery

Mostly driven by the periphery
Unusual in historical perspective



A key factor in explaining these four facts ….

- In a monetary union, a key feature of the adjustment process is that, in response to a negative shock, financial integration goes into reverse (not the same as flight to safety, rather everybody goes home!)
- Both the home bias in government bonds and in the inter-bank funding are part of this story
- The LTRO can address the inter-bank problem by replacing non-domestic funding but tools to deal with the home bias in sovereign market have not been tried although the banking union project when completed would help

Need non standard policies but again no contradiction between price stability and financial stability, rather tradeoffs which have to do with interaction between monetary and fiscal issues

A quantitative exercise and a proposal

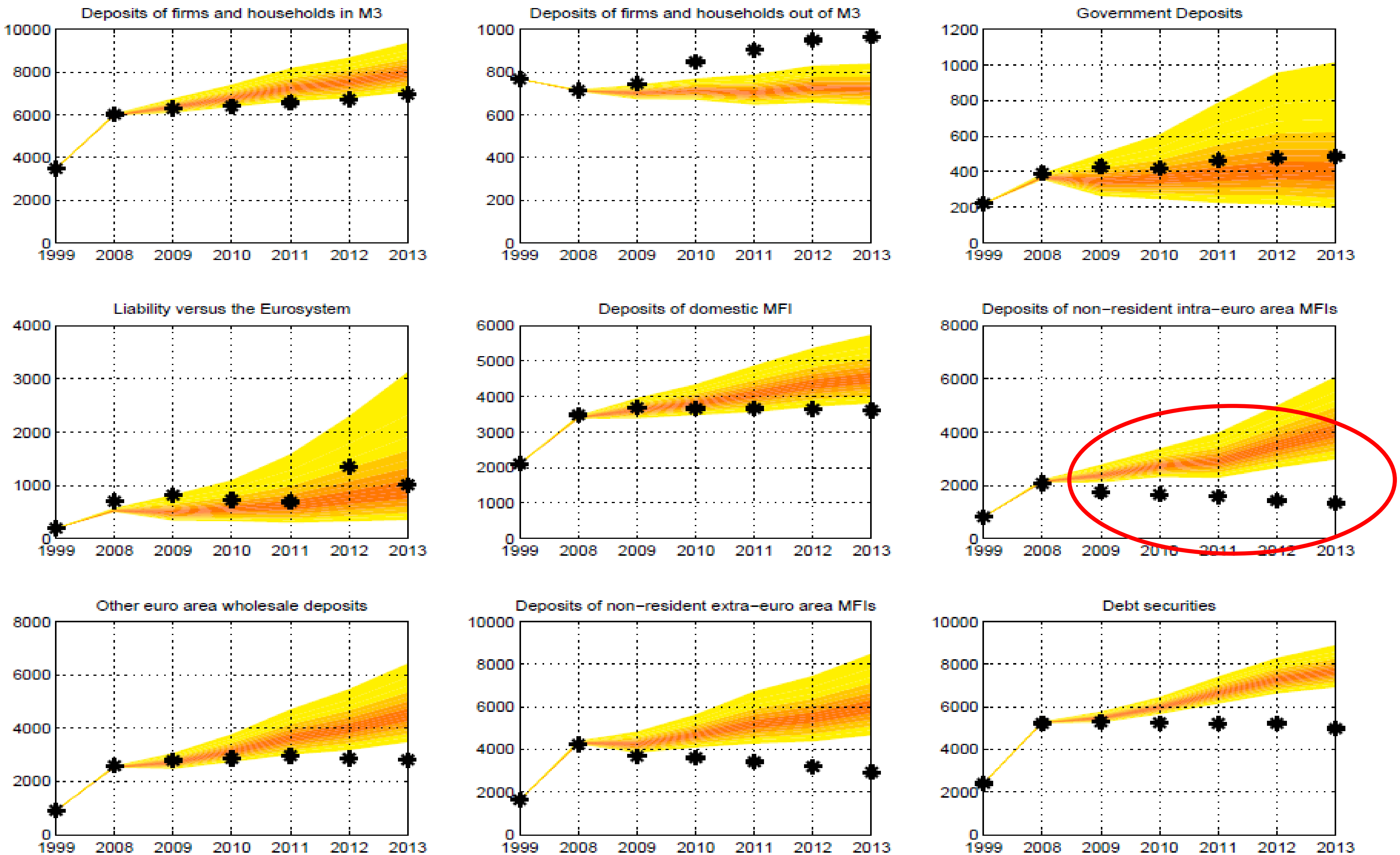
The quantitative exercise (Colangelo, Giannone, Lenza, Pill and Reichlin, 2014):

what have been the BIG changes in banks' balance sheets?

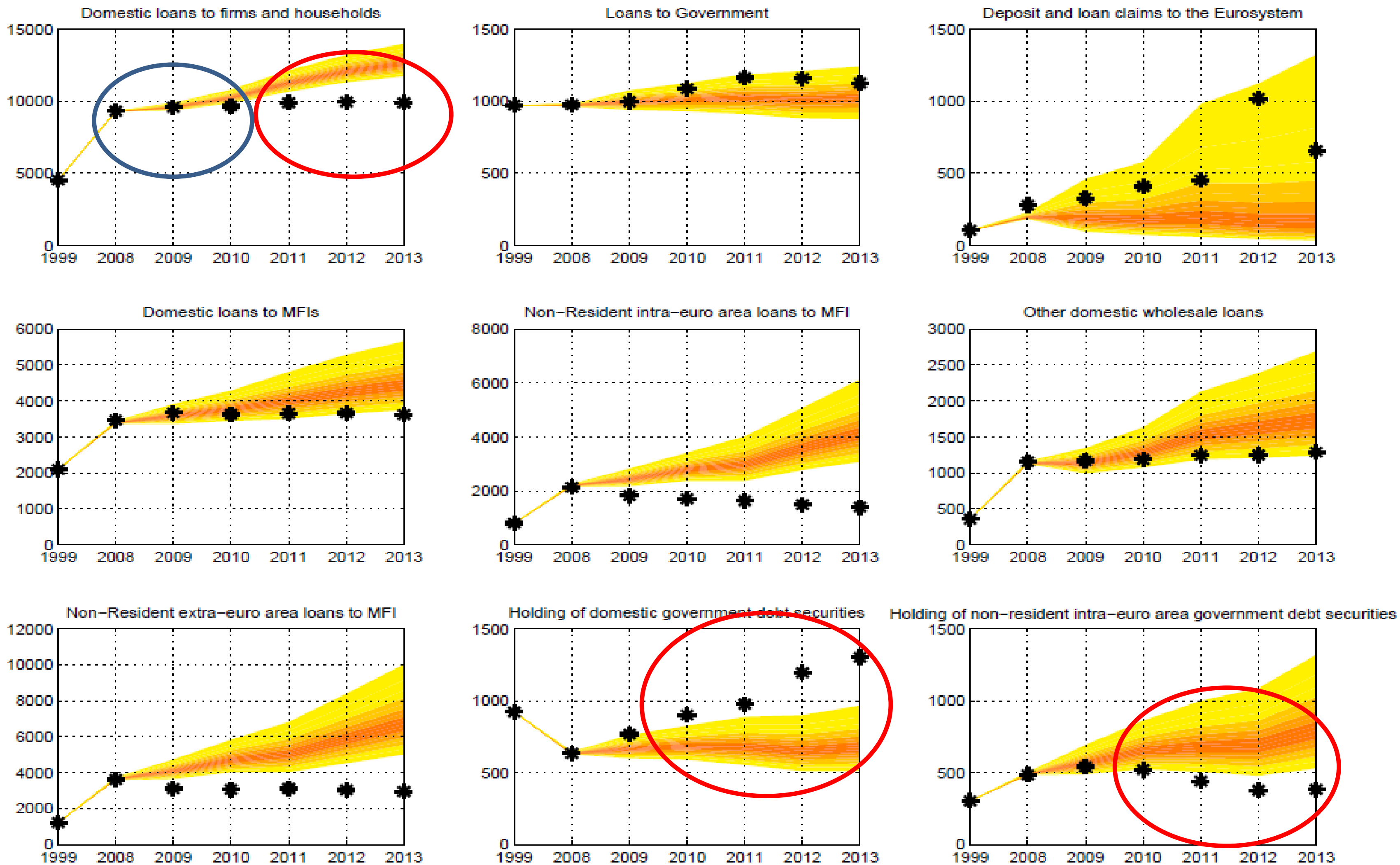
The proposal:

Create incentives for banks to hold geographically diversified sovereign

Banks' balance sheets: big changes since 2008
Liabilities: funding stress is from non-residents from 2008



Banks' balance sheets: big changes since 2008
Assets: shift from loans to government bonds since 2011



Garicano-Reichlin's Proposal

In this context regulation on sovereign bonds and their risk weighting can be used as a monetary policy tool

Sovereign bonds are not risk free but market pricing is distorted

A possible solution

- Impose as a rule that, for sovereign bonds to have a risk free weighting, they must be held by banks in certain constant proportions, for example relative to GDP.
- Although a transition regime will need to be established to avoid hurting banks in the periphery, such proposal would, by dramatically reducing the exposure of banks to their own sovereigns, help to break the link between banks and sovereign risk.
- We also anticipate that such a regulatory initiative bias could help to encourage the emergence of the market driven creation of a euro area safe asset