UBS European Conference

Monetary Policy Panel: "Global Monetary System: Our Currency, Your Problem?"

Remarks by Ignazio Visco, Governor of the Bank of Italy

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1. Since the outbreak of the global financial crisis price stability in major advanced economies has been at risk. Central banks fought this risk with both conventional and unconventional measures, countering financial instability and its macroeconomic implications. More recently the ECB adopted, and then extended, an asset purchase programme.[1] Today, I will discuss the effectiveness of this monetary measure and some concerns that have been raised regarding its possible unintended consequences. I will conclude with some thoughts on the current challenges for monetary policy in the euro area.

Excessively low inflation and the risks of de-anchoring of inflation expectations

2. In the euro area downward risks for price stability increased sharply in the second half of 2014, as inflation kept falling, growth lost traction and monetary and credit dynamics remained weak. Inflation reached historically low levels also in the countries that had not been directly affected by the sovereign debt crisis. In December 2014, no country of the euro area recorded an inflation rate above 1 per cent; in 12 countries out of 18 consumer price dynamics were negative. These developments reflected not only the collapse of oil prices, but also the weakness of aggregate demand.[2]

3. Inflation expectations were progressively affected by the persistent decrease in actual inflation. Indeed, in the second part of 2014 even long-term inflation expectations, which previously had hovered around the definition of price stability, begun to decline substantially. The 5-year forward, 5-years ahead inflation swap rate fell to slightly below 1.5 per cent at the beginning of this year, from around 2.2 per cent in early 2014. The Consensus Economics survey and the ECB's survey of professional forecasters also signalled falling medium- and long-term inflation expectations in the course of 2014.

4. The risk of expectations de-anchoring from the definition of price stability was material. Since mid-2014 negative tail events affecting short-term expectations have been increasingly channelled into long-term ones, igniting both downward revisions of expectations and an increase in uncertainty.[3] These developments were particularly worrying as the formation of expectations is not a linear process: large changes can materialise in a discontinuous manner.

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[1] I have recently advanced my views on the motivations for such a programme, and some related concerns, also in I. Visco, "Eurozone challenges and risks", *Central Banking*, 26, 1, 2015.

[2] A. Conti, S. Neri and A. Nobili, "Why is inflation so low in the euro area?", Banca d'Italia, Temi di discussione (Working Papers), 1019, 2015.

[3] S. Cecchetti, F. Natoli and L. Sigalotti, "Tail comovement in option-implied inflation expectations as an indicator of anchoring", Banca d'Italia, Temi di discussione (Working Papers), 1025, 2015; F. Busetti, G. Ferrero, A. Gerali and A.

5. The high levels of public and private debt are also a source of concern due to the risk of activation of "debt-deflation mechanisms".[4] Even the fact that the decrease in prices was partly associated with a favourable supply shock – the fall in oil prices − was no cause for relief. When interest rates are at the zero lower bound and credit constraints are binding the response of the economy to any given shock is modified and there is no "good" deflation:[5] in such circumstances the fall in the general price level induced by the supply shock increases the real interest rate, which in turn depresses aggregate demand and raises the real cost of servicing debt. The result could be a contraction in aggregate demand, despite the more favourable supply conditions, with further downward effects on prices.[6]

The expanded asset purchase programme of the ECB

6. Against a backdrop of increased downward risks to inflation, in early 2015 the shared assessment within the Governing Council was that the measures adopted up until that time − including the programmes of purchases of covered bonds and ABS, and the targeted longer-term refinancing operations − had not resulted in the desired amount of monetary stimulus. Although they helped to significantly reduce the cost of borrowing for the private sector, the total amount of liquidity injected into the economy was less than initially expected. In late 2014 the size of the Eurosystem's balance sheet was around €2.2 trillion, about €1 trillion (or 30 per cent) below the peak reached in June 2012. During the same period, the balance sheets of the Federal Reserve and of the Bank of England had expanded by around 60 and 10 per cent, respectively.
7. A forceful and unprecedented monetary policy response therefore became warranted: it was important to preserve the credibility of our actions and underpin expectations. At the beginning of 2015 the Governing Council decided to extend its programme of asset purchases to public sector securities. Under this new expanded asset purchase programme (APP) the Eurosystem is making monthly purchases amounting to €60 billion. As explicitly stated, the programme is scheduled to continue at least until the end of September 2016, and in any event until we will observe a sustained adjustment in the path of inflation consistent with a return to price stability.

Locarno, "Deflationary shocks and de-anchoring of inflation expectations", Banca d'Italia, Questioni di economia e finanza (Occasional Papers), 252, 2014.

[4] I. Fisher, "The debt-deflation theory of great depressions", *Econometrica*, 1, 4, 1933.

[5] M. Casiraghi and G. Ferrero, "Is deflation good or bad? Just mind the inflation gap", Banca d'Italia, Questioni di economia e finanza (Occasional Papers), 268, 2015; C. Borio, M. Erdem, A. Filardo and B. Hofmann, "The costs of deflations: a historical perspective", *BIS Quarterly Review*, March 2015.

[6] S. Neri and A. Notarpietro, "Inflation, debt and the zero lower bound", Banca d'Italia, Questioni di economia e finanza (Occasional Papers), 242, 2014.

8. The choice of this particular measure was driven by the consideration that outright asset purchases allow a more direct control of the size of the increase in our balance sheet, and hence of the monetary stimulus itself. The decision to purchase government securities reflected the need to focus on assets available in quantities sufficient to ensure an adequate degree of monetary accommodation and whose returns are able to influence the conditions of the real economy.

9. The APP is a new programme for the euro area, but it is not a revolution in monetary policy making in general. Central banks around the world have relied on large-scale asset purchase programmes to further stimulate the economy and fulfil their mandates after hitting the zero lower bound. Such measures were taken, as we all know, by the Bank of Japan, the first time in 2001, and by the Federal Reserve and the Bank of England, following the global financial crisis in 2008. It seems to me that these policies would have been certainly regarded as "conventional" in the 1960s and 1970s given the emphasis on changes in the composition of private sector balance sheets both in actual policy-making and in academic works on the transmission mechanism of monetary policy.[7] What is more "conventional" for a central bank than creating base money?

10. Asset purchases boost economic activity and raise inflation through several channels: they reduce yields on public sector securities, with effects on other segments of the financial market and on credit conditions for households and firms; they increase the value of assets and hence private sector spending capacity; they cause a depreciation of the currency, which impacts on imported inflation and exports; and they improve inflation expectations and public confidence.

11. Positive effects on the government bond market emerged as soon as the preparation of the programme was announced in early November 2014. Since then, though with some reversal of the initial impact during the spring, the yields on ten-year German and Italian government securities have fallen by about 25 and 80 basis points respectively. The stimulus has spread to market segments not directly affected by the asset purchases. The euro has depreciated by more than 12 per cent against the dollar and by around 8 per cent in nominal effective terms.

12. Credit conditions have also been gradually improving since the announcement of the APP: rates on new loans to firms and to households for house purchase have gone down by around 30 basis points on average in the euro area; larger reductions were generally recorded in the countries hit by the sovereign debt crisis. Positive effects can also be seen in lending volumes. After three

[7] C. Borio and P. Dysiatat, "Unconventional monetary policy: an appraisal", *The Manchester School*, 78, s1, 2010.

years of contraction, the annual growth rate of credit to the non-financial private sector turned positive in April; it stood at 0.7 per cent in September.

13. The ultimate metric to gauge the effectiveness of the APP is the normalisation of the inflation rate around its medium term target. It is too early to provide an assessment, given the lags of transmission of monetary policy, but the general improvements in financial conditions, the main channel through which the programme is expected to work, indicate that so far it has been successful. Overall, the APP has helped push the intended monetary policy accommodation through the intermediation chain and reach households and firms. This is expected to support economic activity and to produce a sustained adjustment of inflation rates towards levels consistent with the definition of price stability.[8] For Italy, our analysis shows that for 2015-16 the APP can be expected to make a significant contribution to the growth of output and prices, of more than 1 percentage point in both cases.[9] The effects of the programme on euro-area output growth and inflation might be somewhat smaller, but are of approximately the same order of magnitude.

What about possible unintended consequences?

14. Notwithstanding the overall positive assessment of the effects of the APP so far, remarks that stepping into this new domain may have unintended consequences on asset prices, on the return on savings and on currencies must be addressed.

15. First, as with any other important policy action, the risks concerning asset prices were carefully considered when evaluating the balance of benefits and possible costs of the APP. To date, there have been no signs that our purchases are provoking generalised imbalances. Financial assets and property prices in the area as a whole do not appear under speculative pressures, investors' risk propensity is still low, and credit growth, while recovering, remains weak. Moreover, while the possibility of some undesired effects cannot be ruled out, the risks would have been far greater had we not launched the programme. Indeed, the greatest threat to the euro area's financial stability comes from the prospect of low inflation and economic stagnation.

16. When discussing financial imbalances I believe that it is important to bear in mind the distinction between what monetary policy can and should do, and what is, instead, the domain

[8] ECB, "The transmission of the ECB's recent non-standard monetary policy measures", *Economic Bulletin*, 7, 2015.

[9] P. Cova and G. Ferrero, "The Eurosystem's asset purchase programmes for monetary policy", Banca d'Italia, Questioni di economia e finanza (Occasional Papers), 270, 2015.

of macro-prudential policy.[10] In the euro area, monetary policy has the primary objective of maintaining price stability over the medium-term. Macro-prudential measures should instead be used to limit the accumulation of systemic risks and to smooth the financial cycle in particular sectors or jurisdictions. Should any threat to financial stability materialise, specific macro-prudential measures can be implemented by national authorities to deal with local risks, as has recently been done in a number of countries, without the need to alter the monetary stance.

17. Furthermore, when assessing the risks related to the APP, we should not forget that the increase in risk-taking associated with portfolio rebalancing is one of the channels of transmission of the programme. Obviously, indicators of overheating should always be monitored and particular attention should be paid to credit developments in order to timely identify any possible build-up of broad-based imbalances.

18. A second worry concerning the consequences of the asset purchase programme is that, by reducing interest rates, it is "expropriating the savers". In my view this claim is based on a very partial understanding of the role of monetary policy and, more in general, of the secular factors that are currently affecting the global economy.

19. In order to assess this concern, it is important to understand the causes of low interest rates. Their current level in the euro area, as well as in most other advanced countries, is not a bizarre choice of the central banks; rather, it reflects the degree of slack in the economy, low inflation and the gradual process of recovery from one of the deepest crises over the past hundred years. An insufficiently accommodative monetary stance in this environment would only give a false perception of higher returns on savings since it is only in the relatively short term that monetary policy can influence real returns. A longer horizon is relevant, however, for the vast majority of savers. A more restrictive monetary policy in times of economic weakness and low inflation would even be harmful to savers as it would exert a negative impact on the economy and, in turn, on its capacity to achieve higher real returns.[11]

20. That said, the potential repercussions for specific sectors of the financial system should certainly not be ignored. Concerning banks, while in the short-term low interest rates might exert a negative impact on profitability, this effect will be progressively more than compensated by the medium-term positive impact of the monetary stimulus. In some countries, the low interest rates could cause problems for pension funds and insurance companies, whose liabilities allow for

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[10] I. Visco, "The challenges for central banks", *Central Banking*, 25, 1, 2014.

[11] U. Bindseil, C. Domnick and J. Zeuner, "Critique of accommodating central bank policies and the 'expropriation of the saver': A review", ECB, Occasional Paper Series, 161, 2015.

defined benefits or guaranteed minimum returns. These companies should limit risks by seeking a better match between the yields and duration of balance sheet assets and liabilities, improving operating results through portfolio diversification, increasing technical reserves and, where necessary, adjusting their obligations to policy holders to the new market scenario.

21. A third criticism of asset purchases is that they might be used as an instrument to obtain competitive advantages over other countries and, in turn, give rise to “currency wars”, with obvious detrimental effects for the global economy. These worries are misplaced. The measures currently implemented in the euro area, including the APP, are intended to bring inflation back in line with the definition of price stability. They exert their impact on the economy through different channels: the foreign exchange rate is only one of them; it is not by any means a target of monetary policy; it reflects differences in the cyclical positions of countries.

Recent developments and the challenges for monetary policy

22. The persistent slowdown of emerging economies − which has also recently reflected the difficult path of adjustment in China from high levels of investment and debt – has put further downward pressure on commodity prices and increased downward risks for the world economy. Economic activity has continued to expand in the main advanced countries although at a somewhat slower pace.

23. While in the euro area recovery proceeds, downside risks have increased. More importantly, in an environment characterised by a prolonged period of low inflation and with additional downward pressures already in the pipeline − as signalled by the subdued dynamics of producer price inflation − the risks of a further decline in inflation expectations and of their de-anchoring from the definition of price stability remain non-negligible.

24. At our last meeting in Malta we stressed that the strength and persistence of the factors that are currently slowing the return of inflation to levels below, but close to, 2 per cent in the medium term require attention and thorough analysis. In this context, the ECB Governing Council will re-examine the degree of monetary policy accommodation at the December monetary policy meeting, when the new Eurosystem staff macroeconomic projections will be available.

25. The appropriate degree of monetary accommodation has to be maintained to fulfil our mandate. This may imply, as it has been stated, a change in the size, composition and duration of the APP. The possibility to once again lower the interest rate on the deposit facility will also be assessed. So far the introduction of negative interest rates in the area has been smooth; other

countries seem not to have experienced difficulties in lowering rates further into negative territory.

26. Let me conclude with the obvious remark that monetary policy cannot guarantee strong and lasting growth on its own. Lacking a common fiscal capacity, demand in the euro area must draw support from a reasonable use of existing flexibility within the limits of European fiscal rules. At the same time the creation of new income, new demand, and new jobs must be supported by measures and reforms designed, as of now, to raise productivity and enhance growth potential. These reforms should take into account the structural challenges that characterise our "new world", including demographic developments, the new wave of technological progress, climate change. A marked expansion in activities that require expertise and new skills is ahead, but at the same time it is possible that the scope for employment in the sectors most susceptible to automation and to the growth of the digital economy will shrink, even considerably. Monetary policy cannot be a substitute for the needed reforms, it can only provide favourable conditions to speed the process up and absorb its short-term costs.