BANCA D'ITALIA
EUROSISTEMA

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New Challenges for Central Banking: A European Perspective

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Outline

1. Central banking: evolution or involution?
2. Central banking in the euro area: the ECB response to the crisis
3. New challenges: (very) low inflation, «low-for-long» interest rates: is monetary policy still effective?
4. Monetary policy: «not the only game in town»
5. New challenges: monetary policy and financial stability (interactions and trade-offs)
6. Conclusions

Central banking: evolution or involution?

Impact of the financial crisis and the "Great Recession"

«A third of a century ago […] monetary policy, the maintaining of financial stability and supervision of banks formed a single composite, the parts of which were sometimes difficult to disentangle. That world was perhaps not fundamentally different from what central banking had been one or one and a half centuries earlier." **(Tommaso Padoa-Schioppa, Central banks and financial stability: exploring a land in between, 2002)**

A progressive deconstruction, after the high inflation of the 1970s, through the "Great Moderation"

- **Focus on price stability, the ECB**
- **Independence (and fading away of financial stability from central banks' responsibilities)**
- **Discretion to rules: (flexible) inflation targeting**

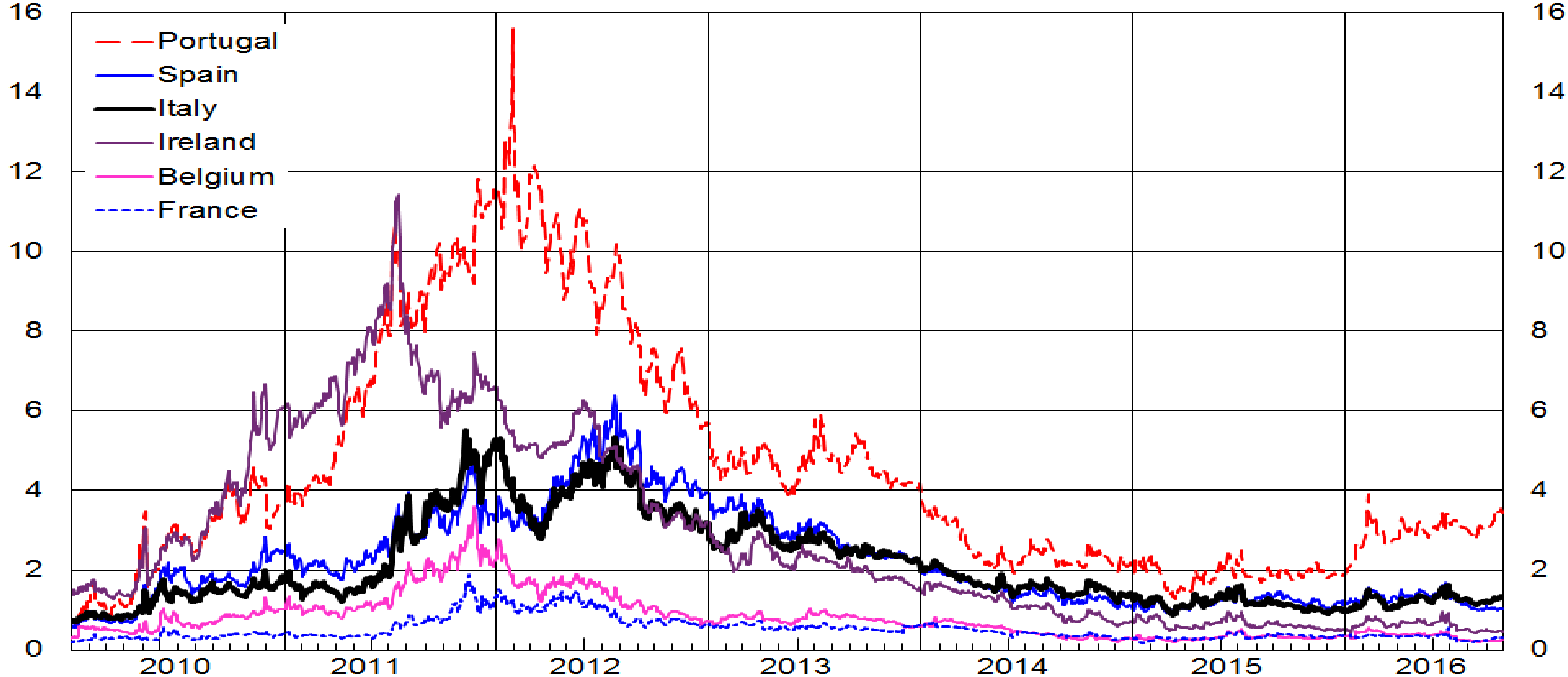
Another phase in the development of central banking?

«In the years to come, the most interesting developments will probably be precisely in the sphere of supervision and regulation. […] Whatever its detractors may say, the central bank has no need to move into new lines of business. […] Capitalism generated the central bank and capitalism will come to it again, even if the current infatuation with the financial markets' self-regulating capacity were to endure.» **(Curzio Giannini, The age of central banks, (2004) 2011)**

Central banking in the Euro Area

- ✓ **After the 2008-09 global financial crisis: the sovereign debt crisis**
- ✓ **Sustainability risk versus redenomination risk**

10-y Government bond spreads against Bund (percentage points)



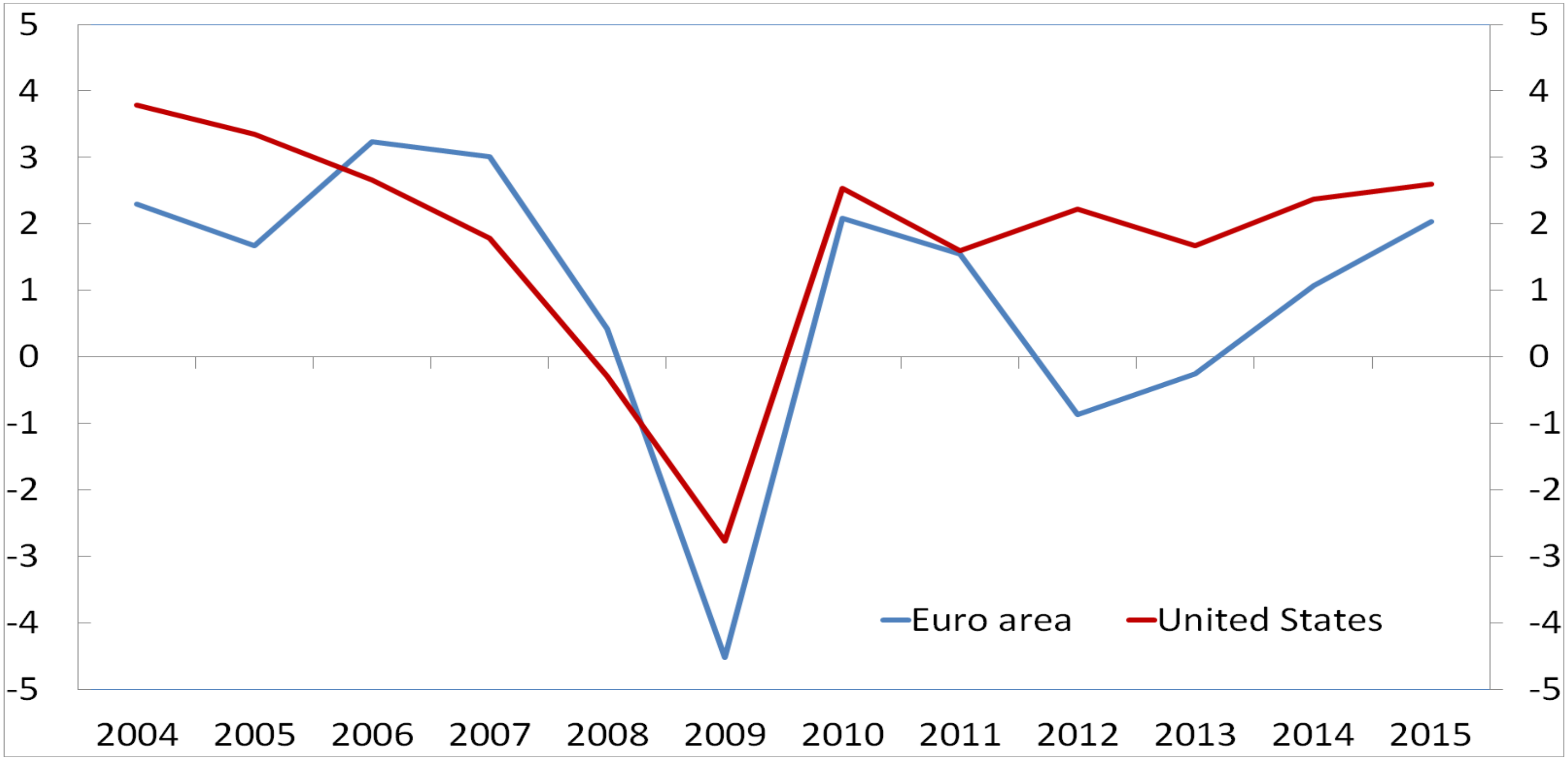
The ECB and the quest for price stability:

- structural feature: bank-based financial intermediation (vs market-based in the US)
  - ✓ banks' total assets to GDP:
    - 3 to 4 in France, Germany and Italy; slightly above 1 in the US
  - ✓ bank loans to non-financial corporates:
    - 80% to 90% of total financing in France, Germany and Italy; 57% in the US
- financial fragmentation along national lines: impaired monetary policy transmission mechanism

In the aftermath of the sovereign crisis: a slow recovery…

Real GDP growth in the euro area and in U.S.

(year-on-year growth, percent)

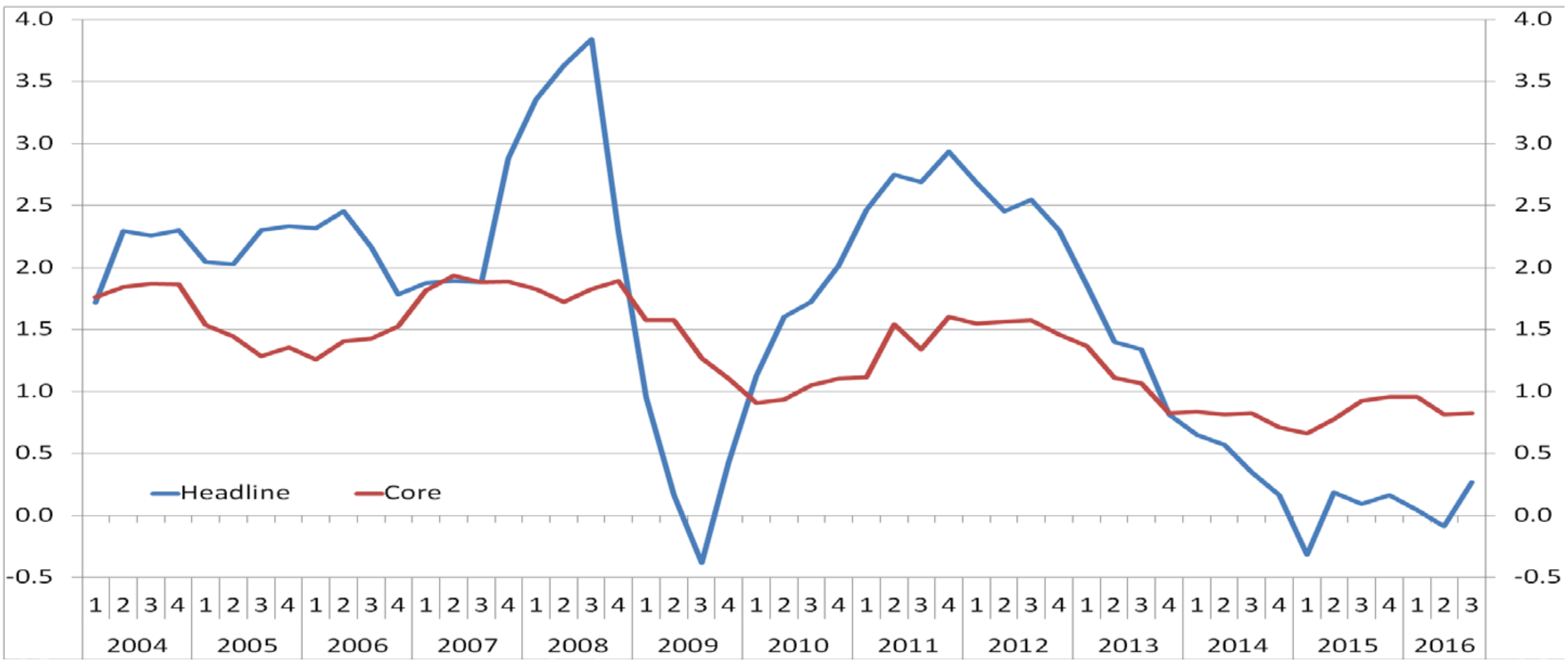


Central banking in the Euro Area

…and (very) low inflation

Euro area HIPC inflation

(quarterly; percentage change over corresponding period)



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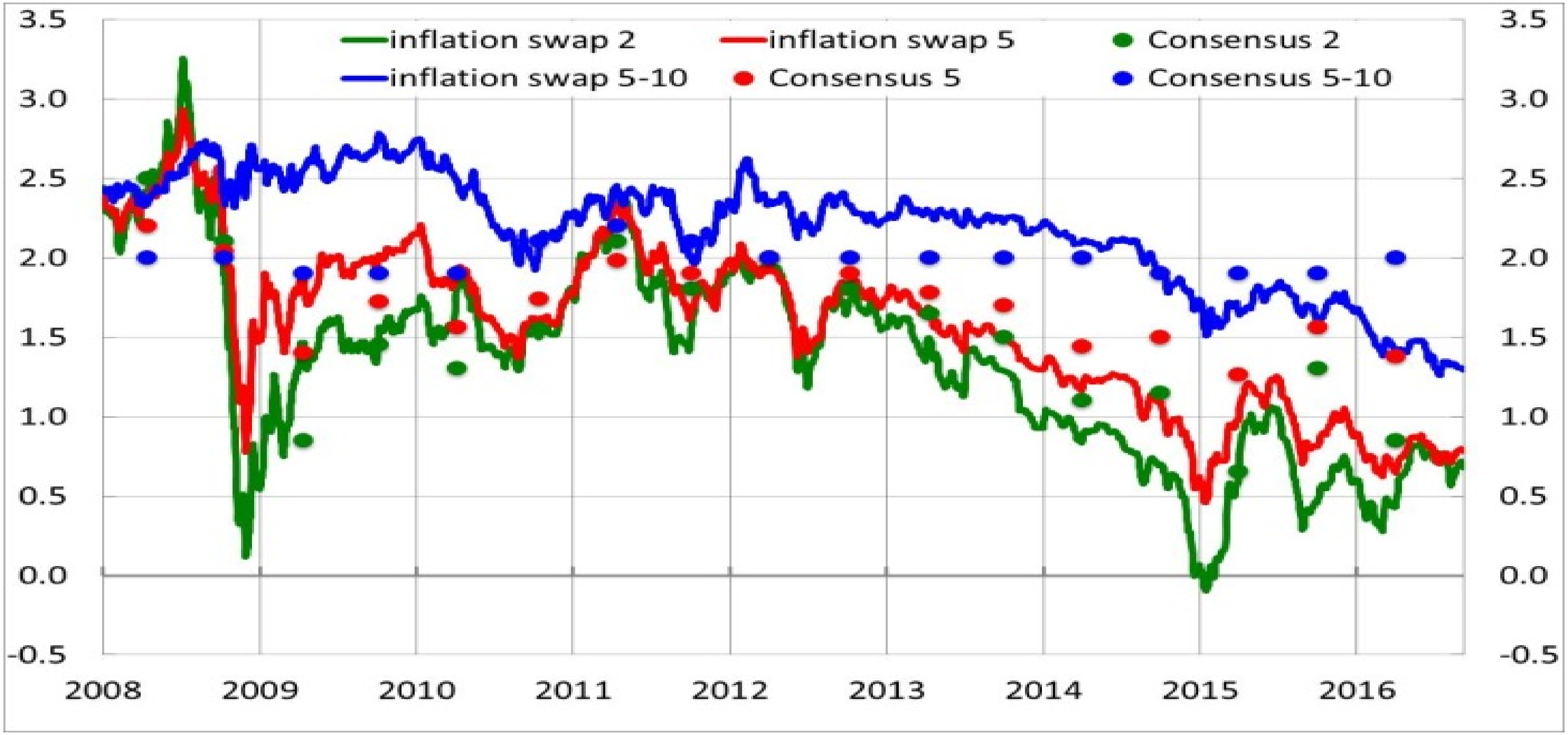
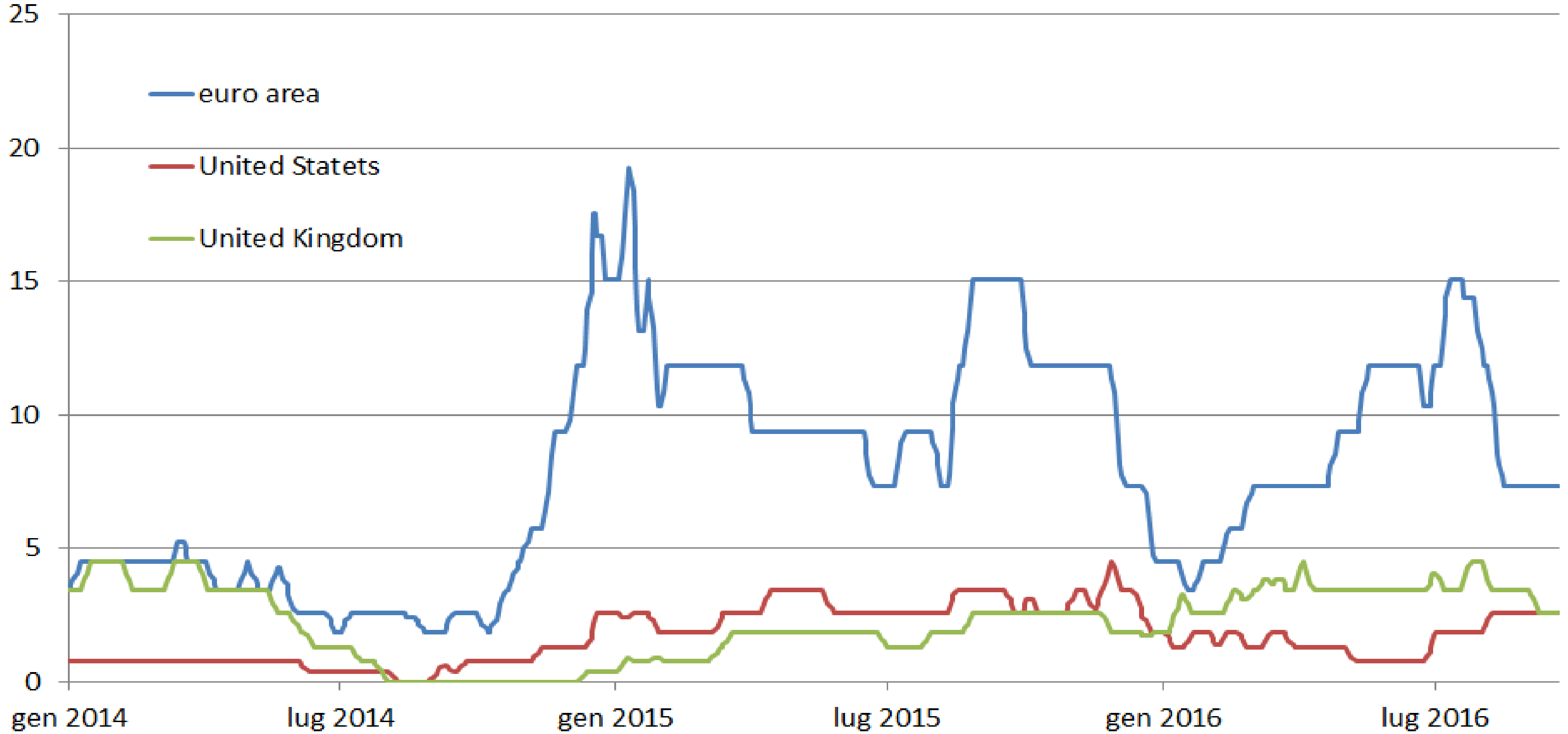
Risk of de-anchoring of inflation expectations: in 2013-2016 expectations decreased at all horizons in the euro area



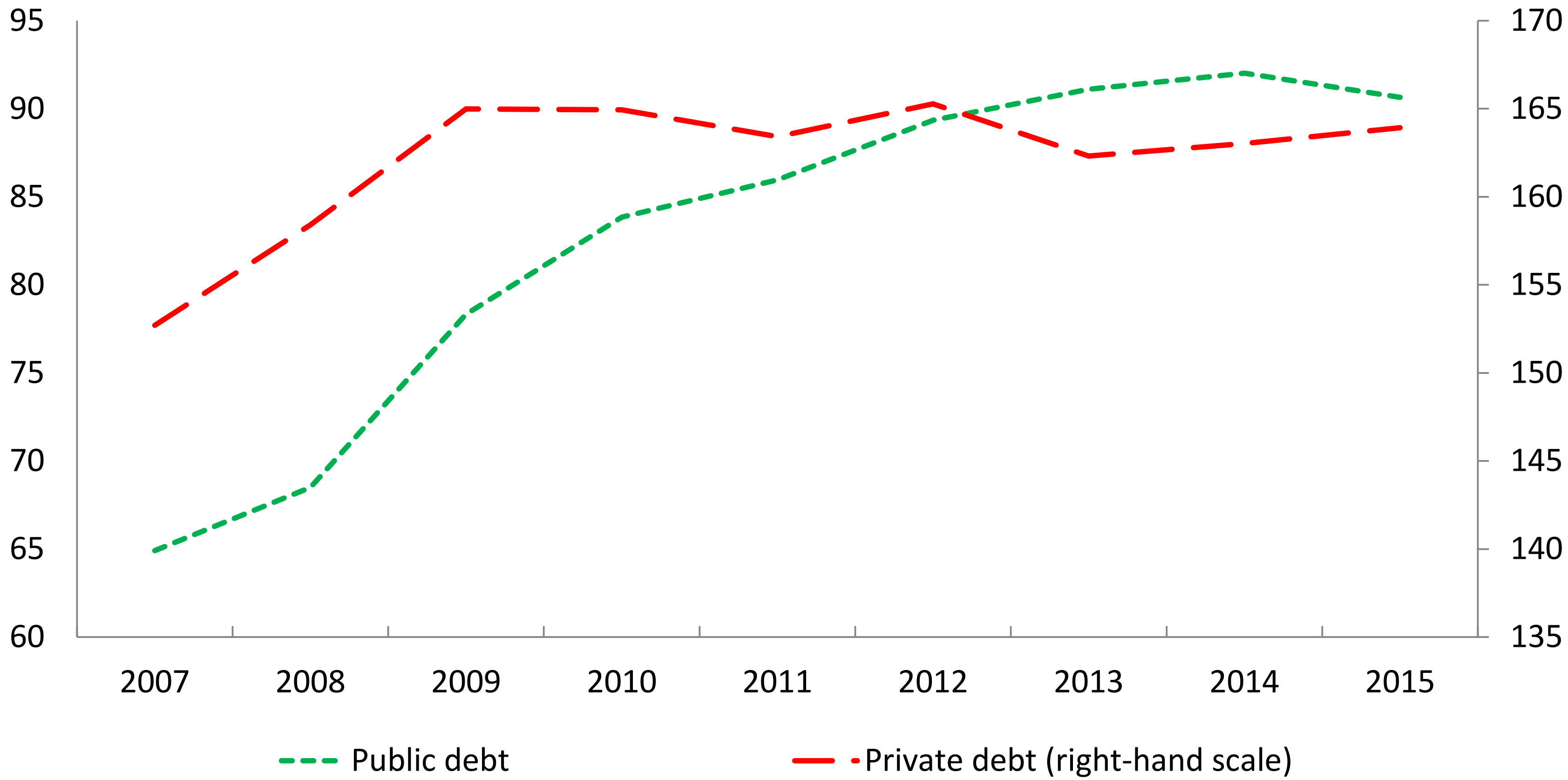
Central banking in the Euro Area

Risk of de-anchoring of inflation expectations: probabilities of co-movement of short-term/long-term indicators



Source: Natoli and Sigalotti, Bank of Italy Working Papers, forthcoming

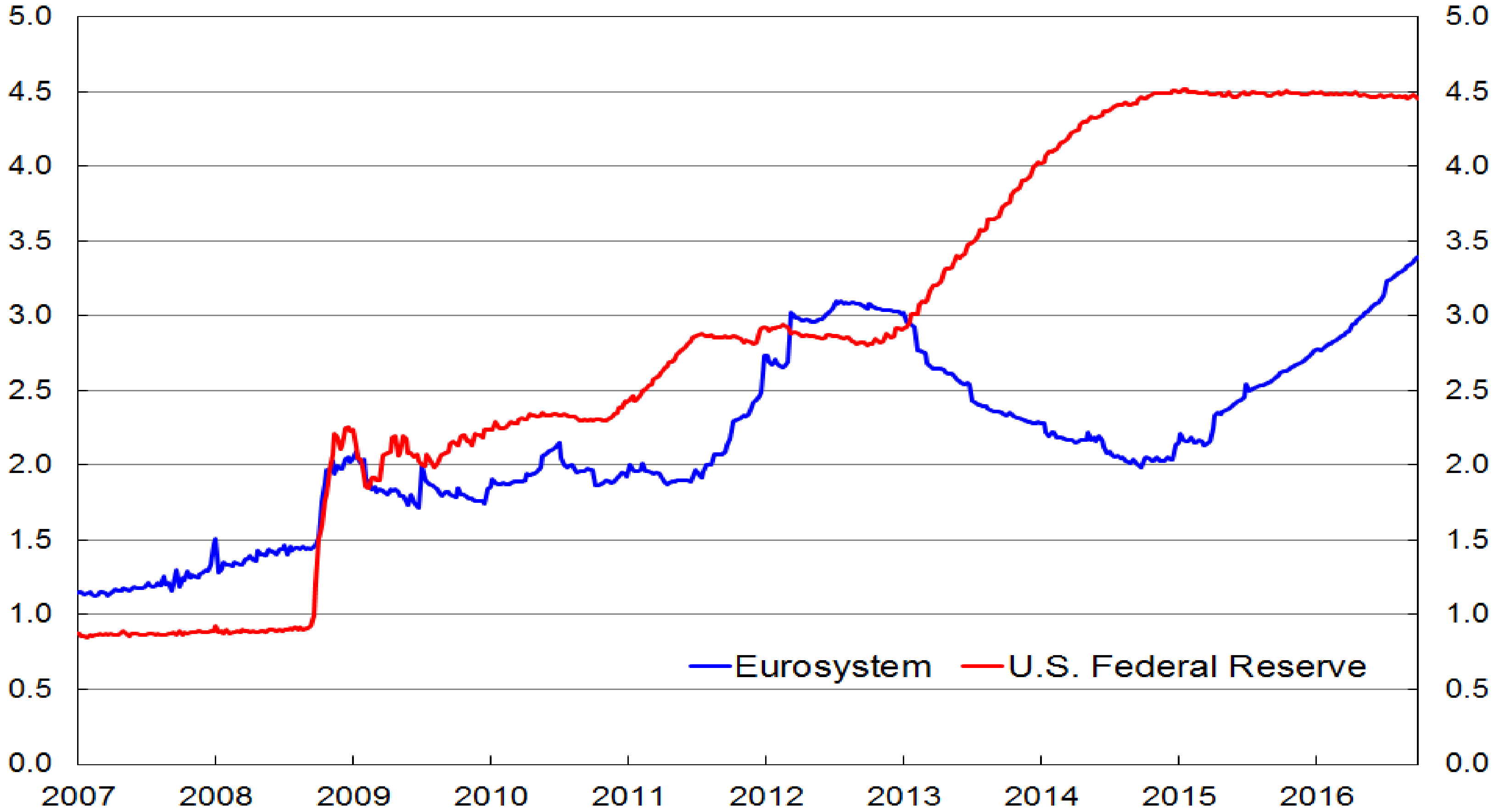
Risk of Fisher's debt deflation: euro area public and private debt, 2007-2015 (percentage of GDP)



The ECB policy response to deflationary risks:

- conventional measures
  - ✓ interest rates
- unconventional measures
  - ✓ money and credit (and Asset Purchase Programme)
  - ✓ negative interest rates

Central banks' balance sheet in the euro area and in U.S. (total assets; trillions of dollars and euros)



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New Challenges for Central Banking: Monetary Policy

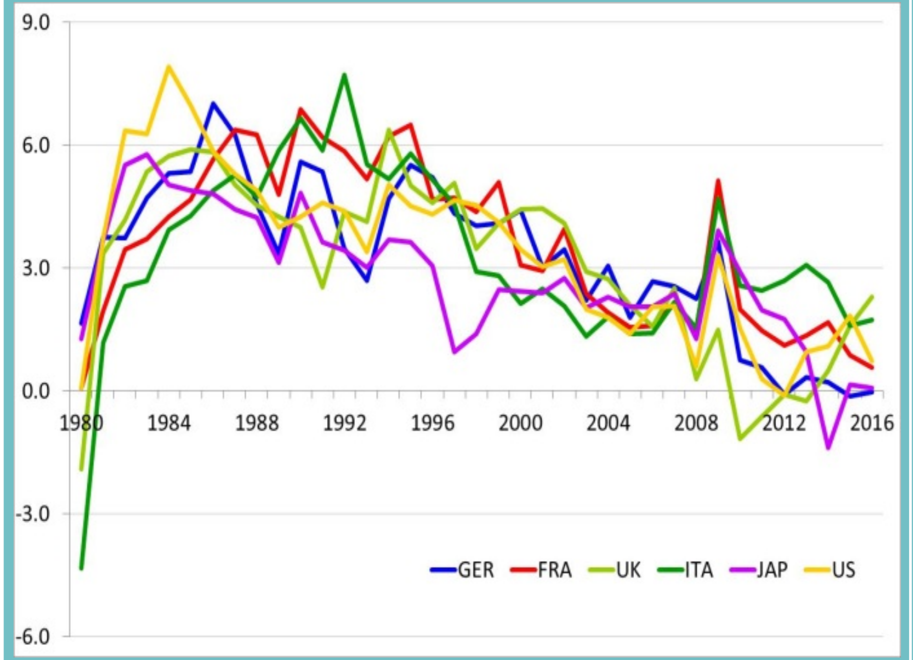
1. Is monetary policy still effective?
   - yes: counterfactuals
2. medium- and longer-term challenges:
   - coping with («low-for-long»?) interest rates
   - interacting with other policies
3. *possible questions*:

- changing the strategy? (price level or NGDP targeting)
- raising the inflation target to remove the ZLB?
- making conventional the unconventional?
- «helicopter money»?

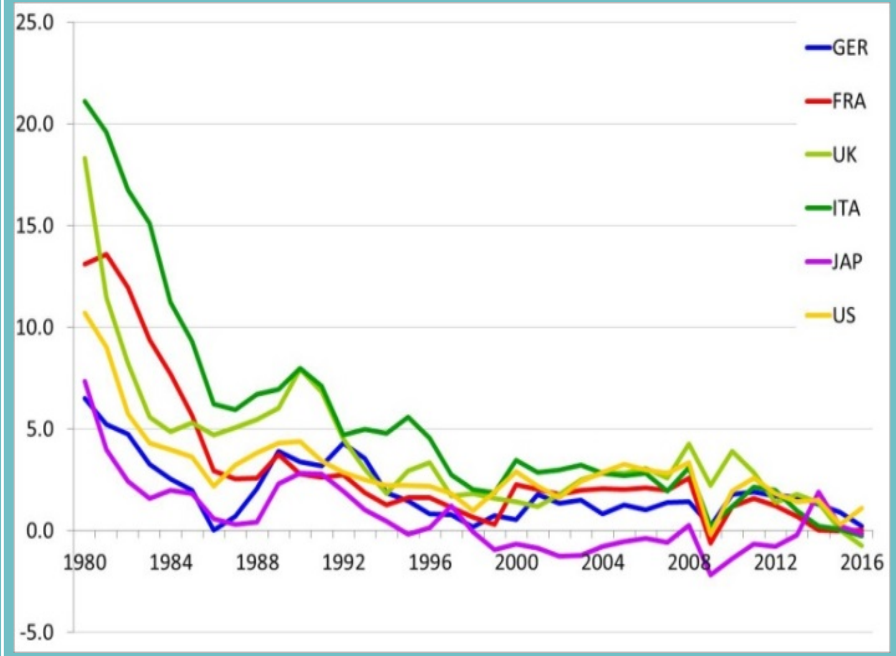
New Challenges for Central Banking: Monetary Policy

The fall in nominal interest rates is explained by the reduction of both inflation (and inflation expectations) and of real interest rates.

a) Long-term real interest rates



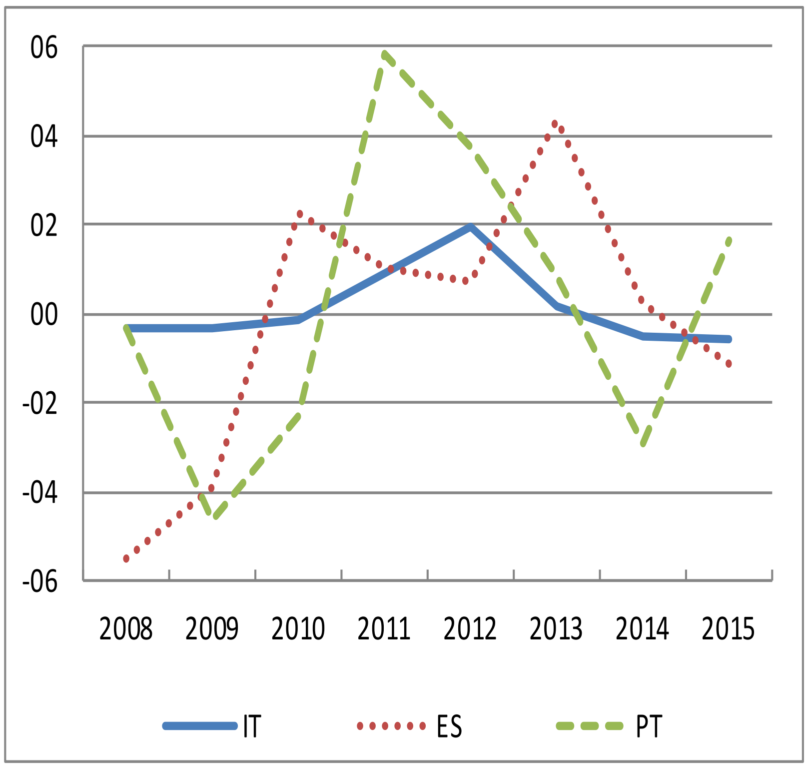
b) CPI inflation

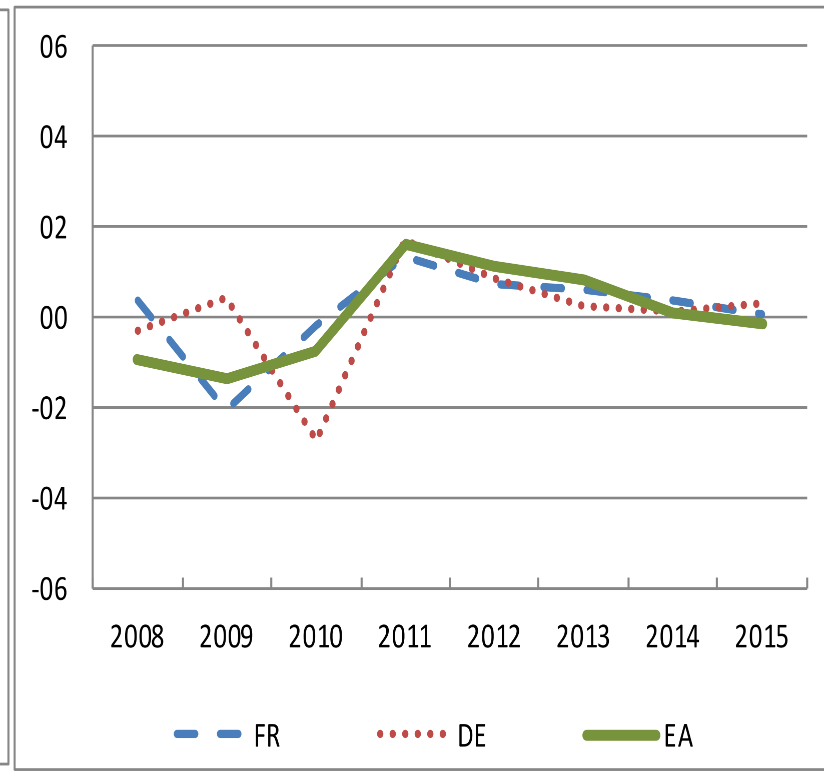


Source: European Commission. Note: nominal rates deflated with private consumption deflator.

Is fiscal policy supporting growth? Fiscal stance 2008-2015

(annual changes in cyclically adjusted primary balance; per cent of GDP - a positive value indicates a contractionary stance)





Monetary Policy «not the only game in town»: the role of other policies

1. **Fiscal policy in the euro area: incomplete institutional architecture**
   - ✓ *single* monetary policy, *single* supervisory mechanism but *multiple* fiscal policies

2. **Reforms of the EU/EMU fiscal governance framework**
   - ✓ developing a fiscal capacity
   - ✓ devising a euro area aggregate fiscal stance

3. **Structural reforms: increasing potential growth**
   - short-term impact and long-term benefits

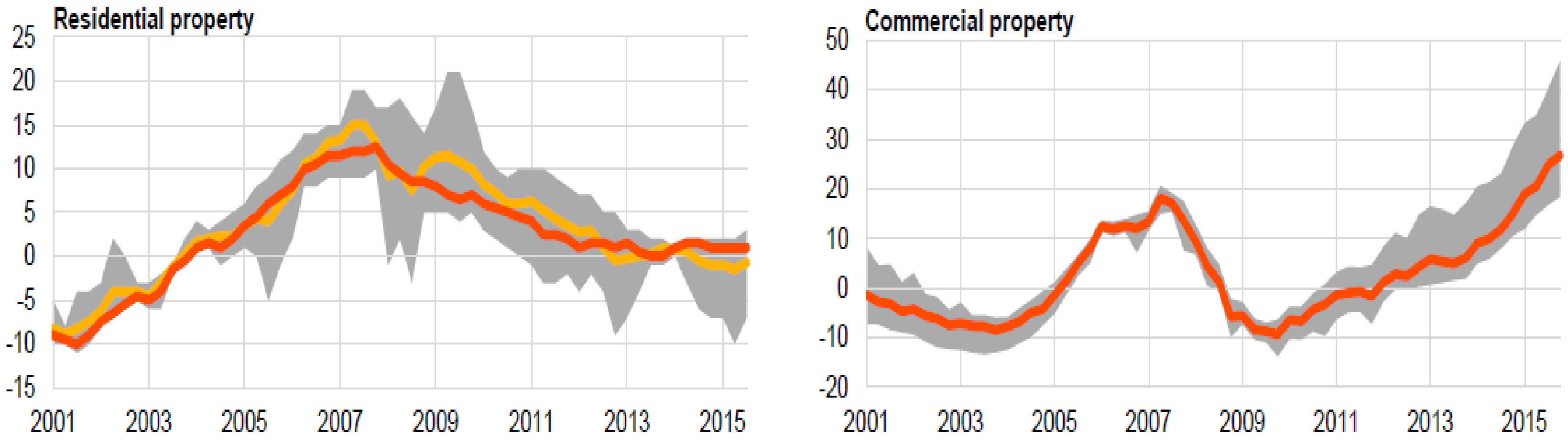
New Challenges: Monetary Policy and Financial Stability: Interactions and Trade-offs

1. Potential side effects of accommodative monetary policy:
   - excessive risk taking
   - credit «booms»
   - asset price «bubbles»
   - lower banks' profitability
2. What is the current evidence telling us?

Over/undervaluation of residential property prices in the euro area

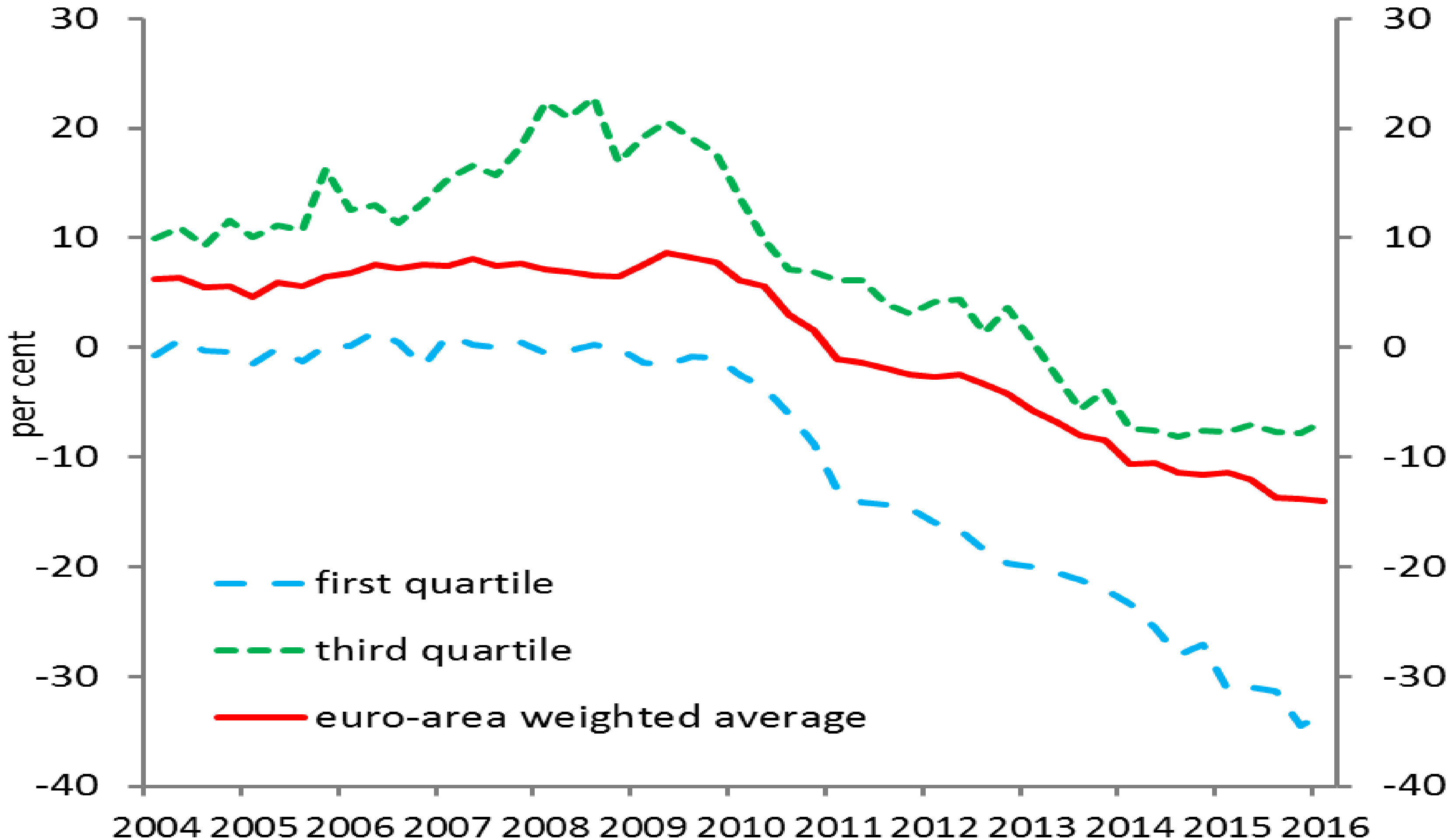
Valuation estimates of residential property prices at the euro area level

(Q1 2001 – Q4 2015; percentages; average valuations; minimum-maximum range across valuation estimates)



Sources: ECB and ECB calculations.
Notes: Valuation estimates for residential property prices are based on four different valuation methods: the price-to-rent ratio, price-to-income ratio and two model-based methods, i.e. an asset pricing model and a new model-based estimate (BVAR). For details of the methodology, see Box 3 in *Financial Stability Review*, ECB, June 2011, as well as Box 3 in *Financial Stability Review*, ECB, November 2015. For residential property, the yellow line represents the average of the four valuation methods, while the orange line is an average based on the price-to-income ratio and the new model-based method. For details on valuation estimates for prime commercial property, see Box 6 in *Financial Stability Review*, ECB, December 2011.

Domestic credit-to-GDP gap in the euro area



New Challenges: Monetary Policy and Financial Stability: Interactions and Trade-offs

- Low interest rates and bank profitability: net interest income and margins remained broadly stable since 2011

- Decline in profitability mainly due to exceptional increase in asset write-downs

  - ✓ in some countries NPLs stocks have reached historical highs

- Recovery in profitability: dependent on economic activity and adjustment in business model

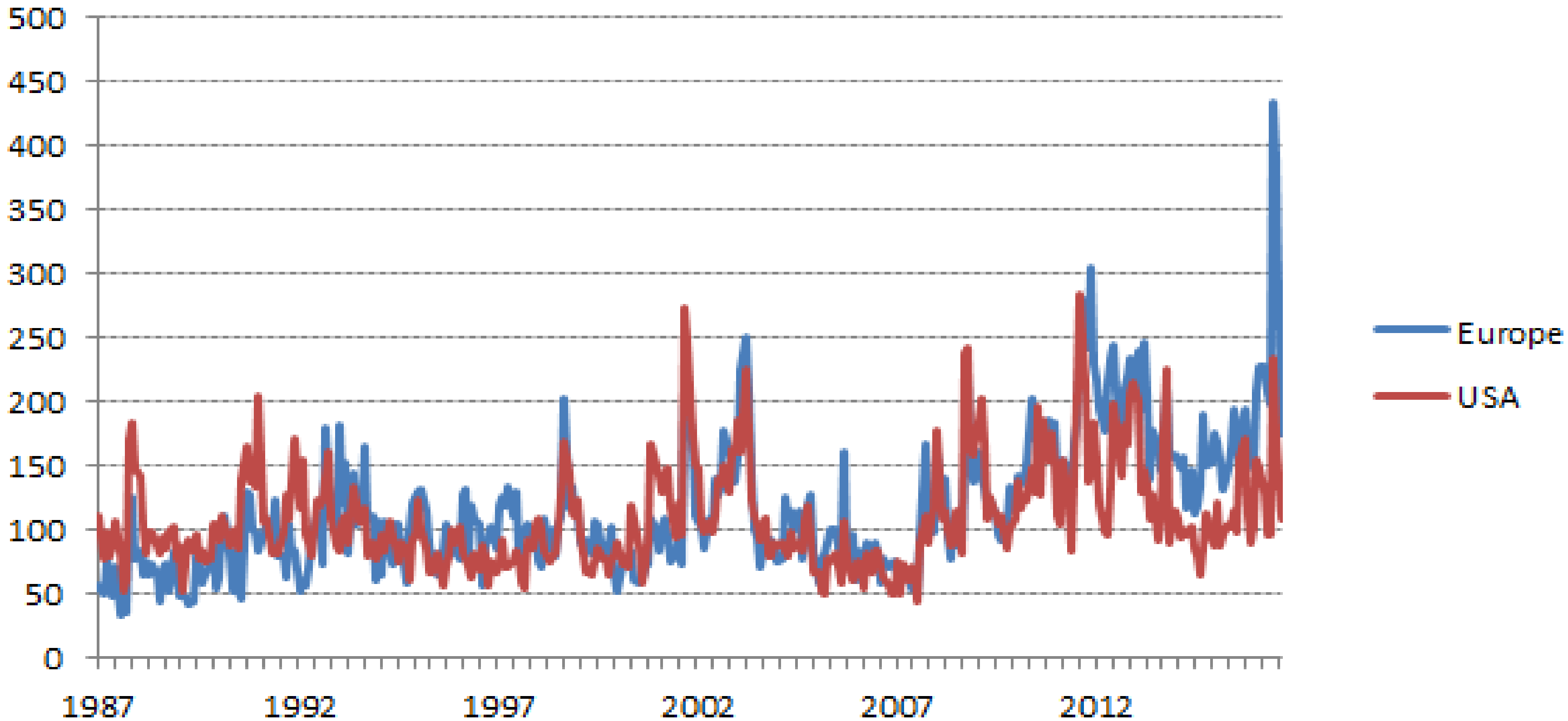
1. **MP, MAP, MIP: complementarities and tradeoffs**
   - ✓ Policy:
     - MAP can "lend a hand" to MP (if buffers are available)
     - in recessions MAP and MIP can be in conflict
   - ✓ Governance:
     - ECB vs ESCB
     - ECB vs SSM
2. Avoiding prociclycality is key

Conclusions (I)

- Monetary policy alone can guarantee neither balanced and sustained growth, nor financial stability
- Banking Union is a major step towards preventing systemic financial crises: must be completed
- Investment is key to returning to sustained and balanced growth: held back by uncertainty (policy; geopolitical; technology; demographics)

Conclusions (II)

Policy uncertainty index (news-based)



Source: calculation based on the Baker-Bloom-Davis methodology with data from www.policyuncertainty.com

Conclusions (III)

Challenges for central banking in the aftermath of the crisis:

1. **preserving monetary policy effectiveness in a (very) low inflation environment**
2. **complementary role of other policies: no overburdening of monetary policy**
   - **establish a fiscal capacity for the EMU**
3. **safeguarding financial stability and the independence of monetary policy**

Conclusions (IV)

Curzio Giannini's 2004 quote

The central bank produces an intangible but essential good – trust – of which capitalism (based as it is on a pyramid of paper if not mere electronic signals) has an immense need.

[…] trust, or its synonym "confidence", derives from the Latin fides, meaning faith, which cannot be produced simply by contract.

[…] the legitimacy of central banks does not lie in their policy activism, or the ability to generate income, or even, save in a highly indirect sense, their efficiency. […] it derives from competence, moderation, the long-term approach, and the refusal to take any tasks beyond their primary role. […] another phase in the development of central banking […] will spring from these values.