New Challenges for Central Banking: A European Perspective

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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)
Central banking in the Euro Area

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
Central banking in the Euro Area

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)
Risk of de-anchoring of inflation expectations: in 2013-2016 expectations decreased at all horizons 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
Central banking in the Euro Area

Risk of Fisher’s debt deflation: euro area public and private debt, 2007-2015 (percentage of GDP)
Central banking in the Euro Area

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

Source: European Commission. Note: nominal rates deflated with private consumption deflator.
Monetary Policy «not the only game in town»: the role of other policies

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

1. MP, MAP, MIP: complementarities and trade-offs

✓ 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 procyclicality is key
• 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
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
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.