# The fiscal-monetary policy mix in the euro area: Challenges at the zero lower bound

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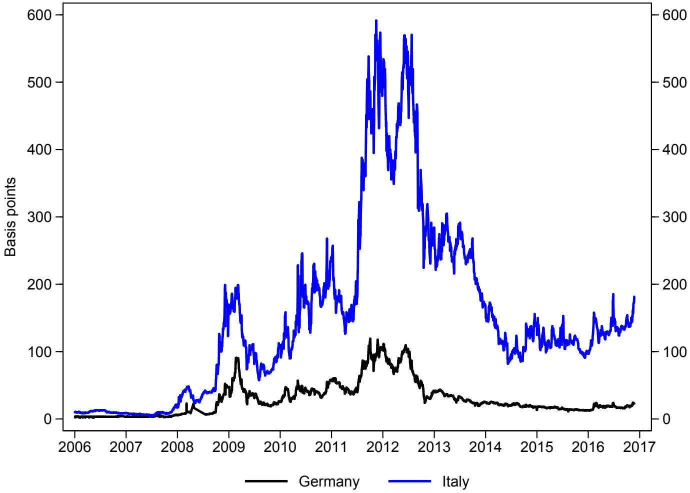
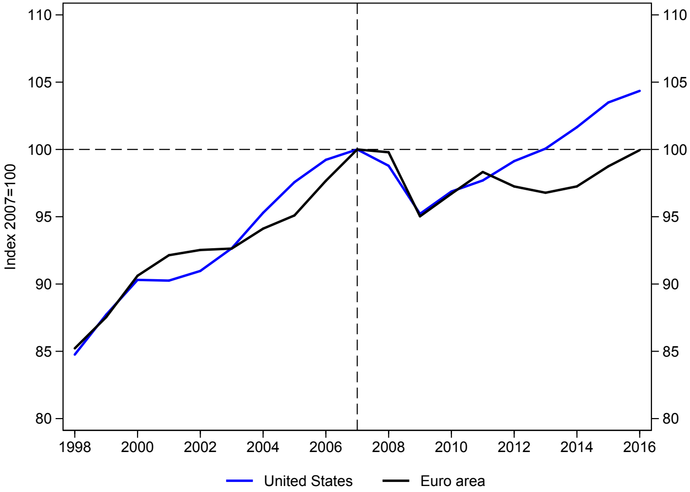
# The ongoing crisis: Sovereign default risk



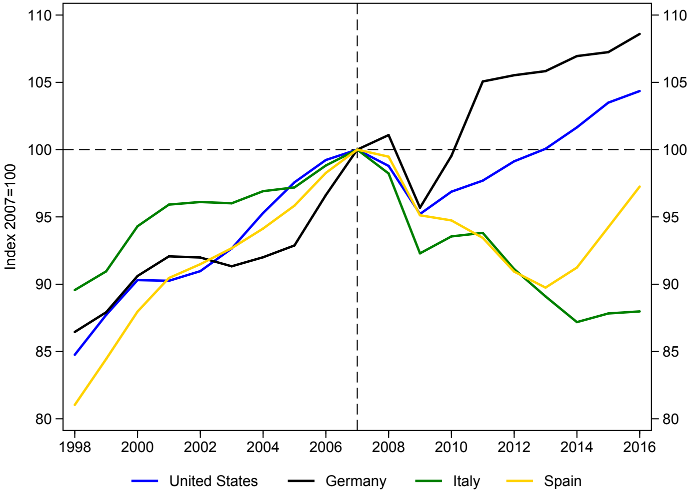

Five-year CDS on sovereign debt

# The crisis: Real GDP per person



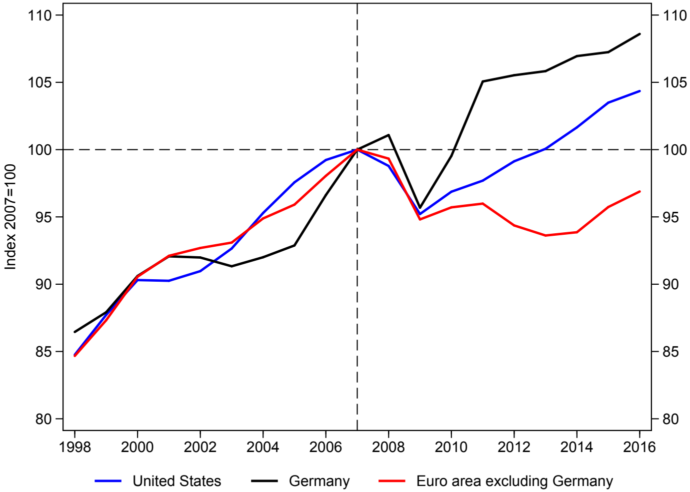

Annual real GDP per person. IMF WEO, October 2016.
Euro area reflects EA12 aggregate

# Drifting apart: Real GDP per person




Annual real GDP per person. IMF WEO, October 2016.

# Drifting apart: Real GDP per person

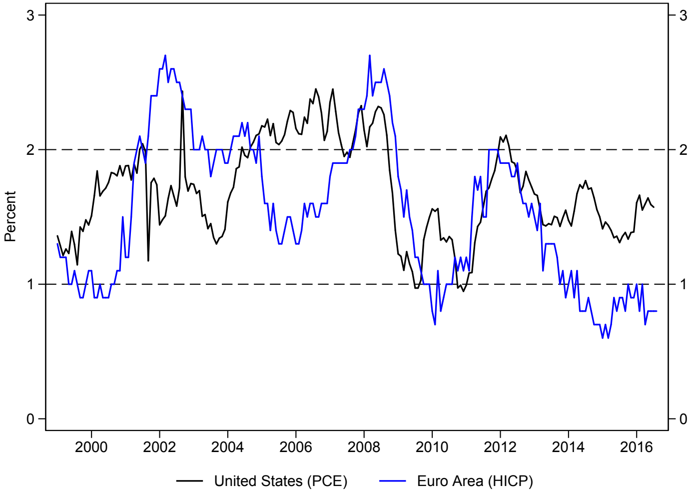



Annual real GDP per person. IMF WEO, October 2016.
Euro area reflects EA12 aggregate

# The Fiscal-Monetary Policy Mix

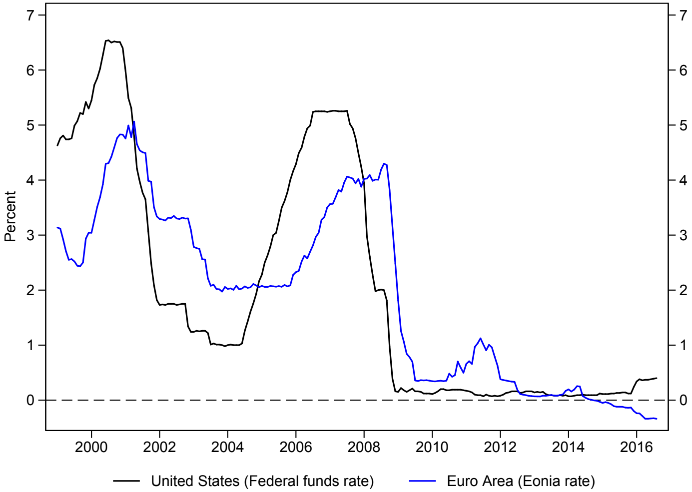
- Crisis mismanagement in the euro area resulted in lower growth for euro area as a whole and greater divergence across member states
- Fiscal policy: Too tight overall
- Monetary policy: Too tight overall and implemented in a manner that contributes to divergence
- Complications due to ZLB?
- Can alternative implementation improve outcomes?

# Fed vs ECB: Core Inflation




A sustained divergence in inflation outcomes since 2012.

# The zero lower bound: A constraint on policy?




Overnight interest rate.

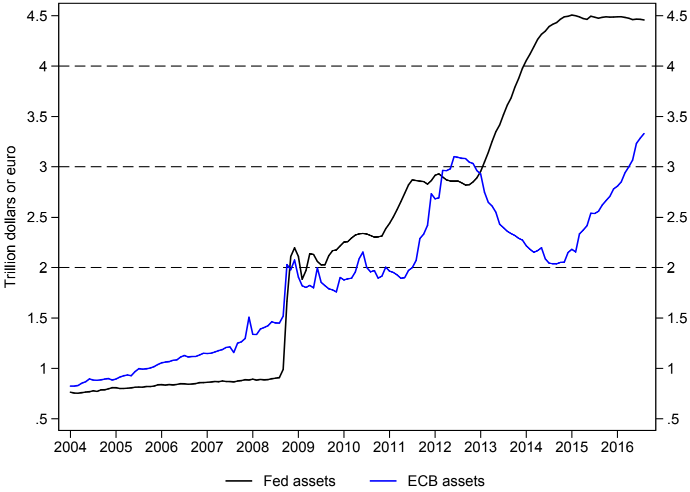
# The zero lower bound: A constraint on policy?

- The zero lower bound constrains “conventional” easing by reducing very short-term nominal interest rates
- But monetary policy remains supremely effective.
- Focus turns on longer-term interest rates and asset prices.
- Monetary policy easing through government bond purchases.
- A complication: Dealing with risks on CB balance sheet.

# Risk sharing in a monetary union

- Monetary policy involves taking *some* risk on the balance sheet.
- In unual context of one CB and one corresponding fiscal authority not a big issue—can think of consolidated balance sheet. In monetary union?
- At ZLB, monetary policy *is* fiscal policy.
- Failure to acknowledge the inevitability of fiscal/monetary links and adopt needed balance sheet policies can lead to policy paralysis.
- Fed vs ECB policy?

# An unusual divergence in balance sheet policy




Size of balance sheet, in dollars/euro, respectively

# Projections before ECB QE

Euro area forecasts as published by ECB

| | GDP Growth | | | Inflation | | |
|---|---|---|---|---|---|---|
| Forecast Date | 2014 | 2015 | 2016 | 2014 | 2015 | 2016 |
| Sept. 2013 | 1.0 | | | 1.3 | | |
| Dec. 2013 | 1.1 | 1.5 | | 1.1 | 1.3 | |
| Mar. 2014 | 1.2 | 1.5 | 1.8 | 1.0 | 1.3 | 1.5 |
| June 2014 | 1.0 | 1.7 | 1.8 | 0.7 | 1.1 | 1.4 |
| Sept. 2014 | 0.9 | 1.6 | 1.9 | 0.6 | 1.1 | 1.4 |
| Dec. 2014 | 0.8 | 1.0 | 1.5 | 0.5 | 0.7 | 1.3 |

Balance sheet contraction despite declining inflation forecasts.

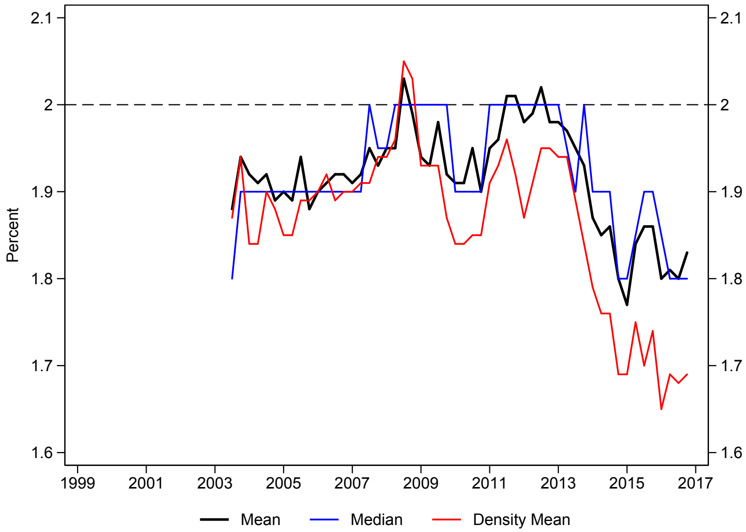
# Projections after ECB QE: 2015 and 2016

Euro area forecasts as published by ECB

| | GDP Growth | | | Inflation | | |
|---|---|---|---|---|---|---|
| Forecast Date | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 |
| Mar. 2015 | 1.9 | 2.1 | | 1.5 | 1.8 | |
| June 2015 | 1.9 | 2.0 | | 1.5 | 1.8 | |
| Sept. 2015 | 1.7 | 1.8 | | 1.1 | 1.7 | |
| Dec. 2015 | 1.7 | 1.9 | | 1.0 | 1.6 | |
| Mar. 2016 | 1.4 | 1.7 | 1.8 | 0.1 | 1.3 | 1.6 |
| June 2016 | 1.6 | 1.7 | 1.7 | 0.2 | 1.3 | 1.6 |
| Sept 2016 | 1.7 | 1.6 | 1.6 | 0.2 | 1.2 | 1.6 |

No further easing since March 2016, despite forecasts.

# Long-term inflation expectations




ESP SPF. Data since May 2003 clarification of ECB inflation objective.

# The ECB's low inflation problem

- Costs of too low inflation in the environment of a depressed euro area economy well understood:
  - "Lowflation" (IMF and others, since 2014)
  - Arias, Erceg, Trabandt (2016) (interactions with ZLB)
- ECB research acknowledges that policy easing (through asset purchases) can reduce these risks:
  - Coenen and Schmidt (2016) (De-anchoring)
  - Andrade et al (2016) (Effectiveness)
- Overly tight ECB policy has become part of the euro area's problem.

# Two issues with ECB QE

- Problem with quantity: Insufficient balance sheet expansion.

- Problem with implementation: It reinforces divergence in yields.

# Two issues with the implementation of ECB QE

- Eligibility
- Loss sharing

# ECB QE: January 2015

- "[The Governing Council] decided to launch an expanded asset purchase programme, encompassing the existing purchase programmes for asset-backed securities and covered bonds. Under this expanded programme, the combined monthly purchases of public and private sector securities will amount to €60 billion."
- "They are intended to be carried out until end-September 2016 and will in any case be conducted until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term."

# ECB QE: Moving away from risk sharing

- "The Eurosystem will make use of decentralised implementation to mobilise its resources."

- "With regard to the sharing of hypothetical losses, the Governing Council decided that purchases of securities of European institutions (which will be 12% of the additional asset purchases, and which will be purchased by NCBs) will be subject to loss sharing. The rest of the NCBs' additional asset purchases will not be subject to loss sharing."

- "The ECB will hold 8% of the additional asset purchases. This implies that 20% of the additional asset purchases will be subject to a regime of risk sharing."

# Discussion as reflected in account of meeting

"With regard to the sharing of hypothetical losses under an expanded asset purchase programme, the Governing Council could choose from a continuum of loss-sharing options. One polar option was full loss sharing and another was no loss sharing for the part of the portfolio held on the balance sheets of NCBs. Both options involved trade-offs." (ECB, 2015.)

# Discussion as reflected in account of meeting

"Members discussed the appropriate modalities of risk sharing related to the purchases of securities issued by euro area governments and agencies and European institutions. On the one hand, arguments were made in favour of full risk sharing so as to counter perceptions of a lack of unity. Full risk sharing would also underline the singleness of monetary policy. On the other hand, in view of concerns about moral hazard it was argued that a regime of partial loss sharing would be more commensurate with the current architecture of Economic and Monetary Union and the Treaties under which the ECB operates." (ECB, 2015.)

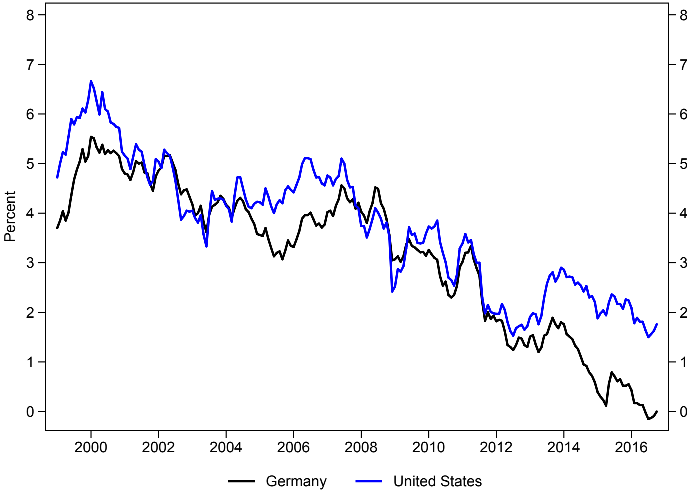
# Implications of deviation from risk sharing

- Decision signaled that ECB wishes to be prepared for states leaving the euro area, creating a dynamic that might make a member state leaving the currency area inevitable, hardly consistent with the ECB's mandate.
- Decision reinforced spreads among government debt of different member states. Effectively this represented a tax on member states perceived as weak and a subsidy on member states perceived as strong.
- Instead, purchases should have reflected the joint responsibility of the eurosystem for euro area monetary policy, as is the case with ordinary monetary policy operations.

# The ECB's self-imposed restriction on eligibility

- The ECB has imposed a restriction that it will only purchase government debt with an investment-grade rating (unless a country is in a program).
- This policy raises the financing costs of governments facing market pressure and elevates importance of ratings agencies (S&P, Moody's, Fitch and DBRS).
- Case in point: Portugal faced possibility of exclusion from QE on 21 October, when DBRS was considerering downgrading Portugal by one notch.

# Effectiveness of unconventional policy easing




Ten-year government bond yield

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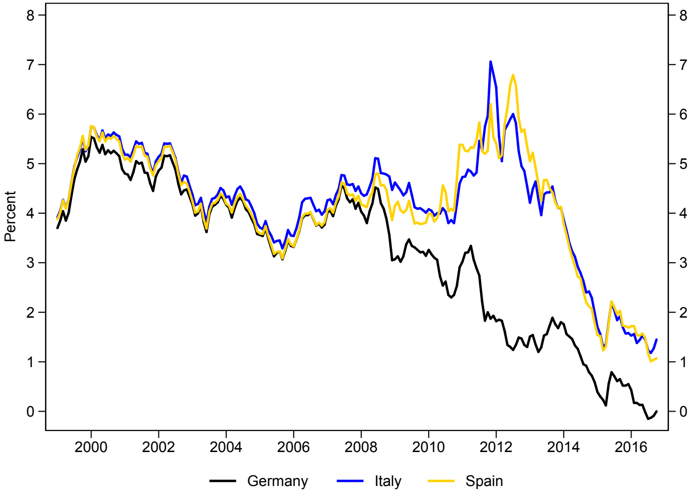


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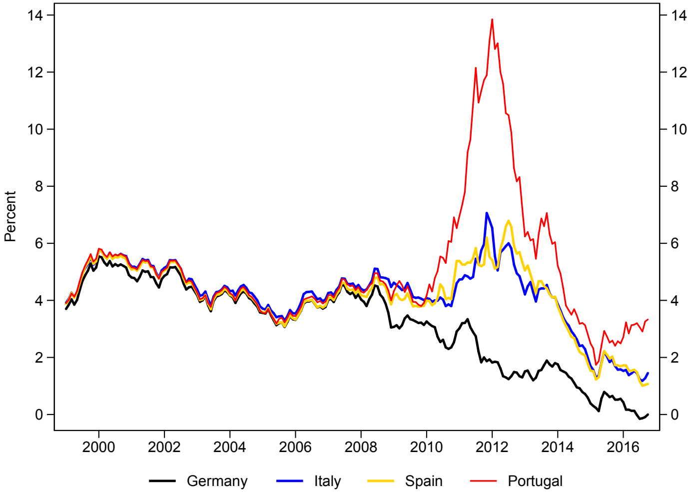


Ten-year government bond yield

# Needed adjustment of ECB policy

- Pace of QE must increase to correct undershooting of inflation

- Implementation of QE must be corrected to diminish spreads in the cost of financing of government debt.