

ECB CONFERENCE ON MONETARY POLICY: BRIDGING SCIENCE AND PRACTICE

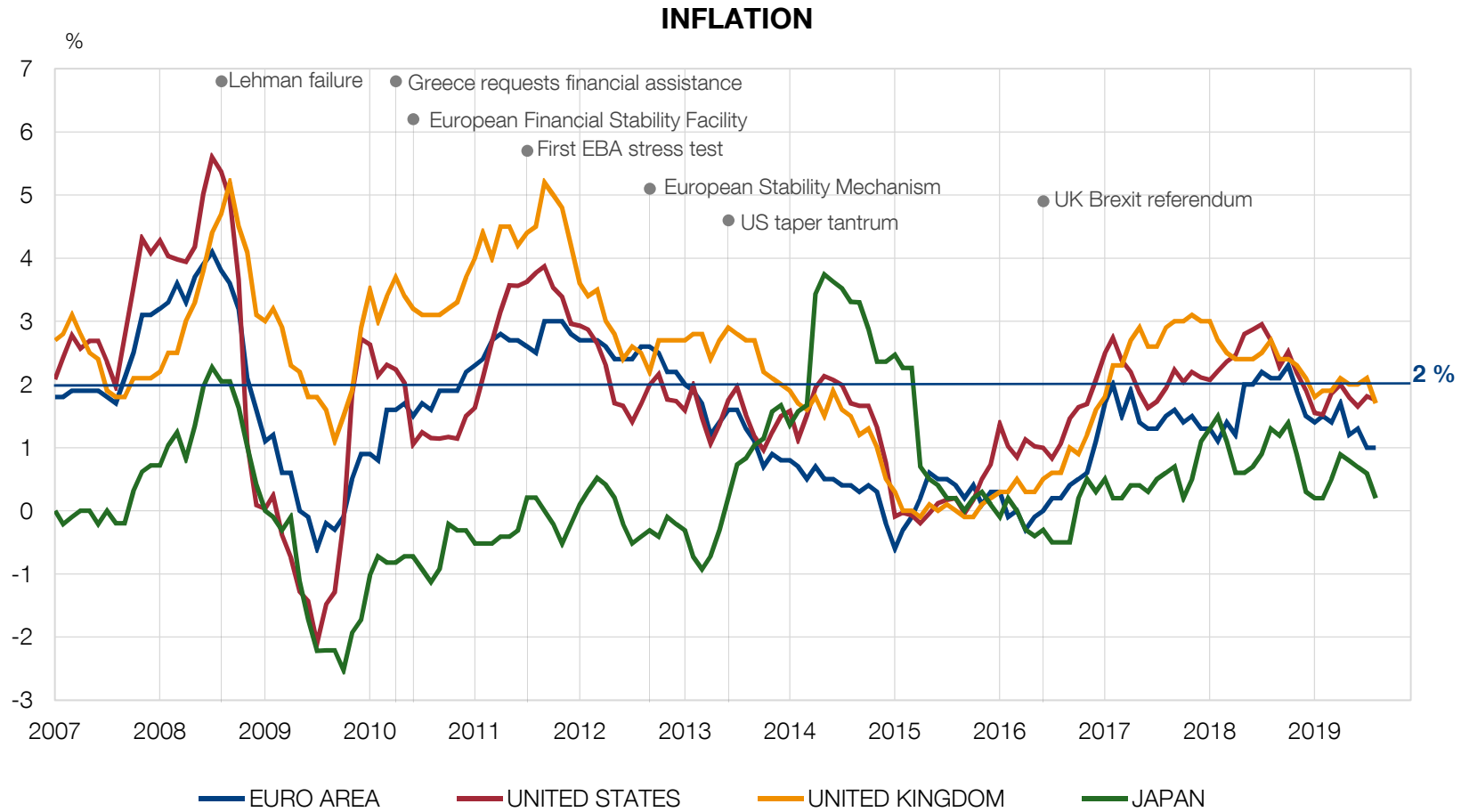
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Frankfurt am Main

8 October 2019



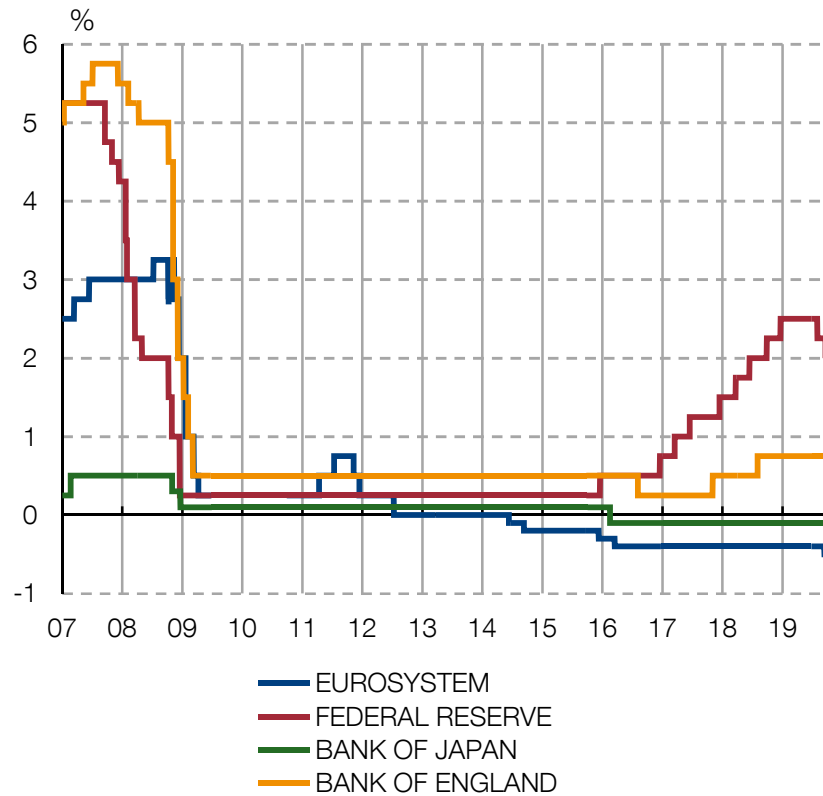
IN THE LAST DECADE ADVANCED ECONOMIES HAVE BEEN EXPOSED TO PERSISTENT DISINFLATIONARY PRESSURES



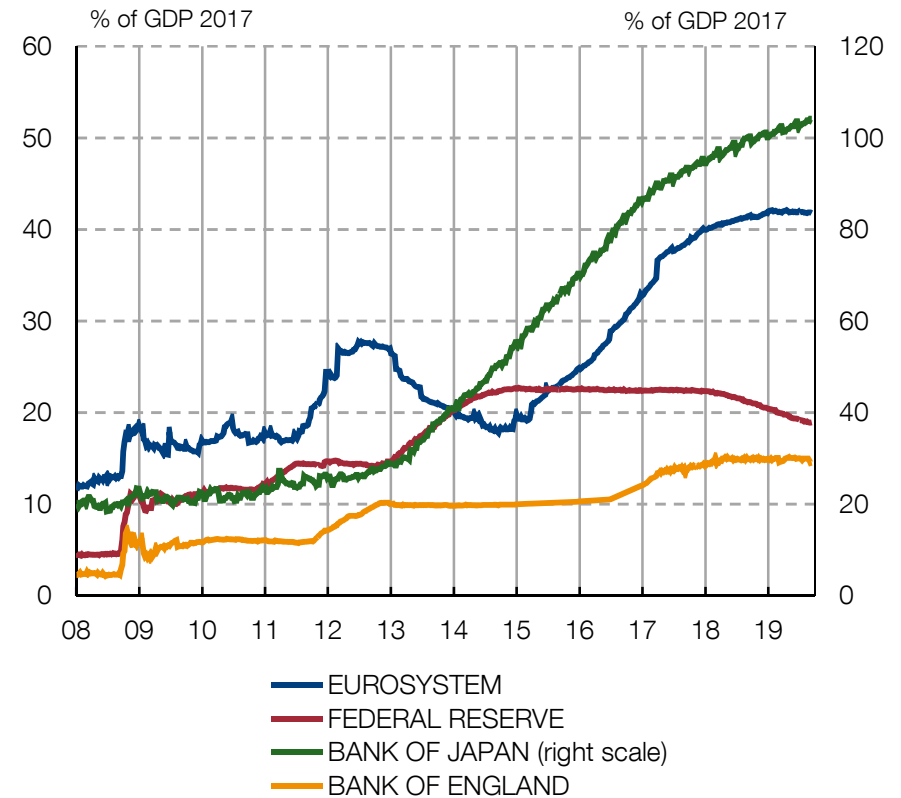
SOURCE: Eurostat, Thomson Reuters Datastream. Last observation: 2019 August.

LOW INFLATION PERSISTS IN SPITE OF UNPRECEDENTED MONETARY POLICY STIMULUS

POLICY INTEREST RATES



CENTRAL BANKS BALANCE SHEET

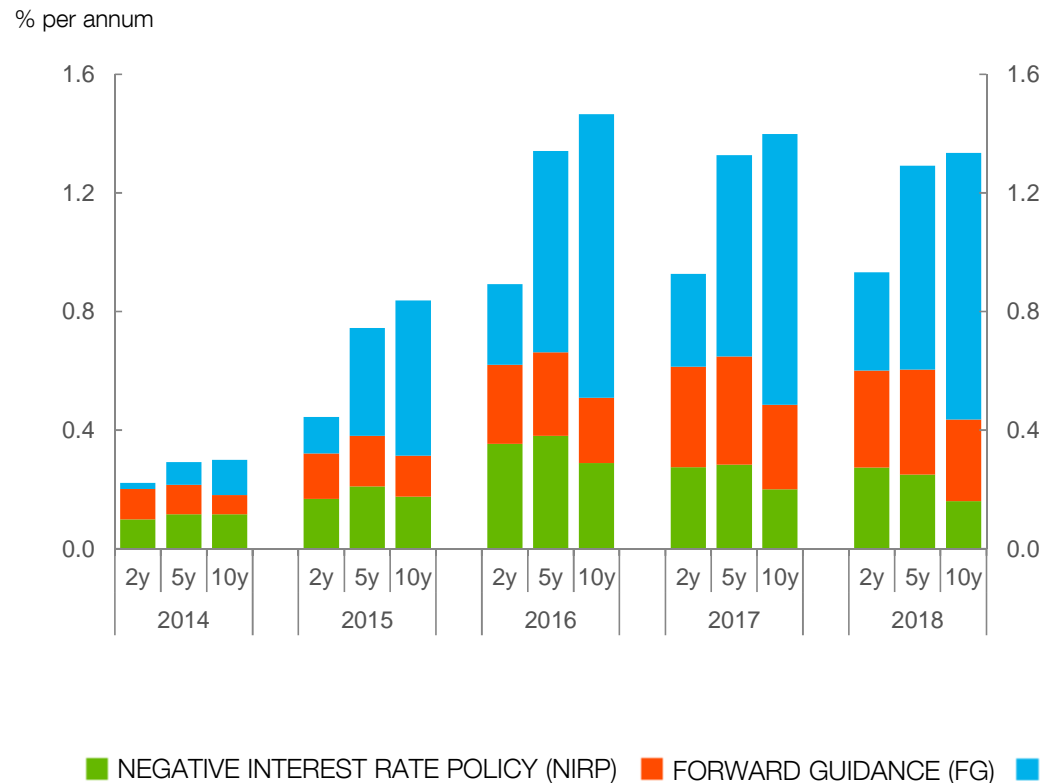


SOURCES: Datastream, European Central Bank and Banco de España.

Last observations: Rates, 19 Sep 2019; Balance sheet: Eurosystem, 12 Sep 2019; FED, 11 Sep 2019; BoJ, 09 Sep 2019; BoE.

UNCONVENTIONAL MEASURES HAVE BEEN EFFECTIVE AT EASING FINANCIAL CONDITIONS, SUCH AS YIELD CURVES...

UPWARD PRESSURES ON EURO AREA SOVEREIGN BOND YIELDS IN ABSENCE OF ECB'S NON-STANDARD MEASURES 2014-2018

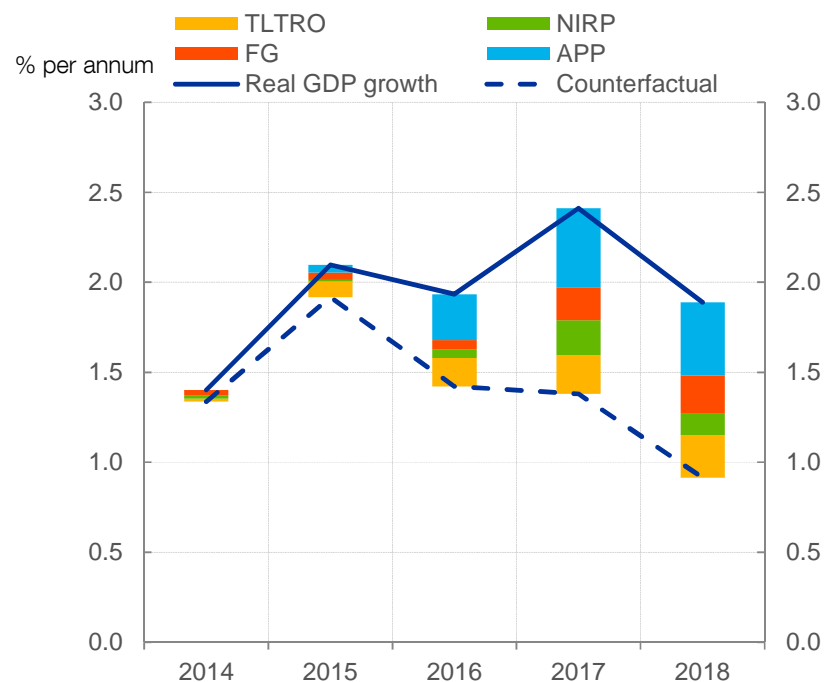


SOURCE: *Rostagno, Altavilla, Carboni, Lemke, Motto, Saint-Guilhem, Yiangou (2019), forthcoming.*

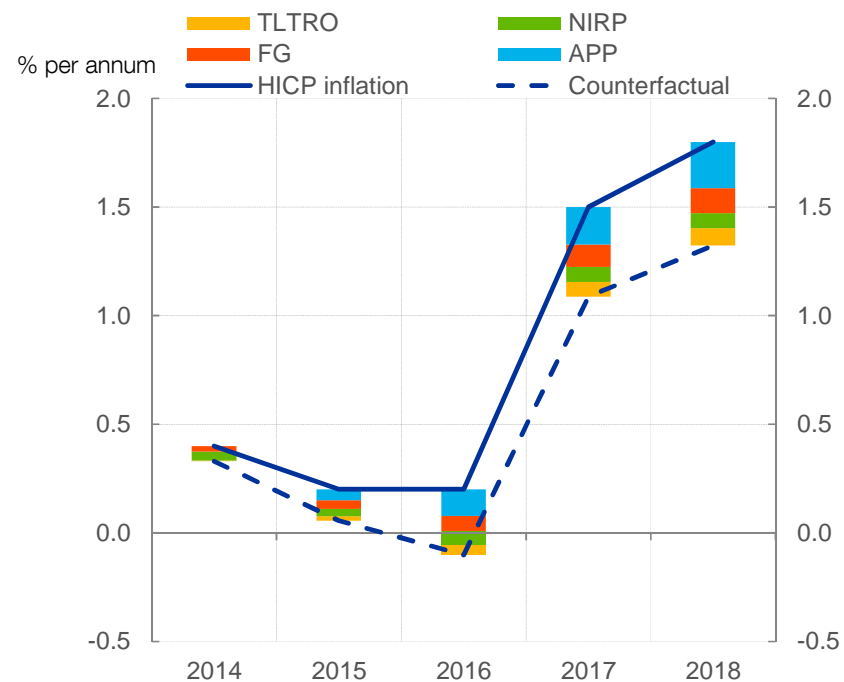
Notes: The chart shows the impact of ECB non-standard measures on the GDP-weighted aggregate of euro area sovereign bond yields.

...AND AVERTING THE RISKS OF DEFLATIONARY SPIRALS AND STIMULATING GROWTH AND INFLATION

CONTRIBUTION OF ECB NON-STANDARD MEASURES TO REAL GDP GROWTH 2014-2018



CONTRIBUTION OF ECB NON-STANDARD MEASURES TO HICP INFLATION 2014-2018



Source: Rostagno, Altavilla, Carboni, Lemke, Motto, Saint-Guilhem, Yiangou (2019), forthcoming.

Notes: The chart shows the impact of ECB non-standard measures on macro variables based on a macroeconomic model with financial variables conditioning on their estimated impact on the yield curve.

RESEARCH BASED ON MICRO DATA HAS YIELDED VALUABLE LESSONS ABOUT UNCONVENTIONAL MONETARY POLICY MEASURES

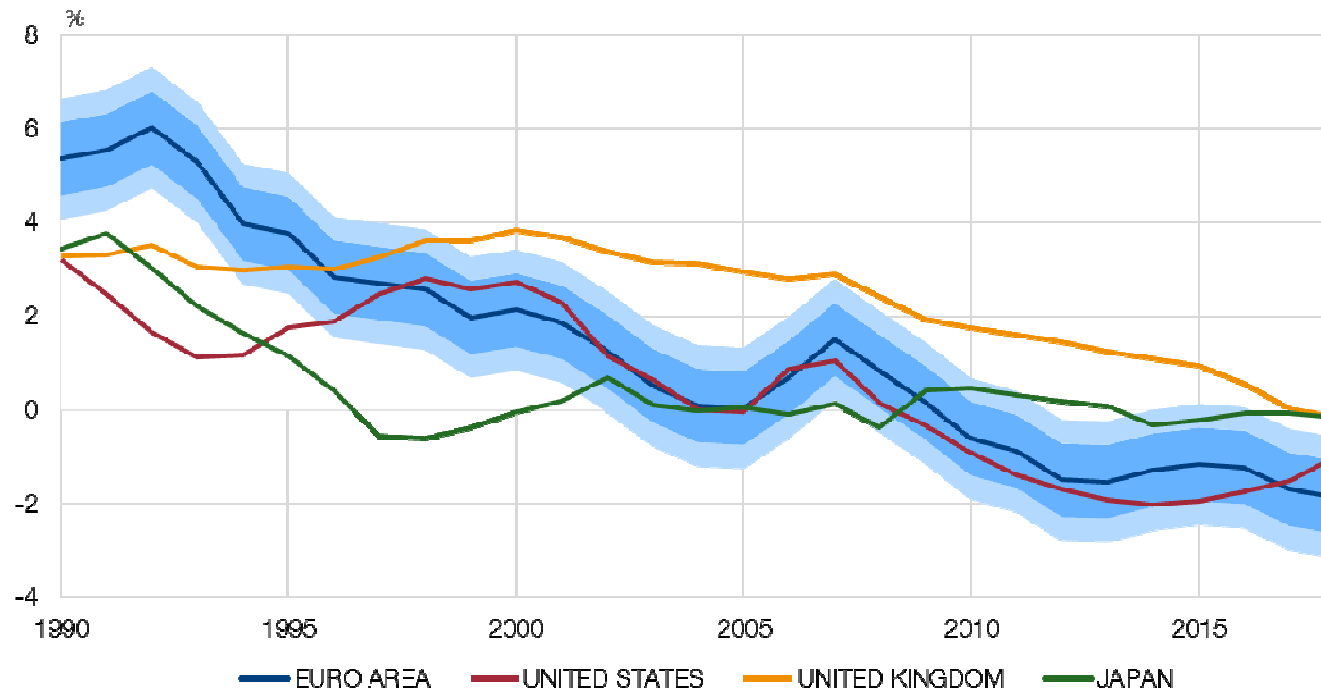
For instance, they enable us to document that:

- **Refinancing programs** have contributed to enhancing funding conditions and to stimulating credit (e.g., [Andreeva and Garcia-Posada, 2019](#); and [Garcia-Posada and Marchetti, 2016](#)).
- Central bank **asset purchase programs** had positive effects on the cost of financing and the supply of credit (e.g., [Arce, Gimeno and Mayordomo, 2019](#)).
- **Negative interest rates**: the effect on credit conditions is more difficult to assess as it occurs through different channels (e.g., [Arce, García-Posada, Mayordomo and Ongena, 2019](#), [Heider, Saidi, and Schepens, 2019](#), and [Demiralp, Eisenschmidt and Vlassopoulos, 2017](#)).

GOING FORWARD, LOW/NEGATIVE RATES ARE LIKELY TO PERSIST, DUE TO A LOW 'NATURAL' INTEREST RATE

- The **natural interest rate** (r^*) is a key determinant of policy interest rates
- Evidence of sustained **decline** in recent decades, reflecting different **structural** factors:
 - demographics (e.g. [Eggertsson and Mehrotra, 2014](#)), low productivity growth ([Gordon, 2015](#)), safe asset scarcity ([Caballero and Farhi, 2017](#)), etc.

NATURAL INTEREST RATE ESTIMATES FOR THE MAIN ADVANCED ECONOMIES



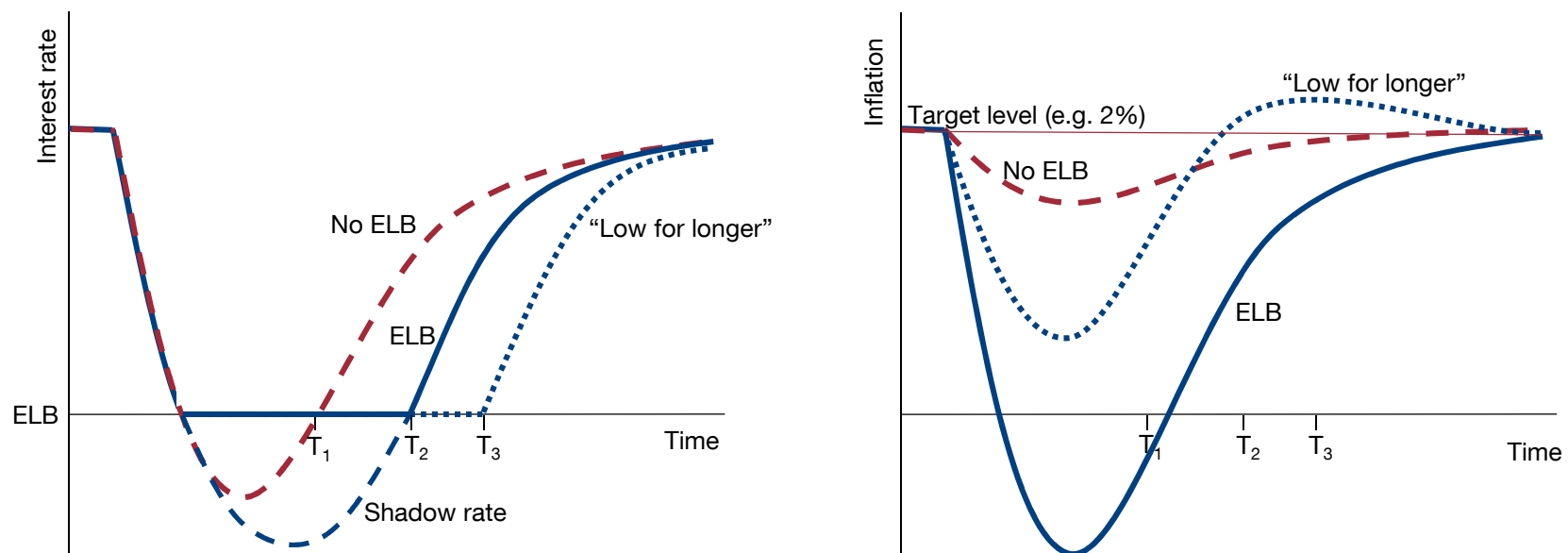
SOURCE : *Banco de España Annual Report 2018*, based on the model of [Fiorentini, Galesi, Pérez-Quirós and Sentana \(2018\)](#). The bands for the euro area refer to confidence levels of 68% and 90%.

HOW SHOULD MONETARY POLICY BE CONDUCTED IN AN ENVIRONMENT OF LOW NATURAL INTEREST RATES?

- A low (and falling) r^* implies that the incidence of the **effective lower bound (ELB)** may increase in the future.
- If the **reversal rate** (Brunnermeier and Koby 2018) is higher than “switch-to-cash” ELB, conventional policy space may be smaller:
 - Evidence suggests that we have not yet reached the reversal rate...
 - ... but if rates remain negative for long this may end up hampering bank-based monetary transmission (e.g. Arce, García-Posada, Mayordomo and Ongena, 2019).
- Adjusting our **monetary policy strategy** to this challenging environment should be a priority

COMMUNICATION HAS PROVED TO BE A KEY MONETARY POLICY TOOL

- **Forward guidance** was proposed in the academic literature as a way to address the ELB constraint (Eggertsson and Woodford, 2003).
 - A commitment to provide a monetary stimulus longer than required by the central bank reaction function (“**low for longer**”).
- Forward guidance requires **credibility** and **transparency**, both of which must be centerpiece of (revised) monetary policy strategies.



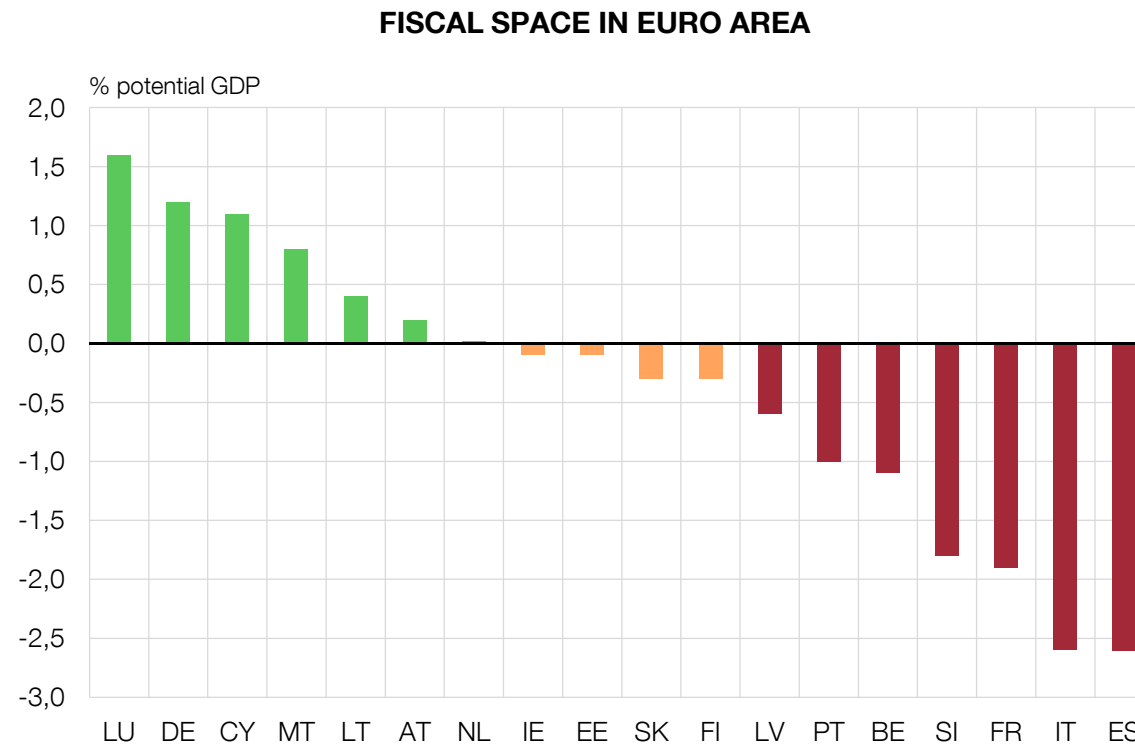
SOURCE : Banco de España

MONETARY POLICY CANNOT BE THE “ONLY GAME IN TOWN”

- The ELB imposes **limits** to conventional and unconventional **monetary policy**
- **Other policies** must play a role in providing stimulus when needed and alleviating such side effects
- Countercyclical **fiscal policy** may help support growth and inflation:
 - Positive **synergies** between monetary policy, fiscal policy and structural reforms under the ELB ([Arce, Hurtado, Thomas, 2016](#)).
 - Positive fiscal spillovers ([Alloza, Burriel y Pérez, 2019](#)).
- **Macroprudential policies** can help to alleviate some of the negative side effects associated with unconventional monetary policy

IN THE EURO AREA, THERE ARE IMPORTANT CHALLENGES TO THE EFFECTIVE IMPLEMENTATION OF COUNTERCYCLICAL FISCAL POLICY

- Many EU members face **limited fiscal space** to enact expansionary fiscal policies.
- Potential **asymmetry** of national business cycles across the euro-area



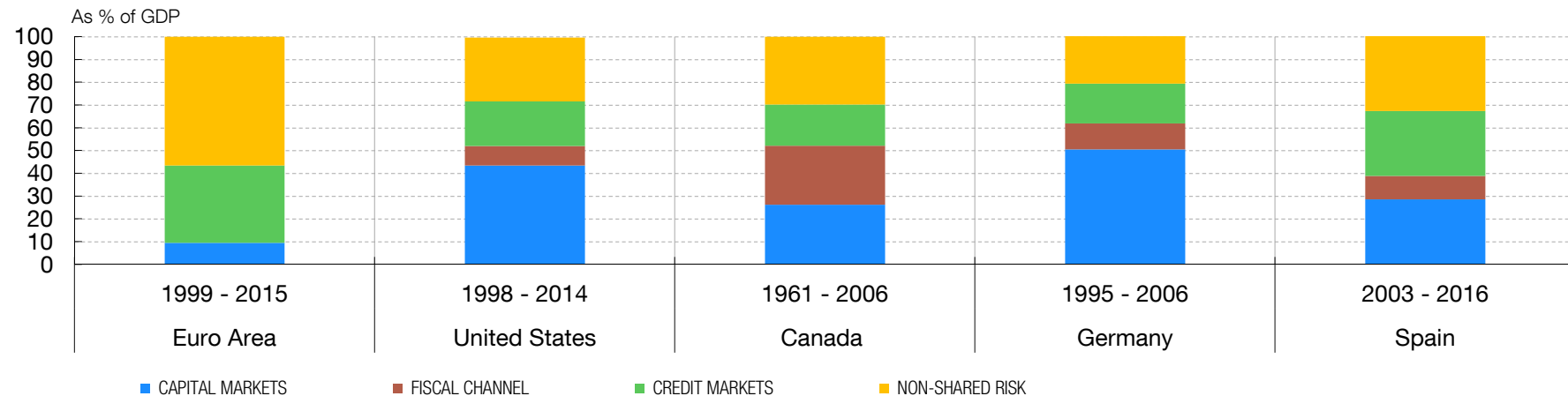
SOURCE : *European Commission*.

NOTE: Fiscal space is computed as structural deficit – medium term objective

TOWARDS A EURO AREA-WIDE FISCAL POLICY?

- Therefore we need a **euro area-wide** fiscal instrument powerful enough to:
 - stabilize aggregate fluctuations in the area.
 - help accommodate the impact of idiosyncratic shocks to EMU members.
- **Risk sharing** through fiscal policy plays a more important role in other more complete monetary unions.
- Bonus: under additional conditions, euro area (supranational) debt would become a union-wide **safe asset**.

STRENGTH OF RISK-SHARING CHANNELS (a)
INTERNATIONAL COMPARISON



SOURCE: Banco de España Annual Report 2016 and Burriel (forthcoming).

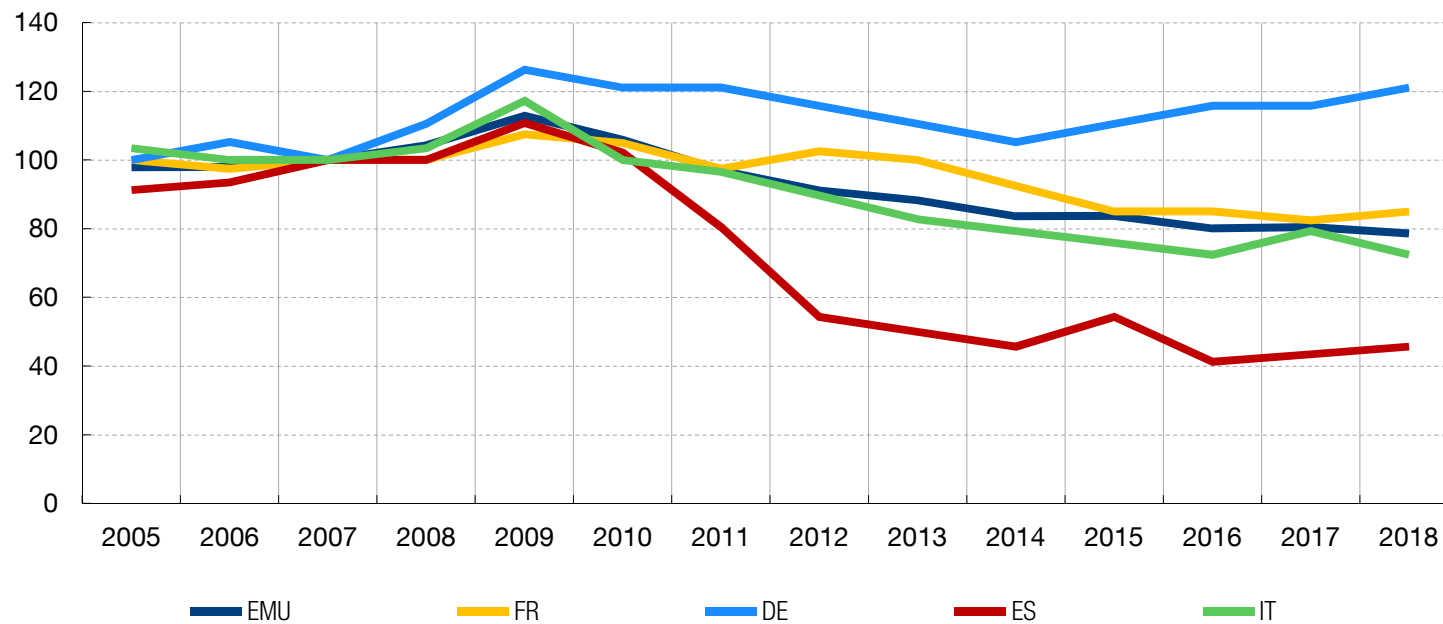
a Estimated following the methodology of Asdrubali et al (1996), which approximates the percentage of shocks recorded in an economy's GDP that pass through to that economy's residents' income and consumption decisions. The channels that enable the impact of the shocks to be softened are, firstly, the capital markets channel whose strength depends on the income that residents obtain from other countries not affected by the shock because they hold shares in the companies of those countries and obtain income from labour and from other financial assets. Secondly, the shock may be softened by public intervention through fiscal transfers from the federal budget, as in the case of the United States, or from other regions (fiscal channel). Finally, households and firms in that economy may smooth their consumption by resorting to their savings or to the credit market (credit channel).

BEYOND CYCLICAL STABILIZATION, FISCAL POLICY AND STRUCTURAL REFORMS MAY HELP TO RAISE THE NATURAL INTEREST RATE

- **Structural reforms** can boost economic activity ([Andrés, Arce and Thomas, 2017](#)) as well as the potential growth rate.
- **Fiscal policy** can achieve a more growth-friendly composition of public finances (e.g. public investment geared towards increases in productivity).

PUBLIC INVESTMENT AS A RATIO TO GDP

2007=100



SOURCE : Eurostat.

Thank you for your attention.

