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Finance & Markets

Financial Sector Advisory Center (FinSAC)

Challenges Derived from ECB's Unconventional Monetary Policy

Fernando Montes-Negret
FinSAC Coordinator

Vienna, May 22, 2015

Constraints on ECB's Ability to Implement Conventional Monetary Policy (President Draghi)

Constraints:

1. Interest (policy) rates reaching the nominal Zero lower-bound: Move to introduce negative interest rates on ECB's deposit facilities;

2. Unforeseen/ unexpected consequences of conventional monetary policy, including changes in the distribution of wealth and the allocation of resources.

Monetary Policy in an Uncertain Environment

Intended outcome:

- Provision of longer-term, cheap funding, to the banking system, conditional on loan expansion to the real economy.

Constraint: Vicious circle resulting from the endogeneity of credit growth

- High risk perception from banks, leading to high interest rates/high spreads (margins).
- Limiting the already weak demand for new credit from firms & resulting in high NPLs, validating ex-post high risk premia.

=> Result: Limited traction of ECB LTROs and Slower economic recovery

Virtuous Circle: Incentivize banks to increase their low cost lending

- ECB monetary easing (TLTROs).
- More competition for good credit at reduced margins.
- Lower rates facilitate NPL resolution and increase the demand for new lending, validating, ex-post, lower risk premia.
- Convergence in the cost of lending/borrowing across Euro Area countries.
- Low oil & commodity prices, stronger Euro (€): Windfall gains, but "lowflation" or deflation; rising real interest rates, weak aggregate demand and EU stagnation.
- ECB stronger asset purchases, including ABS and covered bonds, aiming to reverse the rise in real interest rates flooding the market with liquidity. Improved inflation & growth outlook & (public/private) Debt dynamics

Unintended consequences: Side-effects (1)

- **Misallocation of resources in a low inflation environment (see next slide):** How serious a threat to future financial stability?
- Uneven liquidity distribution: from inconsistent policies? Danger signals:

Market-makers play a crucial role in providing liquidity to facilitate market efficiency & functioning.

Matching sellers and buyers: **Agency trading** (matching orders) and **Principal trading** (w/own Balance Sheet affecting inventory positions). As latter weakens, trades take longer to execute.

Assessment of risk/return.

However, change in post-crisis incentives, including from new regulations (capital charges, limits or taxes on balance sheet size, LCR, NSFR, Volcker Rule (no proprietary trading), etc.), are leading to market-makers to retreat (lower security inventories & more risk-aversion) and entry of less regulated entities, increasing the **liquidity risk** for less liquid fixed income instruments, particularly Sovereign & Corporate Bonds.

Bond Yields: Are the interest (deflation and QE program) and default (corporates & junk bonds) risks being underestimated?

In distressed markets: Selling the most liquid paper (liquidity bifurcation). **Market liquidity increasingly concentrated in most liquid securities, while conditions deteriorate in less liquid ones. Market-makers focused on activities requiring less capital and less risk.**

Understand behavior of liquidity providers (risk tolerance) and changes in their business models (balance sheet strength & funding).

See BIS Committee on the Global Financial System,"Market-making and proprietary trading: Industry trends, drivers, and policy implications", November, 2014.

Unintended consequences: Side-effects (2)

Policy Implications:

(i) Supporting Initiatives; and/or

(ii) Introduction of Backstop facilities? To:

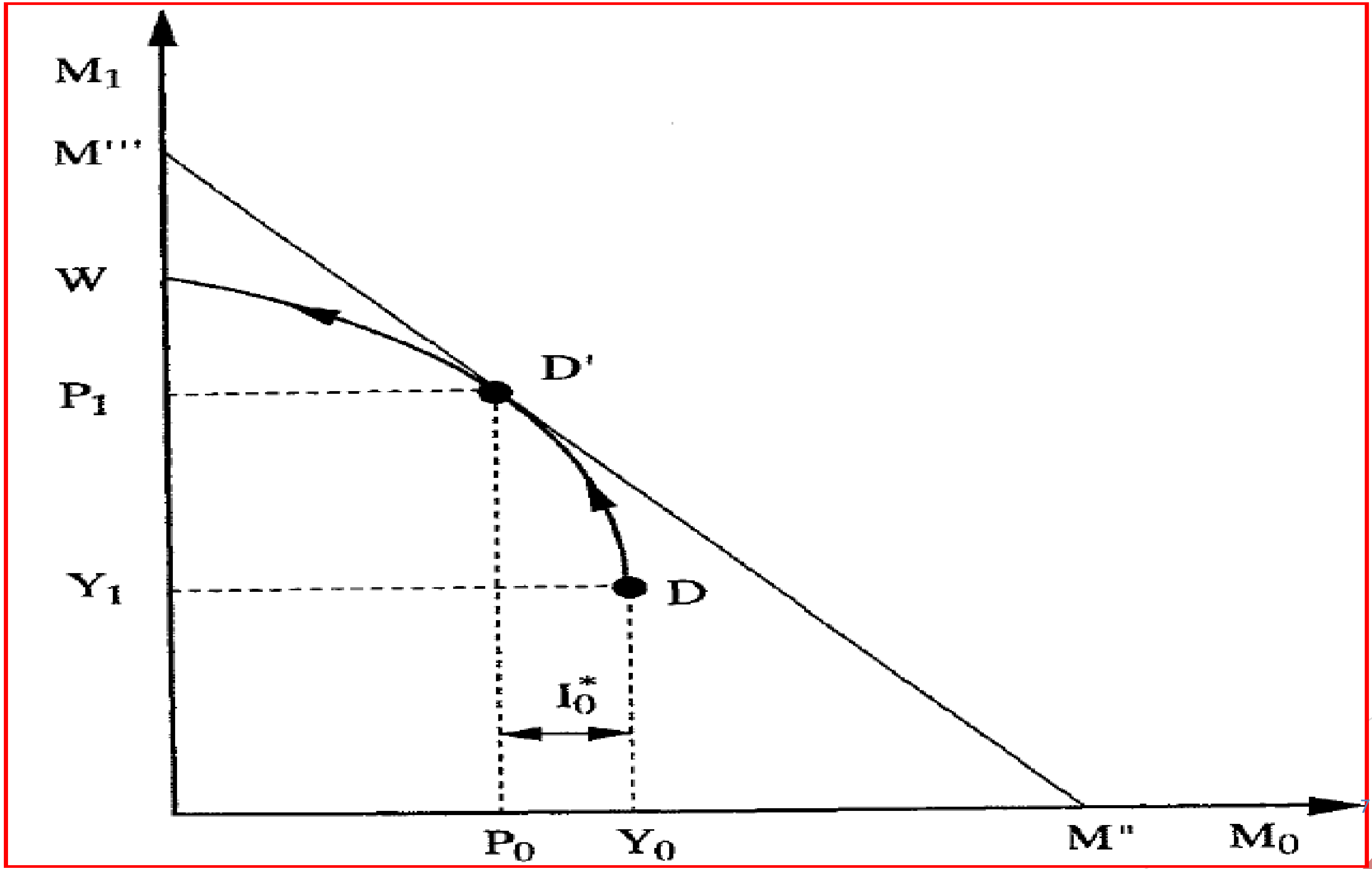
- Mitigate the risks of "liquidity illusion": More transparency, targeted liquidity tests & Monitoring;
- Better coordination of still uncertain new & cumulative "Regulatory Policies", in order to understand and mitigate **impact on markets**. Unexpected outcomes and side-effects can result.
- **Enhance non-market distorting measures, including review of collateral policies, encourage more homogeneous security classes (depth), lumpiness, and securities lending activities, to enhance secondary market liquidity.**

Understand trade-offs:

- Banking system safer, but are markets less efficient?
- Less liquidity & More volatility?
- Are these structural or transition issues?

See Fender I. and I. Lewrick, "Shifting tides – market liquidity and market-making in fixed income instruments, BIS Quarterly Review, March 2015.

Inter-Temporal Opportunities for Investment and Financing (with decreasing marginal productivity of capital)



Volatility: The international dimension

- Great uncertainty about future evolution of interest rates in the US & EU. Lift-off has been delayed, but once it happens turmoil will be inevitable.
- Repositioning of investment flows and cross-border reallocation of funds.

Risk of "negative spirals":

- Capital flight and exchange rates. Countries with high share of foreign-currency denominated or linked debt - build up during the pre-crisis period - makes the country vulnerable to depreciation against other currencies (ex., US dollar Euro or Swiss Franc).
- "Rapid depreciation of the domestic currency can lead foreign investors to abruptly reduce their holdings of local currency debt and thus create a debt-rollover challenge to the public sector."

IMF, GFSR, April, 2015, page 43.

- Banks' Vulnerability to over-indebted corporates in FX : it is a major risk, particularly when interest rates rise. Higher risk weights recommended.
- Reduce excess volatility in currency markets, providing FX funding in times of stress.

Thank you!

fmontesnegret@worldbank.org

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