Challenges Derived from ECB’s Unconventional Monetary Policy

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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).**

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?

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!

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