Lorenzo Bini Smaghi: One size fits all?

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the 16th Annual Conference of the German-British Forum "The European Central Bank in a global perspective – central banking and the challenge of rising inflation", London, 26 May 2011.

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Ladies and gentlemen,

It is a great pleasure to speak at this German British Forum on the important issue of "The European Central Bank in a global perspective – The challenge of rising inflation".

I would like to address an issue which is raised time and again, namely, can the monetary policy implemented by the ECB fit different underlying economic performances in the Member States of the euro area? And in the current situation, the question is often asked whether the ECB's monetary policy doesn't risk hampering the recovery in the euro area periphery and jeopardising the implementation of the adjustment programmes.

As I said, the issue is not new, but it is certainly topical. I am sometimes tempted to answer that this is not the right question, or at least that the question comes too late, given that we now have had a monetary union for more than 11 years and there are no alternatives in sight. But I realise that some more structured answers have to be given at some point, and that's what I would like to do today.

As you all well know by now, the ECB has been assigned the primary objective of maintaining price stability in the euro area. The ECB therefore has no choice but to take a *euro area perspective*: its policy decisions aim at area-wide price stability. Those decisions draw on all available information, including that deriving from national indicators, but they cannot be tailored to the specific needs of a single Member State.

As we have seen, economic divergences can emerge and persist across countries and regions within the euro area. In principle, there are several reasons why such variations in growth or inflation may emerge within a monetary union. Initial differences in the level of development or income may lead to some countries catching up with the area-wide average through a period of faster growth, associated with relative price changes.[1] Certain economic shocks may affect the economic performance of one country but not another.[2] The transmission of monetary policy may differ across countries and regions because of variations in economic and financial structures.[3]

Although the economic literature prior to the introduction of the euro emphasised the importance of asymmetric shocks, the cross-country variation in growth and inflation in

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[1] One explanation of these catch-up effects is the so-called Balassa-Samuelson effect, see: Balassa, B. (1964). "The purchasing power parity doctrine: A reappraisal," Journal of Political Economy 72, pp. 584–596; and Samuelson, P. (1964). "Theoretical notes on trade problems," Review of Economics and Statistics 46, pp. 145–154. For an application to the euro area, see: Honohan, P. and P.R. Lane (2003). "Divergent inflation rates in the euro area," Economic Policy 37, pp.359-94.

[2] See: Bayoumi, T. and B. Eichengreen (1992). "Shocking aspects of European Monetary Unification," NBER working paper no. 3949; Obstfeld, M. and G. Peri (1999), "Regional nonadjustment and fiscal policy: Lessons for EMU," NBER Working Paper No 6431.

[3] An analysis of this issue made prior to the introduction of the euro is offered by: Dornbusch, R., C.A. Favero and F. Giavazzi (1998). "Immediate challenges for the ECB: Issues in formulating a single monetary policy," *Economic Policy* 26, pp. 25–64.

recent years has been driven by differences in the impact and diffusion of a common shock, namely the financial crisis.

The crisis has been a *global* shock that affected *all* countries in the euro area – and others, of course. It started with the emergence of market tensions in mid-2007 associated with uncertainty about the valuation of US mortgage-backed securities and escalated sharply in September 2008 with the bankruptcy of Lehman Brothers. The varying impact of this shock on financial conditions across countries has led to a potential for dramatically different transmission of the single monetary policy stance determined by the ECB's Governing Council. This is especially the case in the most recent phase of the crisis, when sovereign debt concerns and their interaction with the strength of bank balance sheets have been central.

In those euro area countries where government and banking sector balance sheets remain sound and access to external financing has been maintained, the transmission of monetary policy continues in line with historical regularities. But in those countries where the sovereign debt and bank funding markets have virtually seized up, its transmission is threatened.

The interest rates on corporate loans and on mortgages, which ultimately affect real economic activity, will be higher in countries where banks are having funding problems. The increase in bond yield spreads experienced by the countries hardest hit by the sovereign debt crisis is likely to be passed through, in large part, to the cost of financing for the private sector. Indeed, the latest data on bank interest rates show that mortgages and corporate loans are significantly more expensive to service in those countries with sovereign debt tensions. For example, while lending rates on loans to non-financial corporations have tended to fall in all euro area countries since October 2008 – following the reduction of ECB policy rates – the fall has been less pronounced in Greece and Portugal. In December 2009, lending rates on loans to non-financial corporations in these two countries were approximately 1 percentage point higher than in Germany. Similarly, long-term rates on bank mortgage loans to households have increased in Greece, Ireland and Spain since the eruption of the sovereign debt crisis in May 2010, while they continued to fall in France and Germany until the end of 2010.

Considering the scale of the underlying problems and thus the time it will take to resolve them, the potential for cross-country variation in monetary policy transmission will persist. So the single monetary policy may have different effects in different parts of the euro area, leading to persistent differences in economic performance, even with the single policy stance established by the ECB's Governing Council.

We are already seeing greater variation from country to country than in the pre-crisis period. While the German economy appears to have recovered quickly from the recession – growing 1.5% in the first quarter of this year – in those countries most affected by the sovereign debt crisis growth remains sluggish. As a result, current cross-country growth differentials are significant compared with the pre-crisis period.

To some extent, these differences are a mirror image of those before the crisis. Those countries which had more buoyant growth during the pre-crisis period are also those that have accumulated large financial imbalances. In the middle of the past decade, the strong growth in household loans fuelled housing and construction booms in countries such as Spain and Ireland. Loan growth rates there peaked at annual rates of around 25%, compared with an area-wide peak of 10%.

As a result of the crisis, these countries have been undergoing a painful adjustment, unwinding the imbalances created during the boom. The recessions affecting them have sometimes been much deeper, with GDP growth several percentage points below that seen

in the euro area as a whole.[4] Consistent with this, loan growth has fallen significantly. For example, household loan growth has turned strongly negative in Ireland and has remained stagnant in Greece and in Spain over the past 2 years, while it returned to positive growth rates in 2010 in the euro area average.

Has the single monetary policy exacerbated these cross-country differences? The answer depends greatly on the counterfactual scenario you choose.

It is certainly possible to construct a *theoretical* counterfactual within which credible and independent national monetary policies would have ensured price stability in every country now in the euro area, rather than only at the average euro area level. In this scenario, cross-country inflation differentials would have been reduced, although I should emphasise that these have remained small in the euro area, even when compared with those in different regions of the United States, which is a currency area typically seen as being closer to the optimum size and structure.

However, a *more realistic* counterfactual would envisage euro area countries being connected by some version of the old Exchange Rate Mechanism (ERM), with the policies of several countries being in some way related to the policies implemented in particular by Germany and the respective currencies linked to the DM.

Arrangements like the ERM imply a strong interdependence of national monetary policies, not a free float with complete monetary independence. In practice, because of the importance of the German economy in Europe and the stability of its currency, the ERM accorded a central role to the monetary policy implemented by the Bundesbank, set on the basis of German macroeconomic conditions.

If we think about how such a system would have worked prior to the crisis, we would get to the conclusion that it would have made the divergences between countries more acute than those we have actually seen within the euro area. For example, policy interest rates determined by the Bundesbank on the basis of the outlook for price developments in Germany alone would probably have been lower before the crisis than those determined by the ECB for the euro-area as a whole. Within an ERM regime, lower German interest rates would have been transmitted elsewhere in Europe, including to countries such as Spain or Ireland, where domestic inflation and house price developments would not have warranted such an easy policy stance. The resulting lower real interest rates and easier financing conditions might well have exacerbated the accumulation of financial and real imbalances by supporting even bigger asset and credit bubbles and ultimately have led to a larger crisis as these bubbles burst.

During the crisis, Monetary Union has also helped to contain cross-country heterogeneity in bank credit conditions and supported the availability of loans to the private sector. Not only have standard and non-standard monetary policy measures served to ease financial conditions on average, they have also helped to limit the dispersion of bank interest rates across countries. For example, the range of long-term rates on bank mortgage loans to households across euro area countries has been limited to around 1½ percentage points in recent years, which is similar to the dispersion seen at the end of 2006, before the crisis started. While the spreads between interest rates on bank loans to non-financial corporations in Greece and Portugal have increased by up to 2 percentage points over the euro area average, the equivalent spreads for Ireland and Spain have remained modest over the entire crisis period.

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[4] In 2009 and 2010, GDP growth equalled: –7.6% and –1.0%, respectively, in Ireland; –2.3% and –4.4% in Greece; and –2.6% and 0.8% in Portugal. These figures compare with GDP growth of –4.1% and 1.8% in the euro area as a whole.

Another *theoretical* argument can be made suggesting that independent national monetary policies could be more expansionary when national fiscal policies turn restrictive in the pursuit of fiscal consolidation. In principle, national monetary policies have the advantage of being able to counter the negative pressure on inflation produced by the fiscal tightening. In practice, however, countries in urgent need of fiscal retrenchment do not necessarily experience lower inflation. At present, inflation is higher than the euro area average in Portugal, Ireland, Spain and, in particular, Greece. In a counterfactual without the euro, the national monetary authorities responsible for monetary policy could not implement a more expansionary policy stance than is currently the case in the euro area as a whole without endangering their credibility and the maintenance of price stability.

These observations are broadly supported by the experience here in the United Kingdom. Despite the extra degree of freedom offered to policy-makers by remaining outside the euro area, economic activity in the UK remains further below its pre-crisis peak than either in Germany or France. In relative terms, the depreciation of sterling against the euro has not cushioned growth but rather led to a higher rate of domestic inflation in Britain than in the euro area.

In sum, I would maintain that there are no clear reasons for believing that cross-country variation in economic performance within the euro area has proved larger than would have been the case if national monetary policies had been retained and the euro not introduced. But, at the same time, I do not think that cross-country differences in Monetary Union, which raise the potential for persistent divergence of economic performance, can or should be ignored.

Looking forward, the financial crisis and its impact on the functioning of financial markets in some countries has led to a situation in which cross-country heterogeneity owing to differences in monetary policy transmission may be more pronounced than before the crisis – at least if effective remedial measures are not taken.

This new environment has posed, and will continue to pose, challenges to the single monetary policy. How is the ECB dealing with these challenges?

Since the start of the financial crisis, the ECB has implemented a set of non-standard measures, taking advantage of the range of instruments available within the Eurosystem's framework for the implementation of monetary policy. Foremost among these measures has been the adoption of a fixed rate tender procedure with full allotment in the ECB's monetary policy operations. In conjunction with the flexible nature of the Eurosystem's collateral framework, these measures allow banks to obtain funding even in the face of market dislocation.[5] This has avoided a disorderly deleveraging of bank balance sheets and the associated potential for a fire sale-driven, vicious downward spiral in asset prices and bank capital.

In the face of the sovereign debt crisis these non-standard measures, supplemented by targeted asset purchases under the ECB's Securities Markets Programme, have addressed and contained the country-specific impediments to monetary policy transmission. The Eurosystem has provided – and is still providing – support to those national banking systems which face liquidity needs. I would like to underline that the key precondition for such a support is that the country concerned sticks to the EU/IMF adjustment programme and are on track. In other words, the responsibility for ensuring the conditions for the Eurosystem to support the banking system of the countries under stress is with the authorities of the countries themselves. There should be no doubt about it.

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[5] For further details, see Trichet, J-C. (2009). "The ECB's enhanced credit support", address at the University of Munich, http://www.ecb.europa.eu/press/key/date/2009/html/sp090713.en.html.

The support provided to the banking system has been substantial. It is reflected in financing conditions at the euro area level, which have become more favourable of late, amid an ongoing gradual normalisation.

Recent euro area bank lending surveys show signs of improvement in credit conditions compared with the peaks recorded during the apex of the financial crisis. While in most euro area Member States we have seen broadly unchanged or slightly loosened credit standards over the past few quarters, in a few others the bank lending surveys point to constraints remaining in the supply of bank loans to firms and households.

On the basis of these and other data, recent analyses by ECB staff members suggest that the transmission mechanism of monetary policy is normalising.[6] The impact of a monetary policy tightening on economic activity – at almost all horizons – is currently not statistically different from pre-crisis regularities. The impact on inflation shows a similar pattern in terms of time variation.[7]

In sum, the monetary policy framework of the ECB allows policy rates to be changed according to macroeconomic and price developments area-wide, while its non-standard measures aim to maintain monetary policy transmission so as to make the stance of policy rates effective throughout the euro area.

The standard and non-standard measures thus complement one another. The standard monetary policy instrument has been used to pursue the ECB's primary objective of price stability in the euro area as a whole. The non-standard measures have addressed the impediments to monetary policy transmission stemming from financial market dislocations and related threats to financial stability, and have thus helped to avoid cross-country divergence arising from discrepancies in the national transmission of the common monetary policy.

These measures have maintained the effectiveness of the single monetary policy in challenging circumstances. During the crisis, the credibility of the ECB has been instrumental in ensuring that medium-term inflation expectations have remained well-anchored around price stability. This, in turn, has significantly helped to ensure that lower nominal yields at various maturities translate into lower real interest rates, and thus support aggregate demand and avoid the spectre of a deflationary spiral.

Current challenges therefore do not call into question the primacy of the ECB's objective of price stability. On the contrary, it is precisely in this challenging environment that the benefits of price stability for Monetary Union as a whole will be reaped.

The credible achievement of price stability reduces overall uncertainty in the macroeconomic environment and thereby keeps risk premia embedded in financial yields lower than would otherwise be the case. In turn, this will foster growth, and thus provide support to those countries facing financing difficulties. At the same time, price stability is a crucial element in restoring stability to financial markets and improving market access for distressed sovereigns and banks.

That said, we must be careful not to overburden monetary policy, in both its standard and non-standard incarnations. Obviously, monetary policy cannot take up the slack where fiscal or other authorities fail to live up to their responsibilities.

While central banks can, should and do provide *liquidity* support to financial markets, they cannot provide *solvency* support. That would represent an encroachment upon the domain of

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[6] See the analysis presented in Giannone, D., M. Lenza, H. Pill and L. Reichlin (2011). "Non-standard monetary policy measures and monetary developments," ECB Working Paper No 1290.

[7] See the framework developed in Ciccarelli, M., A. Maddaloni and J-L. Peydró (2010). "Trusting the bankers: A new look at the credit channel of monetary policy," ECB Working Paper No 1228.

the fiscal authorities and blur the distinction between monetary and fiscal policy. It would threaten the independence of the central bank, on which the credible pursuit of price stability relies. In the face of a financial crisis, the fiscal authorities may be called upon to shore up capital in the banking system. The monetary authorities cannot and should not play any role in this area.

Structural reforms are also crucial. In those countries suffering from anaemic growth due to a lack of competitiveness, reforms to reduce unit labour costs have to be put in place. Foremost among them are measures to improve the flexibility of the labour market. Member States with large fiscal imbalances and debt overhangs must address them by adopting measures to achieve a primary fiscal surplus.

I recognise that implementing these measures is challenging. And the starting point is, in many cases, unfavourable. Disinflation to improve price competitiveness may serve to increase the real burden of a country's debt overhang.

But there is no alternative to these measures if Monetary Union is to work effectively, and the countries concerned are to regain the stability and prosperity that they seek.

And, in all cases, convergence has to be with the best performer in the euro area. We cannot accept any weakening that would be implied by the averaging-out of the performance of all Member States. Indeed, all countries have homework to do: there is much scope for improvement even in the strongest countries if the benefits of price stability are to be fully reaped by the people of Europe.

The responsibility for fiscal and structural policies remains at national level. But we may need to consider some policy areas where, in order to ensure the stability of Monetary Union and the euro, more responsibilities should be assumed at area-wide level. The financial crisis has demonstrated that a lack of financial integration can complicate the implementation, and threaten the effectiveness, of the single monetary policy. Policy interest rates can only guarantee price stability when their transmission to the economy is effective and reasonably uniform.

To ensure such transmission, we need greater harmonisation in financial supervision and regulation. These are tasks that should be performed at euro area level.

Harmonised financial supervision and regulation will also support deeper financial integration within the euro area. In turn, such integration will foster risk-sharing and improve the shock-absorbing capacity of Monetary Union. Some of the vulnerabilities of the euro area we have seen in recent years stem – at least in part – from the fragmented nature of the European financial sector and the supervisory regime that supports it.

What we have witnessed over the past few years in financial markets represent the growing pains of the euro, not its death throes. With the necessary actions taken at national and area-wide level, I am confident the euro will go from strength to strength.

Thank you for your attention.