Vítor Constâncio: Effectiveness of Monetary Union and the Capital Markets Union

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the EUROFI Conference, Malta, 6 April 2017.

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Introduction

In my remarks today I will link the role of monetary policy with the project of the Capital Markets Union (CMU). Monetary policy has played a vital role in bolstering euro area resilience to the large shocks that have occurred over the past decade. Indeed, it is the only expansionary macroeconomic policy in support of the resilient recovery now underway in the euro area. Nevertheless, we have not yet completed the task of attaining our goal of a sustained path of inflation close to but below 2%.

But while monetary policy has been successful at sustaining the area-wide recovery, it is unable to significantly counteract the effects on individual countries from asymmetric shocks, which have been substantial in recent years. There is an important role here for capital markets. By permitting households and businesses to draw on cross-border income streams and lending, deeper financial integration reduces the impact of asymmetric shocks.

The degree of financial integration in the euro area is currently insufficient. Indeed, in the recent crisis, the degree of financial integration fell, as interbank markets fragmented along national lines. This fragmentation exacerbated the overall impact of the shocks on the euro area, deepening the recession, lengthening the recovery and increasing the need for unconventional monetary policy measures. The single currency area provides fertile conditions for deeper financial integration and that deeper integration in turn helps build resilience to shocks and strengthens the effectiveness of monetary policy by means of a more homogenous transmission. Monetary policy and CMU are thus linked.

Let me start by discussing the current situation and the contribution of monetary policy in sustaining the current recovery before returning to discussing how CMU can help generate greater resilience to future shocks.

The current economic conjuncture

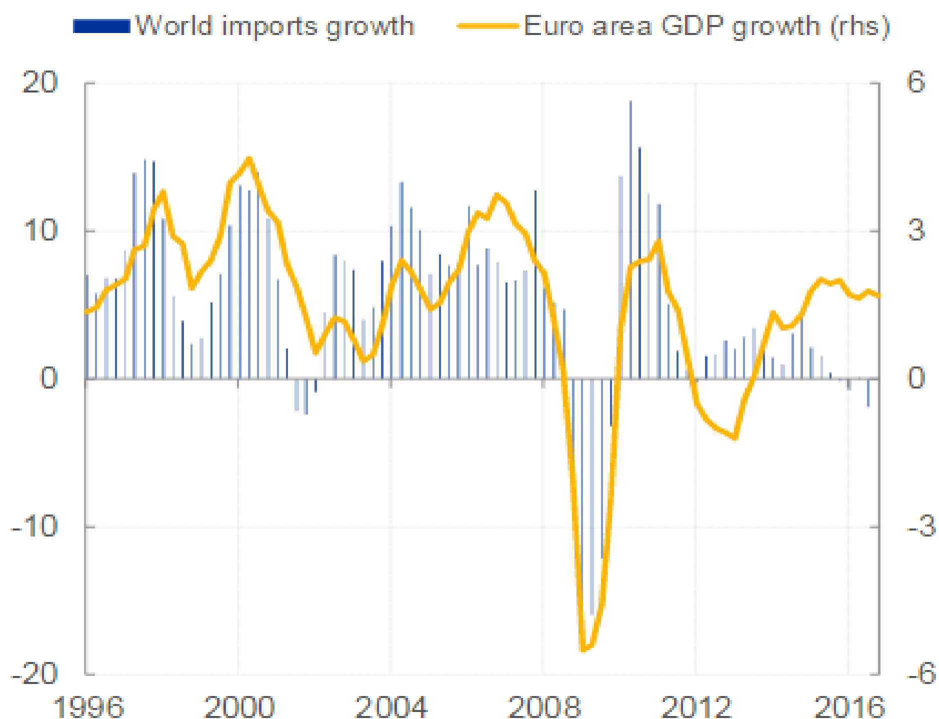
The euro area recovery is gaining momentum, broadening across sectors and countries. This is evidenced by 15 consecutive quarters of positive real GDP growth, unemployment at its lowest level since 2009 and over four and a half million more people employed now than was the case three years ago. Growth in manufacturing also reached its highest rate since 2011.

Moreover, the current recovery has shown considerable resilience amid an environment of uncertainty. Typically, euro area activity closely co-moves with world trade, so if the latter slows this acts as a headwind for growth. However, the strength of domestic demand has enabled euro area growth to continue to expand, despite the marked slowdown in global trade (Chart 1).

Chart 1

World imports and euro area real GDP growth

(quarterly data, year-on-year percentage change)



Sources: Eurostat, ECB staff calculations.

Latest observation: 2016 Q3 for world imports growth and 2016 Q4 for euro area

What, then, is supporting domestic demand? Employing a range of econometric models, ECB staff show that the current recovery has been very reliant on two factors: the exceptionally low oil prices in 2014–15 and our monetary policy measures. This monetary support can for the most part be traced back to the measures which the ECB started introducing in June 2014 in order to arrest the downward drift in inflation at the time and the risk of a self-sustained period of deflation.

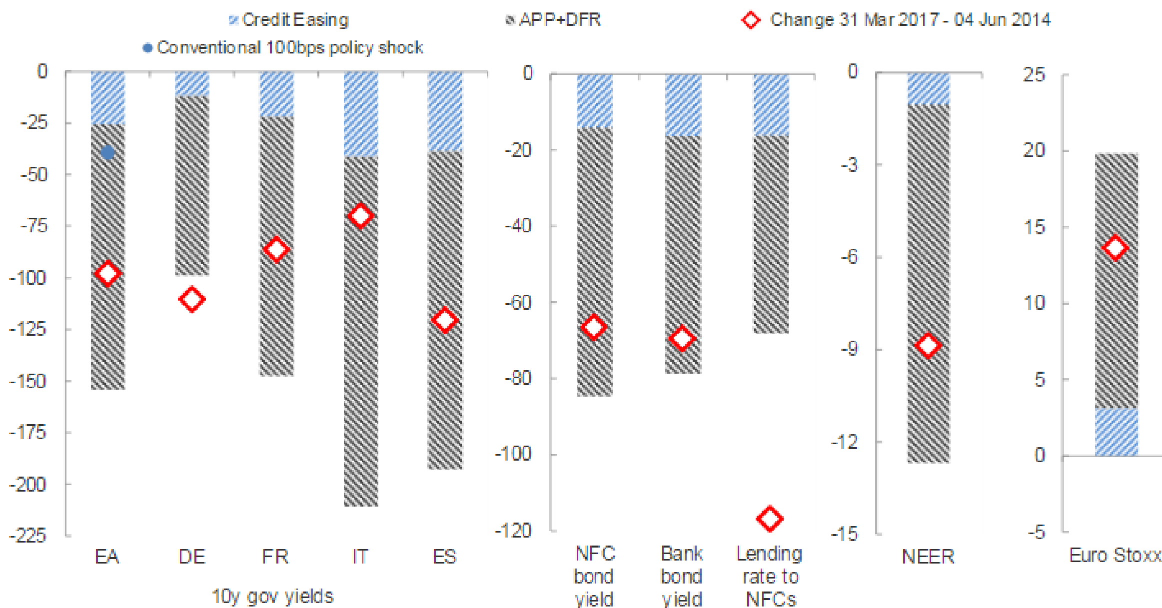
These measures have had a considerable impact on euro area financing conditions. Bank lending rates for both firms and households are currently at historical lows, and lending volumes experiencing an upward trend. Borrowing costs in vulnerable countries have been significantly reduced, reducing fragmentation and small and medium sized enterprises are especially benefitting from the increasing pass-through of policy rates to lending rates. In this regard, monetary policy has had some success in mitigating the asymmetric impact of shocks.

To give an example of the contribution of monetary policy to this easing in financing conditions, ECB staff estimate that lending rates to non-financial firms would be about 70 basis points higher absent our policies (Chart 2). In combination with other factors, lending rates to non-financial firms dropped by 120bp from June 2014 to date.

Chart 2

Impact of ECB measures on key financing conditions

(contributions in basis points and percent)

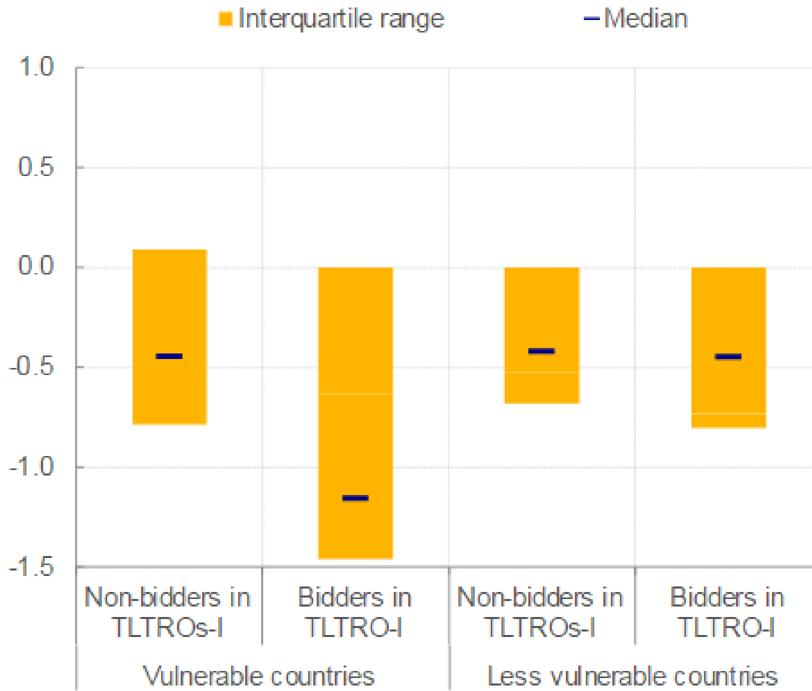


Source: Bloomberg, ECB, ECB calculations.

Note: The impact of credit easing is estimated on the basis of an event-study methodology which focuses on the announcement effects of the June-September package; see the EB article "The transmission of the ECB's recent non-standard monetary policy measures" (Issue 7 / 2015). The impact of the DFR cut rests on the announcement effects of the September 2014 DFR cut. APP encompasses the effects of January 2015, December 2015, March 2016, and December 2016 measures. The January 2015 APP impact is estimated on the basis of two event-studies exercises by considering a broad set of events that, starting from September 2014, have affected market expectations about the programme; see Altavilla, Carboni, and Motto (2015) "Asset purchase programmes and financial markets: lessons from the euro area", ECB WP No 1864, and De Santis (2015), "Impact of the asset purchase programme on euro area government bond yields using market news", ECB WP No. 1939. The quantification of the impact of the December 2015 policy package on asset prices rests on a broad-based assessment comprising event studies and model-based counterfactual exercises. The impact of the March 2016 measures and the impact of the December 2016 measures are assessed via model-based counterfactual exercises.
* Changes in lending rates are based on monthly data, the reference period for which is June 2014 to February 2017.

The effectiveness of our measures is also visible from a more micro perspective, by examining the lending behaviour of individual banks in the context of our TLTROs. Incentives underpinning the TLTROs (Targeted Long-Term Refinancing Operations) are resulting in the cheaper funding costs being passed-on to customers, particularly in vulnerable euro area countries (Chart 3).

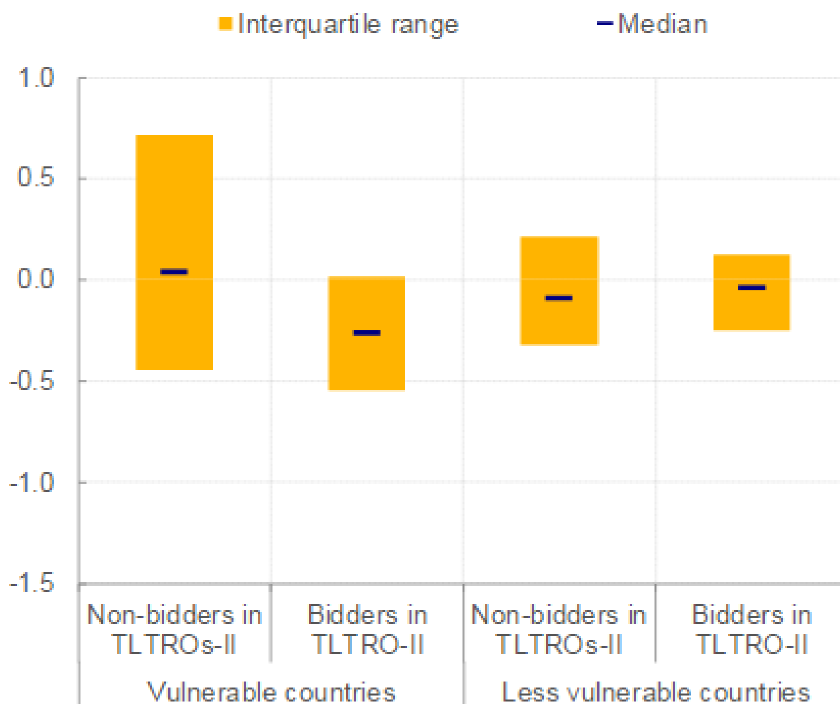
Chart 3



Source: ECB

Notes: The chart covers the period from June 2014 to July 2015. In "vulnerable" countries the "non-bidders in TLTROs-I" group comprises ten banks and the "bidders in TLTRO-I" group comprises 49 banks. In "less vulnerable" countries the "non-bidders in TLTROs-I" group comprises 71 banks and the "bidders in TLTRO-I" group comprises 43 banks.

Change in lending rates for NFCs (TLTRO II)



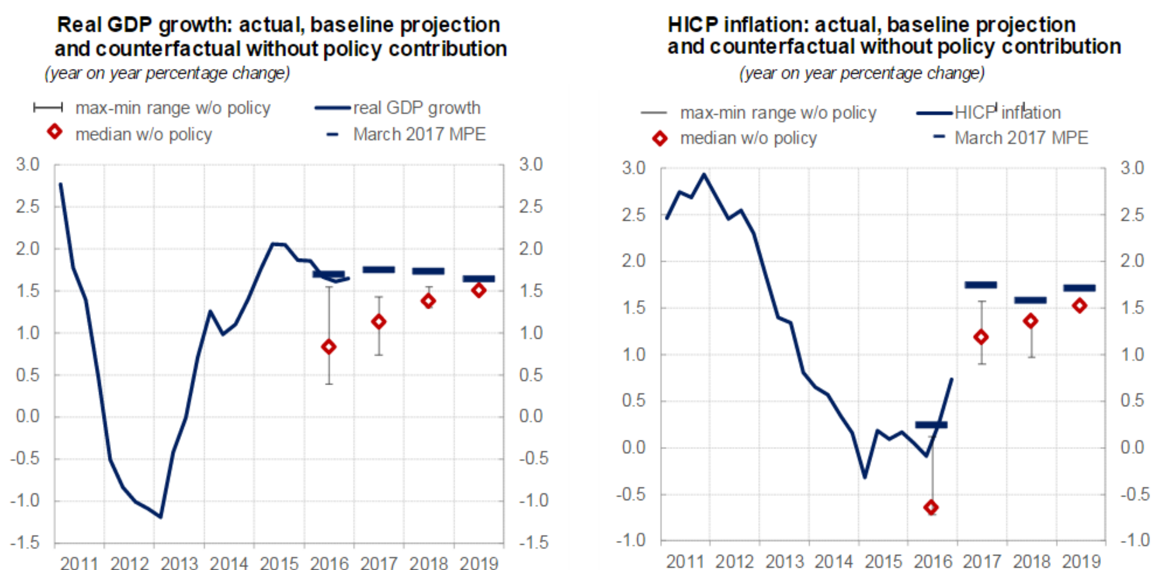
Source: ECB.

Notes: The chart covers the period from March 2016 to December 2016. In "vulnerable" countries the "non-bidders in TLTROs-II" group comprises 24 banks and the "bidders in TLTRO-II" group comprises 47 banks. In "less vulnerable" countries the "non-bidders in TLTROs-II" group comprises 73 banks and the "bidders in TLTRO-II" group comprises 51 banks.

Euro area activity has been improving against this backdrop of easing financing conditions. Higher employment has boosted labour incomes and consumption, and investment has begun a cyclical recovery. Global growth prospects are showing signs of strengthening and may well further support the recovery. Indeed, despite the waning support from oil prices, growth has continued to broaden and gain momentum. While risks to the outlook remain on the downside, they are less pronounced than before.

Our latest staff macroeconomic projections were revised slightly upwards, with annual real GDP is expected to increase by 1.8% in 2017, 1.7% in 2018 and 1.6% in 2019. The impact of monetary policy measures on euro area GDP growth is sizeable, adding a cumulative 1.7% over the period 2016–2019 (Chart 4).

Chart 4



Sources: ECB staff projections and calculations.

Notes: HICP inflation and real GDP growth are based on the March 2017 MPE; the median and range reflect estimates of HICP inflation and real GDP growth over the projection horizon in the absence of monetary policy support. These estimates are obtained on the basis of a large suite of models, encompassing various dimensions in relation to the treatment of the financial sector, the degree of forward lookingness, and the way non-standard measures are implemented in the models. Latest observation: 2016 Q4 for HICP and real GDP growth.

But while significant progress has been made, it is too soon to declare complete success. Headline inflation has increased, but has yet to sustainably converge towards our objective. The increase mostly reflects rising energy and food price inflation, with underlying inflation pressures still subdued (Chart 5). The flash estimate for March shows that headline inflation has dropped to 1.5% from 2% in February and that underlying inflation decreased from 0.9% to 0.7%. We had previously warned that headline inflation could decline after March-April as a result of the reduced statistical base effect of comparing this year's price levels of oil and other commodities with their value a year ago.

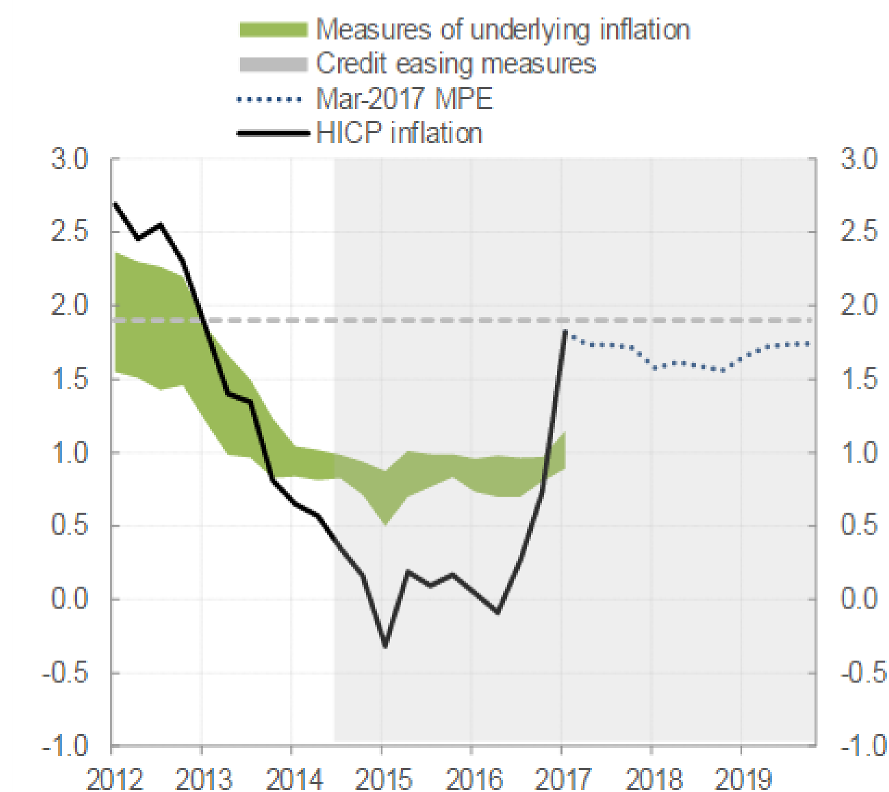
The decrease in underlying inflation, however, is disappointing. The domestic drivers of inflation, namely wages, are not yet responding to the recovery and the narrowing output gap. According to our latest projections, inflation is expected to move towards 1.7% in 2019 (Chart 5), predicated on underlying inflation and wage growth of 1.8% and 2.4%, respectively. Without the foreseen increase in wages, the baseline scenario of our staff projections for growth and inflation will not materialise in 2019. At early stages of its recovery, the US also faced the same subdued behaviour of underlying inflation and wages that accelerated only later.

To achieve our goals concerning self-sustained inflation, we have to be sure that domestic drivers of inflation are behaving accordingly. In this perspective, it is worth mentioning that the projections rely on the continued substantial degree of monetary accommodation. Absent our policy package, inflation would on average be almost 0.5% lower than currently projected in each year over 2016–2019 (Chart 4). In other words, inflation is not yet self-sustaining. For this reason, the Governing Council at its last meeting confirmed the appropriateness of the current monetary policy stance. As ever, we are data dependent; we recognise that there has been improvement in the situation and if inflation gives signs of a sustained path towards our aims, we will reassess our present policy stance.

Chart 5

Actual and projected HICP inflation, and measures of underlying inflation

(year-on-year percentage change)



Sources: ECB, ECB staff projections and calculations.

Notes: The measures of underlying inflation (green range) include HICP inflation excluding food and energy, and U2 core and Super-core.

Latest observation: 2017 Q1 for HICP inflation and measures of underlying inflation

Improving future resilience

To recap, monetary policy is successfully sustaining a resilient recovery from the large shocks that have hit the euro area over the past decade. Our unconventional measures introduced since June 2014 are working. But that is not to say that monetary policy has been successful in completely eliminating the effects of those shocks on individual countries. That is beyond the ability of monetary policy. What other options are there, then, to build resilience in the euro area against future shocks?

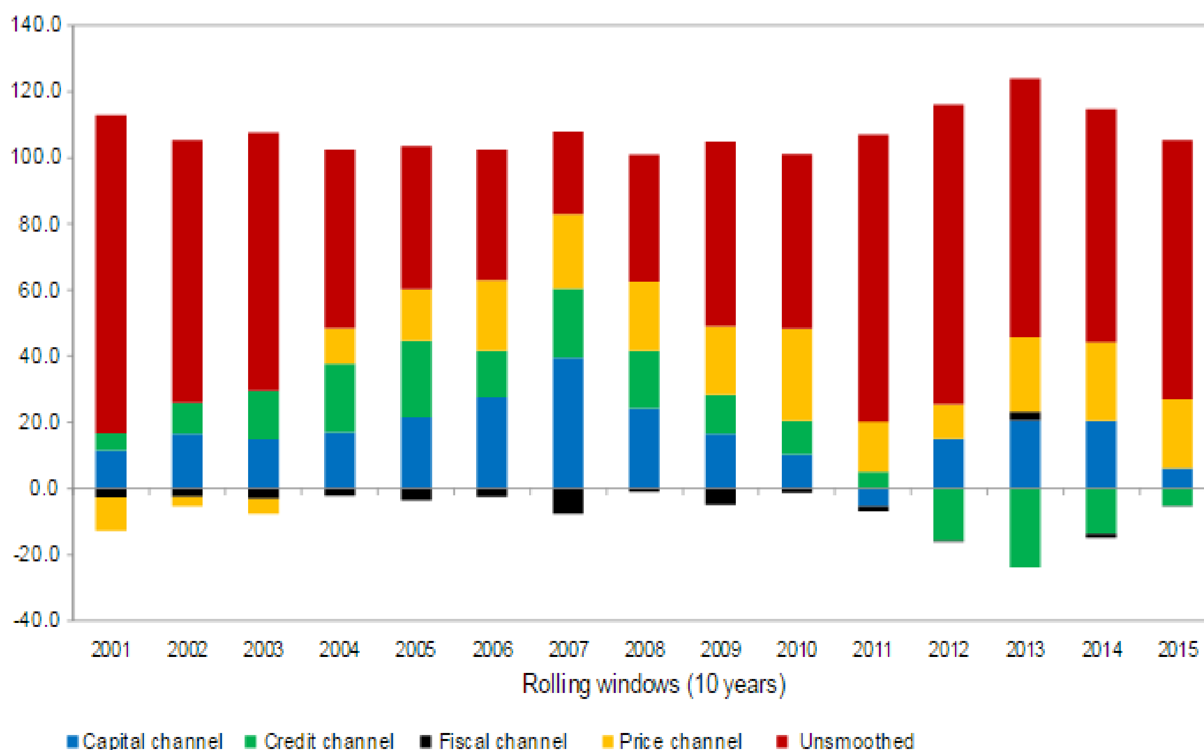
First, it is worth noting the absence of other macroeconomic policies in sustaining the recovery. There has been little support from fiscal policy, and the progress on structural reforms has not been completed. We have frequently discussed how a greater counter-cyclical role for fiscal policy and more flexible economies can help reduce the impact of shocks and buttress the efforts of monetary policy. Those views remain true today. But there is a role, too, for deeper financial integration through the CMU to build resilience.

Well-functioning political, economic, and monetary unions are normally characterised by high levels of risk-sharing across regions. For example, evidence suggests that three quarters of shocks to the per-capita gross product of individual states in the United States are smoothed, and that capital markets and credit markets together account for around two-thirds of that smoothing, dwarfing the contribution from federal transfers (13%).[1] Similarly, in post-unification Germany around 69% of region-specific shocks to GDP growth are smoothed through capital markets and credit markets, and only about 11% through fiscal tools.[2]

In comparison, the overall contribution of markets to risk sharing in the euro area has, on average, been limited (chart 6).[3] At present, little more than 20% of the idiosyncratic shocks to a country's economy are smoothed, with changes in relative prices contributing the most to risk sharing.

Chart 6

The channels of risk sharing in the euro area, 1991—2015



Note: The Chart summarizes the five-year cumulative contributions of capital markets, credit markets, fiscal tools, and relative prices to the smoothing, in terms of consumption growth, of a 1-standard-deviation shock to GDP growth. Each bar thus measures the parts of the shock to country-specific GDP that are absorbed by the respective channels. The remainder is interpreted as the unsmoothed portion of a GDP shock, i.e., the part of a shock to country-specific GDP growth that is reflected into country-specific consumption growth. Contributions sum up to 100 percent, and a negative contribution corresponds to dis-smoothing of consumption growth. The respective contributions are estimated over rolling ten-year backward-looking windows, based on annual data and applying the Asdrubali and Kim (2004) approach enhanced for relative price adjustments in the spirit of Corsetti, Dedola, and Viani (2011).

Risk-sharing via cross-border ownership of assets increased substantially following the introduction of the euro, smoothing between 30% and 40% of country-specific shocks to GDP by the mid-2000s. But the contribution of capital markets declined substantially during the financial and especially during the sovereign debt crisis. The contribution of credit markets has been lower, and it even became negative during the financial crisis when European banking sector was particularly hit.

In the absence of a European supra-national system of taxes and transfers, it is more pressing than ever to boost Europe's risk-sharing potential through financial market mechanisms. The risk-sharing benefits of integrated financial markets could in principle be large.

Another major benefit of the CMU is the contribution to convergent growth among member countries, resulting from the improved circulation and allocation of savings across the Union. In this perspective, Brexit makes it more crucial that the CMU is effectively implemented and that European growth can avail itself of the services of an integrated financial system. This is particularly true of a CMU focused on stimulating equity financing. Indeed, equity and foreign direct investment (FDI), and longer-maturity debt in general, are leading to a more resilient form of financial integration. Deeper equity markets constitute an unquestionable advantage to the US, notably in relation to the role of venture capital in promoting innovation. For the expansion of such an activity it is important to create a deep equity market that can provide significant returns in successful IPOs (Initial Public Offers) that can offset losses incurred by failing risky projects.

The CMU is aimed at completing the single market for capital by building integrated markets for equity and bond finance. This should be achieved through both regulatory and non-regulatory actions, including the harmonisation of key legislation and policies related to financial products, such as investor protection and bankruptcy procedures.

A number of concrete measures are set out in the Commission's Action Plan to underpin the further development of large capital markets in the EU.[4] The same applies to improving financial literacy and to stimulating a shift in household savings from bank deposits to equity holdings.

We need a CMU that is ambitious; it should come with a roadmap in terms of goals and milestones to be achieved. Broad objectives such as deepening financial integration and achieving risk sharing should be matched with specific proposals such as facilitating funding for corporates in general and for SMEs in particular. Key areas such as securitisation, insolvency regimes, and tax legislation need to be prioritised. Cross-border barriers to clearing and settlement should be removed.

Financial stability concerns also need to be addressed, including an assessment of whether additional macro-prudential instruments should be developed. The proper regulation of financial products and supervision of financial entities, such as insurers and pension funds, as well as full transparency of new financial products, should be put in place as they are essential to convincing households to switch to more market-based forms of saving. In this respect, enhanced powers for the European Securities Markets Authority (ESMA) and better coordination with the national competent authorities will help strengthen the implementation and enforcement of rules.

Conclusion

Allow me to conclude.

The euro area is experiencing a resilient recovery, sustained by monetary policy. Outturns for high-frequency data so far this year point to continued momentum. But it is too soon to declare complete success: we have yet to secure a sustained convergence in inflation towards our goal of close to but below 2% over the medium term.

With the recovery underway, we should aim to build euro area resilience to future shocks. In this

regard, clear progress on CMU will help put in place the right conditions to encourage a greater degree of financial integration in the euro area.

This in turn will help dampen the asymmetric effects of future shocks, bolster the effectiveness of monetary policy and enhance the welfare of our citizens.

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[1] Asdrubali, P., Sorensen, B. and Yosha, O., "Channels of interstate risk sharing: United States 1963–1990", *Quarterly Journal of Economics*, Vol. 111, 1996, pp. 1081–1110; Athanasoulis, S. and van Wincoop, E., "Risk sharing within the United States: What do financial markets and fiscal federalism accomplish?", *Review of Economics and Statistics*, Vol. 83, 2001, pp. 688–698. See also Del Negro, M., "Asymmetric shocks among US States", *Journal of International Economics*, Vol. 56(2), March 2002, pp. 273–297.

[2] Hepp, R. and von Hagen, J., "Interstate risk sharing in Germany: 1970–2006", *Oxford Economic Papers* 65, 2013, pp. 1-24.

[3] Balli, F. and Sorensen, B., "Risk sharing among OECD and EU countries: The role of capital gains, capital income, transfers, and savings", MPRA Working Paper No 10223, 2007.

[4] See "Action Plan on Building a Capital Markets Union", Commission Communication, Brussels, 30 September 2015.