SEMINAR IN EUROPEAN ECONOMICS

THE SOVEREIGN DEBT CRISIS AND FINANCIAL INTEGRATION: CHALLENGES FOR MONETARY POLICY

PRACTICAL CLASS 4

2024-25 S1

THE SOVEREIGN DEBT CRISIS AND FINANCIAL INTEGRATION: CHALLENGES FOR MONETARY POLICY

- Chronology of a crisis
  - Build-up of vulnerabilities and macroeconomic imbalances
  - Sudden-stop
  - Contagion effects
  - Policy responses?

- Impact on financial integration

- ECB’s Response to COVID-19

- ECB’s Response to Inflationary Pressures

CHRONOLOGY OF A CRISIS

Figure 1. Risk premiums disappeared in the run up to the crisis.

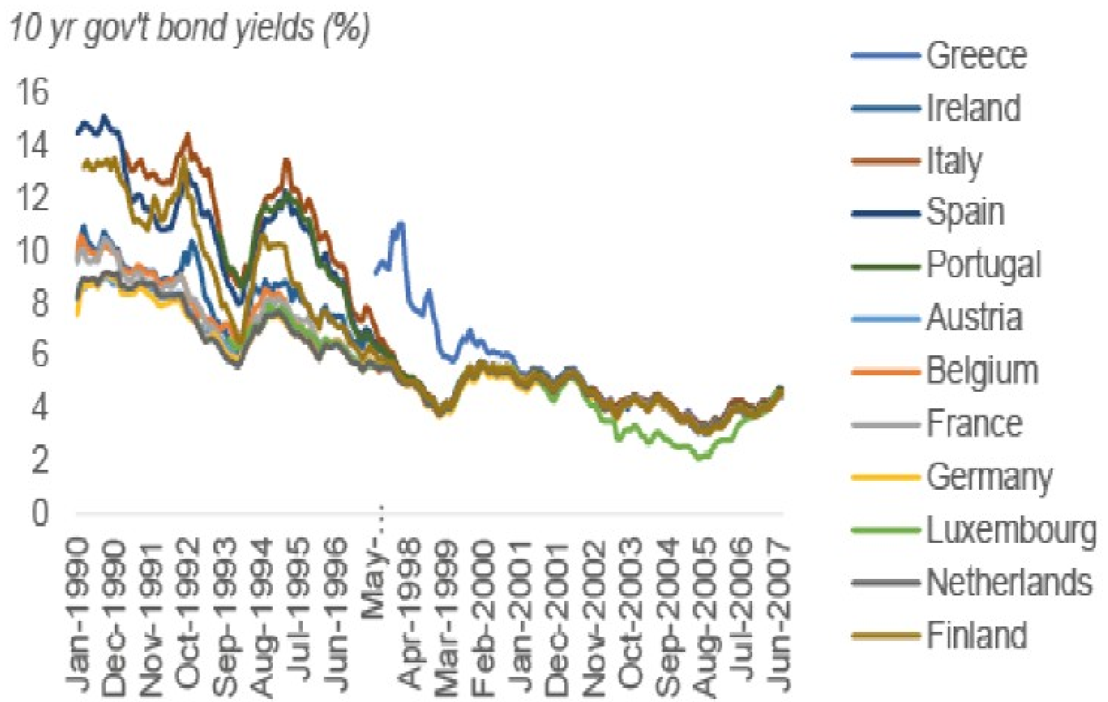
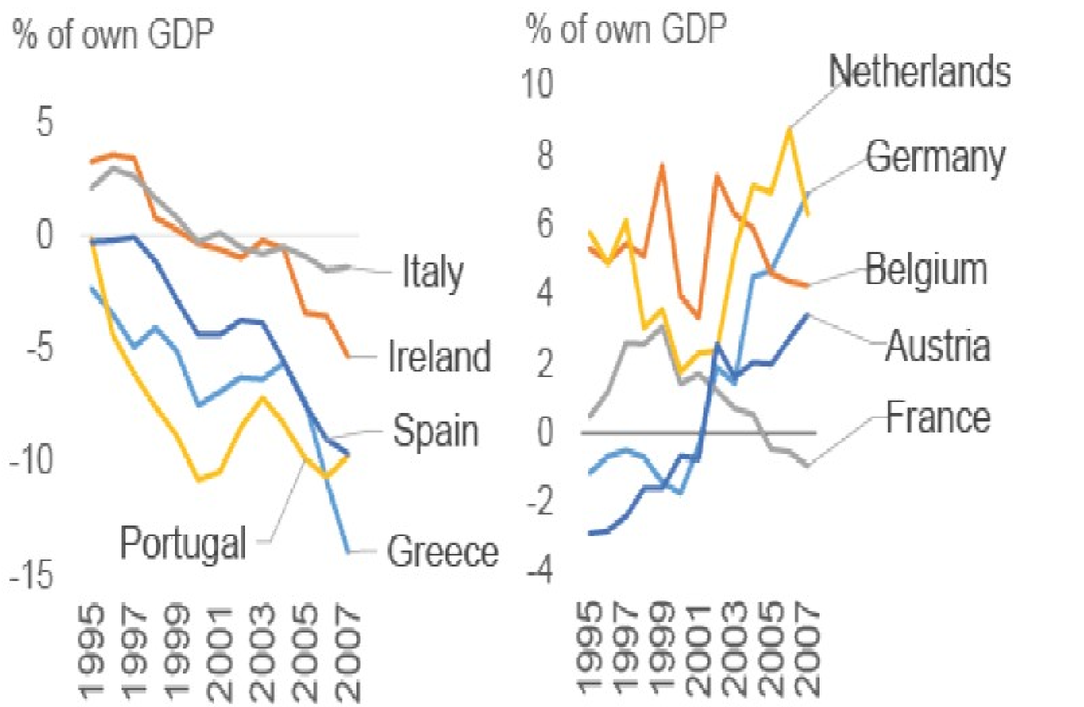
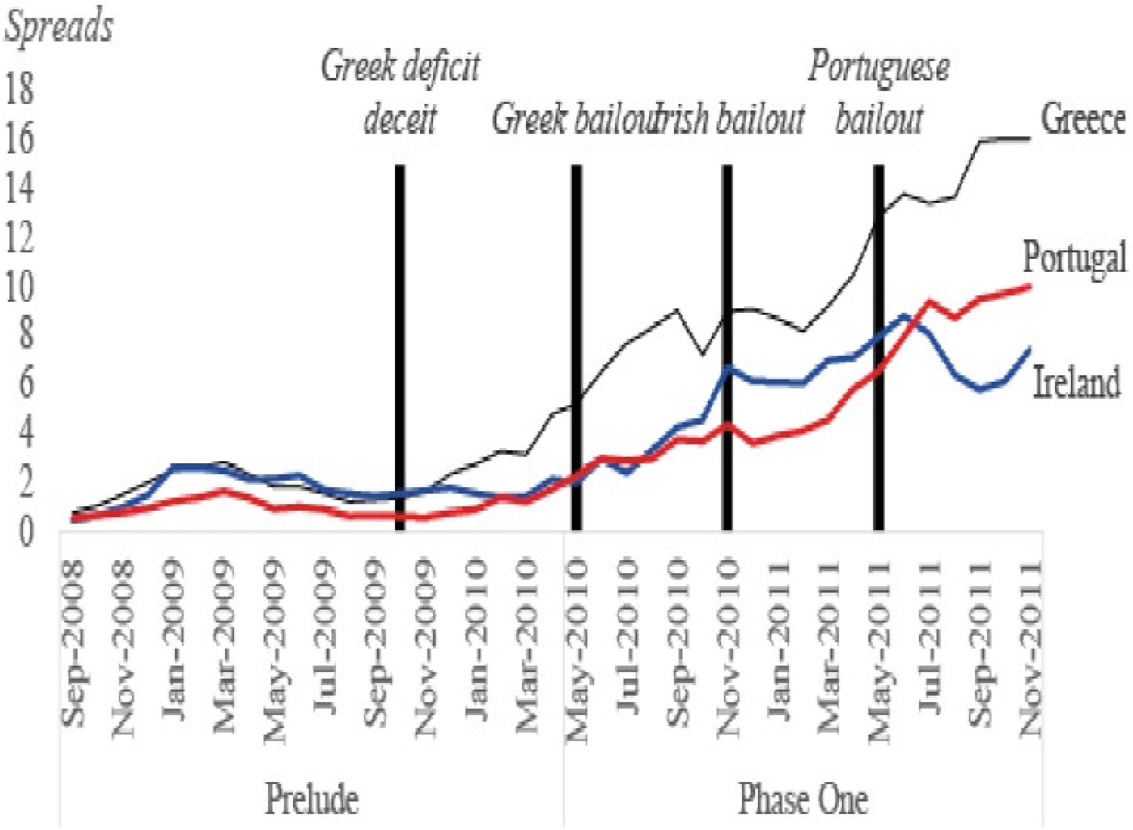


Figure 2. Current accounts: The core lent to the GIIPS from 2000 to 2007.



- Eurozone (EZ) interest rates converged in anticipation of the single currency
- Asymmetrical effects on countries with current account deficits (CAD)
- Convergence effect? (Inefficient reallocation of resources; pressures on prices and wages; rigid labor and product markets)

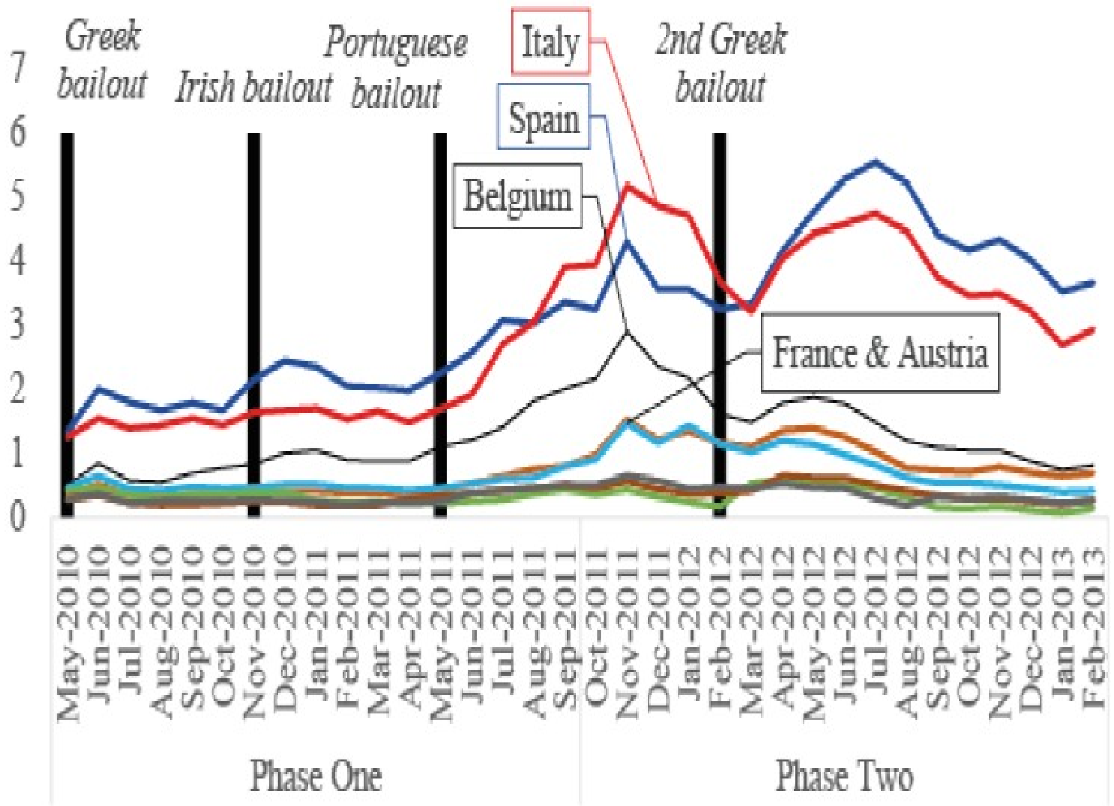
CHRONOLOGY OF A CRISIS: SUDDENT STOP OF CAPITAL FLOWS



- The global financial crisis triggered change in market sentiment – greater awareness to risk
- Countries with CAD, which relied on external financing became more vulnerable
- Predominance of bank finance
- Concerns about viability of banks (feedback loop between banks and sovereign)
- No lender of last resort (LOLR)

CHRONOLOGY OF A CRISIS: CONTAGION

Figure 9. Phase two – Contagion spreads to the Eurozone core

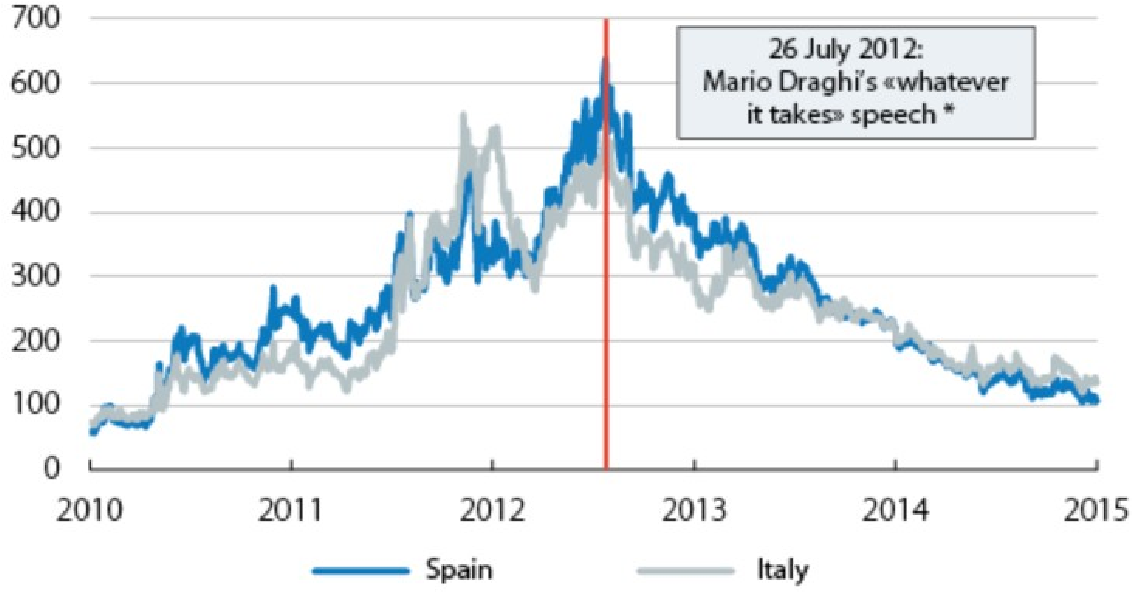


- Solution to Greek situation: financial assistance program (not immediate, too late, too little?)
- Lack of clear viable solutions triggered concerns about other vulnerable countries
- Feedback loop between banks and sovereign
- Two equilibria – ‘self fulfilled prophecies’

CHRONOLOGY OF A CRISIS: POLICY INTERVENTION

The ECB President's communication power

Risk premia for Spanish and Italian 10-year sovereign debt (bp)



Note: * On 26 July 2012, the ECB President, Mario Draghi, stated in London that the central bank would do «whatever it takes» to preserve the single currency.
Source: CaixaBank Research, based on data from Bloomberg.

- Concerns about the euro sustainability
- 'Whatever it takes speech'

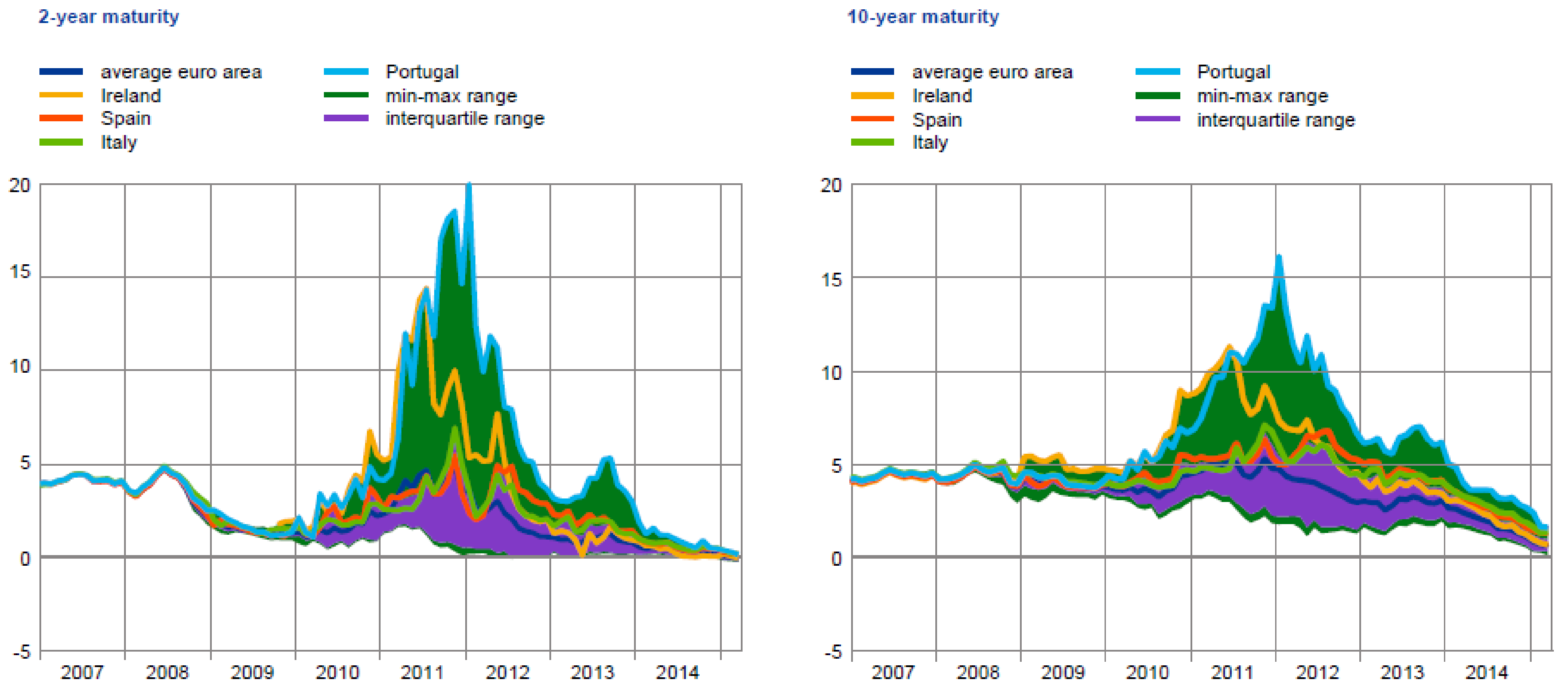
'Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough'

- OMT (outright monetary transaction)
- European Stability Mechanism

IMPACT ON FINANCIAL INTEGRATION

Dispersion of euro area sovereign bond yields

(percentage points)



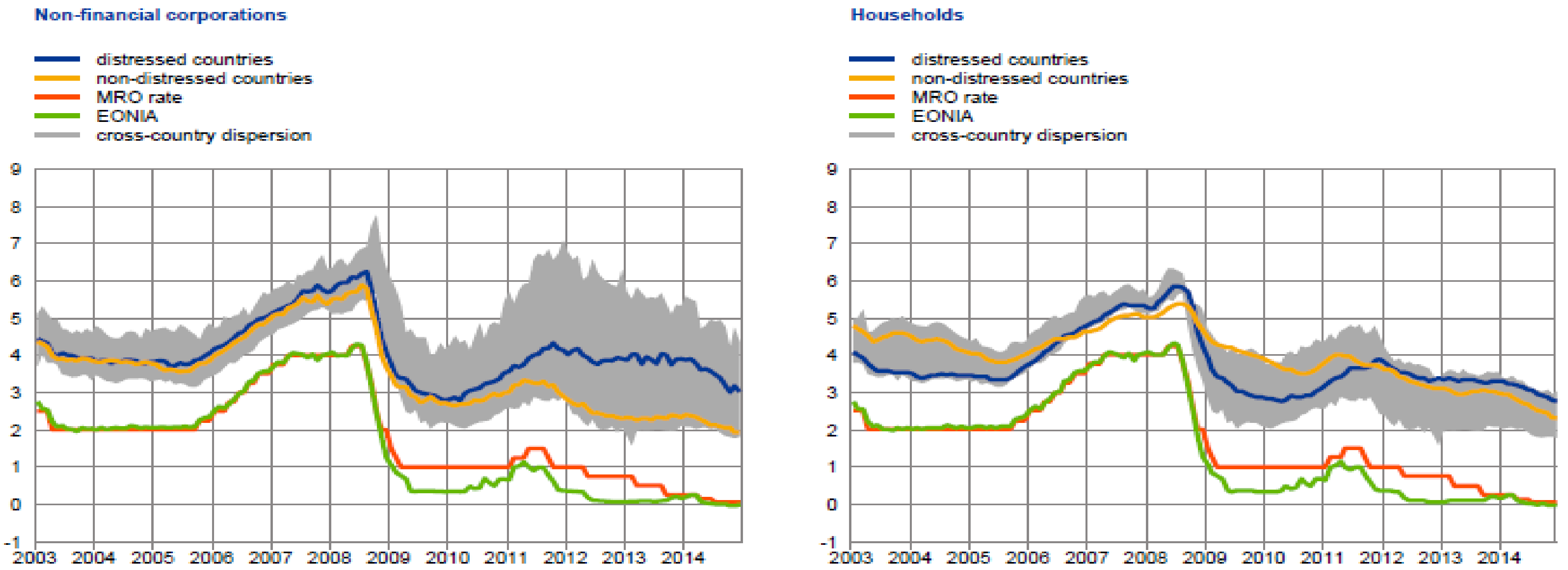
Sources: Thomson Reuters and ECB.
Note: The data used are based on euro area country composition as in 2011. The yields for Greece, Cyprus, Estonia, Luxembourg, Malta and Slovenia are excluded owing to infrequent observations or a lack of observations.

IMPACT ON FINANCIAL INTEGRATION

Composite indicators of the cost of borrowing from MFIs

MFI - Monetary financial institution

(percentages per annum)

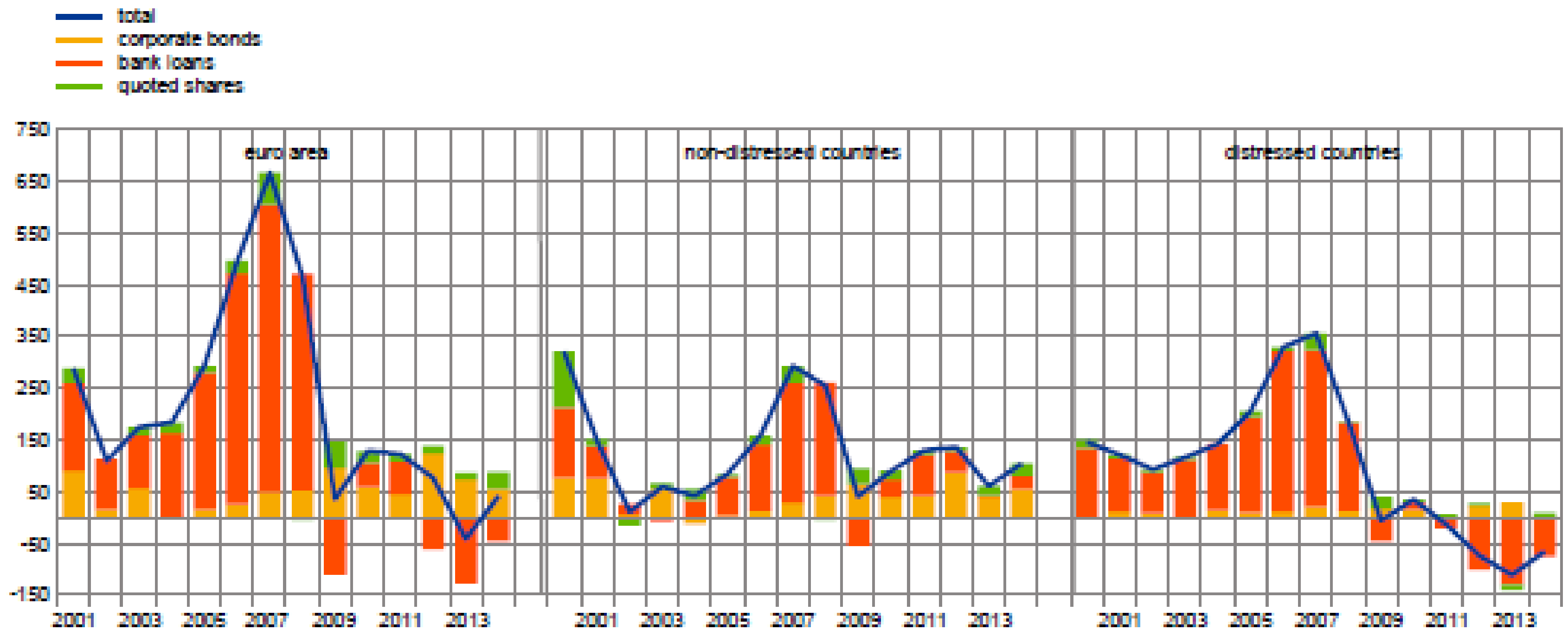


Sources: ECB and ECB calculations.
Notes: The indicator is computed by aggregation of short and long-term rates, using 24-month moving averages of new business volumes as weights. Distressed countries are ES, GR, IE, IT and PT. Non-distressed countries are AT, BE, DE, FI, FR, LU and NL. Within each country group, national rates are aggregated using 24-month moving averages of new business volumes as weights. At the beginning of the sample, weights are fixed at the first computable value. The cross-country dispersion displays the min-max range after trimming the two extreme values.

IMPACT ON FINANCIAL INTEGRATION

NFCs' debt security, bank loans and quoted share issuance

(EUR billions; annual sums)



Sources: ECB.
Notes: The observations for 2014 provide the volumes observed up to December 2014

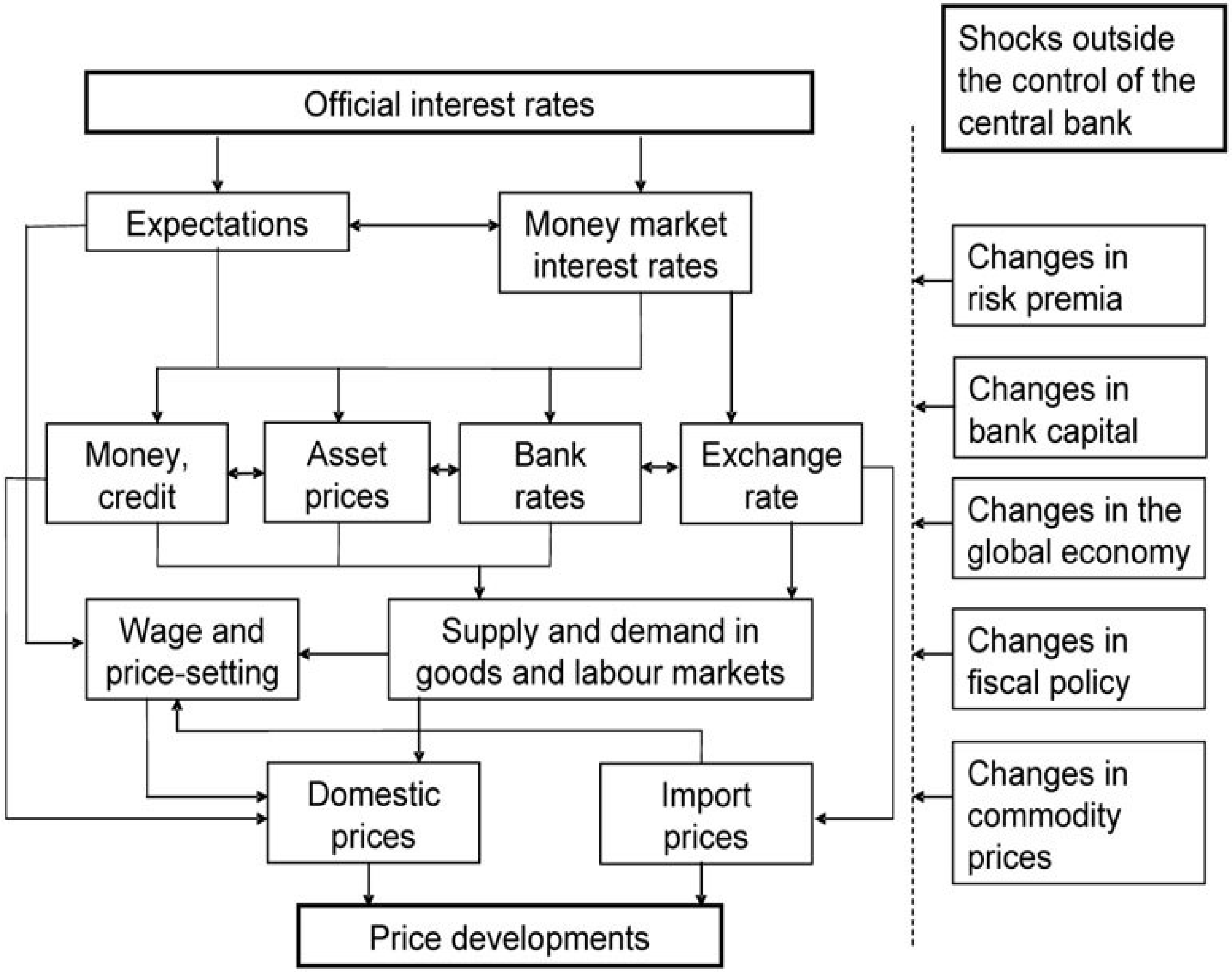
IMPACT ON MONETARY POLICY

- Greater dispersion in financing costs highlights a lower degree of financial integration
- Costs of borrowing of non-financial counterparties and households higher in distressed countries higher (less affected by policy rates – effectiveness of transmission mechanism of monetary policy)

Lack of financial integration and low interest rate environment (LIRE) complicate role of monetary authority:

- ➢ Affect the transmission mechanism of monetary policy (downward rigidity in deposit rates and lower pass-through to lending rates)
- ➢ Affects financial stability: banks' profitability (lower interest rate margins) and bank's behaviour (search for yield, excessive risk taking and the emergence of speculative bubbles)

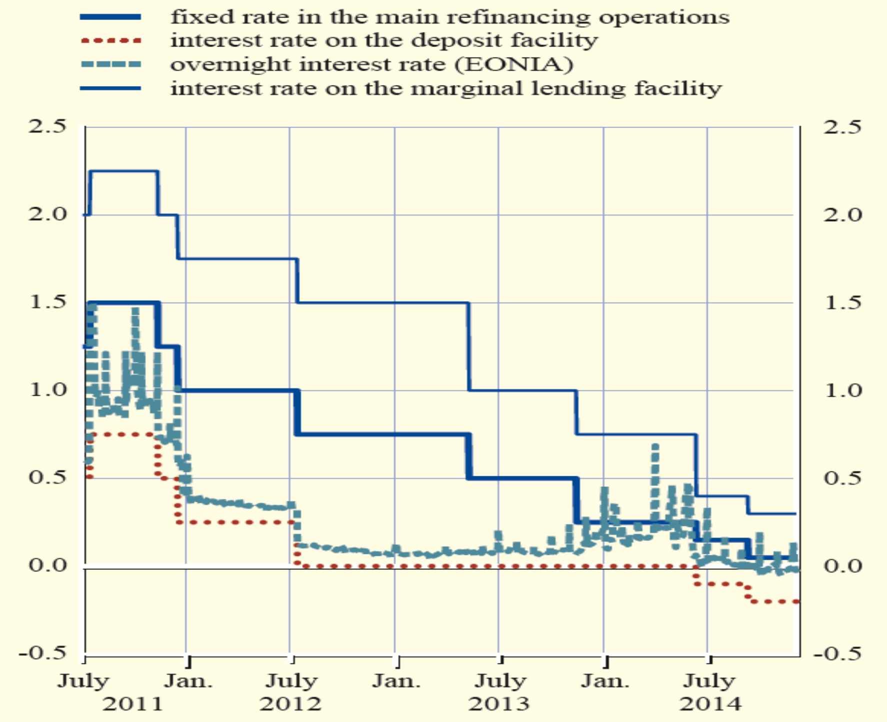
TRANSMISSION MECHANISM OF MONETARY POLICY - ECB



MONETARY POLICY: INTEREST RATES AND STANDARD INSTRUMENTS

Chart 21 ECB interest rates and the overnight interest rate

(percentages per annum; daily data)

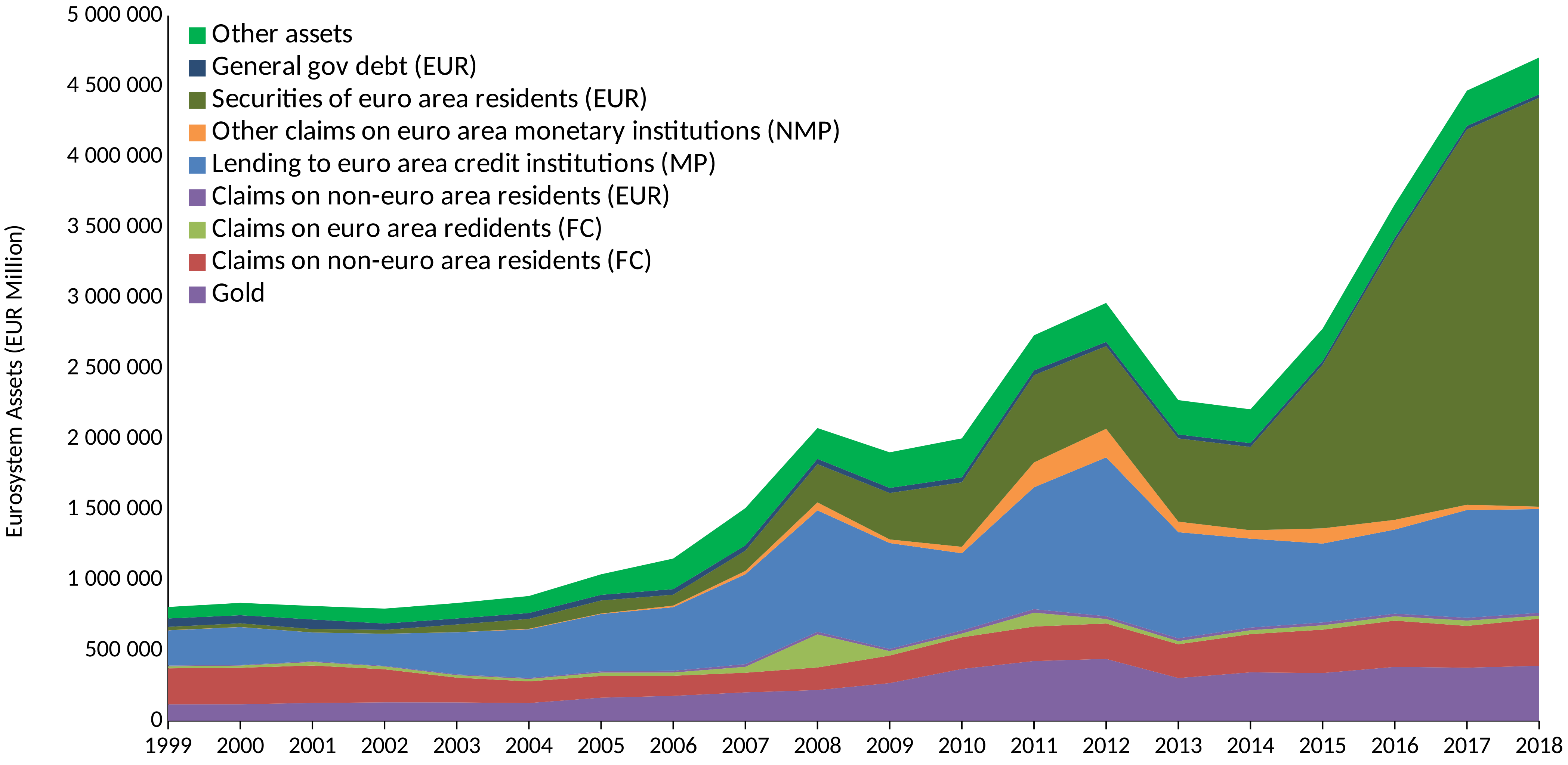


Sources: ECB and Thomson Reuters.

Table 4.1 Eurosystem monetary policy operations

Monetary policy operations	Type of transaction[1]: Liquidity-providing	Type of transaction[1]: Liquidity-absorbing	Maturity	Frequency
Open market operations				
Main refinancing operations	• Reverse transactions	–	• One week[2]	• Weekly
Longer-term refinancing operations	• Reverse transactions	–	• Three months	• Monthly
Fine-tuning operations	• Reverse transactions • Foreign exchange swaps	• Reverse transactions • Collection of fixed-term deposits • Foreign exchange swaps	• Non-standardised	• Non-regular
Structural operations	• Reverse transactions	• Issuance of ECB debt certificates	• Standardised/ non-standardised	• Regular and non-regular
	• Outright purchases	• Outright sales	–	• Non-regular
Standing facilities				
Marginal lending facility	• Reverse transactions	–	• Overnight	• Access at the discretion of counterparties
Deposit facility	–	• Deposits	• Overnight	• Access at the discretion of counterparties

MONETARY POLICY: EUROSYSTEM BALANCE SHEET



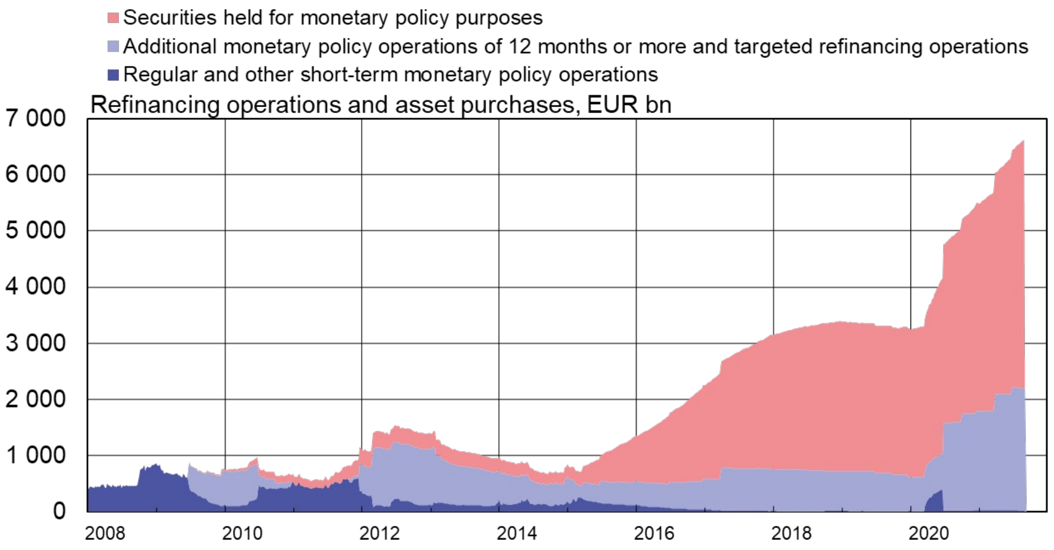
ECB’S RESPONSE TO COVID-19

- €1,850 billion pandemic emergency purchase programme (PEPP) aims to lower borrowing costs and increase lending in the euro area

- Limits for issuing sovereign debt that characterized the so-called Public Sector Purchase Program were also eliminated;

- Decided to buy commercial paper within the scope of the Corporate Sector Purchase Program (CSPP) and to relax the conditions related to the collateral eligible for banks' refinancing operations.

Asset purchases and refinancing operations have expanded Eurosystem balance sheet significantly during COVID-19 crisis



Source: ECB.
eurojatalous.fi / bofbulletin.fi
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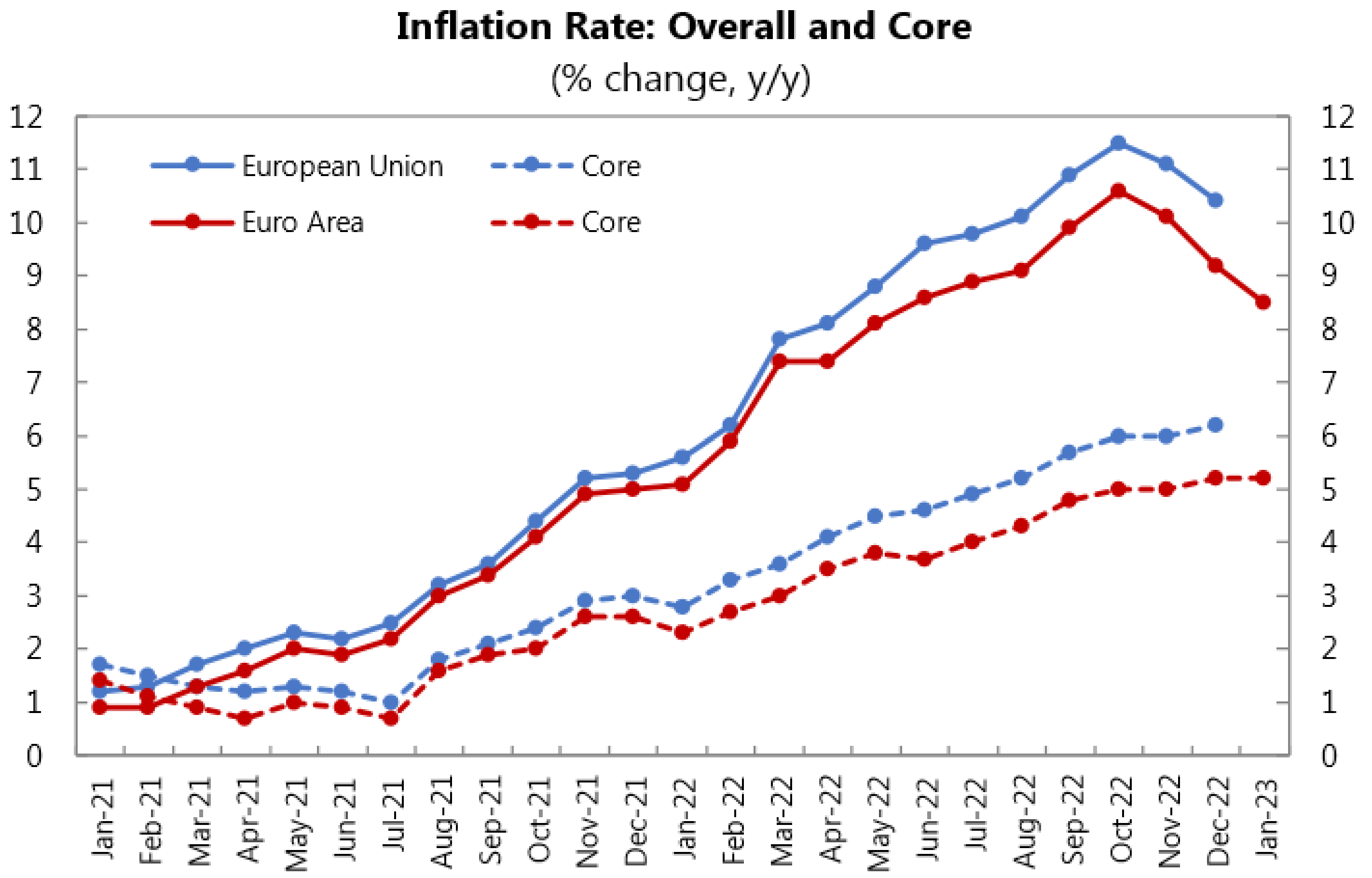
Useful reading: https://www.ecb.europa.eu/home/search/coronavirus/html/index.en.html

AND NOW…INFLATION IS BACK

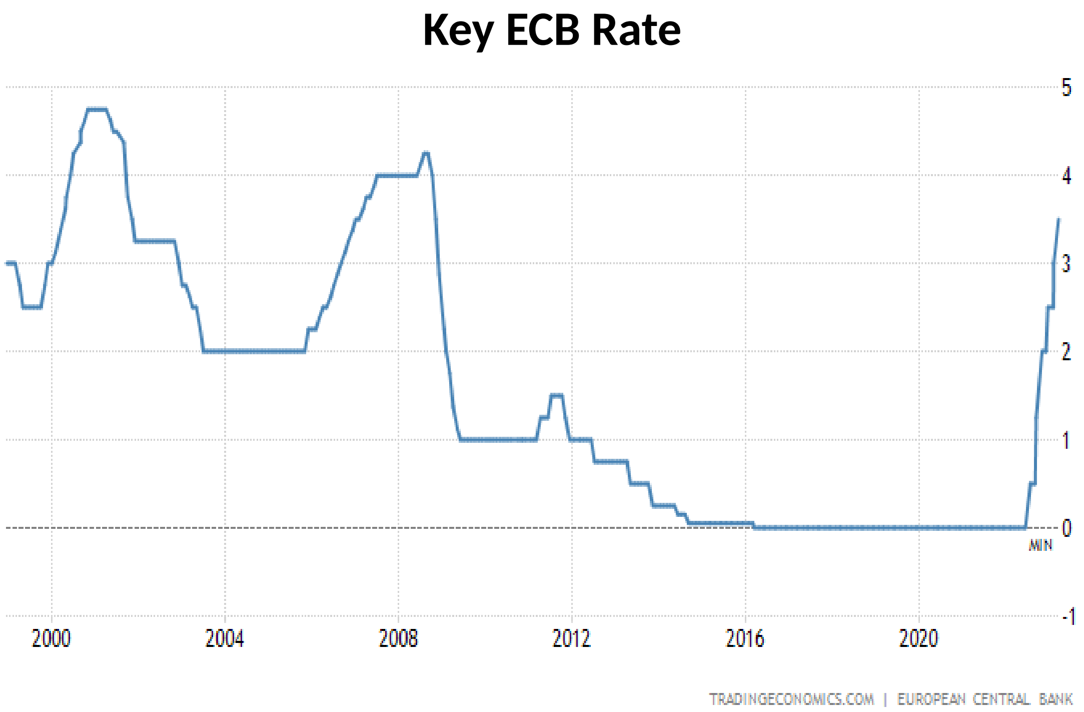


ECB RESPONSE TO INFLATIONARY PRESSURES

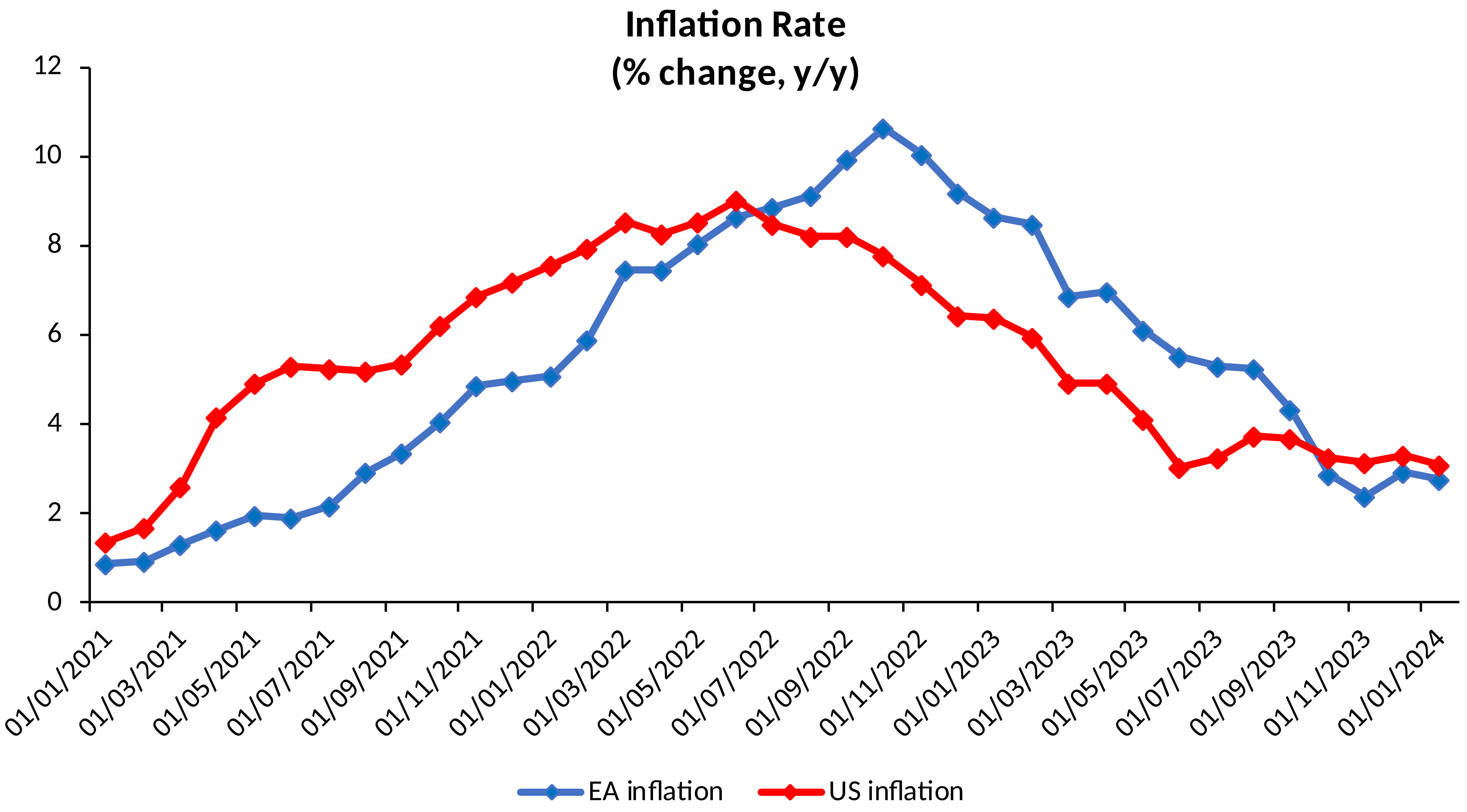
After several years below target, the inflation rate in the euro area surged in 2022, reaching levels close to those observed in the 80s.

To contain inflationary pressures in the Euro Area, the ECB:

- Discontinued the net purchases of government bonds through the PEPP and the APP;
- Increased the ECB’s policy interest rates.



IS INFLATION GOING AWAY?



Resit Exam – 19th June 2018

Over the recent years monetary policy has been maintaining very low interest rates.

a) Why have interest rates been persistently low?

Interest rates have been low even before the crisis. The credibility of monetary policies and low inflation targets enabled central banks to keep inflation low without raising interest rates, despite the significant expansion of credit. In addition, globalization and the possibility of importing goods at lower prices from emerging markets may also help explaining the low inflation rate.
Since the international financial crisis central banks have decreased interest rates even further in an attempt to stimulate economic activity.

b) What constrains do very low interest rates imply for the implementation of monetary policy?

Low interest rates imply a proximity to the lower bound, beyond which the expansion of monetary policy can no longer be effective. This is so because agents would be reluctant to deposit money in the banking system at a very negative interest rate. In addition low interest rates may also undermine financial stability and, thereby, affect the transmission mechanism of monetary policy. In fact, low interest rates are frequently associated with risk behaviour (search-for-yield phenomena) and may affect banks' profitability through lower interest rate margins – as banks have more difficulty in transmitting lower rates to depositors.

c) Given these limitations, which measures have been implemented by the ECB to provide a monetary stimulus to the economy?

Given these limitations, the ECB had to resort to a new 'unconventional' approach to expand its monetary stance. This approach relied less on adjusting its main refinancing rate, and more on **directly influencing** ***the whole spectrum of interest rates in the economy that are relevant for private sector financing conditions. These measures consisted in large assets purchase programmes*** **of private and public sector securities,** ***in an expansion of the list of assets eligible for monetary policy operations; in longer-term refinancing operations, etc. These measures allowed the ECB to provide liquidity in a larger scale, at longer maturities and against a wider range of collateral.***

Regular Exam May 2020

2) Monetary and fiscal policies are being strongly used to counteract the economic impacts of the current pandemic crisis.

a) What has been the ECB approach regarding the response to the crisis and how does this relate with the pre-existing challenges to monetary policy in the euro area?

To face the current uncertain in the markets, the ECB decided to increase the purchase of assets in the financial markets, which implies a further expansion of the money supply. This action intends to avoid that the uncertainty of the present economic situation is transmitted to the financial markets in the form of interest rate rises. The planned large purchase of assets will increase even further the ECB balance sheet, under a context of already historically prolonged low interest rates in the markets. This low interest rates have been maintained due the unconventional monetary policy followed by the ECB (Outright Monetary Transactions, Longer-Term Refinancing Operations, Quantitative Easing) which has been effective in keeping the financing of the markets, but limits the room of the monetary authority to further intervene in a new crisis. The operationalization of the latest measures is ongoing but financial markets are expecting their reinforcement. There are some institutional obstacles/challenges due to the mitigated opposition from some countries.

Regular Exam December 2022

2) After several years below target, the inflation rate in the euro area surged in 2022, reaching levels close to those observed in the 80s

a) Compare the monetary policy stance of the ECB before 2022 with the present one. Which policy actions materialized the current stance?

From the aftermath of the sovereign debt crisis in the euro area until mid-2022–monetary policy took a strongly expansionary stance. Initially, this was due to low GDP growth during the sovereign crisis, then it was a way to push inflation above values dangerously close to zero and finally to provide unlimited liquidity in a context where the pandemics lead to high uncertainty and strain in financial (and sovereign bond) markets.

The current reversion is the necessary response to higher inflation rates, which seem to persist and spread to different classes of goods and services, as well as to wage updates.

Nowadays, the reference interest rates have increased and there was a break in the creation of liquidity through non-conventional methods