

# Monetary Policy in the Context of Balance Sheet Adjustments

**Peter Praet**  
**Peterson Institute for International  
Economics**  
**Washington DC, 22 May 2013**

# Monetary policy response to balance sheet adjustments

- **A delicate balancing act:**
  - Policy should not stand in the way of a necessary reversal of past excesses
  - At the same time, policy must ensure that the economy does not enter into a downward spiral that would be inconsistent with price stability
- **Other authorities must play their role**

# Outline

- 1. Monetary policy challenges in the context of acute deleveraging pressures**
- 2. ECB response and role of other policies**
- 3. Flexibility and credibility in the ECB's monetary policy framework**

# I. Monetary policy challenges in the context of deleveraging pressures

- **Swings in asset prices are a matter of concern when facilitated and compounded by trends in debt**
- **Credit intensity of expansive phase closely associated with severity of recession phase**
- **Still: leverage cycles are difficult to interpret and to macro-manage**

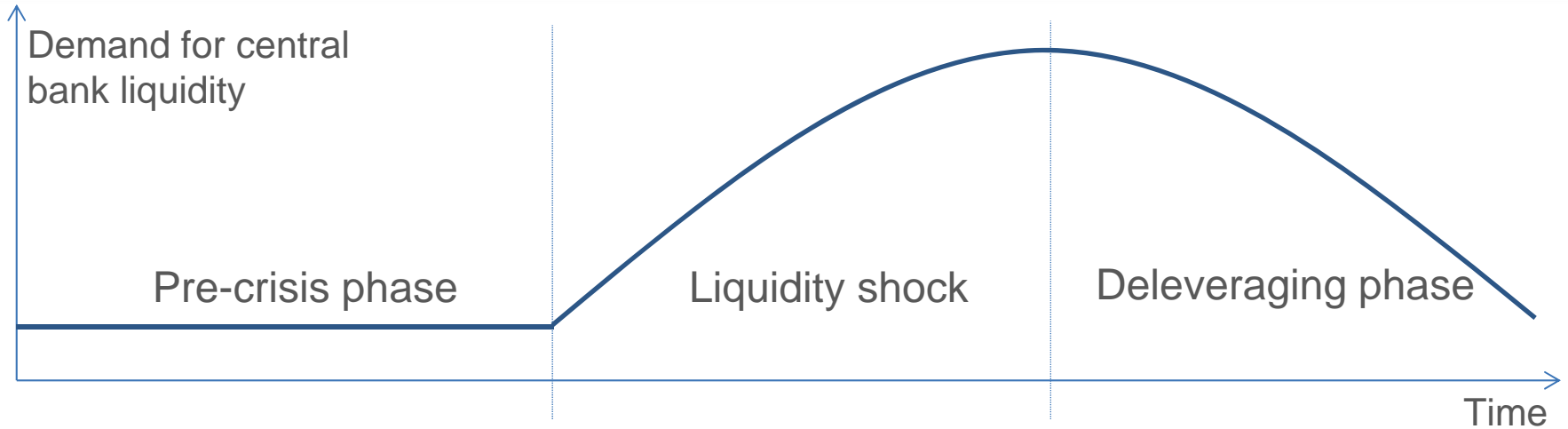
# I. Monetary policy challenges in the context of deleveraging pressures

- **Deleveraging cycles interact with liquidity cycles in complicated ways:**
  - **A funding shock in a context of leveraged and maturity mismatched financial system prompts assets liquidation, falls in asset prices which retroact on funding liquidity**
  - **In presence of bank fragility there may be wild swings in the demand for outside money**

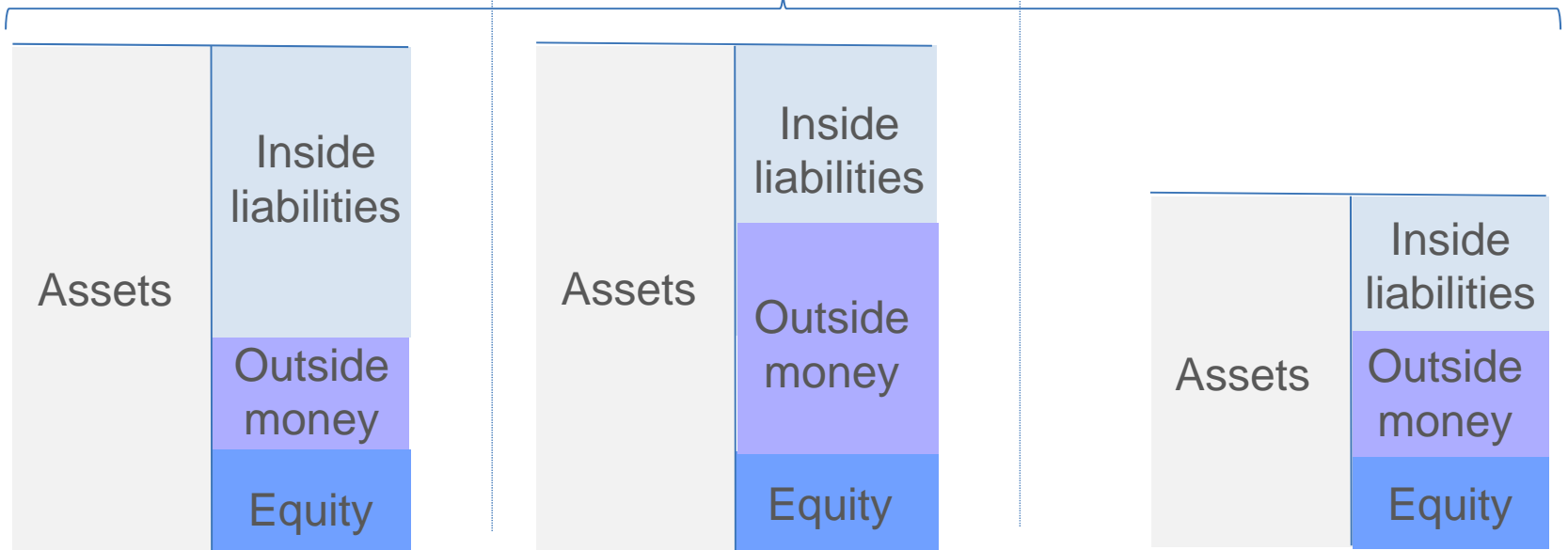
# I. Monetary policy challenges in the context of deleveraging pressures

- **Phases of deleveraging cycle:**
  - **Surge in demand for outside money is accommodated**
  - **Deleveraging cycle starts to run its own course**
  - **Central banks must be vigilant that the pace of asset reduction is commensurate with an evolution of activity that does not create downside risks to price stability**

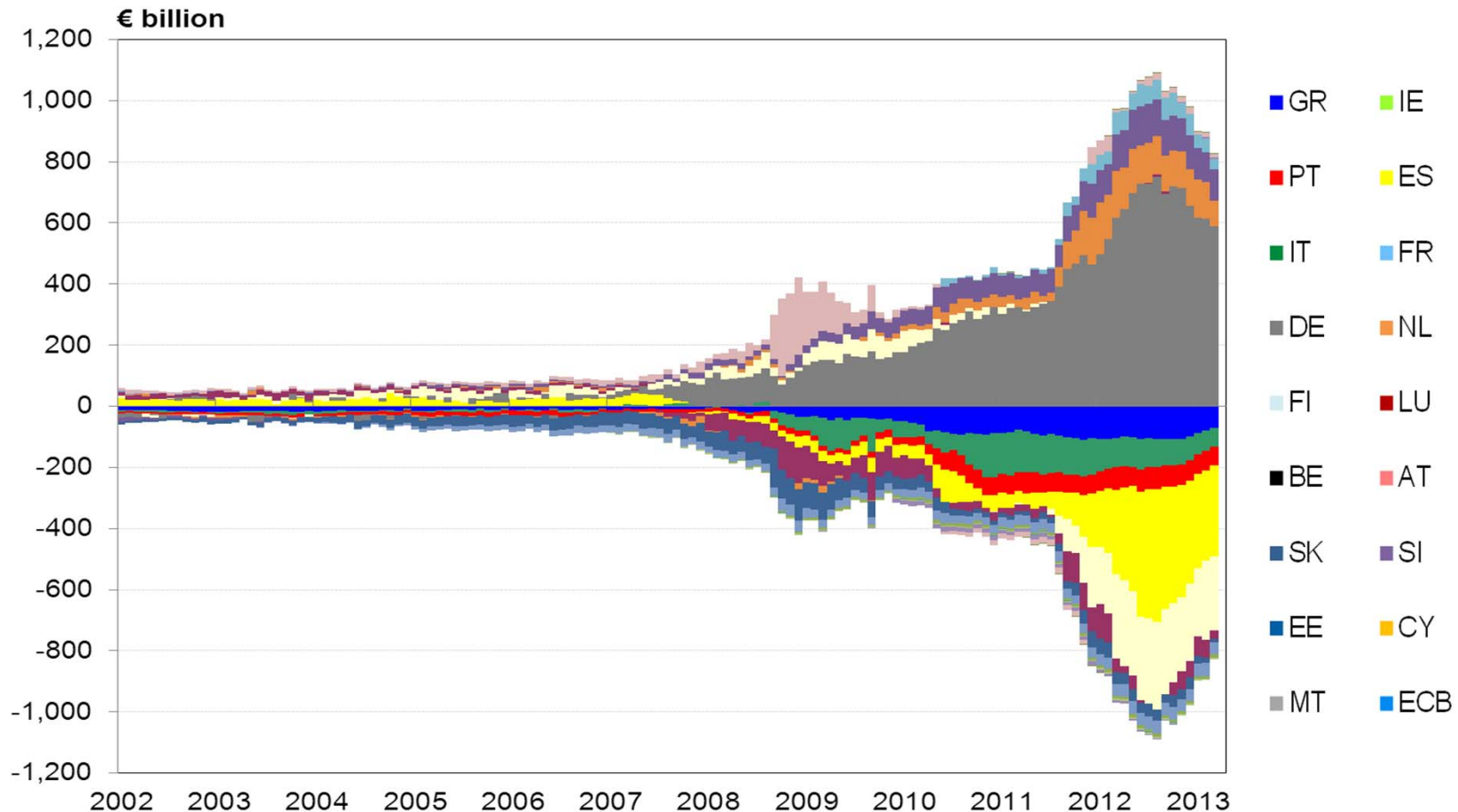
# I. Monetary policy challenges in the context of deleveraging pressures



Evolution of banking sector balance sheet



# I. Monetary policy challenges in the context of deleveraging pressures: evolution of Target2 balances in the crisis



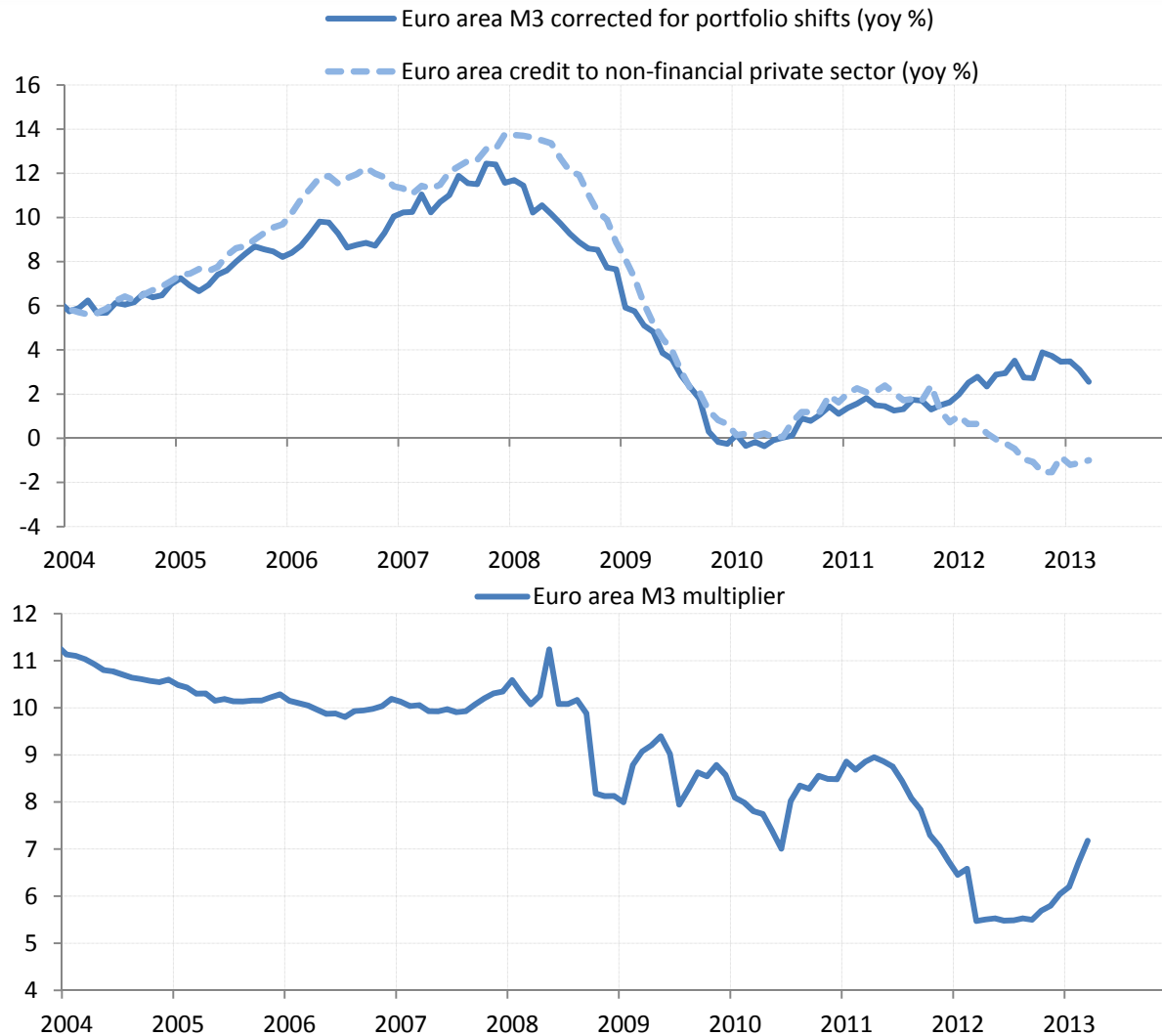
Sources: ECB, NCB and IMF data and author's calculations (P. Cour-Thimann, Target balances and the crisis in the euro area, mimeo).

Latest observations: end-March 2013.

Note: A positive (negative) sign reflects a net claim (liability) of the national central bank vis-à-vis the ECB in the TARGET2 payment system. Claims and liabilities (including that of the ECB) add up to zero.



# I. Monetary policy challenges in the context of deleveraging pressures



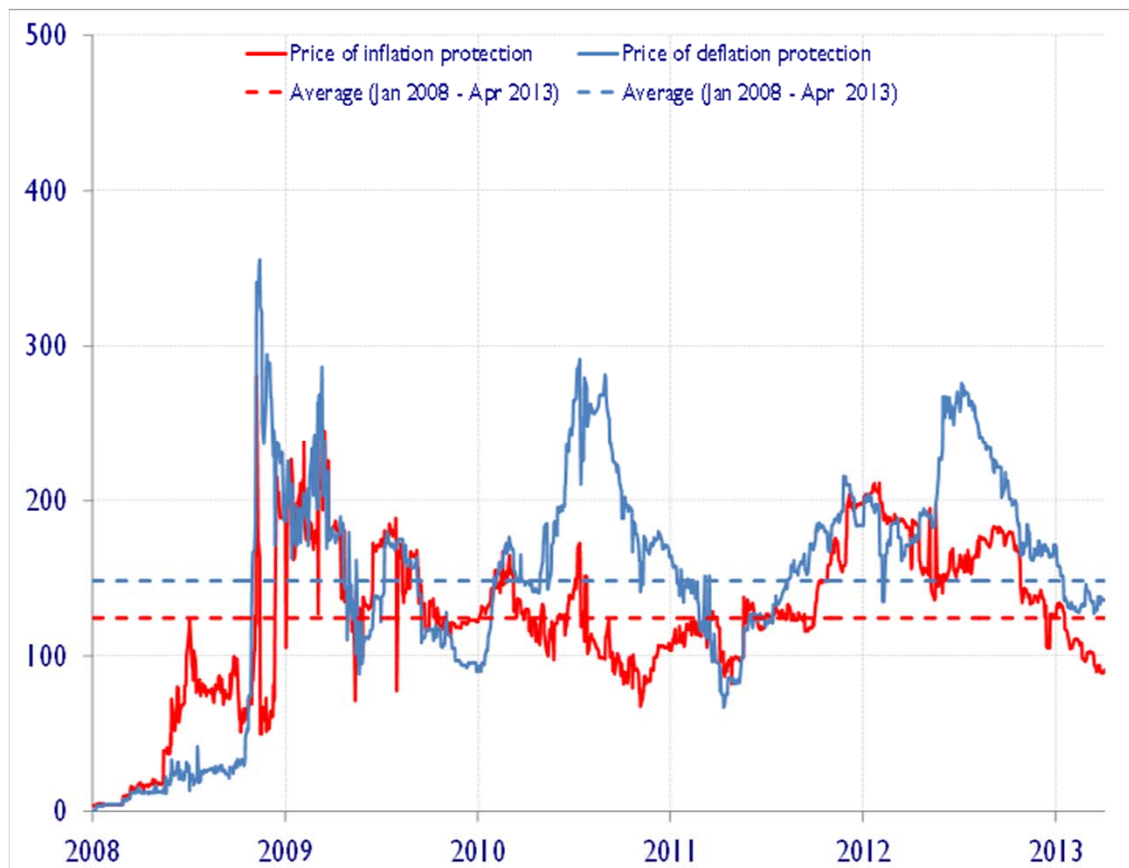
Source: ECB. Latest observation: March 2013

# 11. Euro area crisis response

- **Multidimensional and consistent policy response**
- **Need for a thorough identification of risks on banks balance sheets and reconstruction of equity**
- **ECB responds to price stability risks. Will continue employing its existing instruments and if necessary expand its instruments' set within the safeguards established by the Treaty**
- **Institutional developments are necessary complements to ECB action**

# II. Euro area crisis response

## The price of deflation and inflation protection in the euro area



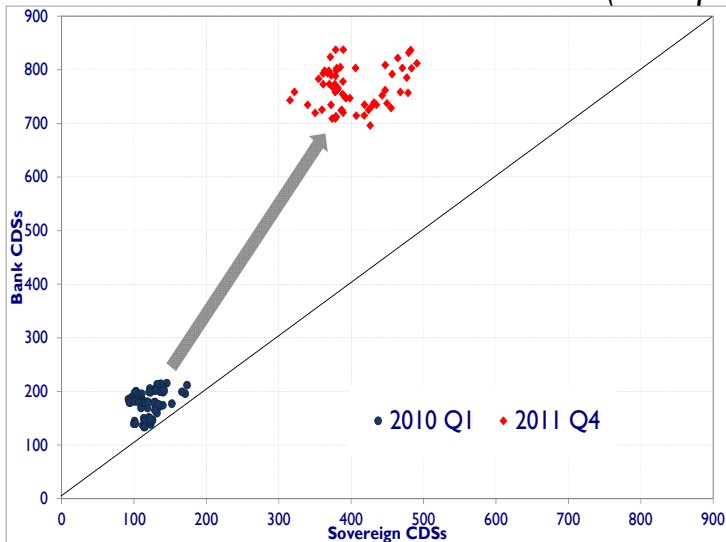
Sources: Bloomberg. Latest observation: 26 April 13

Note: The market for inflation-linked options is relatively illiquid and often heavily influenced by specific demand and supply patterns. Developments should therefore be interpreted with caution. The underlying instruments are for the inflation protection: year-on-year cap of 4% with 5 year maturity; for deflation protection: year-on-year floor of 0% with 5 year maturity.

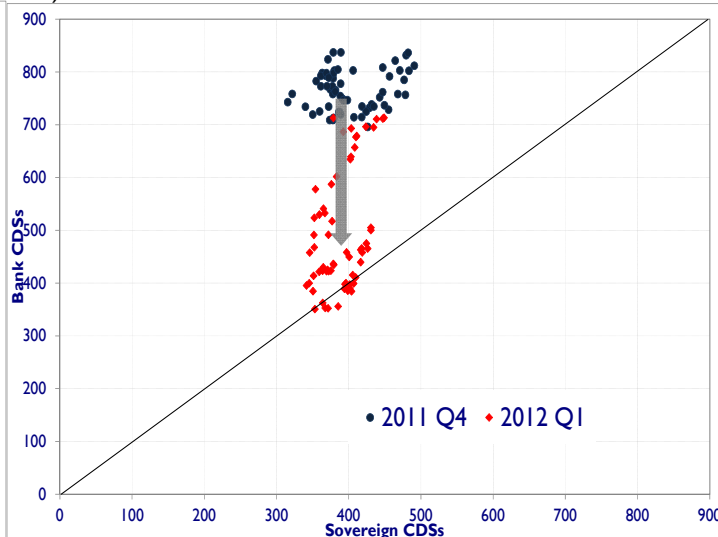
# II. Euro area crisis response: impact of VLTROs and OMT in Spain

(basis points)

Deterioration  
in banking  
sector

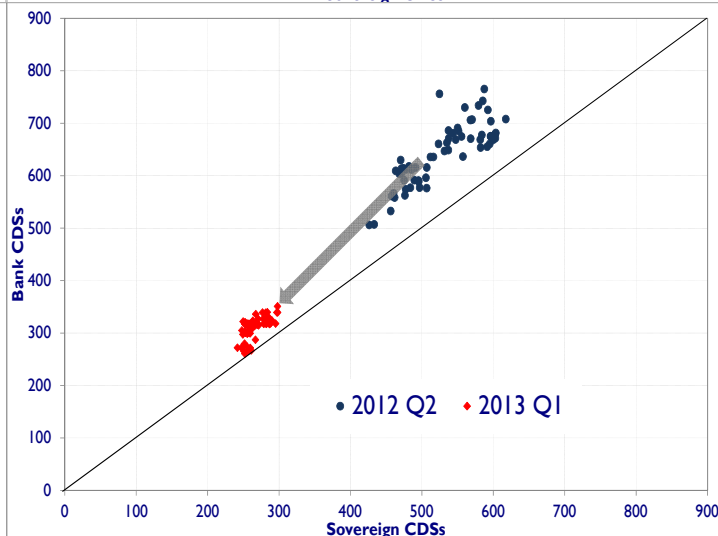
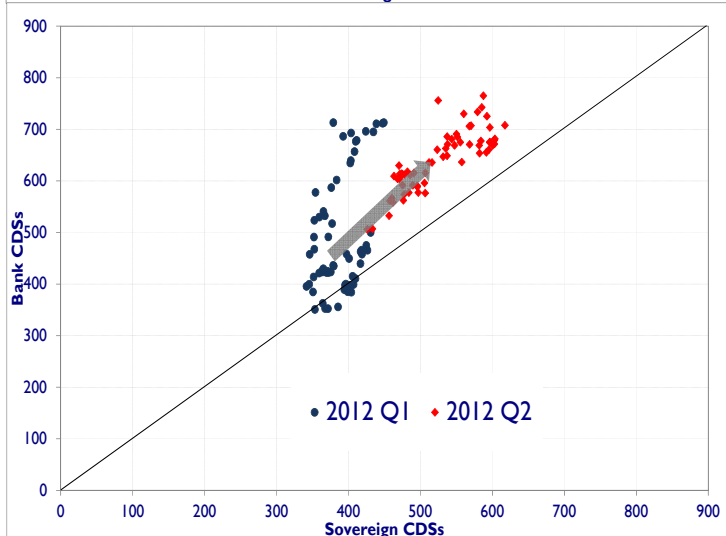


Impact of  
VLTROs



Impact of  
OMT  
announce-  
ment

Summer 2012  
intensification  
of crisis

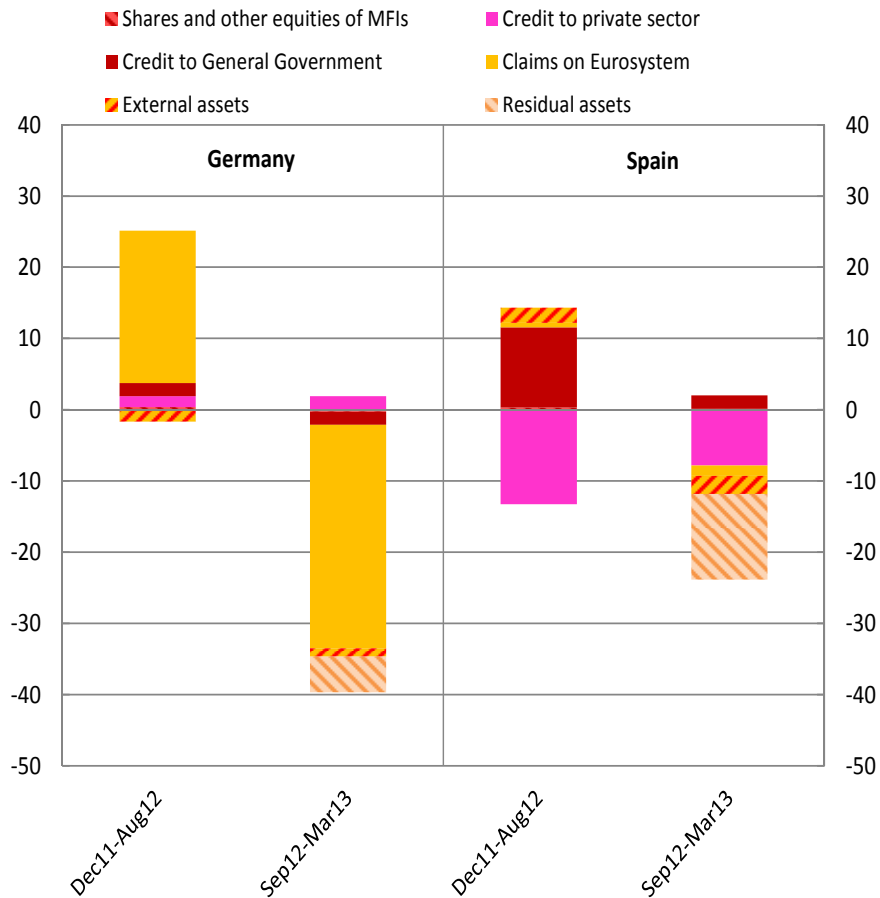


Source: Thomson Financial Datastream and ECB calculations. Last observation: 4 March 2013.

# II. Euro area crisis response: improved funding situation of MFIs and the reduction in Eurosystem borrowing

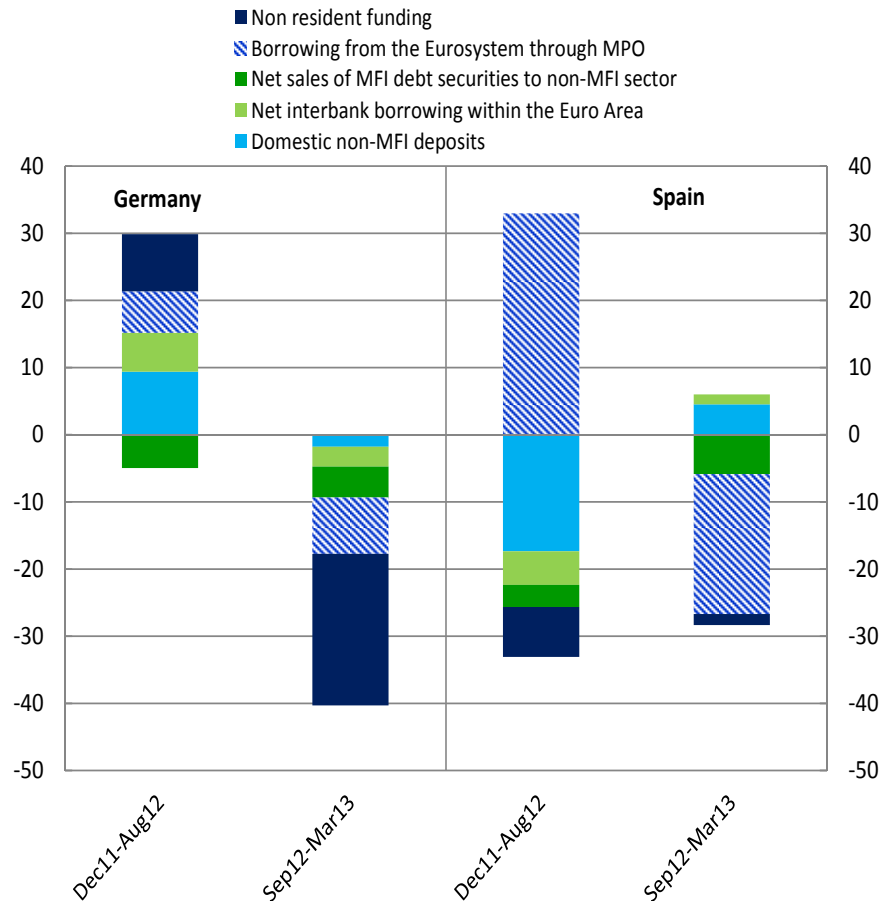
## Main MFIs' assets in selected euro area countries

(average monthly flows in € billions, seasonally adjusted)



## Main MFIs' liabilities in selected euro area countries

(average monthly flows in € billions, seasonally adjusted)



Source: ECB. Latest observation: March 2013.

# III. Long-term ECB strategy

## Strategy must be:

- **sufficiently flexible**
- **sufficiently binding to anchor expectations**

# III. Long-term ECB strategy

**Flexibility derives from three features:**

- **The definition of price stability, formulated in terms of range with an explicit focal point for policy**
- **The definition applies to the medium term. The policy relevant horizon is a choice variable, conditional on the nature of shocks**
- **Instrumental flexibility**

# III. Long-term ECB strategy

## Credibility is a pre-condition for flexibility

- **Confidence that central bank is determined to offset price pressures in line with its mandate mitigates economic fluctuations** (inter-temporal substitution in spending due to well-anchored expectations of future policy action)
- **The ECB institutional framework, and in particular the monetary financing prohibition, is not simply a constraint on what the ECB can do. It is also a safeguard that reinforces its action and protects its capability to act**



**Thank you for your attention!**