

The ECB's Strategy in Good and Bad Times

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The views expressed herein are those of the presenter only and do not necessarily reflect those of the ECB or the European System of Central Banks

Outline

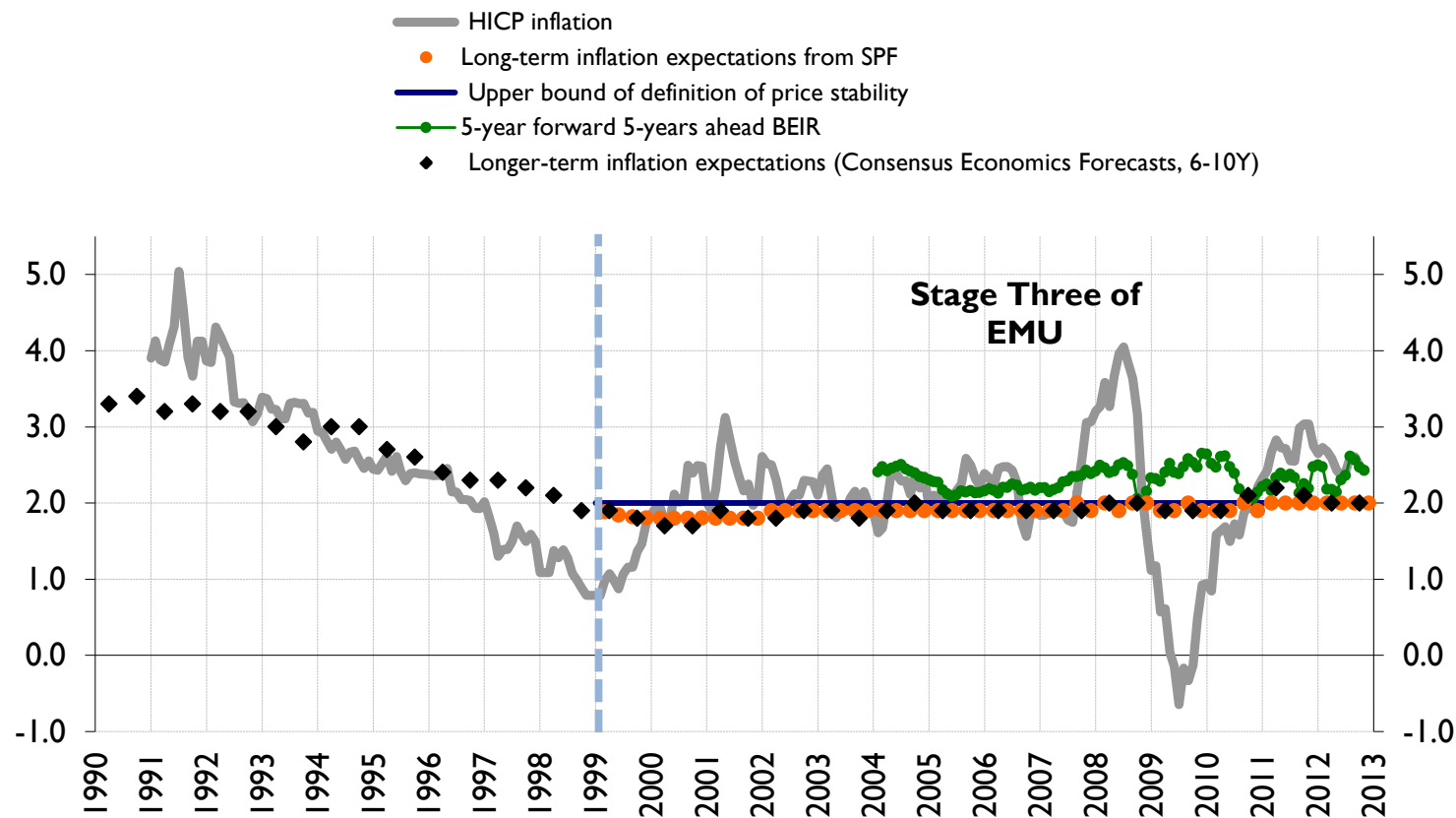
- 1. Track Record**
- 2. Growing Imbalances**
- 3. First Phase of the Crisis**
- 4. Second Phase of the Crisis**
- 5. Completion of the Institutional Architecture**

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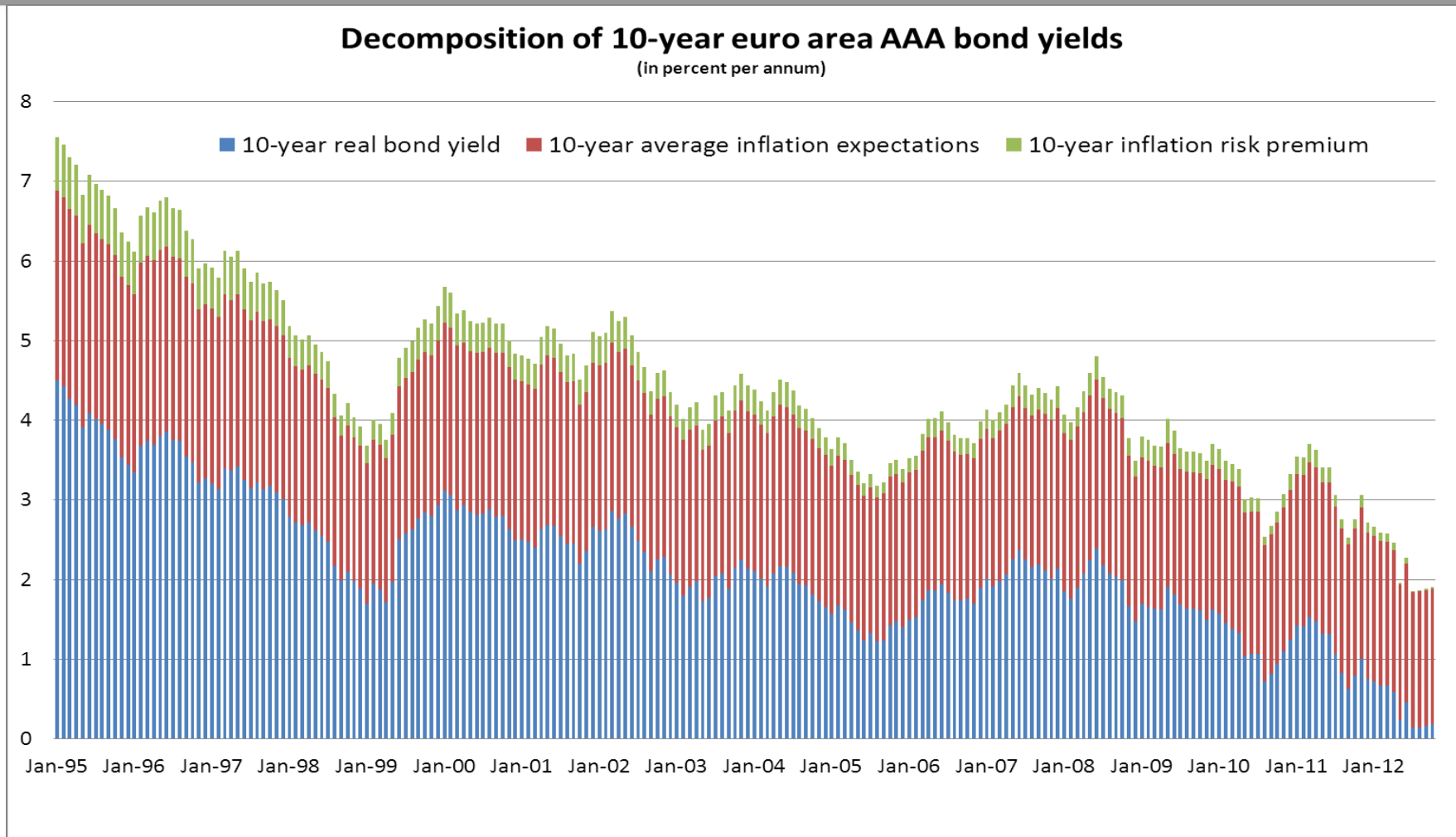
Inflation and the Quantitative definition

Inflation



Inflation Mean: 2.0% in Line with Aim to Maintain it Below But Close to 2%

Quantitative Definition and Bond Yields



Last observation: 19 October 2012

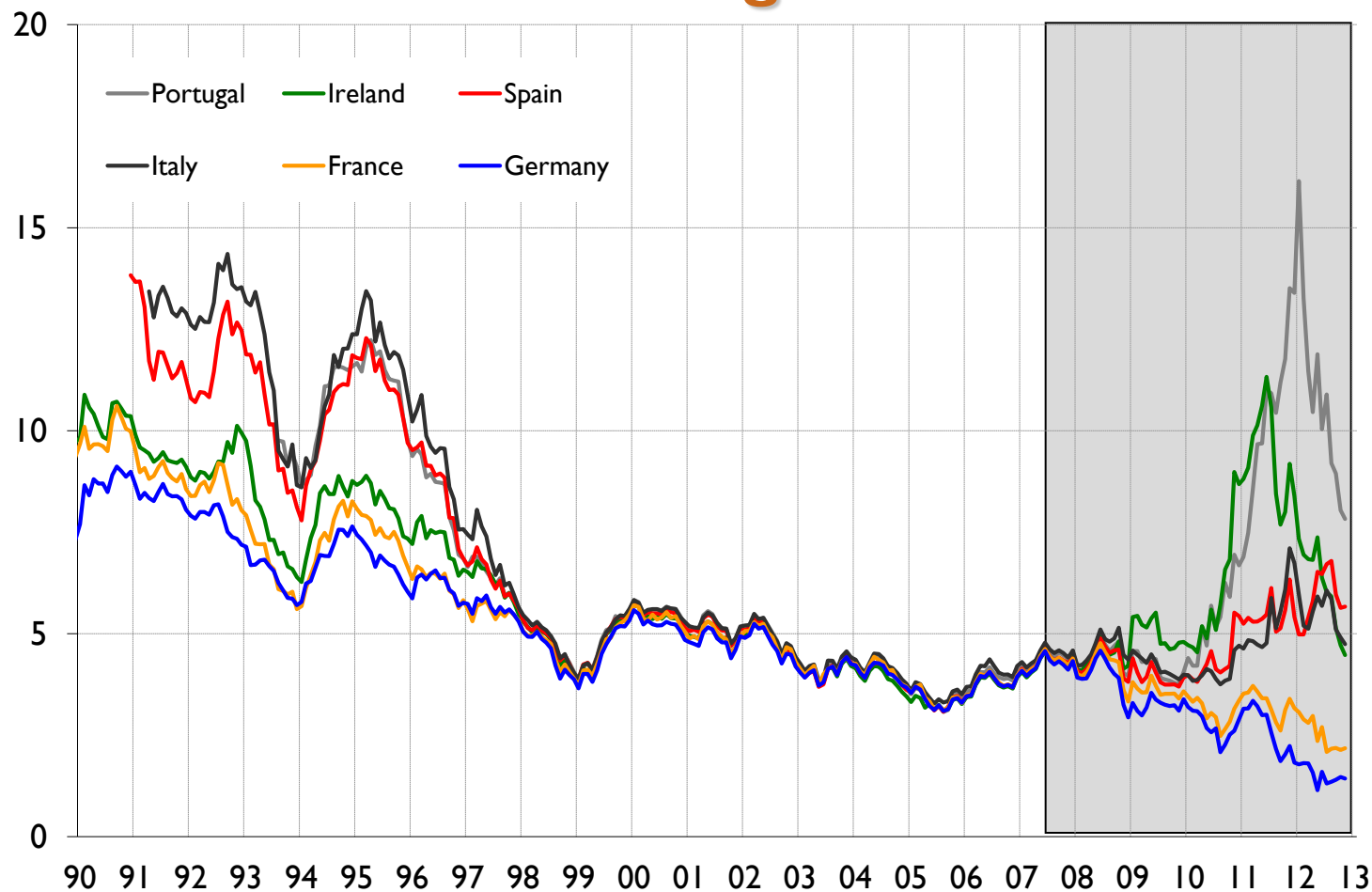
Source: ECB calculations



Inflation Premium in Line with Definition, Zero Inflation Risk Premium

Quantitative Definition and Bond Yields

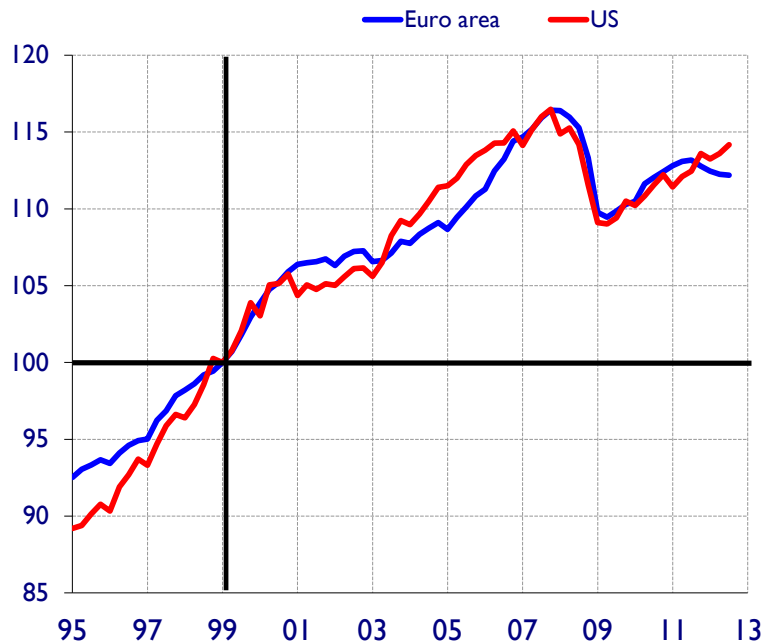
Convergence



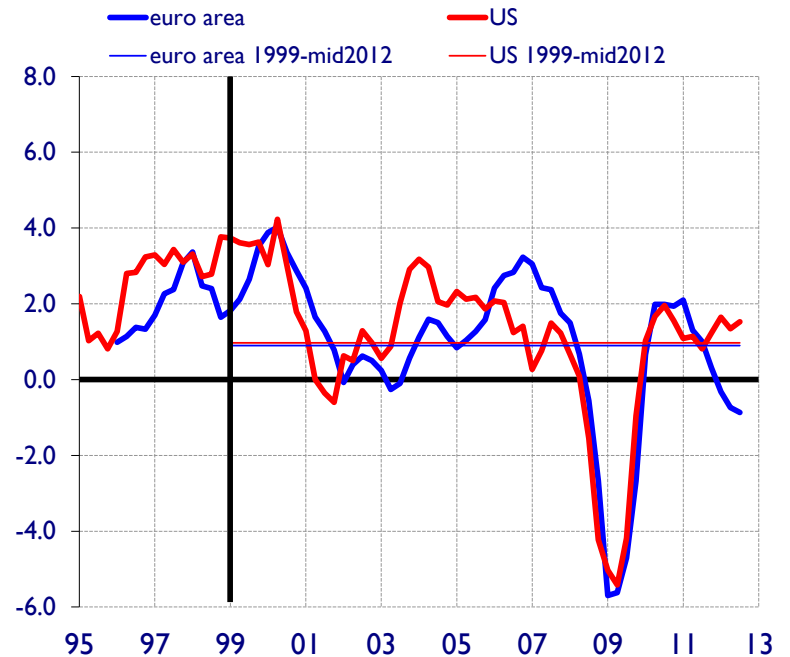
Sources: Bloomberg, Thomson Reuters Datastream and ECB calculations. Note: bond yields are 10-year government bond, end-of-the-month (last value 22Nov 2012).

Growth Performance

Levels of GDP Per-Capital in EA, US (1999=100)



Rates of Growth of GDP Per-Capital in EA, US



EA Per-Capital GDP Grew at 0.9% (Employment at 0.7%)



US Per-Capital GDP Grew at 1.0% (Employment at 0.5%)

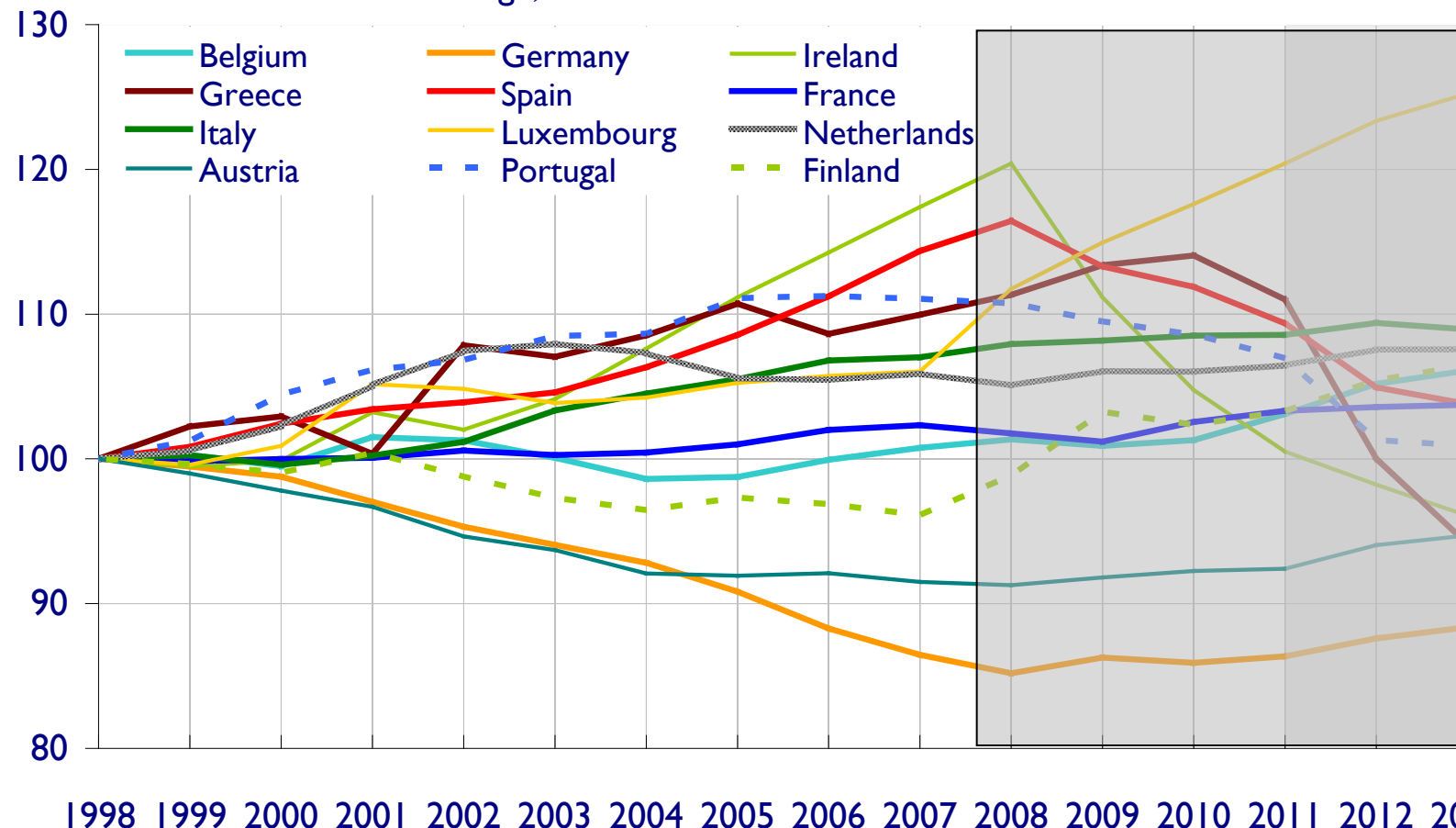
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The Structural Context

Relative Competitiveness

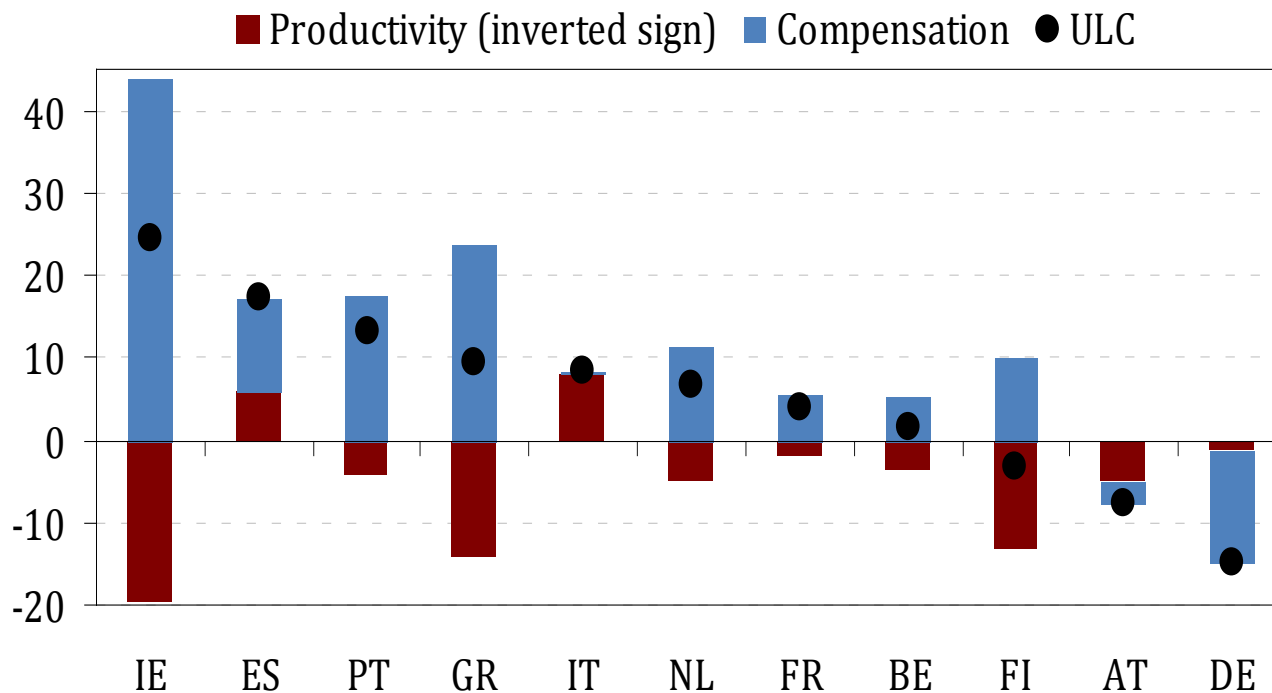
ULC relative to euro area average, 1998=100



Source: European Commission. Note: ULCs are computed as the ratio between compensation per employee and real GDP per employed person.

The Structural Context

Change in ULC between 1999 and 2007 (deviation from euro area)



Source: European Commission. Note: countries ranked in descending order on the basis of cumulated ULC growth.



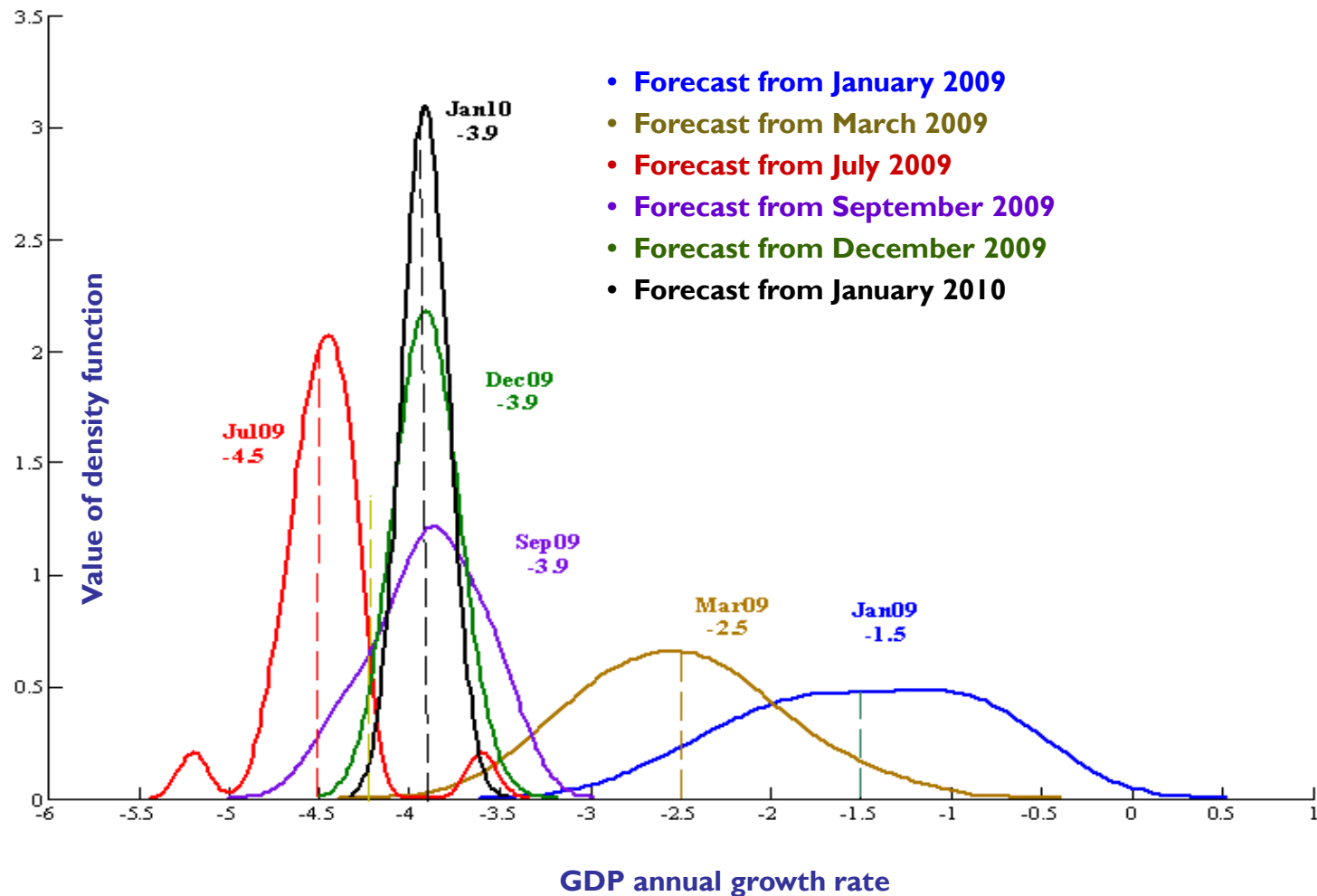
Some Members Were Experiencing Excess Wage Growth

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First Stage of the Crisis

Post-Lehman Free Fall



Source: Eurozone Barometer and ECB calculations. Last observation: January 2010

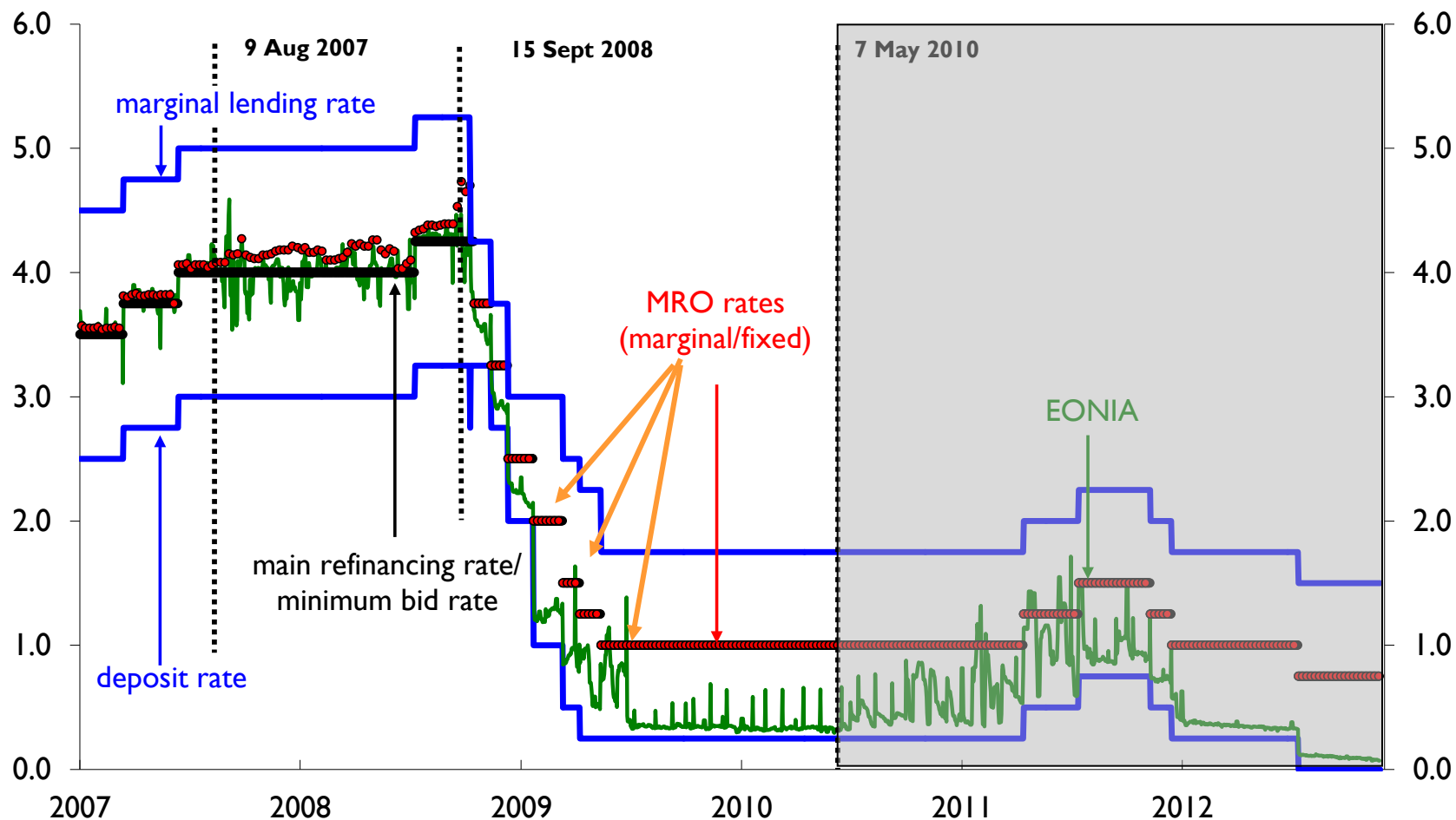
First Stage of the Crisis

ECB Response To Preserve Price Stability

- **A Dramatic Financial Crisis**
 - Induces a Dramatic Recession
 - Poses Downside Risks to Price Stability: Possibly Deflation (fall in Prices)
 - Damages the Transmission Mechanism
- **“Standard” Monetary Policy Response to Downside Risks to Price Stability**
 - Aggressive Reduction in the Policy Rate
- **“Non-standard” Liquidity Measures**
 - Unlimited Volume of Liquidity Offered to Banks in Credit Operations
 - Extended Collateral that Banks Can Use in Credit Operations
 - Increased Range of Maturities for Credit Operations (1-6-12 Months)
 - Credit Operations in Currencies different from Euro
 - Purchase of “Covered Bonds” Issued by Banks

First Stage of the Crisis

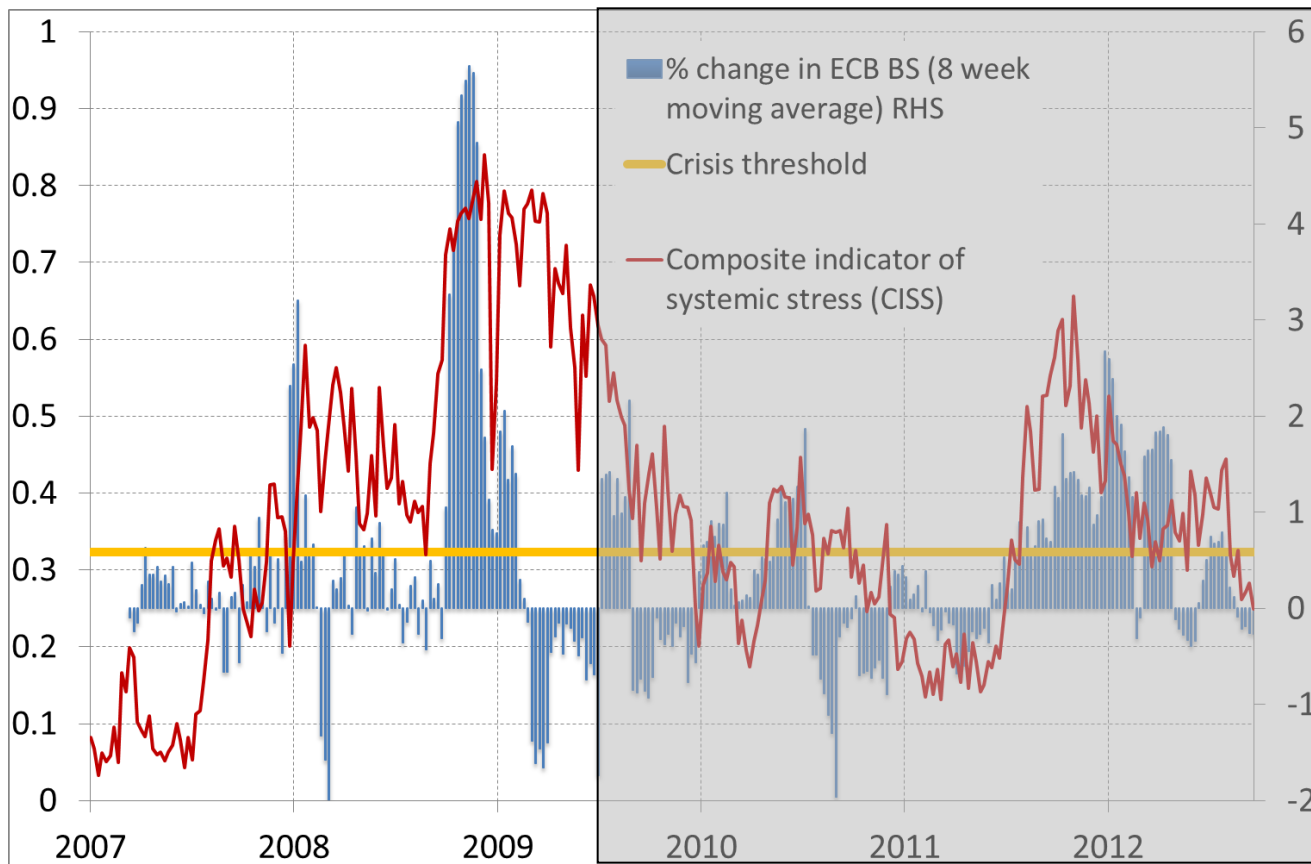
Post-Lehman: Standard Monetary Policy Response



*Note: data in percent. The lower and the upper bound are the deposit facility and the marginal lending facility rate respectively
Last observation: 22 November, 2012.*

First Stage of the Crisis

Liquidity Support and Systemic Stress

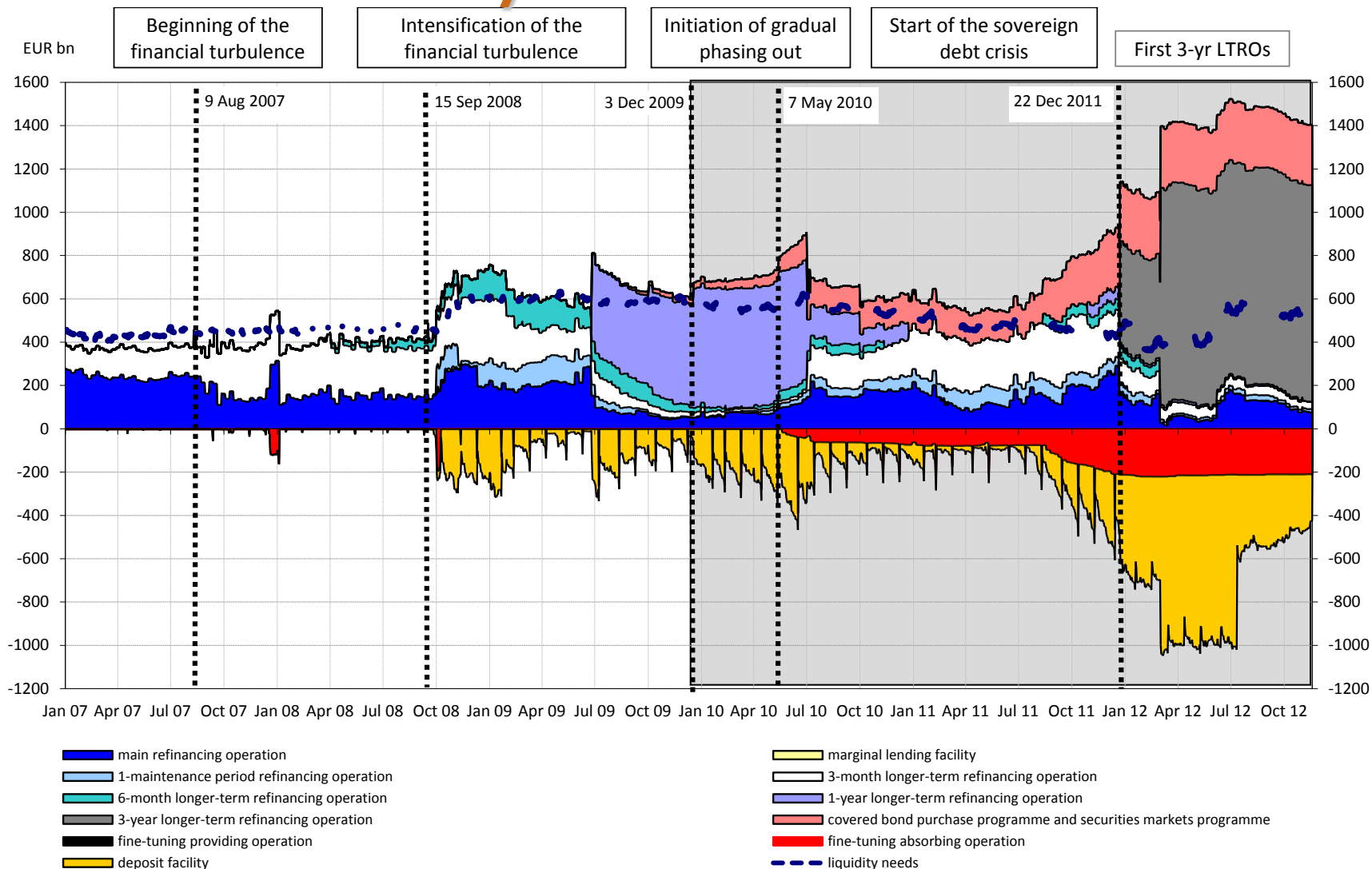


Source: Euro area CISS from Hollo, Kremer and Lo Duca (2012): "CISS - A Composite Indicator of Systemic Stress in the Financial System", ECB Working Paper No. 1426. Balance sheet data from ECB. Own calculations.

Note: Weekly data. Last observation: 9 Nov 2012. - Developments in the CISS can be decomposed into contributions from five stress subindices (relating to money market, bond market, equity market, financial intermediaries, FX market) and the overall contribution from the cross-subindex correlations.

First Stage of the Crisis

The Eurosystem Balance Sheet

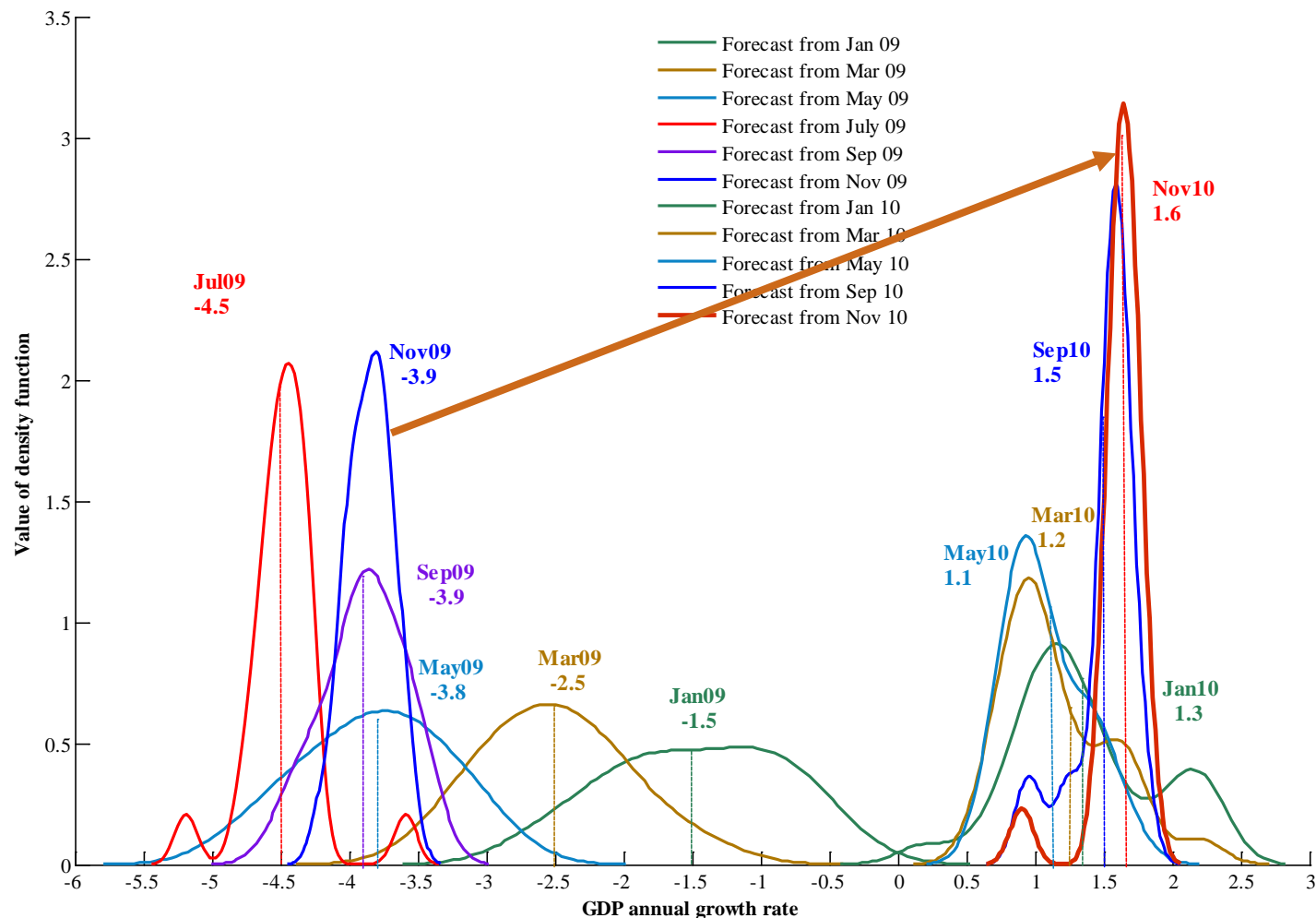


Source: ECB. Last observations: 18 November 2012.

EUROPEAN CENTRAL BANK

First Stage of the Crisis

Post-Lehman: Stabilisation



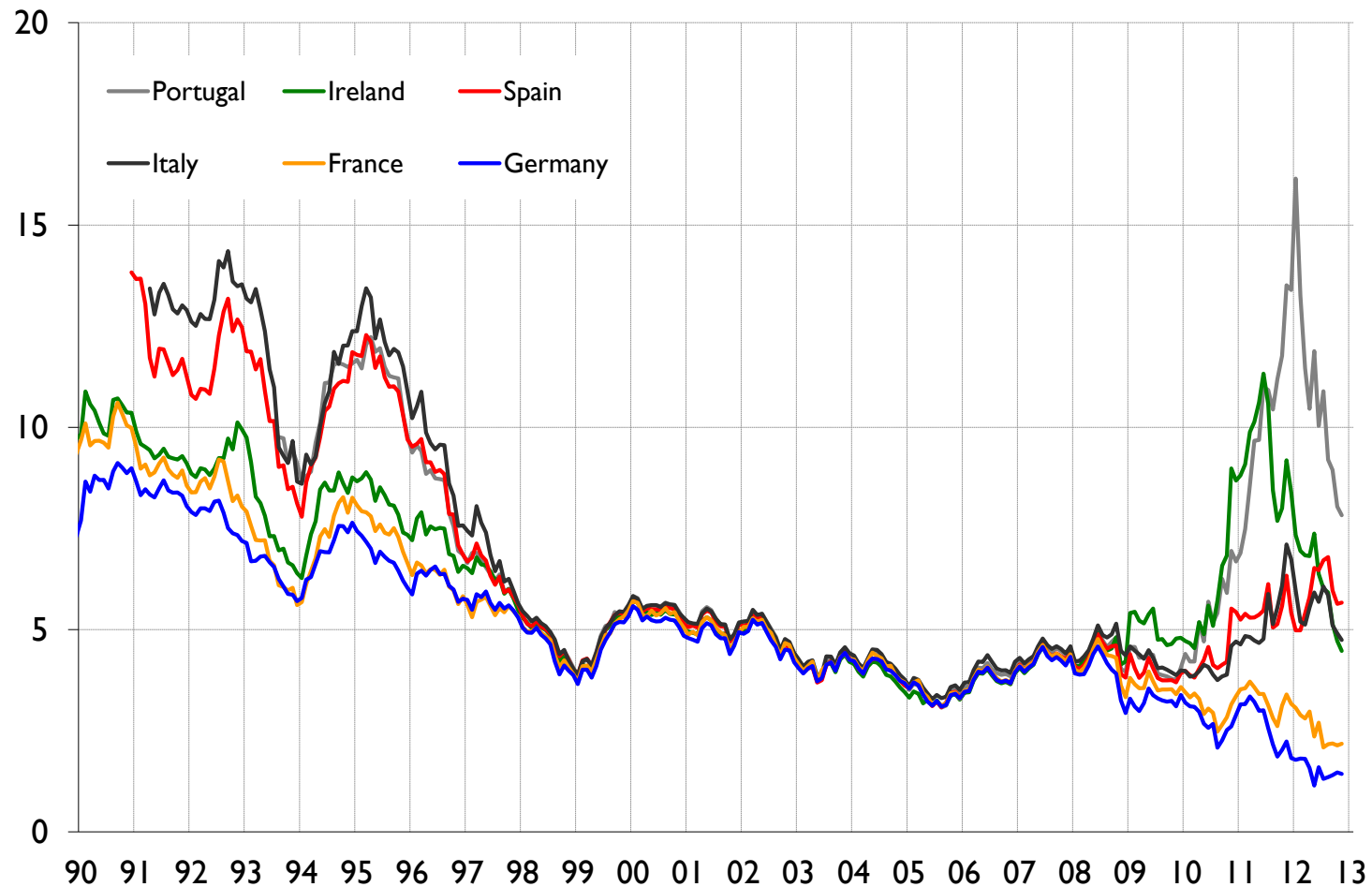
Source: Eurozone Barometer and ECB calculations. Last observation: November 2010

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Second Phase of the Crisis

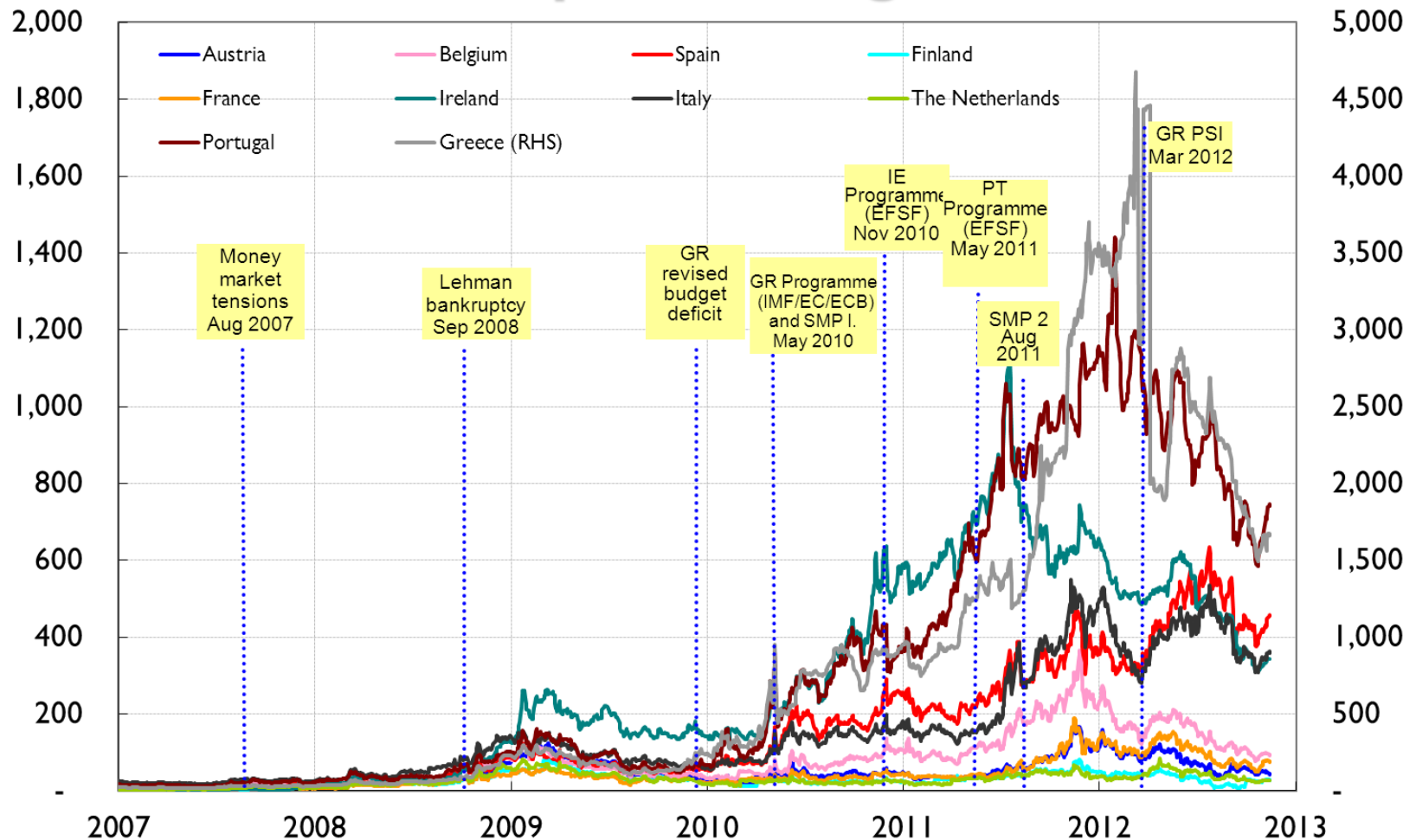
Divergence of Bond Yields to Pre-Union Levels



Sources: Bloomberg, Thomson Reuters Datastream and ECB calculations. Note: bond yields are 10-year government bond, end-of-the-month (last value 22Nov 2012).

Second Phase of the Crisis

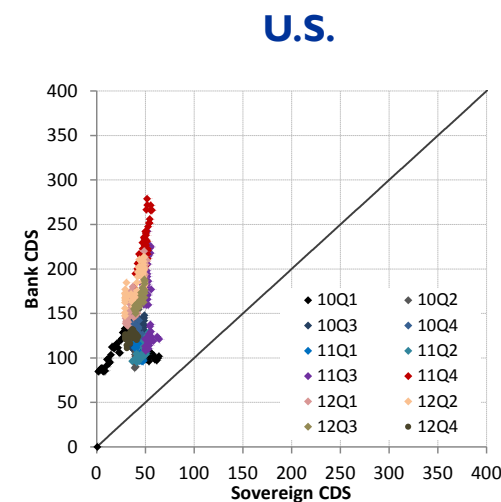
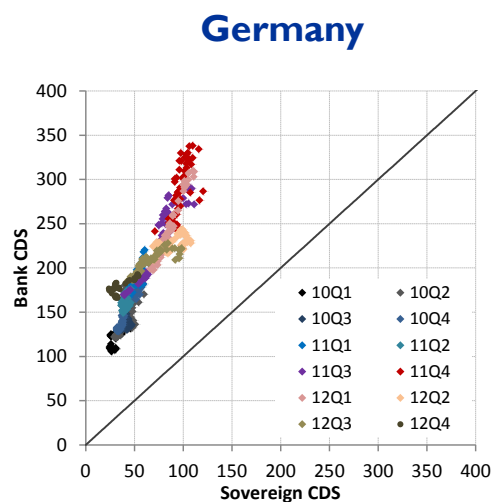
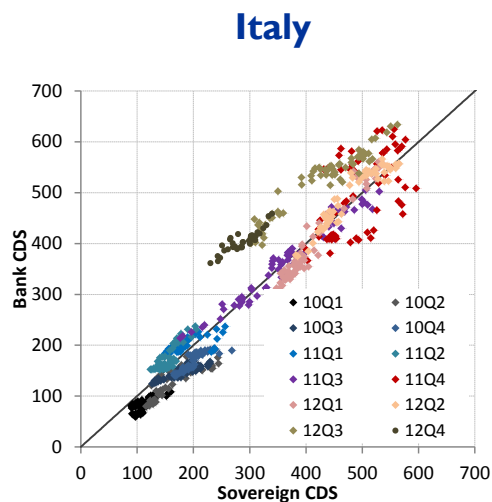
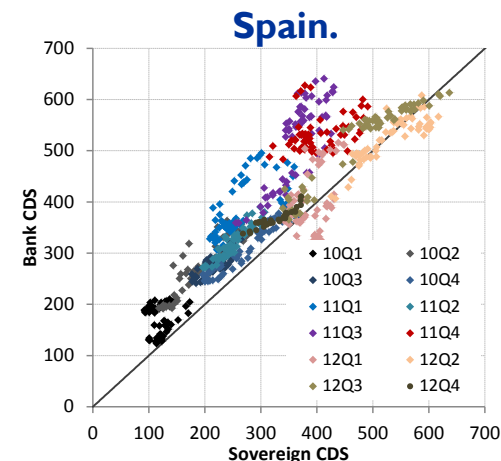
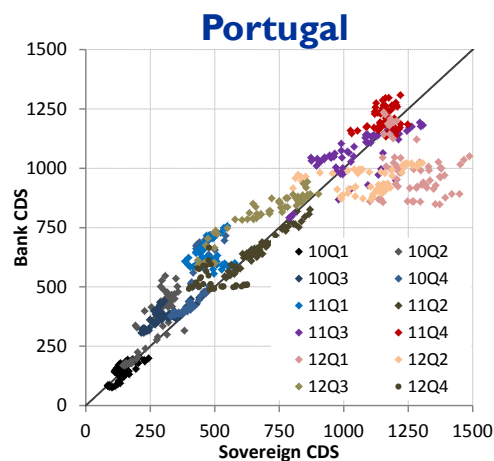
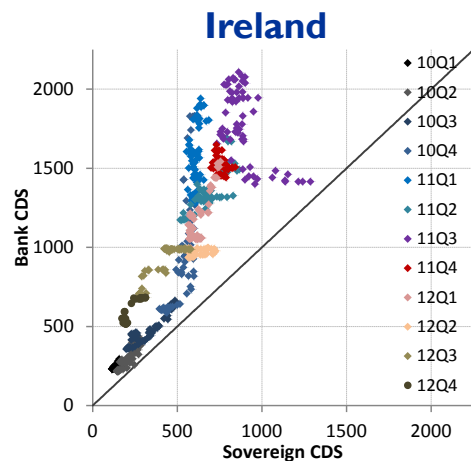
Spreads Surge



Source: Thomson DataStream
Last observation: 22 November 2012

Second Phase of the Crisis

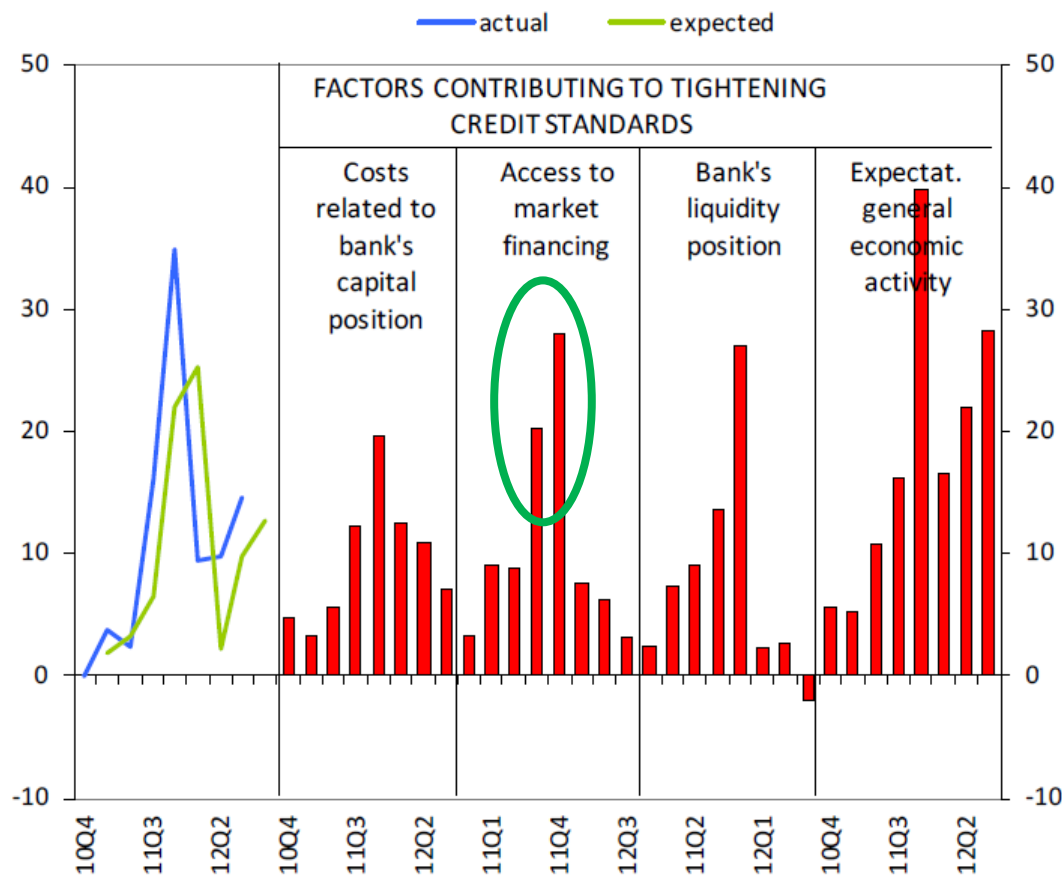
Sovereign and Bank CDS



Source: Source: Bloomberg, ECB and ECB calculations
Note: Last observation: 19 November 2012

Second Phase of the Crisis

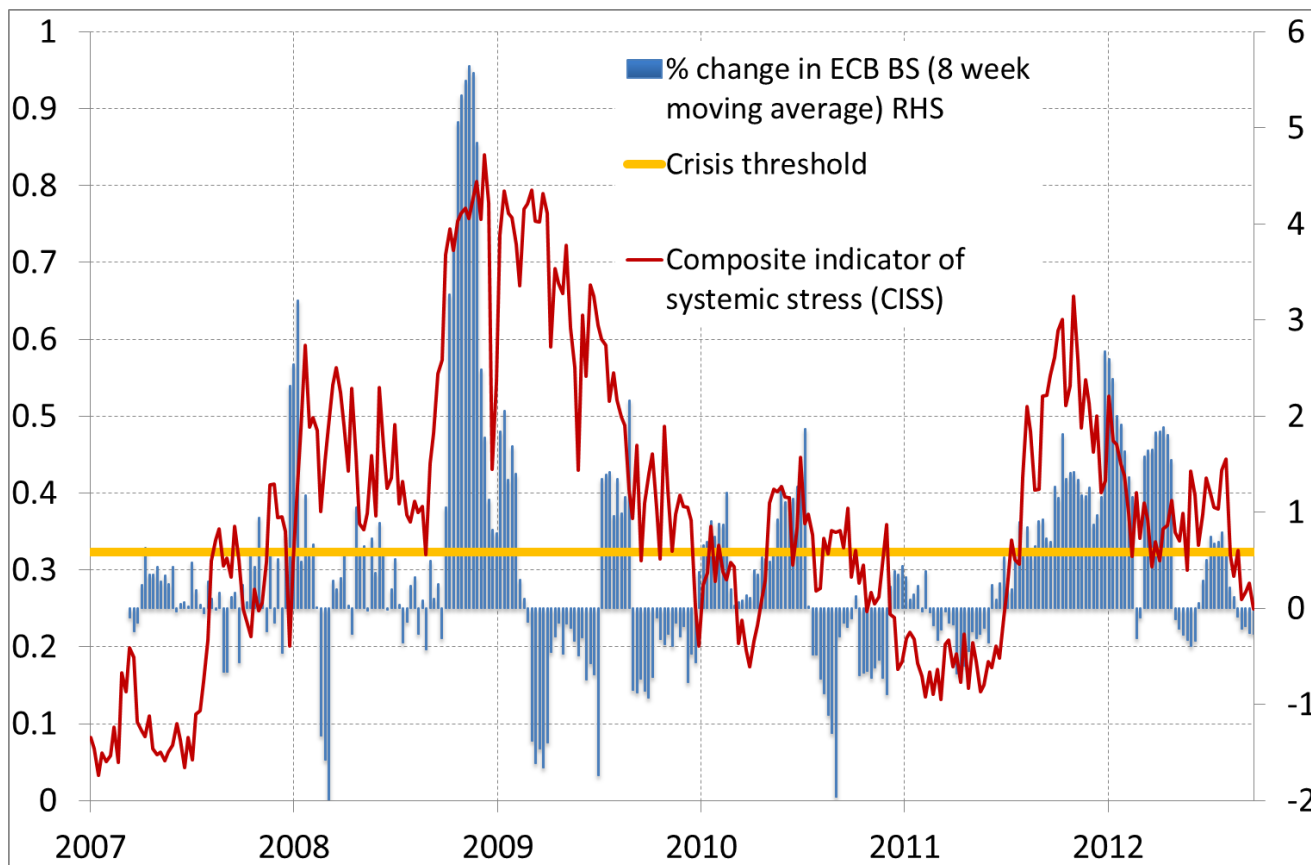
Tightening Credit Standards and Factors Behind



Source: ECB

Second Stage of the Crisis

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Second Stage of the Crisis

ECB Response To Preserve Price Stability

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 - Resumption of 1-Year Long-Term Refinancing Operations
 - Two 3-Year Long-Term Refinancing Operations
 - New “Covered Bonds” Purchase Programme

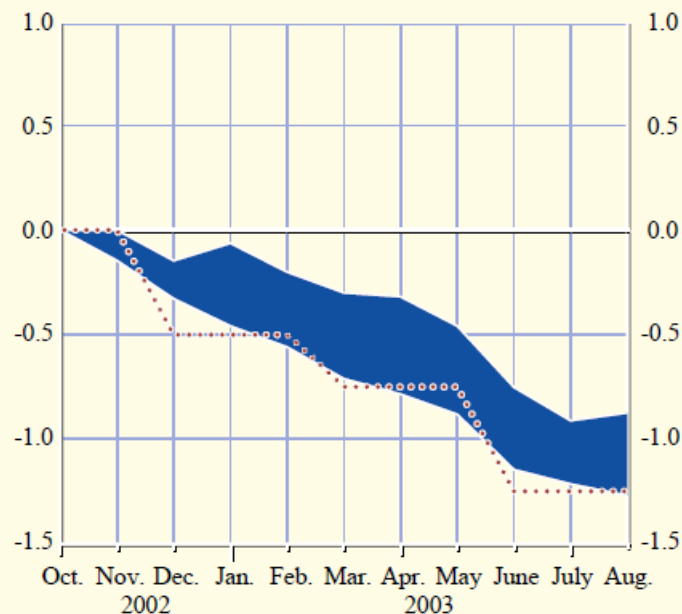
Second Stage of the Crisis

Weaker Policy Pass-Through

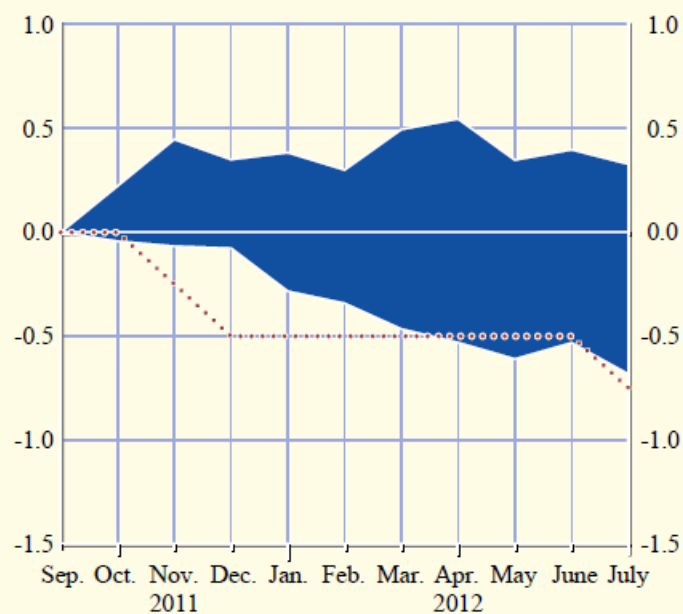
(changes in percentage points)

- range of changes in bank lending rates
- minimum bid rate in main refinancing operations

a) Pass-through 2002-2003



b) Pass-through 2011-2012

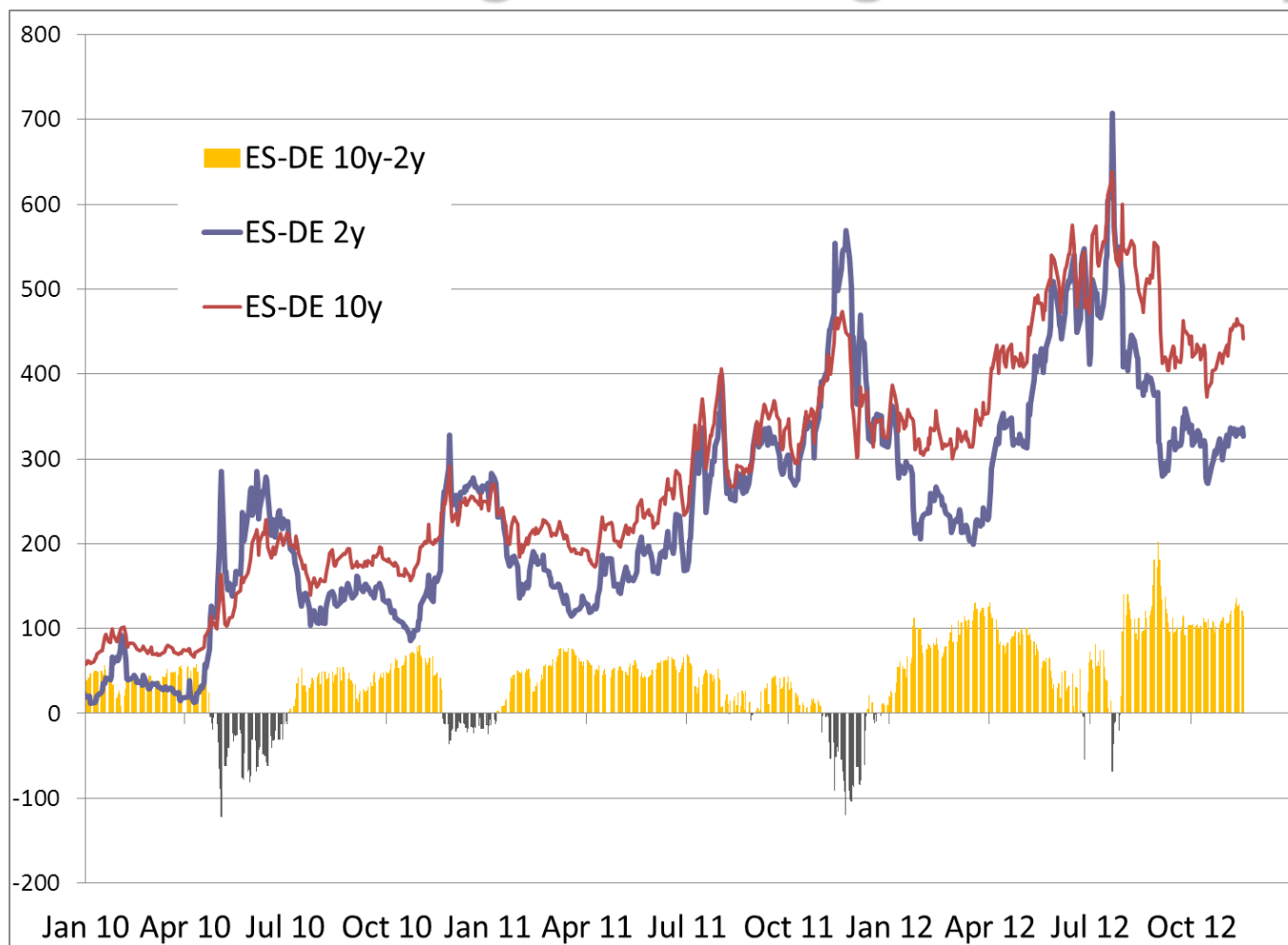


Source: ECB estimations.

Notes: The range defined by the 20th to 80th percentile lines identifies the development of short-term bank lending rates covering three-fifths of the interest rate observations of euro area countries. At the same time, this excludes respectively one-fifth of the observations above and below the lines. The latest observation is for July 2012.

Second Stage of the Crisis

Inversion of Sovereign Curve Signals Break-up Risk



Source: Reuters and ECB calculation.

Note: Last observation 19 November 2012

Second Stage of the Crisis

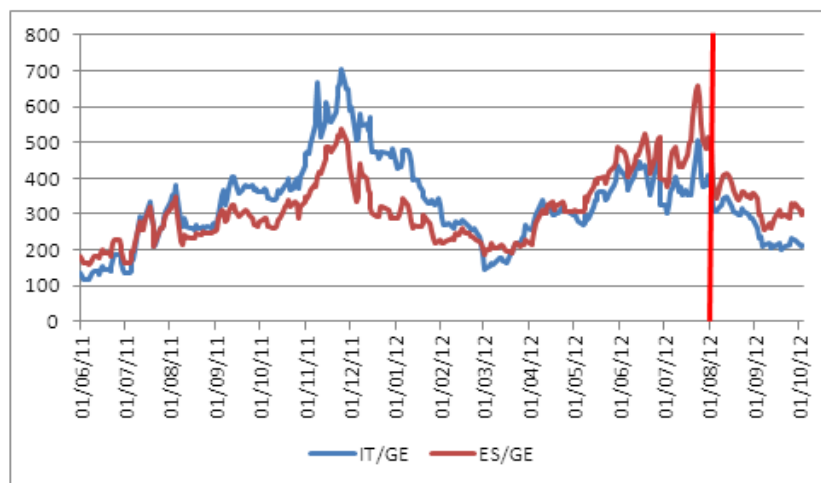
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 - Resumption of 1-Year Long-Term Refinancing Operations
 - Two 3-Year Long-Term Refinancing Operations
 - New “Covered Bonds” Purchase Programme
- **“Outright Monetary Transactions” in Sovereign Securities**
 - Conditional on ESM Programme and Surveillance
 - Interventions in 1-3 Year Maturity Segment
 - Eurosystem Pari Passu Status

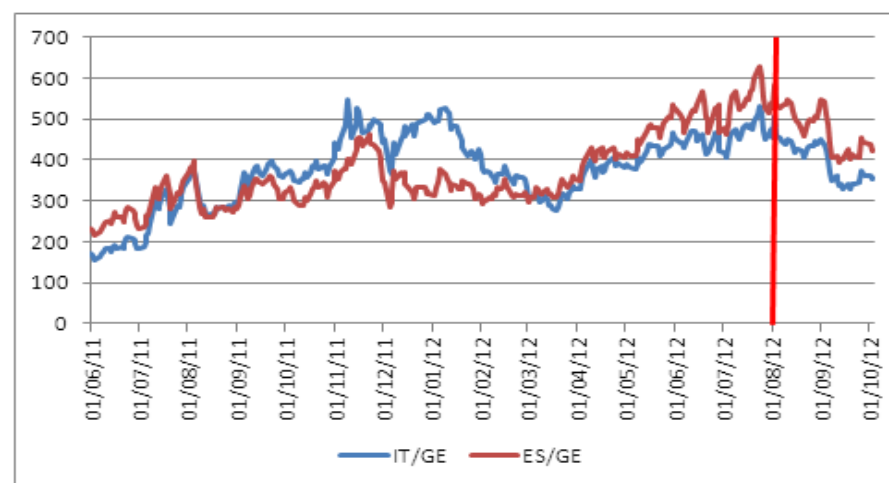
Second Stage of the Crisis

OMT Announcement and Break-up Risk

2-year yield spreads of Italy and Spain versus Germany
(vertical red bar: OMT announcement)



10-year yield spreads of Italy and Spain versus Germany
(vertical red bar: OMT announcement)



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Completion of the Institutional Architecture

- **‘Banking union’**: **Breaking Bank-Sovereign Nexus**
 - **Single supervision of euro area banks**
 - ⇒ **Single Supervisory Mechanism** comprising the **ECB** and national supervisory authorities
 - ⇒ **Expected gradual implementation in the course of 2013**
 - **Single resolution of euro area banks**
 - ⇒ **Harmonised bank recovery and resolution tools** (all tools, including bail-in ready for use 2018)
 - ⇒ **Plans for a single European Resolution Mechanism**
 - **Harmonised deposit insurance schemes**
- **‘Fiscal union’** fiscal rules with ‘real bite’, possibly **EMU** fiscal capacity
- **‘Economic union’** to avoid divergences in competitiveness
- **‘Political union’** to strengthen democratic legitimacy and accountability

Thank You

Quantitative definition of price stability

Definition of Price Stability (1998):

Ø Year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of **below 2% over the medium term**

Clarification of the Strategy (2003):

Ø The Governing Council will aim to maintain the euro area inflation rate **below, but close to, 2% over the medium term**

Why below, but close to, 2%

Below 2%: Economic and social benefits of price stability
(see slide on “Why price stability”)

Close to 2%: arguments in favour of tolerating a low positive inflation rate

- Ø **Measurement bias in the HICP**
- Ø **Deflation and the zero bound on nominal interest rates**
- Ø **Inflation differentials within the euro area**

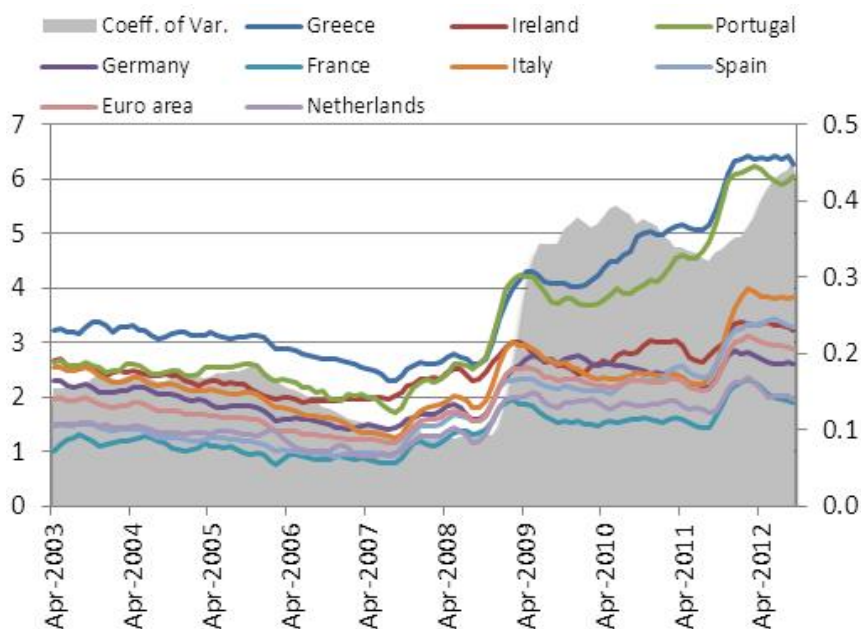
The Fiscal Context

% of GDP	2010	2011	2012	2013
Euro area				
Budget balance	-6.2	-4.1	-3.3	-2.6
Primary balance	-3.7	-1.5	-0.5	0.2
Gross debt	85.4	88.0	93.6	94.9
United States				
Budget balance	-11.2	-10.1	-8.7	-7.3
Primary balance	-9.1	-7.8	-6.5	-5.1
Gross debt	98.6	102.9	107.2	111.7

Sources: IMF World Economic Outlook October 2012

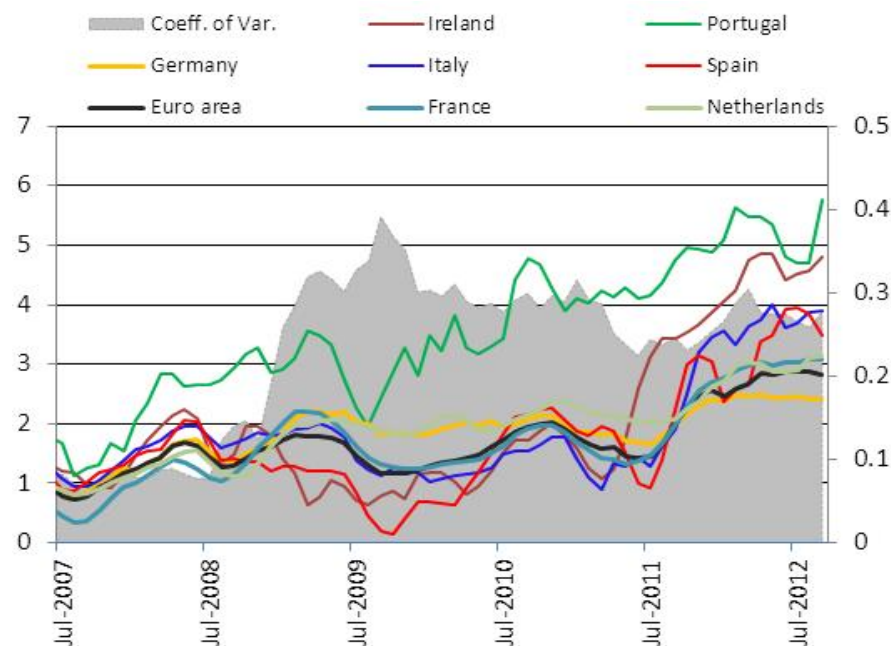
MFI Lending Rates and Policy Transmission

Spread between short-term cost of borrowing for NFCs and 6-month OIS swap rate (p.p.a.; three-month moving averages)



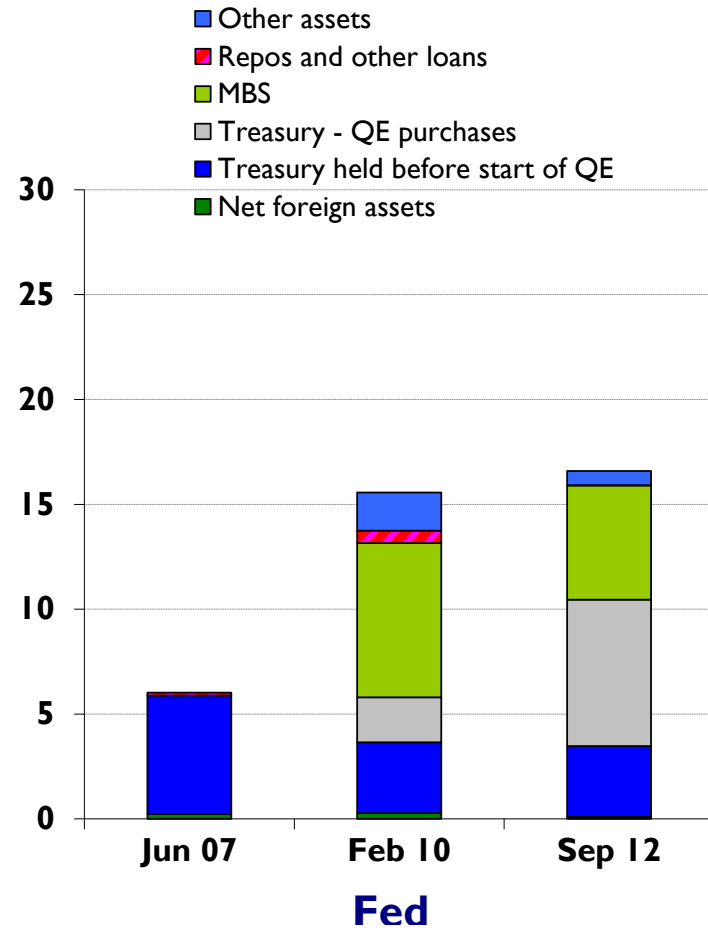
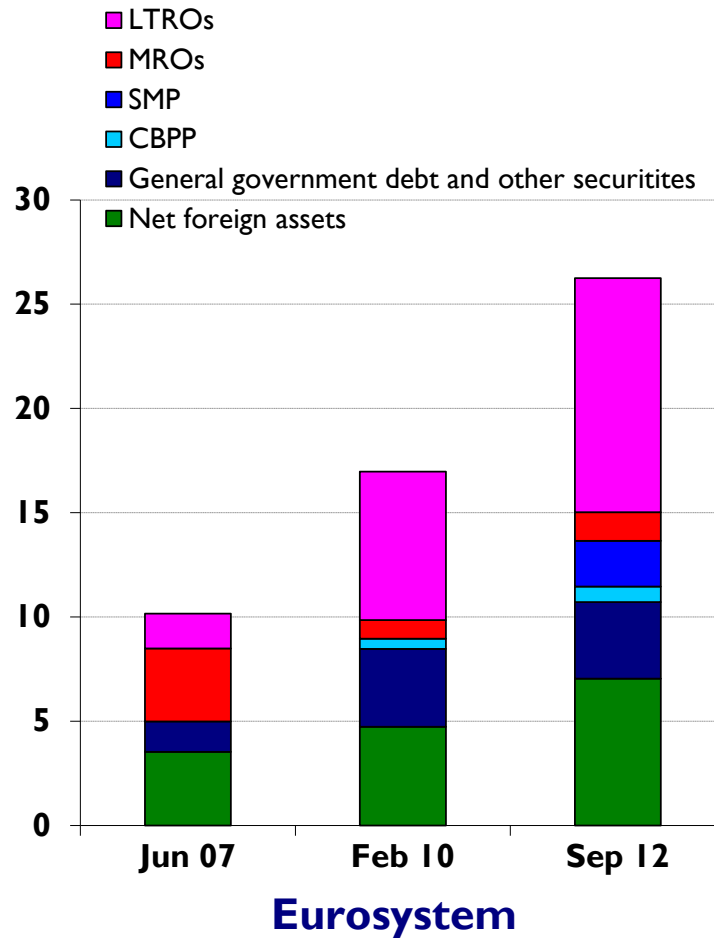
Sources: ECB, as well as the MIR and BSI databases. Last observation is Sept. 12.
Notes: See note to Slide 1 for short-term cost of borrowing for NFCs.

Spread between long-term cost of borrowing for NFCs and 5-year OIS swap rate (p.p.a.; three-month moving averages)



Sources: ECB and the MIR database. Last observation is Sept. 12.
Notes: See note to Slide 1 for long-term cost of borrowing for NFCs.

Balance sheets and Non-Standard Measures



Note: Values are presented in percent of GDP. Last observation refers to 20 September 2012.

Source: US Federal Reserve, ECB and ECB calculations