Implications of QE and Tapering - What will the ECB and the FED focus on going forward?
Intervention of Francesco Papadia [Slide 1]

ECB [Slide 2]

As Far as the ECB is concerned, I think one has to concentrate on two issues:

1. The contrast between the Forward guidance issued by the ECB, according to which interest rates should remain constant or go down, and the clear expectation of the market that rates will go up,
2. The preparatory work for the ECB to take responsibility for supervision in the €-area, starting with the Risk Analysis, the Asset Quality Review and the Stress Test of €-area banks. Let me cover these two issues in turn.

On Interest rates: [click]
As you know the ECB president issued at the beginning of July the following statement: *"The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time."* And has reconfirmed this in following press conferences. The ECB has thus followed on the steps of a number of central banks, starting with the Reserve Bank of New Zealand in 1997, giving forward guidance about their monetary policy.

As in the case of some other central banks, the market has not been overly impressed by this forward guidance. Indeed the money market yield curve is clearly upward sloping. **[Slide 4]**

A little pedantic note is needed here: Draghi referred to ECB interest rates while the chart reports money market rates. However, Draghi also paid a lot of attention to market rates, with his insistence on the ECB checking liquidity conditions and making sure they remain consistent with an accommodative monetary stance. Furthermore the money market yield curve is not consistent with stable or decreasing policy rates going forward, in the summer of 2015 the forward EONIA curve moves above the 50 bp of the current MRO rate.

So, there is a clear contrast: the Governing Council of the ECB has a unanimous downward bias, the market expects that the money market will increase steadily over the next few quarters.

The upward bias of the market seems inconsistent with inflationary perspectives. The ECB projections show that inflation should be well below the 2.0 per cent objective for both 2013 and 2014 (precisely 1.3 per cent in the latter year). While the ECB has not given as yet its projections for 2015, President Draghi said in the last press conference that *"Underlying price pressures in the euro area are expected to remain subdued over the medium term"* and there is little expectation that inflation would move away from a level well below 2.00 per cent in 2015 or beyond. If it is not higher inflation, what then explains the upward bias of the market?

There are 3 possible explanations for the steepening of the money market yield curve in the euro area **[Slide 5]**:

1. The evaporating excess liquidity due, in particular, to the fact that banks are returning gradually the funding obtained under the 2 three year Long Term Refinancing Operations,
2. The confirmation of the ECB view that the recession is over and that the financial crisis has lost in intensity,
3. The initial spill-over from the rate increase in the US triggered by the "tapering" announcement of the FED President.

Explanations 1 and 2 are clearly interrelated as banks are returning liquidity to the ECB just because of the improvement in financial and economic conditions. Let me therefore concentrate on explanations 1 and 3.

The effect of evaporating excess liquidity on EONIA is explained as follows **[Slide 6]**: when excess liquidity is very abundant (higher than 200 billion € or so) market participants are sure that the maintenance period will end with an excess of liquidity and the only relevant rate is the one at which banks will be able to place their liquidity surplus with the ECB, i.e. the deposit rate, currently at 0 per cent. For lower levels of excess liquidity, market participants start to be unsure on whether the maintenance period will end with a surplus or a deficit of liquidity and the market rate will start moving towards the centre of the corridor, corresponding to the rate on the MRO. If market participants would be assured that the ECB would achieve neither a deficit nor a surplus at the end of the maintenance period (as it happened before the crisis) EONIA would stick constantly just above the Main Refinancing Operation rate, in the middle of the corridor.

While the empirical relationship between excess liquidity and the EONIA is quite strong, President Draghi rightly stressed that it is far from precise, especially when liquidity starts moving towards zero, and that it depends on other factors. Here the spill-over from the United States comes into play, which follows a well established pattern, whereby rates in the US influence rates in the rest of the world, including in the €-area.

In conclusion **[Slide 7]**, the Governing Council has good reasons, mostly of macroeconomic nature, for its downward bias: the control of inflation in the €-area surely does not need higher rates for the foreseeable future. But the market has also good reasons, mostly of financial nature, to have an upward bias. How could the conflict be resolved?

In principle the answer is simple: notwithstanding the doubts that I expressed in a blog about the ability of the ECB to control interest rates, it can control money market rates if it really wants to. This was also the view of the ECB President when he said, referring to the possibility to lower rates: *"In any event, we would – as I said – stand ready to take appropriate action as needed."* The practical, and relevant, question is whether the Governing Council wants to enforce its views on the market, judging that macroeconomic reasons trump the financial ones and that the ECB, not the FED, should decide on interest rates in Europe. The answer to this question will determine whether the official rate will be lowered once more in the euro area or not. Signs coming from Frankfurt seem to indicate that this will not be the case.

On the ECB taking supervisory responsibilities. [Slide 8]
It is difficult to exaggerate the importance of this development, for the ECB but also for the €-area overall.

For the ECB because it has to deal with another difficult challenge. If introducing the € is indexed as a difficulty of 100, taking supervisory responsibility is 40. The ECB has passed the test of the introduction of the € with flying colours and, in my judgment, has also managed quite well during the crisis. This is a good omen for this new challenge. A good omen is, however, not the same as a good result.

A look at the new building of the ECB **[Slide 9]** helps us start seeing the challenge. This building was planned before the ECB was given the task to also carry out supervision, and thus, beautiful as it is, it just can not accommodate the about 1.000 additional employees that are needed for the new task. Indeed, with doubtful wisdom, the governors of the national central banks sitting in the Governing Council sized the building very conservatively in the hope to contain the growth of the ECB and thus maintain more prerogatives for their national central banks. In conclusion, the ECB will need to find a different building for its new employees.

But this will be a tiny part of the difficulty of absolving its new responsibility as supervisor.

As Nicolas Veron aptly said in a Bruegel Policy Contribution[5], the **ECB will have two challenges in becoming the euro area supervisor**: one will be difficult, the other will be fiendishly difficult and they together constitute a real risk for the ECB.

The **difficult challenge** is to hire the new people, amalgamate them into the ECB and prepare them to take the new euro area responsibilities forgetting about any national allegiance, master the supervisors intellectual paradigm, which is very different from that of monetary policy, work with a complex decision making, which a Supervisory Board and the Governing Council of the ECB will have to share.

The **fiendishly difficult challenge** is not to succumb to the calls of forbearance that are likely to come strong and aggressive from national supervisors. I fear in particular the pressure for forbearance from French, Italian and German supervisors. These calls already spoiled the previous stress tests and arguably contributed to prolonging the European crisis, not cleaning up the euro area banking system of its weak parts and maintaining a veil of suspicion covering all of it. The first tests for the ECB will be the Risk Analysis, then the Asset Quality Review and the Stress Test, which will have the fundamental role of clarifying what are the responsibilities of the old supervisors and those of the ECB, what are "legacy losses", in the terminology of Veron, and what will be the new losses, what has to be covered nationally and where Europe could help.

Of course a strict approach in assessing the balance sheets of the euro area banks has to be matched by clarity about the back-stops and resolution modalities. But any problem in the latter should not justify the additional problem that would derive from a bland assessment of the state of health of euro area banks.

In conclusion, there is a serious credibility risk: the ECB was chosen to do supervision because it has earned its credibility in establishing the € and then carrying out monetary policy fulfilling its mandate of price stability before and during the crisis, but could lose that credibility, with immeasurable damage, if in carrying out its new function it would cede to the calls to close an eye to the weaknesses it would find in euro area banks. I think the ECB will remain faithful to its responsibilities, but the challenge is there.

FED **[Slide 10]**

One sign of the fact that the European crisis has lost in intensity is that in the recent IMF-WB meetings in Washington, Europe was third in the ranking of concern, after the US and Emerging Markets.

Of course, the attention on the US was more on the fiscal side, with the fight between the Democrats and the Republicans or, may be more precisely, between the Republicans and the Republicans, risking a financial earthquake. But it is not that monetary policy is uninteresting in the US.

As a former ECB official, I have something of a professional imprinting that leads me to look at monetary issues through the inflation prism. The first question, in this respect, is whether one can say something precise about the level of inflation: is there a risk of inflation or deflation in the US? My overall conclusion is that it is very difficult to say something precise here, as there are offsetting forces whose net effect is difficult to assess and probably small.

On one hand the new FED chair has a fame, probably not fully earned, of being very dovish and putting more emphasis on the unemployment rather than on the inflation part of the dual mandate. In addition, the FED has clearly said that, faced with the short-term uncertainties from the lack or distorted nature of macroeconomic data because of the shutdown and the medium term uncertainties derived from the fiscal mess in the US, it prefers erring on the side of ease. This is behind market expectation that, not having been decided at the last FOMC meeting, tapering is likely to be postponed well into next year. Finally, tying monetary policy to a variable, like unemployment, that has an uncertain link with monetary policy and can turn out to be vitiated by wrong assumptions about the participation rate and NAIRU, carries obvious medium term risks.

On the other hand, current inflation is low in the US, inflationary expectations are still well behaved, given the past control of inflation by the FED **[Slide 11]** and I do not think the FED would really want to take serious risks in this area. So, there is little sign that inflation is a risk for the foreseeable future.

If one cannot say something precise about the first moment of a variable, it is natural to ask whether something precise can instead be said for the second moment, i.e. variability. It is indeed my sense that inflation, and particularly inflationary expectations, may be variable going forward, buffeted by the offsetting forces that I mentioned. Looking at survey based inflationary expectations **[Slide 12]**it looks indeed like one year ahead expectations look dispersed while on a 10 year horizon there is no evidence of added dispersion.

On a more long term horizon, **[Slide 13]**I believe that the recurrent difficulty of the US political system to manage in an orderly way its finances could have consequences for the standing of the dollar and of Treasuries going forward. I do not think here of a strong, immediate effect but rather of a kind of undercurrent that could manifest itself gradually. The consequence could be a gradual move of international reserves towards other currencies, like the euro, CND, AUS, CH, Sterling, the kroner and so on. I had an exchange of views with Adam Posen, the director of the Peterson institute on this, and he sees as more important a possible move top the RMB. While I think this could be a possibility in the very long run, my sense is that so much could happen to China over that time horizon that it is impossible to really assess that possibility. In particular I do not see how China could manage in a smooth way its transition from an autocratic to a (somewhat) democratic set-up, which I think is indispensable, again over the very long run, for a functional economy.

Leaving the issue of China alone, the point I made about the erosion of the international trust in the dollar and treasuries could imply one factor of weakness for the dollar and of strength for its possible alternatives, which could make the conduct of monetary policy more complicated in the US as well as in the other relevant countries.

Finally some publicity:

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