



BANCA D'ITALIA
EUROSISTEMA

THE ECB AND ITS WATCHERS

Debate on: “Should the current monetary policy framework be adjusted to meet (new) post-crisis challenges?”

Ignazio Visco

Banca d'Italia

Frankfurt, 7 April 2016

Is (below but close to) 2% objective still appropriate?

Evaluation of ECB monetary policy strategy in 2003 considered three arguments, which are still valid today

- **Risk of deflation** and **lower bound to nominal interest rates** have shown to be an issue, more than we thought back then
- There is still a need to “**grease**” **adjustment of relative prices**, especially across countries
- If any, there is further reason to believe that there is an upward **bias in measurement** (e.g., see Adobe ‘digital price index’, The Economist March 19, 2016)

Why does inflation remain low? Do global forces matter?

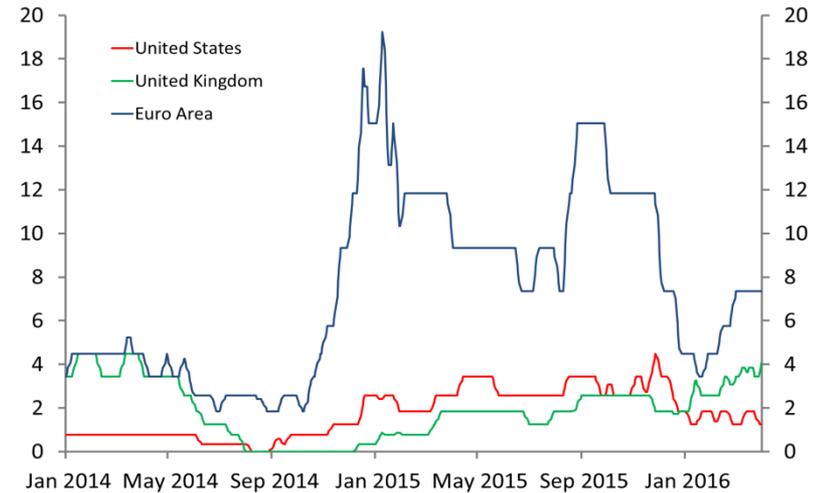
Low inflation has global roots, but also reflects **domestic developments**

Declining **inflation expectations** has been a global phenomenon, but since end-2014 **risk of de-anchoring** has risen in the euro area

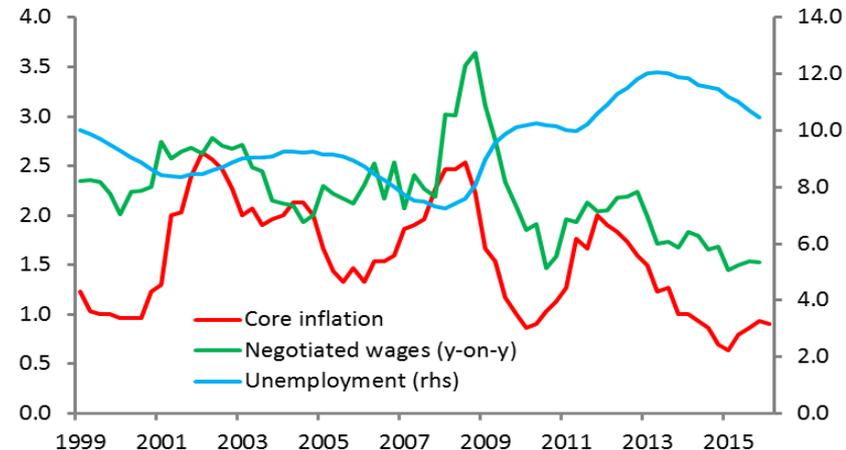
Extremely low inflation in the euro area also depends on persistence of **economic slack and high unemployment**

(*) The chart reports an indicator of co-movement between short and long-term inflation expectations for extremely negative variations, as measured by Natoli, F. and L. Sigalotti, “*An indicator of inflation expectations anchoring*”, Banca d’Italia, Temi di Discussione (Working Papers), forthcoming. Low values indicate that long-term expectations are better anchored.

Indicator of co-movement between short/long-term inflation expectations for extremely negative variations*



Core inflation, wages and unemployment



Is monetary policy still effective?

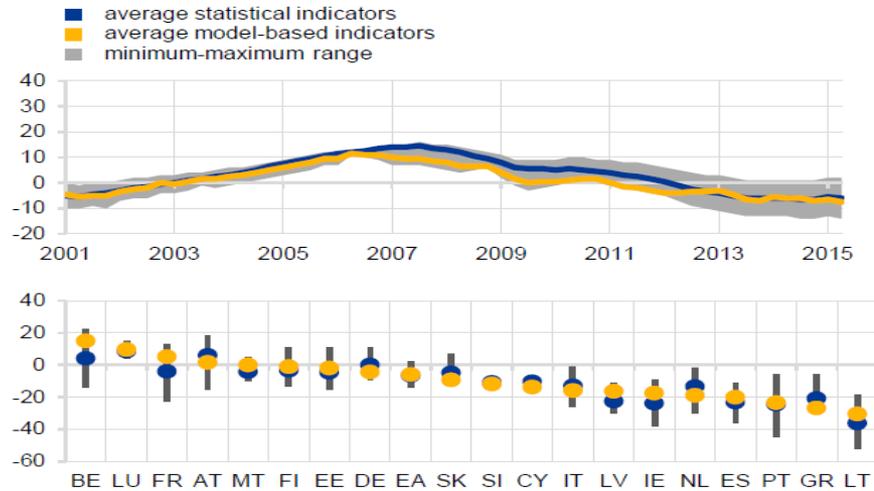
- **Short answer is yes**
 - ✓ Estimates by Banca d'Italia staff (which do not consider non-linear effects) show that without the monetary policy measures adopted between June 2014 and December 2015, annual inflation and growth in the euro area would have been lower by about half a percentage point in 2015-17
 - ✓ Growth in 2015 would have been slightly below 1%, against an observed 1.6; inflation negative, at about -0.5%, against 0.0
- **Commitment to price stability** has been essential to stem the de-anchoring of expectations and maintain the ECB credibility
- **But monetary policy cannot be left to act alone.** Need for fiscal policies at the euro area to maintain appropriate macroeconomic conditions and further reforms to increase potential output growth

Should financial stability considerations interfere with monetary policy?

- Important to consider implications of accommodative monetary policy for **financial stability** ...
- ... but **growth and price stability are key for financial stability**.
A debt-deflation spiral would be very difficult to stop
- **Low nominal rates may hurt** some financial institutions ...
- ... **but they are necessary** for the strengthening of growth, raising disposable income and spending, and ultimately inflation
- This is the only sustainable path to higher nominal interest rates

Should financial stability considerations interfere with monetary policy? (cont'd)

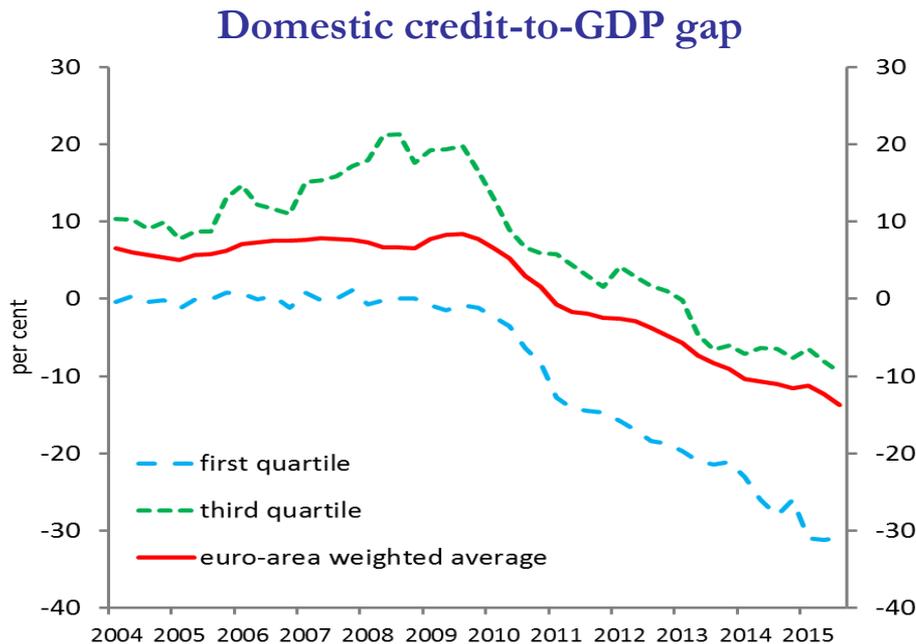
Estimated over/undervaluation of residential property prices*



Available indicators do not point to rising vulnerabilities for the euro area as a whole

Residential property prices are slightly below fundamental levels. No sign of widespread over-valuation

Financial cycle still negative in aggregate, and in most euro-area countries



(*) A positive figure indicates overvaluation, i.e. prices above long-term average (in the case of statistical models) or fundamental values (in the case of economic models).

Concluding remarks

- A protracted very accommodative monetary policy involves **risks**, which need to be monitored carefully; low or negative nominal rates may hurt some financial institutions
- But current **low level of interest rates in the euro area** is not a bizarre choice of ECB Governing Council; rather, it **reflects slack in economy and dangerously low actual and expected inflation**
- A less accommodative monetary policy would be harmful to everyone. **Strengthening growth and job creation is the only sustainable way to raise nominal rates**