

Helena Adegas

Banco de Portugal

Head of Markets and Reserve
Management Department

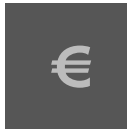
Monetary Policy and Fragmentation

13th ECB Central Banking Seminar | Monetary Policy in the Euro Area
5 July 2019

Overview



Fragmentation in the euro area



The singleness of an heterogeneous currency area



Monetary policy measures toolkit



Lessons learnt



Which monetary policy framework in the future?

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Which monetary policy framework in the future?

Fragmentation in the euro area

1. The markets functioning perspective



It is a **divergence** in certain economic indicators (mainly prices or quantities) ...



... either **within a group** of economic agents with similar characteristics or between **different groups** of economic agents ...



... which cannot be explained by endogenous factors only.



Such differences might result from **environmental, infrastructural or institutional** factors.

Source: Eurosystem Monitoring Working Group

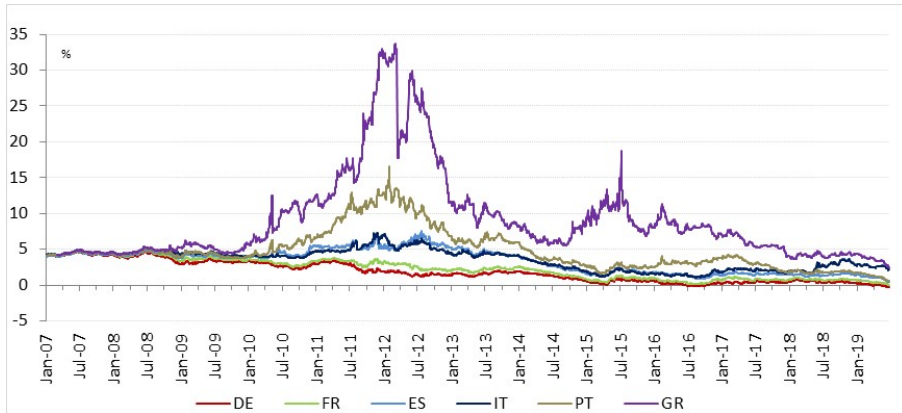
2. The monetary policy transmission perspective

It is the **lack of full tradability of central bank reserves** across borders which cannot be explained by technical (e.g. access to the central banks' standing facilities) or fundamental (e.g. counterparty credit risk) factors.

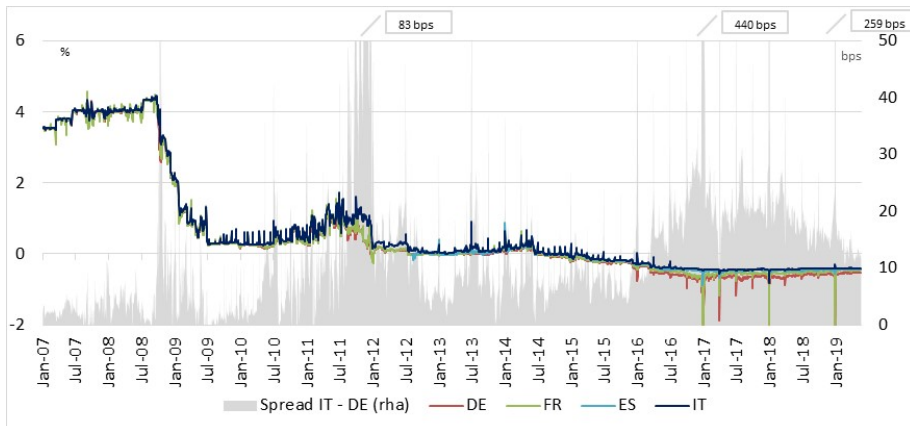
Source: Eisenschmidt *et al.* (2018)

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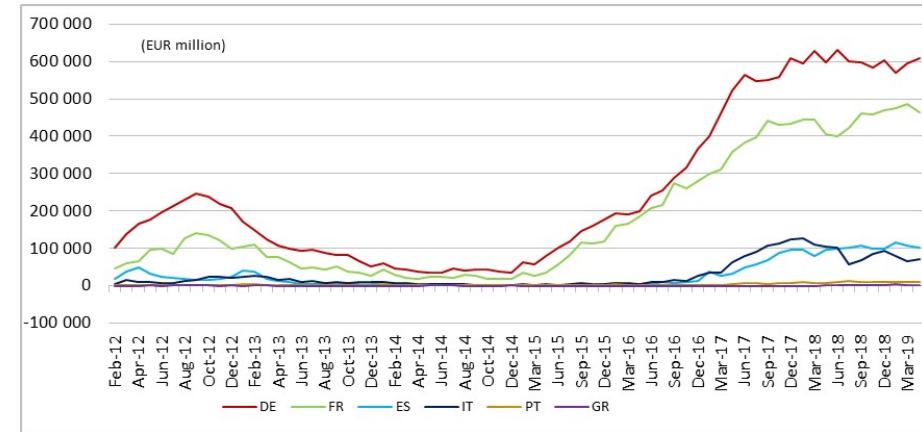
10-year government bond yields



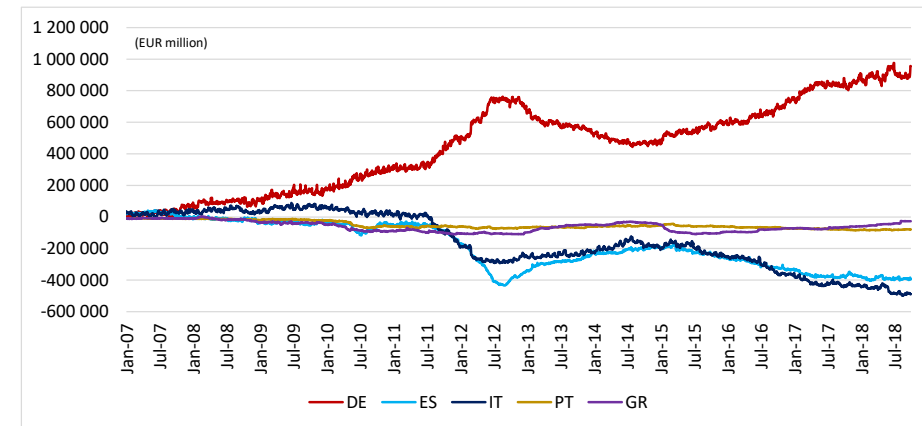
Repo funds rates



Excess liquidity



TARGET balances



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Which monetary policy framework in the future?

How single can an heterogeneous currency area be?

The Economist | Topics | Current edition | More

FRBSF ECONOMIC LETTER | 2011-18 | June 13, 2011

Monetary Policy When One Size Does Not Fit All

Can one size fit all?

The European Central Bank will face a tricky task setting monetary policy, partly because higher interest rates hit some economies harder than others

S&P Global Ratings | RatingsDirect®

Economic Research: Monetary Policy Normalization In The Eurozone: Will One Size Fit All?

The Single Monetary Policy of the European Central Bank: One Size Fits All

Otmar Issing*
European Central Bank.

One size fits all! A single monetary policy for the euro area

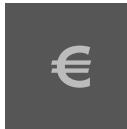
Speech by Otmar Issing, Member of the Executive Board of the ECB
International Research Forum, Frankfurt am Main, 20 May 2005.

- ECB decisions are driven by the mandate to **maintain price stability in the euro area** and as such, they **cannot be tailored to the specific needs of a single Member State**
- However, the ECB was able to **accommodate heterogeneity** when it threatened the transmission of monetary policy

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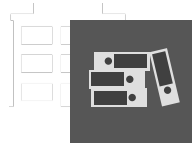
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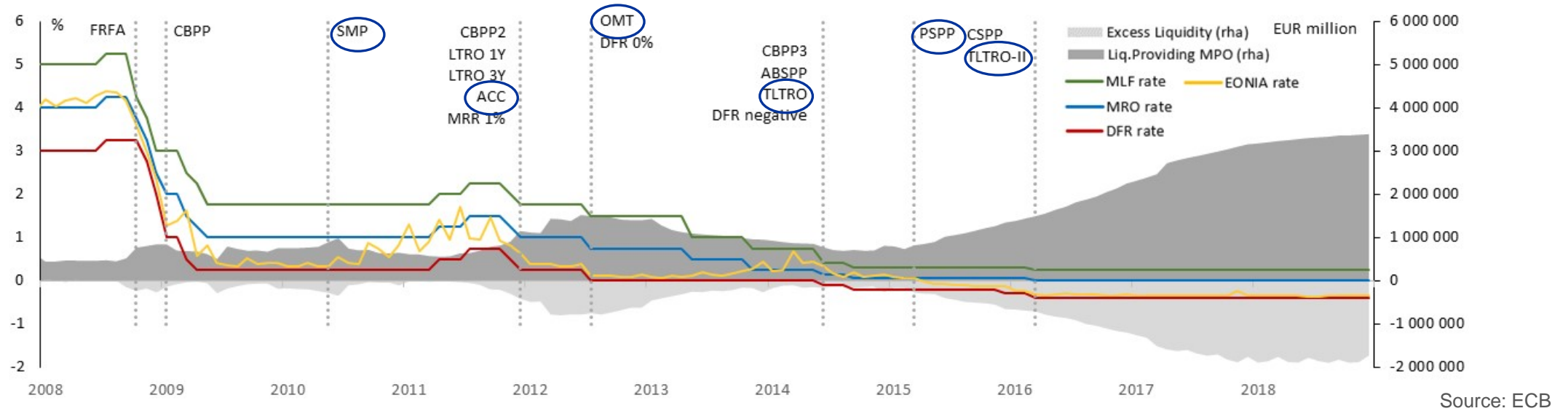


Lessons learnt



Which monetary policy framework in the future?

Monetary policy measures



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Motivation: to allow counterparties' access to new long term Monetary Policy Operations; to avoid collateral shortages by accommodating country specificities

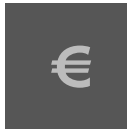
Main Features: individual and aggregated credit claims basis; higher flexibility in terms of probabilities of default; eligibility criteria and risk control measures established by NCB and approved by the Governing Council; non-loss sharing regime as the design is customized to address country needs

Relevance: 15% of the total assets mobilized in Portugal (7% in the Eurosystem); 30% of the collateral mobilized by Portuguese counterparties using ACC (14% in the Eurosystem)

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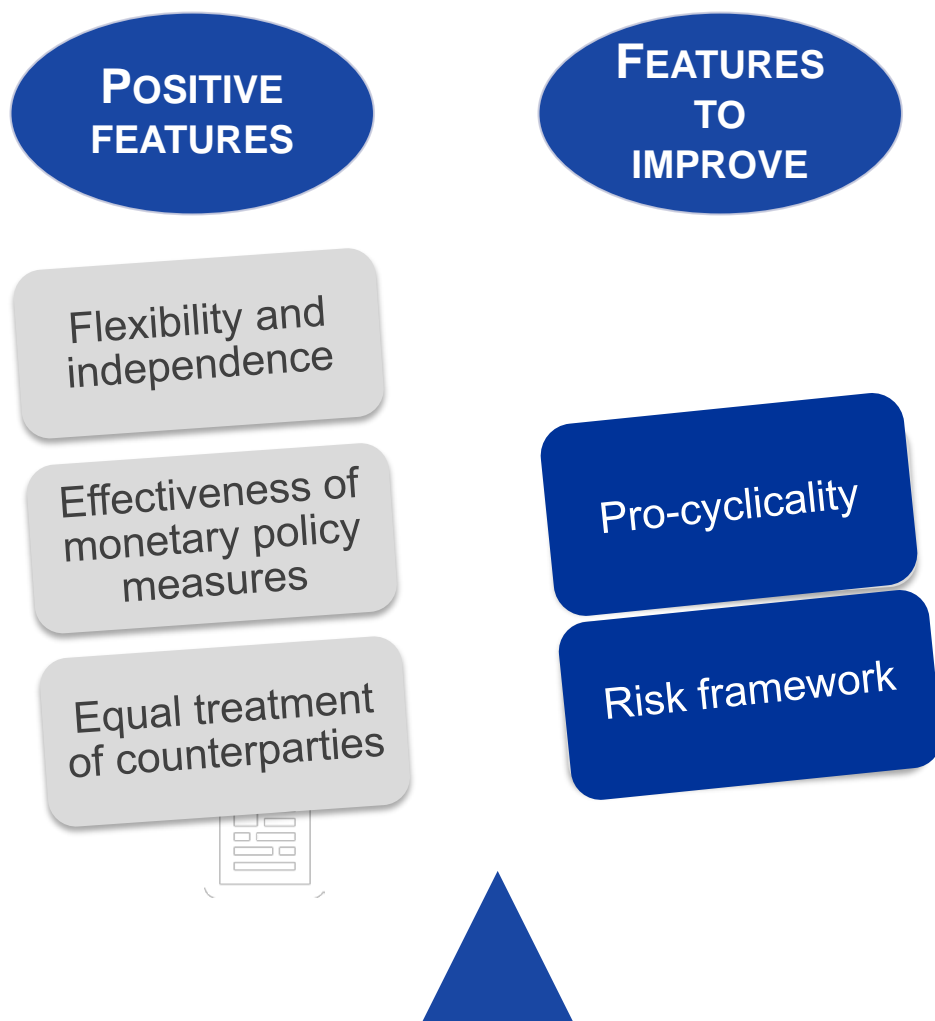


Lessons learnt



Which monetary policy framework in the future?

Lessons learnt



Potentially pro-cyclical elements of the framework:

- ✓ Deleveraging => downward pressure on prices => decline in **banks' capital** => impact on counterparties eligibility
- ✓ External **ratings** => impact on collateral eligibility, haircuts and valuation

Frameworks were adapted to **support the counter-cyclical** Monetary Policy stance: widening of collateral, while respecting the risk equivalence principle

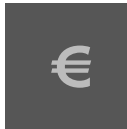
Risk management issues:

- ✓ **Counterparties** => Develop early warning indicators to **enhance due diligence**
- ✓ **Collateral** => Increase consistency of the framework (privilege further the **risk sharing**) and **reassess the reliance on external ratings**

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Which monetary policy framework in the future?

Which future monetary policy framework might minimize fragmentation?

OPERATIONS



- Credit operations that support the steering of short-term rates
- Long-term credit operations and outright purchases in the toolbox
- Respond to liquidity demand arising from uncertain factors

COUNTERPARTIES



- Broad counterparty framework
- Improved information exchange with the supervisor

COLLATERAL



- Extended and diversified collateral framework
- Single collateral layer

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