Monetary Policy and Fragmentation

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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?
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?
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)
Fragmentation in the euro area

10-year government bond yields

Excess liquidity

Repo funds rates

TARGET balances

Sources: Bloomberg, ECB
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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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**Monetary policy measures**

**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

**Positive features**
- Flexibility and independence
- Effectiveness of monetary policy measures
- Equal treatment of counterparties

**Features to improve**
- Pro-cyclicality
- Risk framework

**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 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