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EXECUTIVE BOARD MEETING

SM/23/162
Correction 1

July 10, 2023

To: Members of the Executive Board

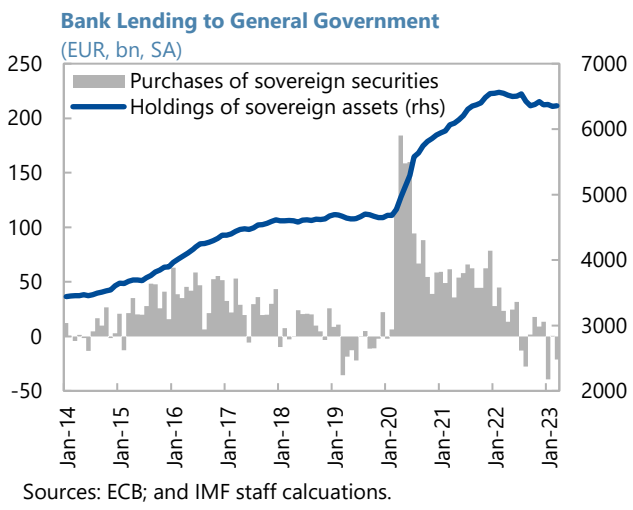
From: The Acting Secretary

Subject: **Euro Area Policies—Selected Issues**

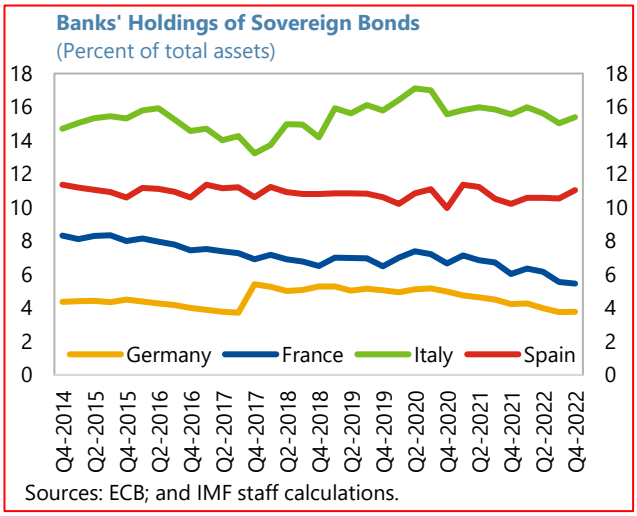
Board Action:	The attached correction to SM/23/162 (6/29/23) has been provided by the staff:
Evident Ambiguity	**Page 9**
Questions:	Mr. Belhocine, EUO (ext. 37075) Mr. Toscani, EUR (ext. 35856) Ms. Nguyen, EUR (ext. 34091)

Protection Instrument (TPI) in July 2022, have reduced the divergence in borrowing rates by compressing spreads.

Figure 4. Euro Area: Sovereign-Bank Nexus



Sources: ECB; and IMF staff calcuations.



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18. Although policy rate changes have overall been passed on smoothly and homogenously since the start of the tightening cycle in July 2022, fragmentation in euro area debt markets remains a concern. In principle, fragmentation should not originate from QT if it proceeds in a predictable and cautious way. The PEPP's flexible reinvestments would be a first line of defense against fragmentation. If an exogenous shock materializes and eligibility criteria are met, the ECB could consider activating the Transmission Protection Instrument (TPI). Sovereign solvency concerns should be addressed through the ECB's Outright Monetary Transactions and the ESM's macro-adjustment programs.

19. Tools designed to support market liquidity should be used to address severe financial market dysfunction. When facing severe and systemic financial market stress, the ECB should deploy liquidity support tools. The use of such tools should respect a separation principle between monetary policy tools geared toward attaining price stability (e.g., policy rates and QE/QT) and emergency support tools designed to address the specific market functioning or financial stability concerns (e.g., central bank lending facilities, reverse auctions, or outright asset purchases; see King and others 2017). At the same time, the pace of balance sheet reduction could be reassessed. Upholding this separation principle, however, can be challenging to communicate as the example of the Bank of England during the LDI crisis in September 2022 to proceed with passive QT along with targeted market interventions.

More Aggressive QT Implies a Shallower Path for the Policy Rate

20. In principle, building back unconventional policy space is desirable but this needs to be balanced against the costs of giving up some conventional policy space. As long as the effect of QT on the monetary stance is small, there is no tradeoff between rebuilding conventional and unconventional space. Given the advantage that gaining conventional policy space has in terms of making a return to the ELB less likely, the rational of gaining unconventional policy space is less