Monetary policy of the ECB: strategy and tools

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Oreste Tristani
Directorate General Research
The views expressed are those of the presenter and should therefore not necessarily be viewed and not be reported as representing the views of the European Central Bank.
Outline

• The ECB’s monetary policy
  • Principles of the ECB’s monetary policy
  • The ECB monetary policy strategy

• Monetary policy instruments
  – Standard monetary policy
  – Non-standard measures and the ECB’s response to the crisis
ECB’s monetary policy objective

• Article 127 of the Treaty of the Functioning of the European Union:

• The primary objective of the ESCB [Eurosysterm] shall be to maintain price stability

• Without prejudice of the objective of price stability, the ESCB [Eurosysterm] shall support the general economic policies with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.
Safeguards for sound monetary policy

- **Institutional** safeguards
  - **Clear mandate**: Price stability as primary objective
  - **Instrument independence**
  - **Rule-based framework and credibility**

- **Strategy and rules**
  - Numerical definition of price stability
  - Consistent **framework** for analysis and decision-making
  - Clear and transparent **communication**
ECB’s quantitative definition of price stability

• The Governing Council [GovC] of the ECB in October 2008 defined price stability as…
  • …a year-on-year increase of…
  • …the Harmonised Index of Consumer Prices [HICP]…
  • …for the euro area…
  • …below 2%.
  • Price Stability is to be maintained over the medium term.

• **The GovC aims to maintain inflation rates at levels below, but close to, 2% over the medium term.**
Why “below, but close to, 2%”?

• “Below” in order to fully reap the benefits of price stability.

• “Close to” to ensure an adequate margin that…
  • …avoids risks of deflation,…
  • …takes possible small measurement bias in HICP into account.
Inflation and inflation expectations

Source: Bloomberg, ECB and ECB calculations.
Latest observation: September 2011, end-of-month data (inflation swaps) and monthly data (HICP), percentage points.
The ECB’s monetary policy strategy

Primary objective of price stability

Governing Council takes monetary policy decisions based on an overall assessment of the risks to price stability

Economic analysis

Analysis of economic dynamics and shocks

Monetary analysis

Analysis of monetary trends

Full set of information

cross checking
THE MONETARY POLICY INSTRUMENTS

Standing facilities

Deposit facility
(Rates generally lower than market rates)

Marginal lending facility
(Rates generally higher than market rates)

Open market operations

Main refinancing operations
(Maturity: one week)

Longer-term refinancing operations

Fine-tuning operations

Structural operations

Reserve requirements

RESERVE BASE
Deposits, debt securities and money market paper

RESERVE RATIO
2% for the majority of the items to which the reserve base applies

REMUNERATION
Reserve holdings will be remunerated at the Eurosystem’s rate on its main refinancing operations

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 Monetary transmission in normal times

- **Overnight rate** mirrors official key interest rate over maintenance period.

- ECB influences **money market conditions** by setting key interest rates and managing the liquidity situation in the banking sector by benchmark allotment.

- Inter-bank money market rates affect **lending rates and returns on longer term financial assets**

- Lending rates affect **aggregate demand** (consumption and investment) and ultimately **prices**
Steering money market conditions

Source: ECB.
Latest observation: August 2011, monthly averages of daily observations
How does it work (ex post)?

• **Taylor rule** (for the US)
  \[ i = 4.0 + 1.5 \ (inf - 2) + 0.5 \ gap \]

• “Taylor principle”

• Simple (simplistic)?

• Alternative (**Orphanides rule**)
  \[ i = i_{t-1} + 0.5 \ (Einf - 2) + 0.5 \ Egap \]
Does it work? (Orphanides, 2010)
Non-standard measures

• Over the past few years monetary policy has become “non-standard”
  • what does this mean?
  • is it appropriate?
• Four examples
  • Enhanced Credit Support programme
  • ZLB
  • Securities markets programme
  • Outright monetary transactions
Turmoil in the money market

August 2007: Beginning of the Turmoil

September 2008: Intensification of the Turmoil

April 2010: Tensions in debt market segment

Sources: Bloomberg and ECB calculations.
Note: Spreads are the difference between 12-month Euribor/Libor and Overnight Index Swap rates, in basis points. Last observation 22 October 2010.
Question 1: satisfy demand?

• Poole (1970) model: choice of the CB instrument, interest rate or quantity of money
• CB has partial information on disturbances to money demand and to aggregate demand
• Interest rate is better instrument if aggregate demand relatively stable, but money demand is unstable
Credit spreads

Financial market spreads

- EURIBOR/OIS
- LOANS/OIS
Question 1: satisfy demand?

Why did interbank spread increase:

• liquidity or solvency?
• MBSs
• asymmetric information + counterparty risk
• leverage
Leverage

Euro area debt (1999-2010)
(in % of GDP)

US debt (1950-2010)
(in % of GDP)

Notes: Debt is defined as loans for euro area households (credit market instruments in the US), for NFCs and financial corporations debt is credit, securities excluding equity, and pension liabilities, net of inter-company loans (credit market instruments in the US), debt by governments are loans and securities.

Source: Quarterly Euro Area Accounts Eurostat, Flow of Funds Federal Reserve, BEA,
Question 1: satisfy demand?

• Answer: yes
  – to prevent disruptions in the monetary transmission mechanism, with repercussions on price stability
• Price stability vs. financial stability
• How about leverage?
• Which non-standard measures?
The ECB’s response to the crisis

• **Immediate response** on 9 August 2007
  - Allowed banks to draw full amount of what they needed on overnight basis against collateral at the prevailing main refinancing rate (ca € 95 bn)

• In the **following months**
  - Supplementary refinancing operations with 3 and 6 months maturity
  - Intra-maintenance period frontloading
  - More frequent fine-tuning operations
  - Provision of US dollar liquidity against euro-denominated collateral
Financial to economic crisis

- Decline in GDP components: euro area
Financial to economic crisis

- Decline in GDP components: US

US: Real Private Fixed Investment, Real Personal Nondurable and Durable Consumption (seasonally adjusted, % change year-on-year)
Question 11: cut rates?
Decline in key interest rates by 325 bp in 7 months

Source: ECB.
Last observation: August 2011, monthly averages of daily observations.
Question III: reach the ZLB?

• The zero lower bound: at negative interest rates, better to hold cash

• low inflation expectations imply high real rates …

• which cannot be lowered if nominal rates already at zero …

• so high real rates, low growth, low inflation expectations

• “liquidity trap”
QE vs. ECS

• Solutions to ZLB constraint
  • promise to keep low rates in the future
  • QE
  • Substitute for standard interest rate policy

• Addressing impairments in MTM
  – Interventions in specific market segment subject to impairment
  – ECS
  – Complement to standard interest rate policy
Further responses – enhanced credit support

- **ECB’s enhanced credit support** consisted of mainly bank-based measures to support the flow of credit beyond standard interest rate channel
  - Fixed-rate full allotment
  - Expansion of collateral
  - Longer-term liquidity provision
  - Liquidity provision in foreign currencies
  - Financial market support through purchases of covered bonds
- **CB balance sheet as additional instrument of monetary policy**
ECB balance sheet

Sources: ECB. Note: Last observation 15 October 2010
Sovereign spreads

European 10-Year Sovereign Spreads*

Basis points

- Spain (right scale)
- Portugal (right scale)
- Italy (right scale)
- Ireland (right scale)
- Greece (left scale)

*Difference between given country's yield and Germany's yield.
Question IV: intervene?

- Liquidity vs. solvency redux
- Solvency: Current accounts; debt/deficit levels
- Liquidity: theoretical possibility; what has changed in 2010?
- SMP
Current accounts

Saving Balances as a Share of GDP

Source: Eurostat; Haver Analytics.

Note: Saving balances are measured by the current account.
Unit labour costs
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ECB’s response to the sovereign debt crisis

- ECB introduced the **Securities Markets Programme** [SMP] to safeguard the well-functioning of the **transmission process** by conducting interventions in euro area debt securities markets.

- Purchases **ensure depth and liquidity** in dysfunctional securities markets and are conducted on secondary markets only.
The case for intervention

- “Self-fulfilling crises” are possible
- If a perfectly solvent country is suddenly asked to pay exorbitant rates ...
- the countries cost of servicing the debt soars, hence high deficit
- If deficit high enough and increase in rates high enough, the perfectly solvent country would default
- Current developments a case in point?
Outright Monetary Transactions

• Aim to preserve the singleness of monetary policy and to ensure the proper transmission of our policy stance to the real economy throughout the area

• Address financial fragmentation ("severe distortions in government bond markets"), "unfounded fears of the reversibility of the euro"

• "Effective backstop" to avoid destructive scenarios with severe consequences for price stability in the euro area, hence within our mandate to maintain price stability

• Conditionality
Outlook?

• Modal scenario: economic recovery, increase in tax revenues, reduction in default rates, all ends well

• Risks:
  • NSM ineffectiveness?
  • Collateral quality: losses for the Eurosystem?
  • Inflationary pressures?