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The monetary policy of the ECB

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Outline

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Outline

1	**The monetary policy strategy: key features**
2	**The ECB's monetary policy in times of crisis**
3	**Concluding remarks**

Central Banks' Primary Objectives: a comparison

ECB: Primary Objective

"*The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the objectives of the Union*"

[Article 127 Treaty on the Functioning of the European Union]

Banco de México: Primary Objective

"*… [the Central Bank's] main goal will be to foster the stability of the national currency's purchasing power, therefore strengthening the State's role in guiding the country's development.*"

[Article 28 of the Constitution of the Mexican United States]

US Federal Reserve: Dual Mandate

"*Maintain the growth of monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates*"

[Full Employment and Balanced Growth Act, 1978]

Some benefits of price stability

Transparency of the price system	• Efficient allocation of resources
Low interest rate	• Small inflation risk premia
Less frequent price revisions	• Menu costs
No arbitrary redistribution of wealth and income	• Creditor / debtor • Debt-deflation

Quantitative definition of price stability

Medium-term orientation

Two-pillar approach

- Economic analysis
- Monetary analysis

Strengthens anchoring of inflation expectations, independence and accountability

Price stability as a range of values:

Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term.

[Governing Council, October 1998]

Within that range, a special focus on the pursuit of price stability:

*The Governing Council aims **to maintain inflation rates at levels below, but close to, 2% over the medium term.***

[Governing Council, May 2003]

Medium-term orientation

Takes into account **"long and variable lags"** in transmission of monetary policy and in economic developments

Prevents excessive **activism, which may raise volatility** of output and inflation, and may render monetary policy pro-cyclical

(e.g.: Orphanides, Williams, 2004)

Acknowledges **nature of shocks**, degree of **anchoring** of inflation expectations and **monetary/financial imbalances**

Expansionary demand shock

*"The **optimal monetary policy response** always **depends on the specific nature of the shocks.***

*For a wide variety of shocks (e.g. **demand shocks**) **prompt reaction** will not only preserve price stability but will also help to stabilise the economy."*
[Letter of President Duisenberg to Econ Committee, 13 December 2001]

Projection

Policy rate

Inflation

GDP growth

Typically, 1.5 to 2 yrs.
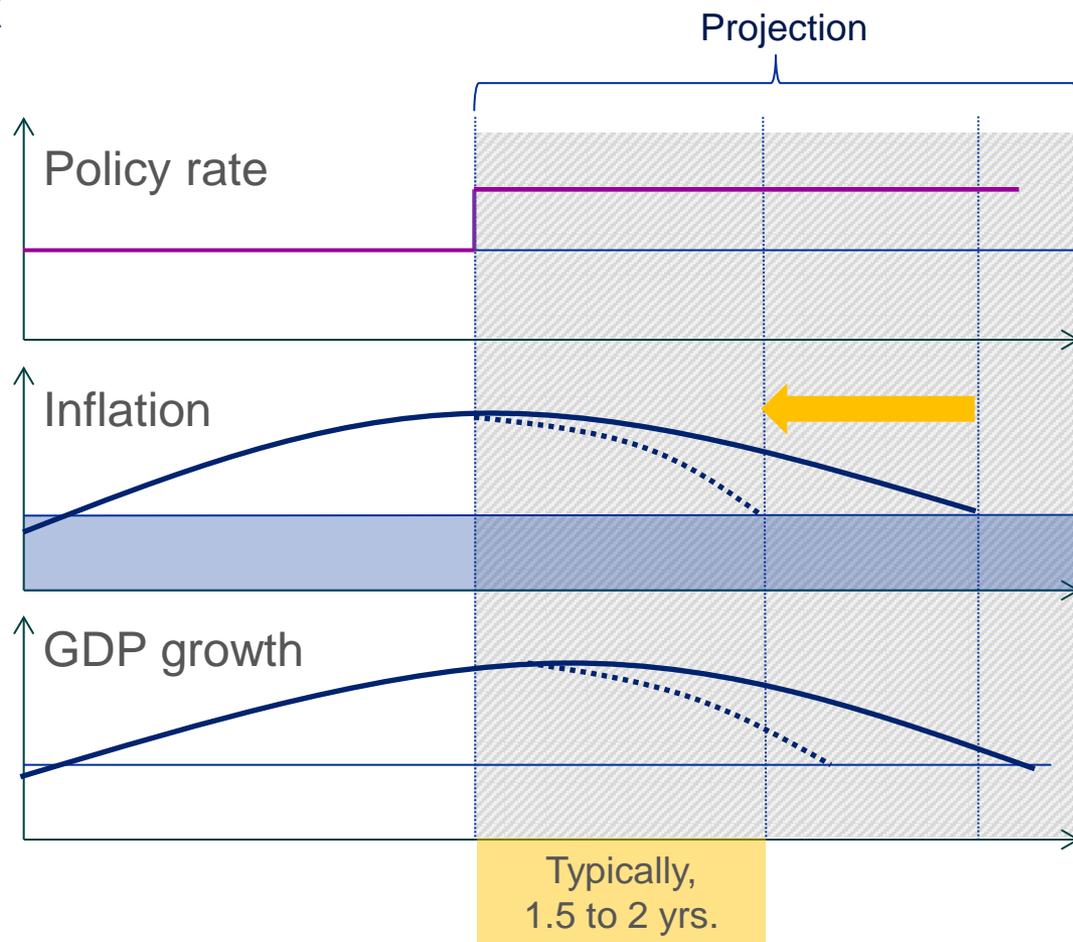
Adverse supply shock

*"In the case of some other shocks (e.g. of a **cost-push** nature) a **gradual response** is appropriate to avoid unnecessarily high volatility in real activity."*
[Letter of President Duisenberg to Econ Committee, 13 December 2001]

➢ But it poses a challenge to monetary policy: temporary vs. persistent effects; implications for inflation expectations

Projection

Policy rate

Inflation

GDP growth
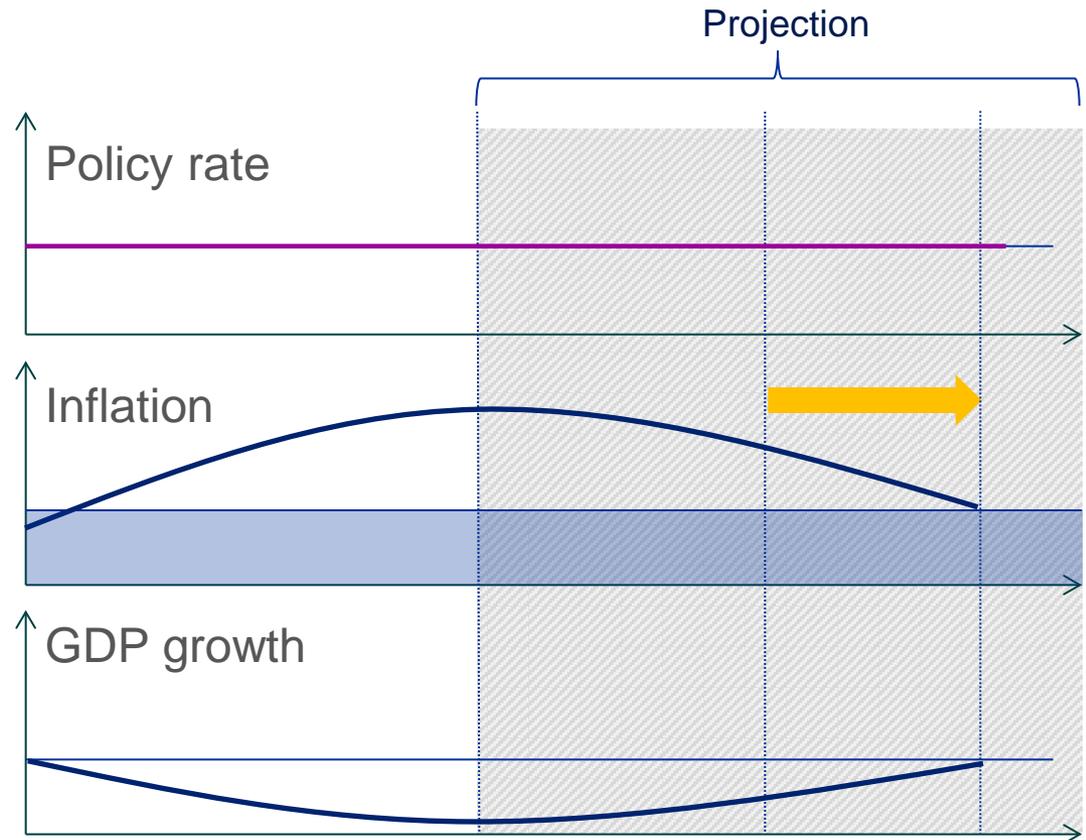
…but only as long as inflation expectations are well-anchored

Degree of anchoring of expectations

If a supply shock leads to a disanchoring of long-term inflation expectations, the outcome is similar to a pure **demand shock**, requiring a forceful response. [Speech of President Trichet at the ECB Watchers conference 5 September 2008]

Projection

Policy rate

Inflation

GDP growth
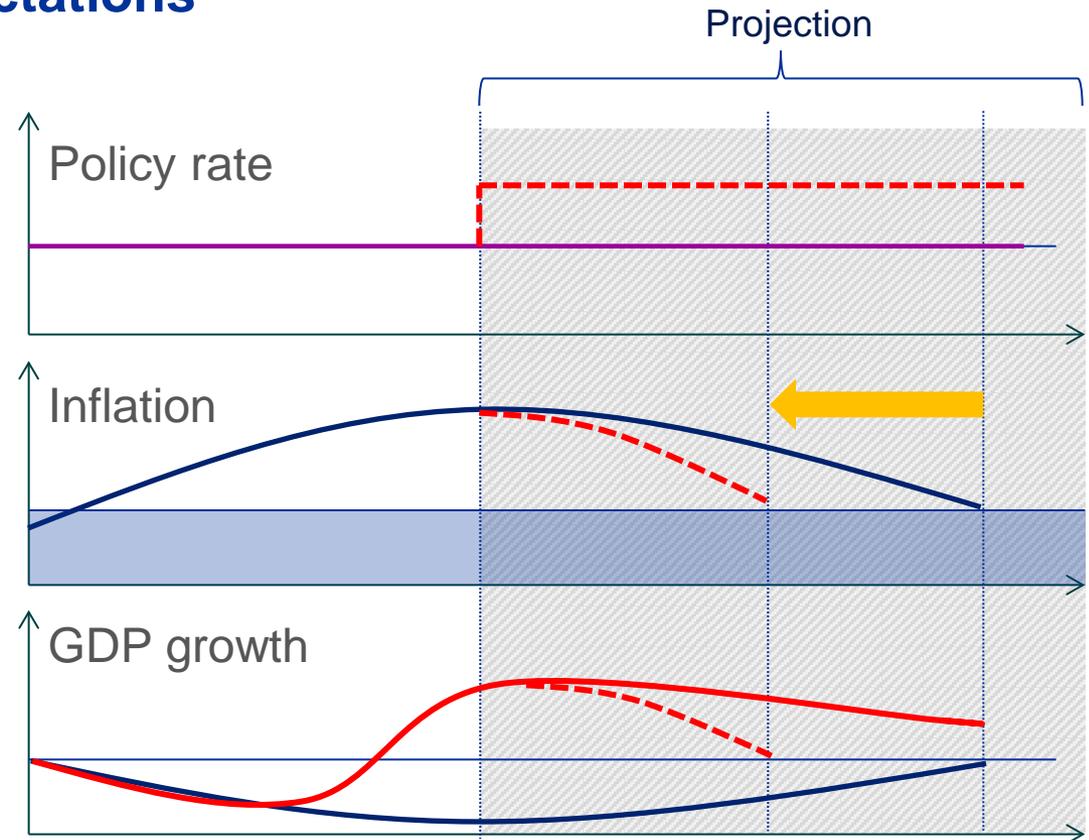
➢ But the length of the medium term cannot be arbitrarily extended to an horizon that would amount to discretion and would risk rendering the primary objective null and void.
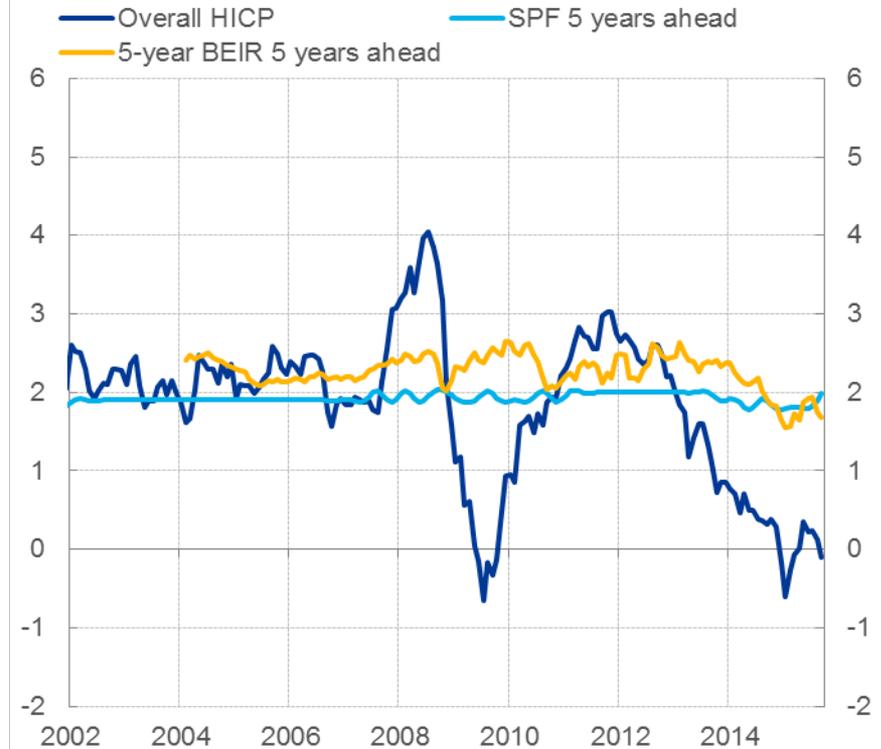
Drivers of inflation and inflation expectations

Euro area HICP inflation
(annual percentage changes)
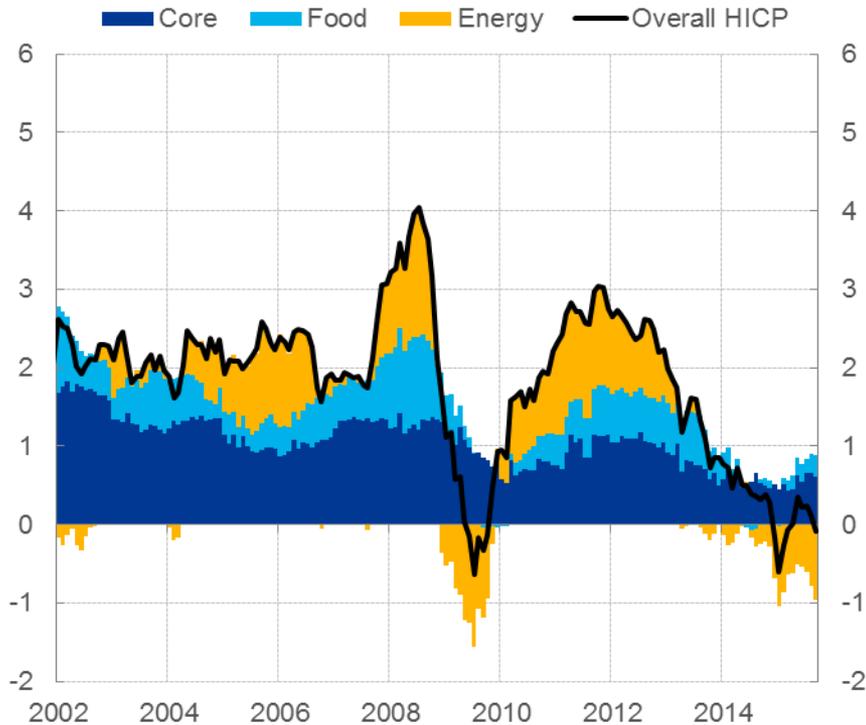
Source: Eurostat.
Latest observation: September 2015.

Long-term inflation expectations
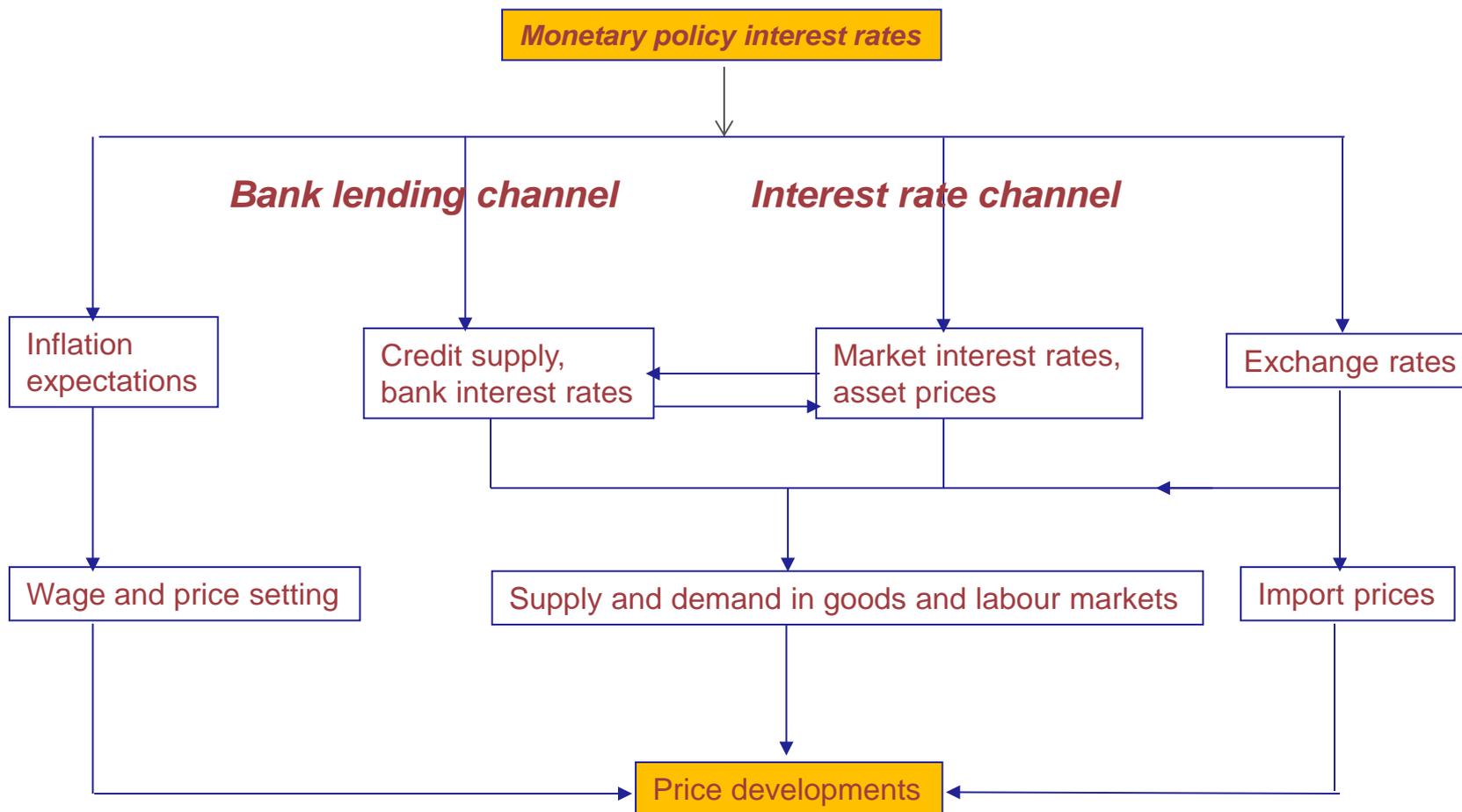*(annual percentage changes)*

Sources: Thomson Reuters, ECB calculations.
Latest observation: September 2015.

The monetary policy of the ECB

1	The monetary policy strategy: key features

2	The ECB's monetary policy in times of crisis

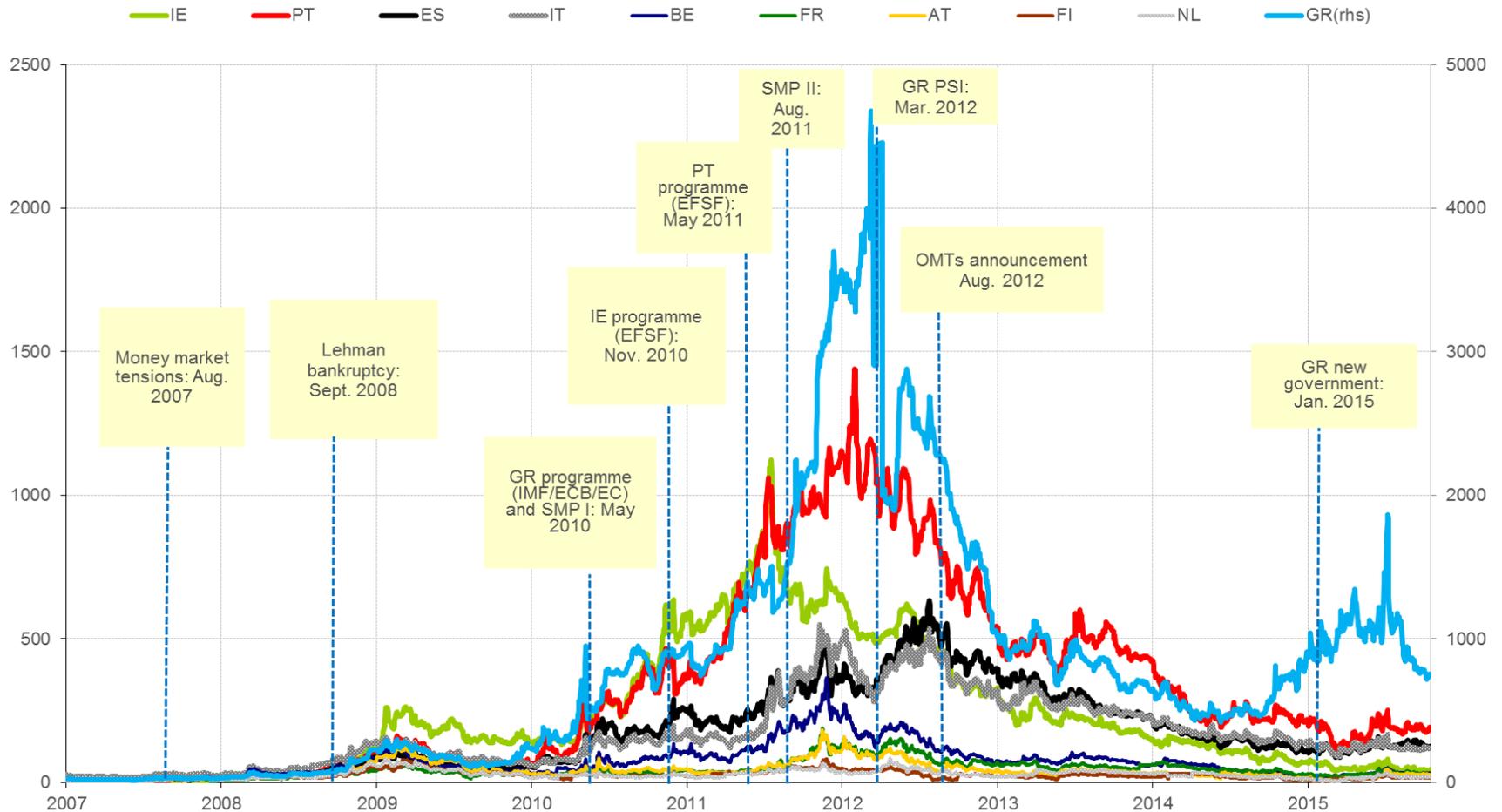| 3	Concluding remarks

Setting of the (standard) policy instrument

12-month EURIBOR/LIBOR – OIS spreads
(percent)
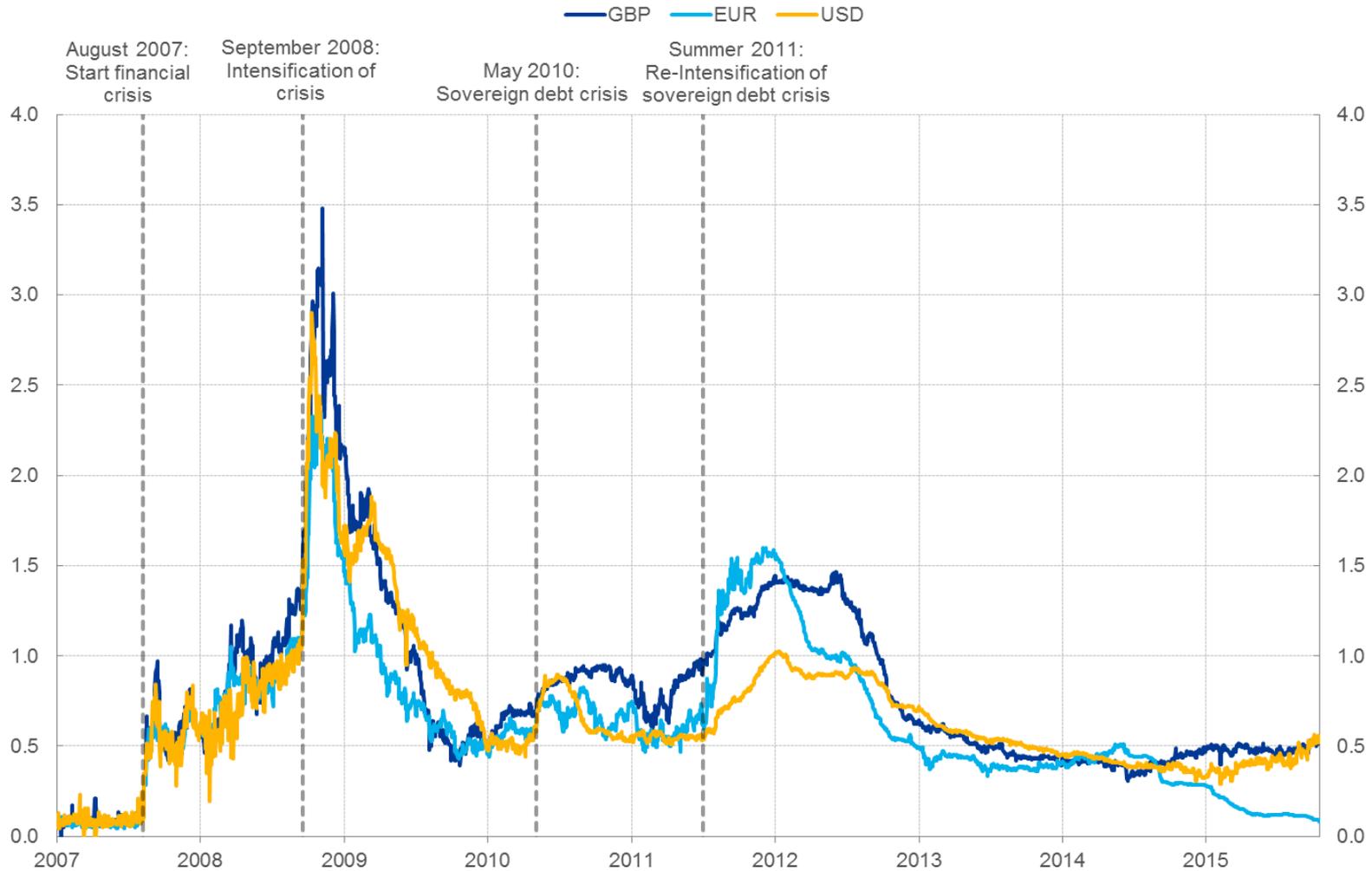
Sources: Bloomberg and ECB calculations.
Latest observation: 15 October 2015.

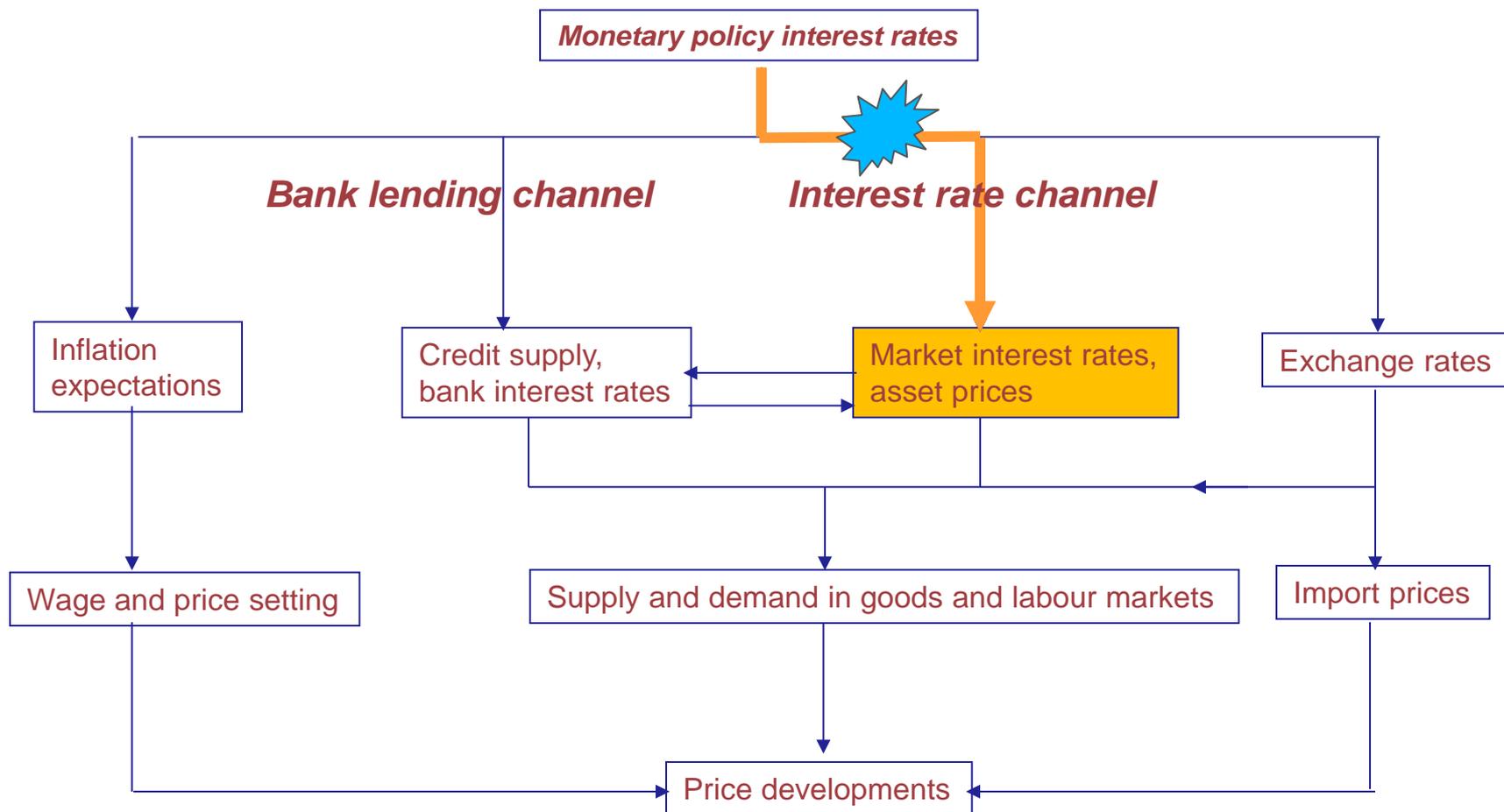## 10-year government bond spreads
(basis points)

Source: Datastream.
Latest observation: 15 October 2015.

Transmission of MRO rate reductions to bank lending rates
(percent)

Post-OMT easing cycle *(July 2012 – Feb. 2015)*
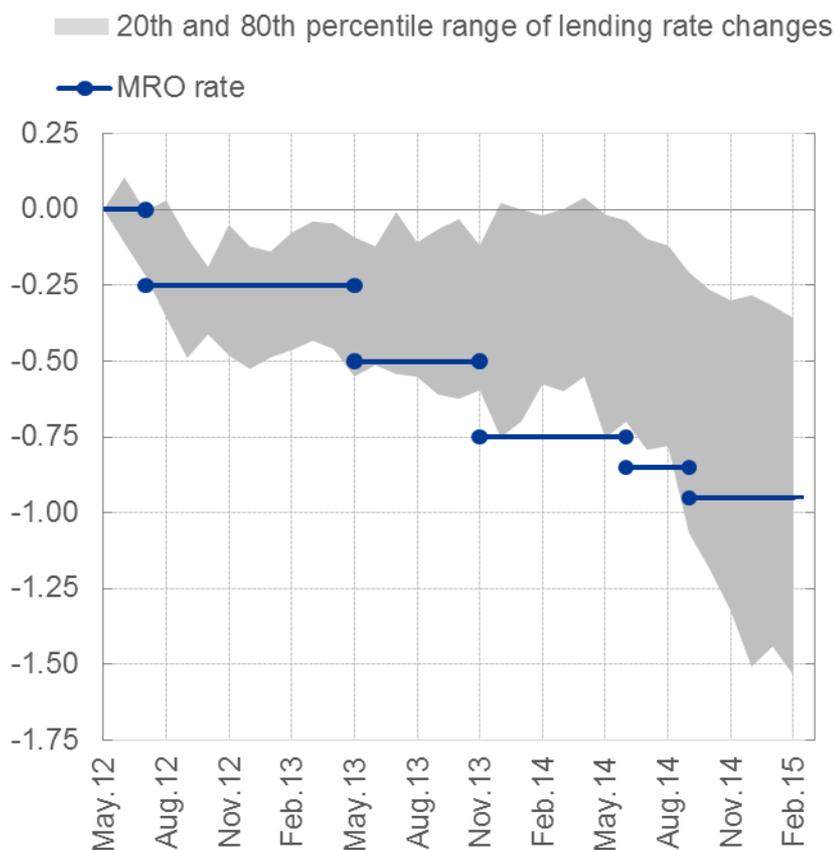
2002-2003 easing cycle *(Nov. 2002 – June 2003)*
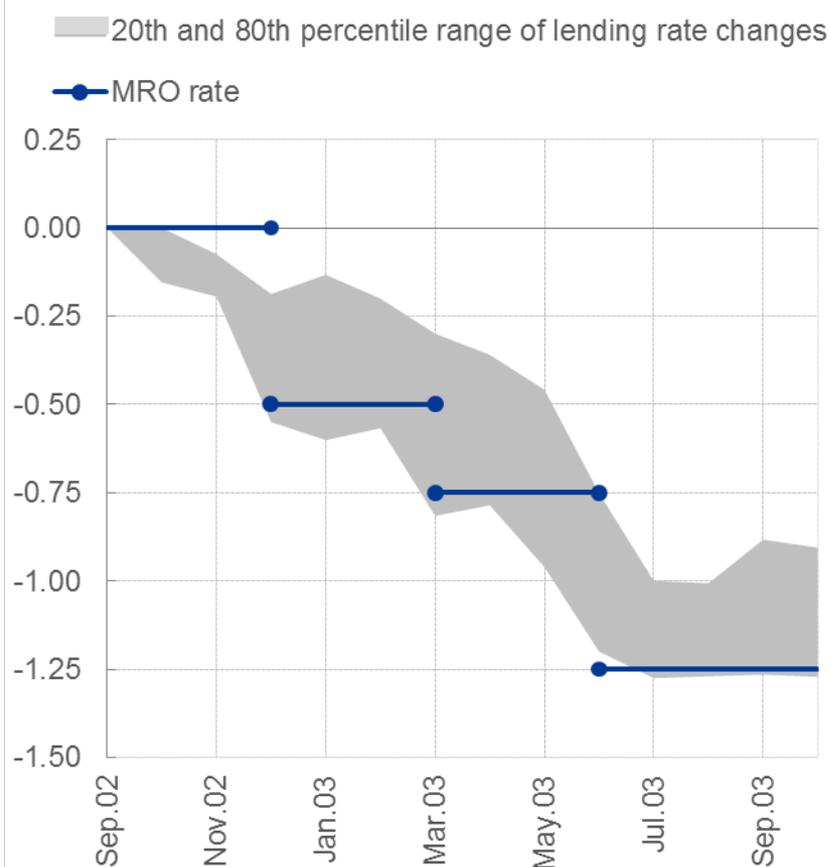
Sources: Reuters, ECB calculations.
Notes: Last observation for lending rates February 2015 (left chart) and October 2003 (right chart). The grey ranges define the 20th to 80th percentile of short-term bank lending rates for small-sized loans (<€1 million) to NFCs.

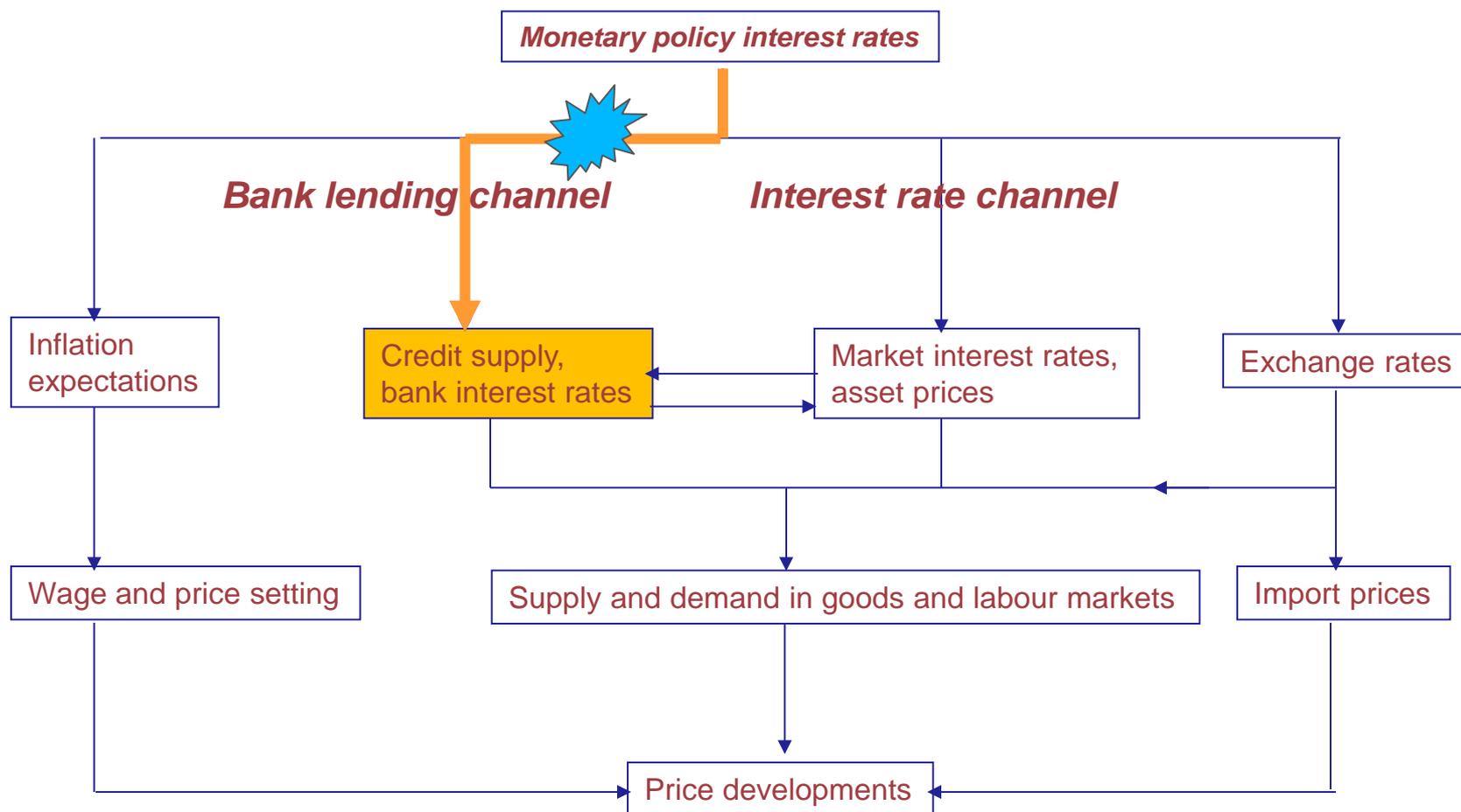## Impairments in bank lending channel continue to persist

Monetary policy interest rates

Bank lending channel

Interest rate channel

Inflation expectations

Credit supply, bank interest rates

Market interest rates, asset prices

Exchange rates

Wage and price setting

Supply and demand in goods and labour markets

Import prices

Price developments

The ECB's monetary policy response to the crisis

Overall strategy

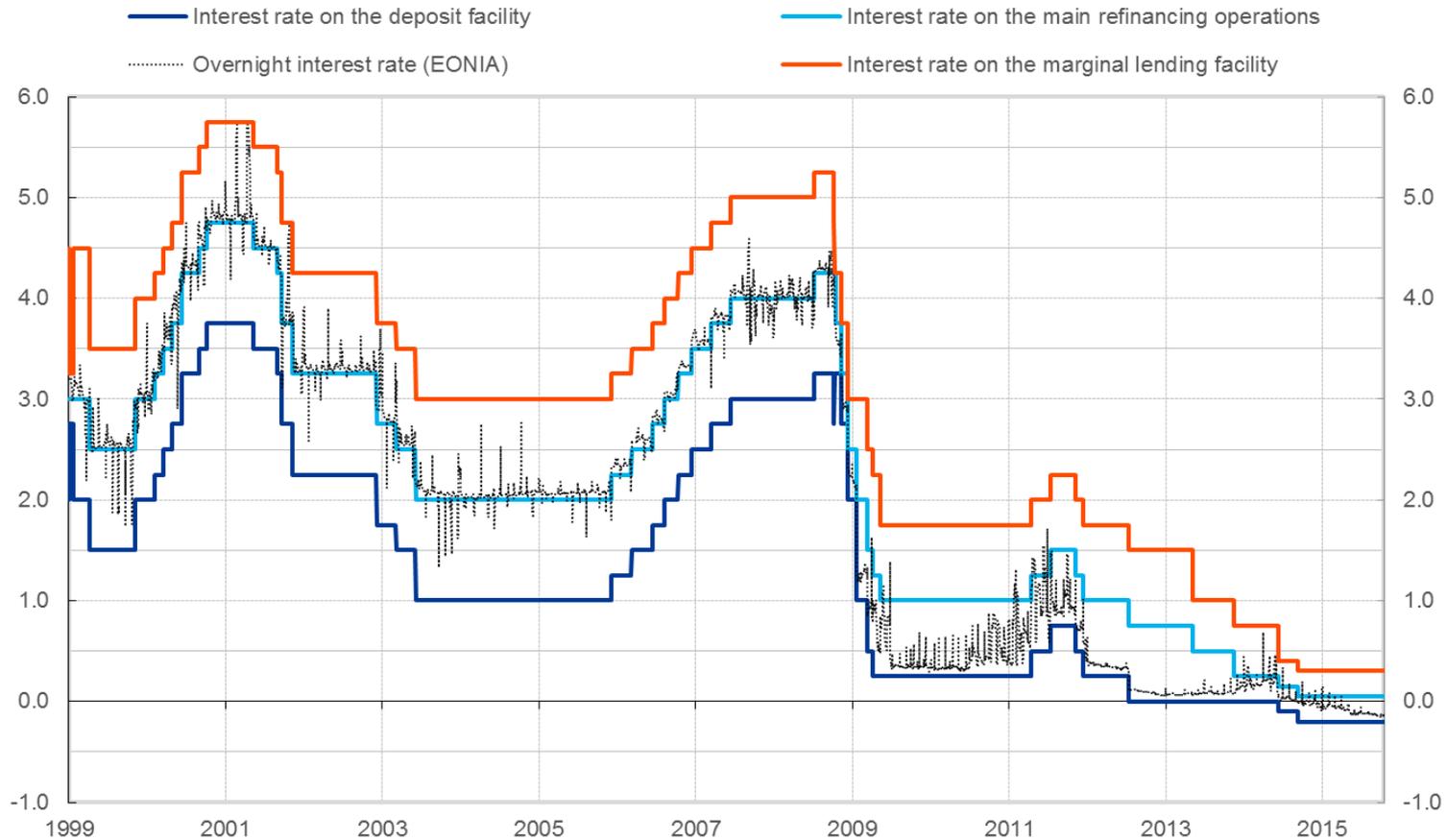Reductions in **main policy rates** counteract acute downside risks to price stability

Non-standard measures complement reductions in main policy rate in the presence of…

…impairments in monetary policy transmission mechanism

…limited room for further loosening (close to zero lower bound)

ECB rates and EONIA
(percentages per annum)

Legend:
— Interest rate on the deposit facility
— Interest rate on the main refinancing operations
······· Overnight interest rate (EONIA)
— Interest rate on the marginal lending facility

Sources: ECB, Thomson Reuters.
Latest observation: 15 October 2015.

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ECB non-standard monetary policy tools

- ## Liquidity and funding measures
  - Fixed-rate tender procedure with full allotment
  - Extension of the maturity of refinancing operations (3-year LTRO in Nov. 2011)
  - Expansion of the collateral pool

- ## Outright purchases in malfunctioning market segments
  - Securities Markets Programme
  - Covered Bond Purchase Programmes
  - Outright Monetary Transactions (Sept. 2012)

- ## Forward guidance (July 2013)

- ## Credit easing and asset purchases (June 2014 to January 2015)
  - Targeted Long-Term Refinancing Operations (TLTRO)
  - ABS Purchase Programme
  - Covered Bond Purchase Programme
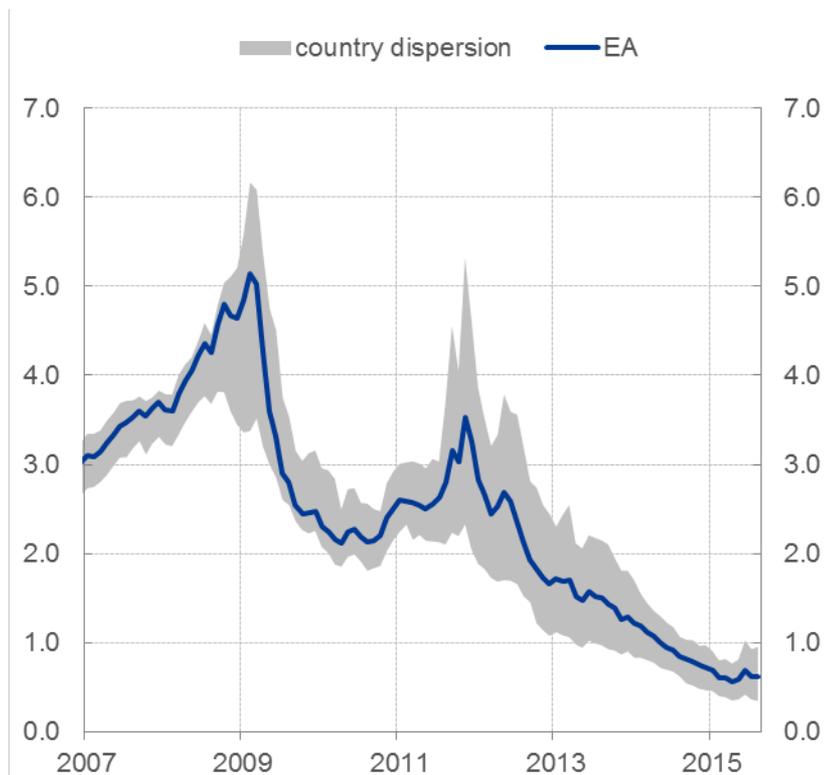 - Expanded Asset Purchase Programme (APP)

The monetary policy of the ECB

ECB measures have restored bank lending channel

Banks' cost of funding
(cost of bank deposit and non-secured market debt funding; percentages per annum)

Total cost of bank borrowing indicator to non-financial corporations
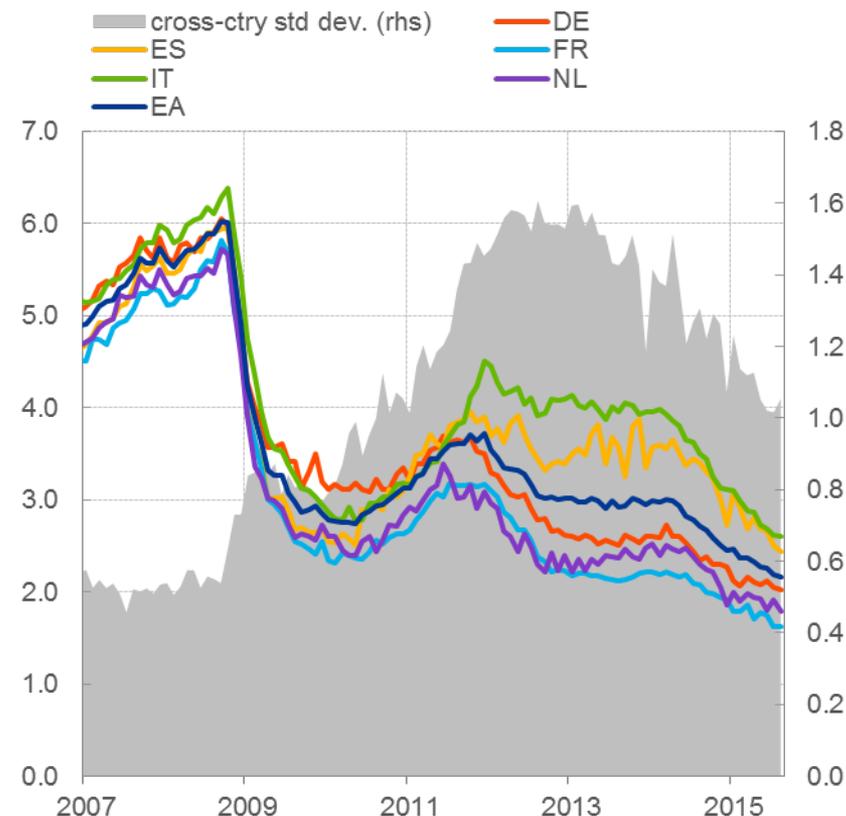*(percentages per annum)*

Sources: ECB, Merrill Lynch Global Index and ECB calculations.
Note: Weighted average of deposit rates on new business and cost of market debt funding. The country dispersion is calculated as min/max over a fixed sample of five euro area countries (DE, ES, FR, IT and NL).
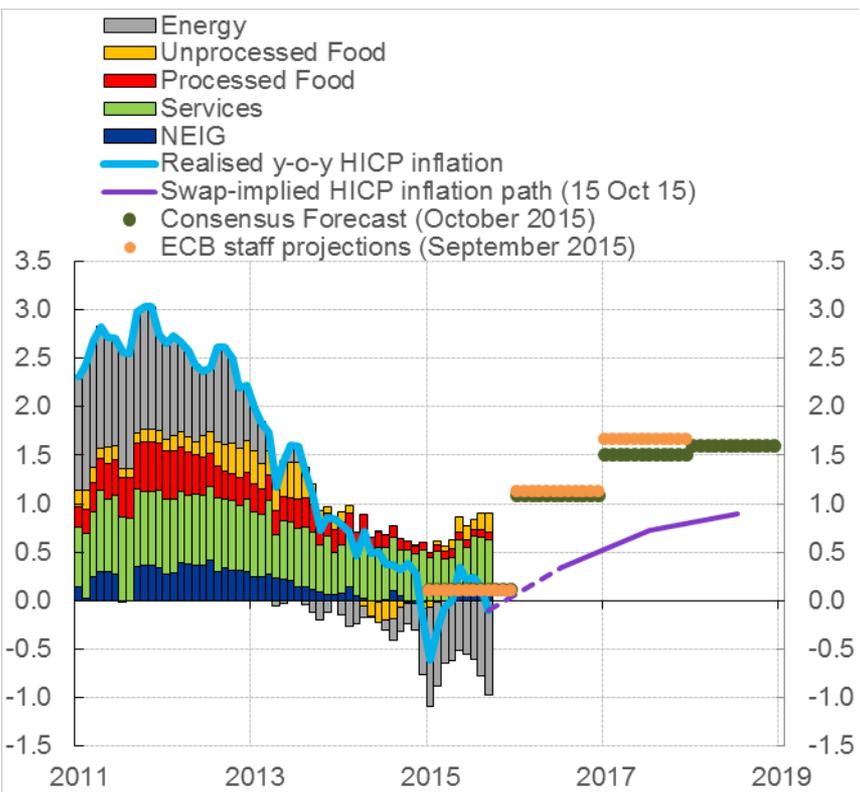*Latest observation: August 2015.*

Source: ECB.
Notes: The indicator for the total cost of borrowing is calculated by aggregating short and long-term rates using a 24-month moving average of new business volumes. The cross-country standard deviation is calculated over a fixed sample of 12 euro area countries.
Latest observation: August 2015.

Economic recovery remains subdued
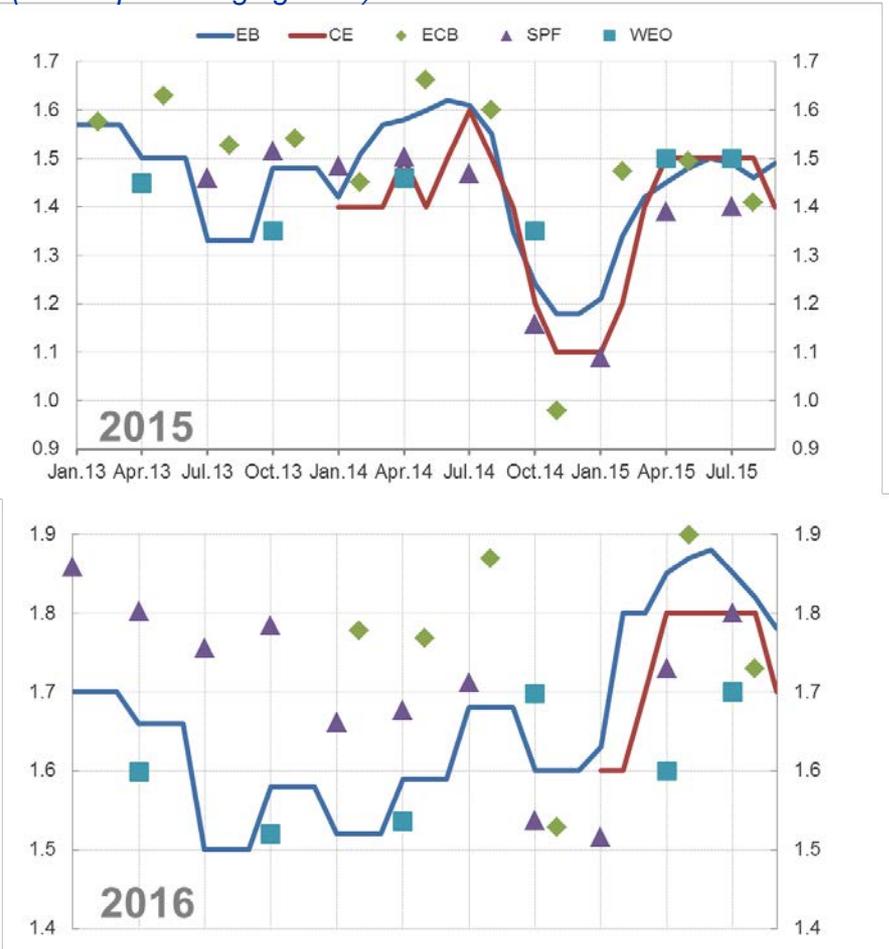
Euro area HICP path
(percentages per annum)

Sources: Thomson Reuters, Eurostat, ECB calculations, Consensus Economics.
Latest observation: 15 October 2015, September 2015 for HICP.

Vintages of euro area real GDP growth forecasts for 2015 and 2016
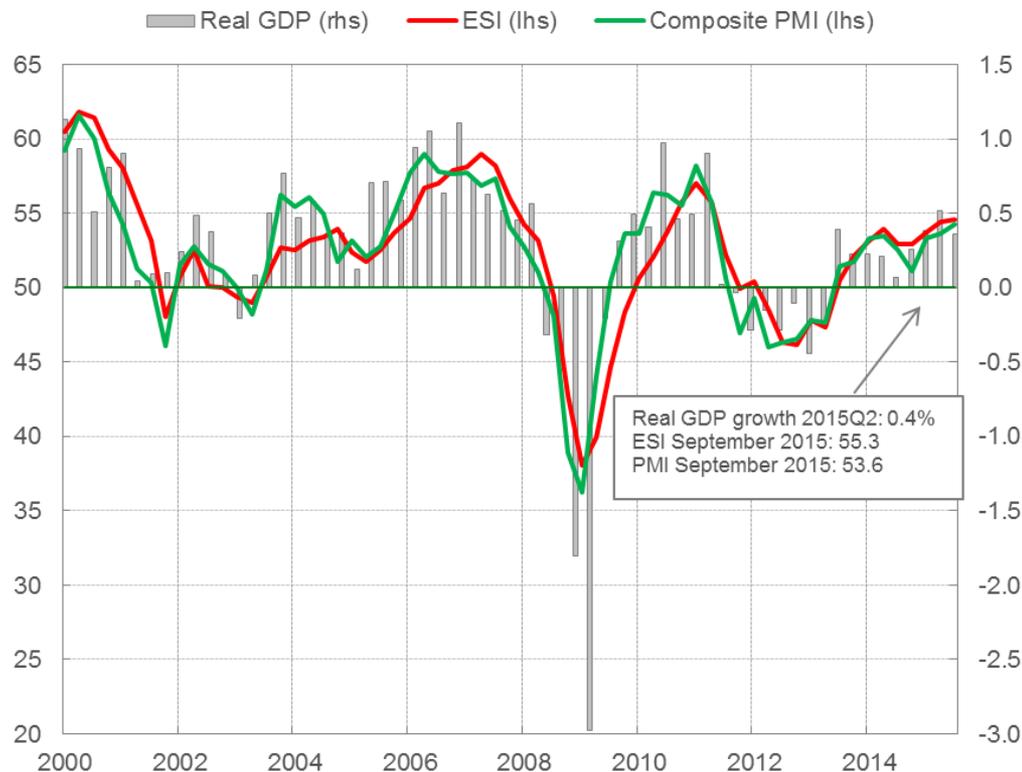*(annual percentage growth)*

Sources: World Economic Outlook (IMF), Eurozone Barometer (EB), Consensus Economics (CE), Survey of Professional Forecasters (SPF) and ESCB and ECB staff projections (ECB).
Note: X-axis refers to the date when the respective forecasts were finalised.

Euro area real GDP, composite PMI and ESI
(quarter-on-quarter growth rate, diffusion index and percentage balance)

Legend: Real GDP (rhs) — ESI (lhs) — Composite PMI (lhs)

Real GDP growth 2015Q2: 0.4%
ESI September 2015: 55.3
PMI September 2015: 53.6

- *"The final PMI reading came in slightly below the earlier flash estimate but still leaves a signal of the eurozone economy having expanded 0.4% in the third quarter."*

- *"However, the failure of the economy to pick up speed over the summer will be a disappointment to the ECB, especially with job creation sliding to an eight-month low."*

Markit Eurozone PMI (5 October 2015)

Sources: Markit, DG-ECFIN and Eurostat.
Latest observation: 2015 Q2 for GDP outcome, September 2015 for the ESI and the PMI.

Ensuring a sustainable recovery

- **Monetary policy has been a key actor in the policy response to the crisis**

- **Progress has been made on the institutional framework of the euro area but remains incomplete**

  - Five Presidents' Report outlines the road map

    - Establishment of a banking union

- **Other policy areas have a role to play**

  - Reforms aimed at raising growth potential can ensure the sustainability of the recovery

Establishing a European banking union

Pillars of a European banking union

Banking union

Supervision	Resolution	Deposit guarantee
• SSM	• Single rulebook with bail-in rules • Single Resolution Board • Single Resolution Fund	• European Commission to make a proposal

Strengthened framework aimed at:

- *preventing banking crises*
- *ensuring orderly resolution of banks in the event of a bank failure*
- *breaking nexus between banks and sovereigns*

Thank You