ECB Monetary Policy: Between a Rock and a Hard Place

Athens-21/22 November-2014
Lex Hoogduin
University of Groningen and Duisenberg School of Finance Amsterdam
Introduction

• ECB looked at as solver of the eurocrisis

• Or at least ECB can buy time for other parties (governments in particular) to come up with a solution

• Will take another perspective
Agenda

• 1. The ECB’s mandate in the EU Treaty and its Statutes

• 2. Where do we stand now?

• 3. The road ahead
ECB’s mandate (1)

• Policy objective given by the Maastricht Treaty

• Primary objective: to maintain price stability

• Support economic policies of the EU without prejudice to price stability
ECB’s mandate (2)

• This objective has been defined and further clarified

• Price stability is defined as an increase of the HICP of the euro area as a whole of below, but close to 2%

• Price stability is to be maintained in the medium term
ECB’s mandate (3)

• Definition is symmetric

• Deflation/too low inflation is disliked, like inflation

• Participating countries in EMU have to meet the so-called convergence criteria on a sustainable basis
ECB’s mandate (4)

• Otherwise no sound basis for the euro and a common monetary policy

• Note that the Treaty stipulates that the euro area is a market economy

• The analytical framework underlying monetary policy is the New Keynesian model
ECB’s mandate (5)

• Money is supposed to be neutral in the medium to long run; Monetary policy can only affect inflation over that horizon, it cannot impact real variables

• Due to frictions in markets, monetary policy has short-to medium term real effects

• Market flexibility is seen as a good thing; It improves welfare and enhances the transmission of monetary policy
ECB’s mandate (6)

• The policy instrument is the short term interest rate

• There is a clear operational framework, but as little as possible ECB interference in financial markets
Where do we stand?(1)

• The framework lies in tatters; non-regime

• Triggered by two things:
  1. Non-compliance with convergence criteria, government finance and the real exchange rate in particular
  2. Strongly asymmetric shock as a result of the worldwide financial crisis; divergence
Where do we stand? (2)

• Criteria for a common monetary policy clearly no longer fulfilled

• ECB victim of the crisis

• Operational framework adapted:
  • 1. Unlimited access
  • 2. Relaxation of the collateral framework
  • 3. Lenghtening maturities of operations
  • 4. SMP and Covered Bond Programme
  • 5. OMT
  • 6. Second Covered Bond Programme and ABS Programme
Where do we stand? (3)

• Interest rate at zero lower bound

• Standard monetary policy has become ineffective

• Own objective not met anymore
Where do we stand? (4)

• Lowflation and deflation

• ECB can only influence average inflation

• Spread problem
Where do we stand? (5)

• Inflation in Southern Europe should be below objective; it is
• In Northern Europe above; it is not
What can be done? (1)

• 1. Extend non-standard measures; prepare QE for if current policies do not have sufficient impact

• Cannot be excluded that recent measures will not work sufficiently

• QE may not solve it either
What can be done? (2)

• QE and other non-standard measures have high costs and may be counterproductive
• A. Formation of bubbles
• B. Hampering/destroying market functioning
• C. Changing incentives for and market behaviour of financial institutions/market participants

• 2. Announce as ECB to be unable to deliver price stability as long as underlying problems have not been tackled
What can be done? (3)

• 3. Redefine price stability as long as the convergence criteria are not complied with

• 4. Emphasise necessary support of other policies

• Is what ECB does already, mainly focusing on structural reforms and fiscal policies
What can be done? (4)

• But fiscal policy within the framework of the adapted Stability and Growth Pact (SGP)

• Could consider not only using maximum flexibility within SGP, but also relaxing the rules

• Understandable resistance in core countries
What can be done? (5)

• Part of the problem: too high taxes/ too big government; not stimulating growth

• From that perspective: government the problem rather than the solution

• Role of wage policies: promote higher nominal wages in core countries
What can be done? (6)

• Not easy to achieve

• New Keynesian model does not provide analytical framework that enables thinking about it

• Longer term redefinition of monetary policy framework
What can be done? (7)

• Not exclusively an euro area issue

• How to exit the current non-framework?

• How to get rid of unconventional monetary policy?
THANK YOU FOR YOUR ATTENTION!