ECB Monetary Policy: Between a Rock and a Hard Place

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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!**