Ten years of common monetary policy

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The European Central Bank was established on 1 June 1998 and has been pursuing an independent monetary policy for the past ten years, since January 1999. The Governing Council of the ECB set itself the objective of securing price stability in the euro area, defining this as the rate of general increase in prices remaining below 2% in the medium term. It has been successful in this objective in spite of strong shocks that have affected price developments from time to time. Inflation expectations have remained anchored in line with price stability. The monetary policy framework defined by the ECB in order to implement its monetary policy has ensured an effective steering of interest rates and liquidity in the euro area. The framework has also proven very flexible in the challenging context of the present international financial crisis.

ECB monetary policy

The European System of Central Banks (ESCB) consists of the European Central Bank (ECB) and the national central banks of the member states of the European Union (EU). The ESCB operates in accordance with the Treaty establishing the European Community and the Statute of the European System of Central Banks and of the European Central Bank and under the management of the ECB's decision-making bodies. The Governing Council of the ECB defines monetary policy, and the Executive Board implements it in accordance with the decisions and guidelines of the Governing Council. The ECB and the central banks of the EU member states that have adopted the euro comprise the Eurosystem. To the extent possible and appropriate, and if necessary to ensuring efficient operations, the ECB can use national central banks to carry out operations falling within the scope of the Eurosystem. The monetary policy operations of the Eurosystem are undertaken on identical terms in all member states.

The primary objective of the Eurosystem as determined in the Treaty is to maintain price stability. Without prejudice to this primary objective, the Eurosystem is also expected to support the general economic policies of the European Community. In pursuing these objectives, the Eurosystem must act in accordance with the principle of an open market economy with free competition, favouring the efficient allocation of resources.

Definition of monetary policy strategy

When the Governing Council of the ECB began its activities in 1998, it defined price stability in the euro area as an annual increase of less than 2% in the Harmonised Index of Consumer Prices (HICP) in the medium term. A quantitative definition of price stability clarifies monetary policy decision-making, increases its transparency and steers

inflation expectations. The objective has been set for the medium term. This provides for flexibility in monetary policy in connection with disruptions in production, and takes account of the fact that monetary policy cannot even out every shock affecting price developments. In 2003, the Governing Council further specified its strategy by announcing that it would aim to keep the inflation rate below, but close to, 2% in the medium term. According to this definition of price stability, deflation, or a general decline in the level of prices, is inconsistent with price stability. Setting the upper limit of inflation well above zero corrects the impact of the positive measurement error exaggerating inflation that is present in the measurement of inflation.

The monetary policy of the ECB includes an analysis of risks to price stability. The approach used by the ECB to conceptualise, evaluate and compare information relevant to the analysis of the risks to price stability is based on two perspectives of analysis. These are called the two pillars: the key role of the money supply (1st pillar) and a broad analysis of inflation prospects (2nd pillar). The Governing Council confirmed and further clarified this approach in May 2003 by instituting two mutually complementary aspects of analysis to conceptualise the information relating to the determination of price stability. The first, the economic analysis aspect, is used to evaluate developments in the real economy and the financial markets in the short and medium term. The second, the monetary analysis aspect, makes use of information on the long-term relationship between the money supply and prices.

The analysis of the real economy focuses on GDP, demand, labour markets, a range of price and cost indicators as well as fiscal policy and the balance of payments for the euro area. The estimates of experts on the economic prospects for the euro area play a key role. They are based on a scenario derived from technical assumptions. At the outset, one of these technical assumptions was that short-term interest rates would remain constant. This assumption has been replaced since June 2006 by short-term market expectations of future interest rate developments. In this way the assumed monetary policy is consistent with price stability, while monetary policy shocks do not affect the estimates of future economic prospects.

The ECB seeks to meet its price stability objective by extensive analysis of the risks to price stability.

Monetary analysis makes use of data on asset prices and returns on financial instruments. Assessments of future price developments calculated on the basis of financial market performance are one of the indicators of risks to price stability. Inflation expectations are also measured with consumer and business surveys and consensus estimates. Deviations in inflation expectations from a position consistent with the definition of price

stability reflect potential credibility issues relating to the conduct of monetary policy. Inflation expectations and estimates of future price developments by Eurosystem experts are of key importance for economic analysis and determination of the monetary policy stance.

Besides the long-term relationship between the money supply and prices, monetary analysis also concerns the institutional characteristics of the financial and credit institution sector and developments in the counter-items of monetary aggregates, particularly loans. At the same time, the reference value set for development of the money supply has become less important, this being a growth rate of M3 considered consistent with price stability in the medium term.

The ECB's main monetary policy instrument is the weekly main refinancing operations.

In recent years, economic analysis and monetary analysis have converged due to increased utilisation of financial sector balance sheet statistics and statistics describing the development of the credit markets. Any escalation of imbalances in the financial markets or ballooning of asset price bubbles may generate uncertainty in economic developments, financial market stability and, eventually, prices.

Economic and monetary analyses ensure that different views are taken appropriately into account and that an overall assessment of the risks to price stability can be made. When the economic situation is interpreted from two different points of view, it reduces the risk of mistakes in monetary policy decision-making due to excessive reliance on any single indicator, forecast or model.

Monetary policy instruments

In order to achieve its objectives, the Eurosystem has at its disposal a range of monetary policy instruments. It conducts open market operations, provides a standing facilities system for its counterparties and requires that credit institutions keep minimum reserves on accounts with Eurosystem central banks.

Open market operations adjust interest rates, respond to liquidity needs in the markets and communicate the monetary policy stance. The main instrument for expressing and implementing the monetary policy stance is the weekly main refinancing operations. These are collateralised loans (reverse transactions) to increase liquidity, whose manner of implementation has varied from variable-rate to fixed-rate auctions. At present, the maturity of the operations is one week. In addition, the ECB has made longer-term 3-month reverse financing operations on a monthly basis. Besides reverse transactions, the Eurosystem may also conduct direct transactions, issue debt obligations, make currency swaps and collect term deposits (Chart 1).

The lending and deposit rates in the standing facilities system form an interest-rate corridor that determines the range of the overnight market

rate (Chart 2). The marginal lending facility allows counterparties to satisfy temporary liquidity needs by taking out overnight liquidity from the national central banks against eligible collateral. Under normal circumstances, the interest rate on the marginal lending facility constitutes an upper limit for the overnight market rate. The deposit facility, meanwhile, enables counterparties to make overnight deposits at the central banks. Under normal circumstances, the interest rate on the deposit constitutes a lower limit for the overnight market rate. By ensuring the availability of liquidity to credit institutions, the Eurosystem secures the smooth operation of financial markets.

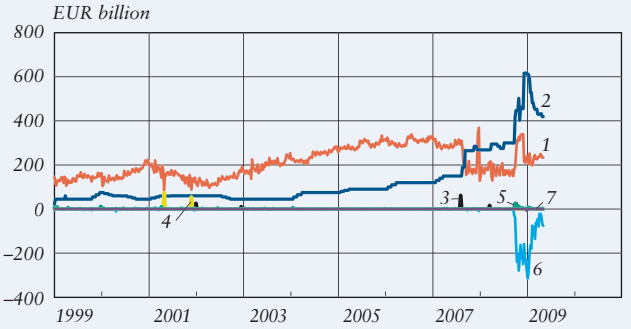
The Eurosystem's minimum reserve system applies to credit institutions in the euro area, and its primary purpose is to even out money market rates and create a need for structural central bank finance. The purpose of the averaging related to the minimum reserve system is to facilitate the stabilisation of money market rates by encouraging institutions to even out the impacts of temporary fluctuations in liquidity.

The monetary policy rate

The ECB implements monetary policy through open market operations and the standing facilities system. The monetary policy stance is expressed by the Governing Council of the ECB primarily through its interest rate

Chart 1.

ECB monetary policy operations

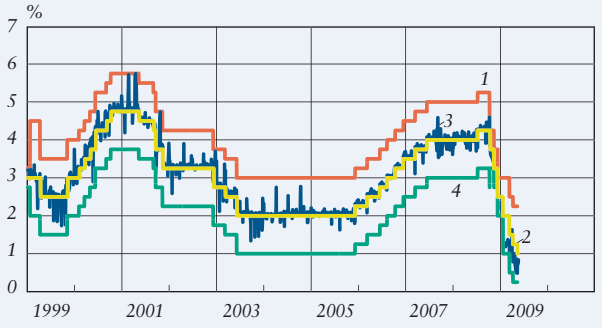


1. Main refinancing operations
2. Longer-term refinancing operations
3. Fine-tuning operations (assets)
4. Structural operations
5. Marginal lending facility
6. Deposits
7. Fine-tuning operations (liabilities)

Source: European Central Bank.

Chart 2.

ECB policy rates and Eonia rate

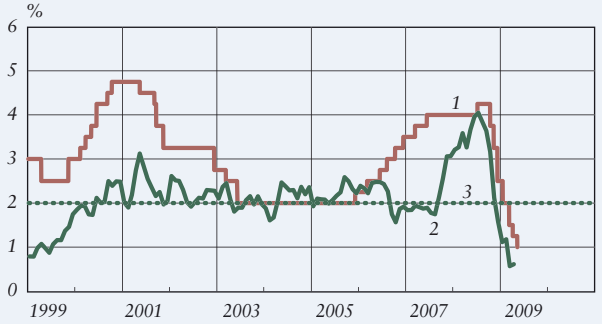


1. Marginal lending rate
2. Main refinancing rate
3. Eonia rate
4. Marginal deposit rate

Source: European Central Bank.

Chart 3.

Key policy rate and inflation

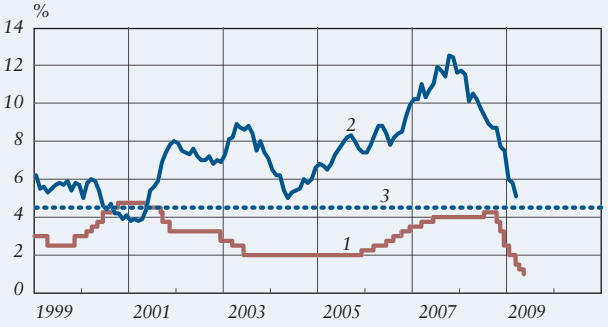


1. Main refinancing rate
2. Harmonised index of consumer prices, 12-month % change
3. Upper limit of price stability

Sources: European Central Bank and Eurostat.

Chart 4.

Key policy rate and money supply



1. Main refinancing rate
2. Money supply (M3*), 12-month % change
3. Money supply reference value

* Seasonally adjusted figures

Source: European Central Bank.

policy. Since the establishment of the ECB, its key monetary policy rate has been the rate on the main refinancing operations or minimum bid rate.

By adjusting the price of short-term money the central bank can influence the state of the financial markets, tightening or loosening it. The central bank's interest rate decisions are impact on the economy via several channels. The most important is the interest rate channel: the policy rate and expectations of its future development are reflected in both short-term and long-term nominal market rates. The policy rate and inflation expectations together determine, through aggregate demand, the development of long-term real interest rates, which in turn have an impact on the development of the real economy. Another monetary policy channel is the credit channel, which has an impact through the volume of bank lending and the real price of credit. By influencing demand for goods and services, the central bank influences the development of prices in the economy. The effect of monetary policy operations on price development is usually only visible after a long period, since the channelling of monetary policy takes place in several phases including a range of different mechanisms and economic agents. Since the extent and strength of the impact may also vary according to the economic situation, it is difficult to assess precisely. The adjacent charts (Chart 3 and Chart 4) illustrate the

main variables for the implementation of the ECB's monetary policy and the monetary policy strategy, namely interest rates, inflation, the upper limit of the definition of price stability, the money supply and the related reference value.

Since the establishment of the ECB, the monetary policy rate has been at its highest in October 2000, when it stood at 4.75%, and at its lowest in May 2009, at 1%. Annual HICP inflation in the euro area has varied between 0.6 and 4.0%. It was at its highest in June 2008 and at its lowest in April 1999. Average inflation in the euro area in 1999–2008 has been 2.2%. Price fluctuations have been affected most by variations in the price of food and energy. Annual growth in the broad money aggregate (M3) in the euro area has ranged from 4.9% (in 2000) to 11.1% (in 2007) and has averaged 7.4% in 1999–2008.

When the ECB began operating, it faced a situation of diminishing price risks, and in April 1999 it cut the policy rate from 3% by 0.5 percentage points. In the second half of 1999 and the early months of the following year, inflation began to accelerate in line with increasing oil prices, and, in the wake of economic growth, the upward risks to inflation increased. As monetary analysis also pointed in the same direction, the ECB increased its policy rate by 2.25 percentage points between November 1999 and October 2000. The annual increase in prices peaked in May 2001, when inflation reached 3.1%. The acceleration in inflation was due to an unexpected increase in the prices of energy and, particularly, unprocessed foodstuffs as uncertainty relating to the spread of animal diseases pushed up food prices.

In the aftermath of the terrorist attack on 11 September 2001, global economic growth began to slow and monetary policymakers the world over emphasised the importance of ensuring the smooth operation of financial markets. Thereafter, the risks to price stability gradually decreased and the ECB cut its policy rate to 2% by June 2003. In 2000–2005, inflation in the euro area was slightly higher than a rate consistent with the definition of price stability, ranging from 2.1 to 2.3%. Economic growth in the euro area slowed to well below potential growth, touching a low of 0.9% in 2002. In addition, geopolitical tensions in the world economy sustained the downside risks to growth. Exceptionally large variations in the subcomponents of monetary aggregates and alternative investments that occurred during this period made interpretation of the money supply a difficult process.

Economic growth in the euro area began to pick up in mid-2003 in the wake of global economic growth. Growth in the money supply also began to accelerate gradually and MFI lending increased, while interest rates remained low. An increase in the

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amount of liquidity together with strengthening economic growth gradually began to increase the upside risks to price stability. In order to secure price stability in the euro area, the Governing Council of the ECB increased the policy rate between November 2005 and June 2007 by 2 percentage points to 4%. In 2006–2007, fluctuating energy prices meant there were also increased variations in the rate of inflation, but HICP inflation remained at an annual level of 2.2% and 2.1%, respectively. Towards the end of 2007, inflation began to rise well above a level consistent with the definition of price stability, due particularly to an increase in oil and food prices. Although inflation expectations did not increase correspondingly, the ECB assessed that the upside risks to price stability had increased. Stability was particularly threatened by risks from second-round effects of a potential spiral of price and wage increases. Economic growth in the euro area accelerated to 2.6% in 2006 and 2.7% in 2007 due to strong domestic demand.

The financial market crisis sparked in August 2007 from the collapse of the US subprime mortgage loan markets significantly increased the uncertainty surrounding economic developments. It was hard to assess the impacts of the financial market crisis on the real economy. At the same time, rapid growth in the money supply and lending indicated the existence of upside risks to prices. In order to prevent second-round effects, the ECB increased the policy rate further, to 4.25%, in July 2008.

In September 2008, after the bankruptcy of the Lehman Brothers investment bank, the economic outlook changed at unprecedented speed. World trade and household confidence collapsed and uncertainty about the state of financial institutions increased despite massive public support measures. Economic growth in the euro area remained at 0.8% in 2008, and the forecasts for growth in 2009 are clearly negative. Inflation in 2008 was 3.3% on average, but has slowed significantly since then, standing at 0.6% in April 2009. The eventual upswing is expected to start slowly, and upside risks to inflation are minor for the time being. Due to these developments, the ECB has reduced its policy rate between October 2008 and May 2009 by 3.25 percentage points, to 1%.

Monetary policy measures during the financial crisis

The impacts of the financial crisis have been extensive. The crisis has undermined banks' balance sheets and capital adequacy. In many countries, there has been a need to recapitalise banks in different ways, or governments have been forced to take full or partial ownership in them. Banks' need to cut their balance sheets to maintain capital adequacy has reduced their ability to

grant loans to households and companies. Due to uncertainty over banking liquidity and capital adequacy, the trust between banks has been reduced to the extent that normal interbank money market trade has almost dried up, which is why banks have had to borrow large sums from central banks as liquidity buffers. Risk premia have grown in all markets. While the cost of market-driven funding has increased, its maturity has shortened, further reducing banks' ability to finance investments and other long-term projects.

As a consequence of the unprecedentedly broad recession, the rise in prices has slowed everywhere. Euro area inflation has slowed rapidly and is expected to sink temporarily into negative territory in the coming months. Decelerating inflation and the replacement of price risks by deflation risks have meant a rapid easing of monetary policy everywhere. The Governing Council of the ECB has lowered its policy rate to 1% since October 2008. In many countries, such as the United States and Great Britain, the lower limit of nominal interest rates, the zero lower bound, has been reached, after which traditional monetary policy easing is no longer possible. As a consequence, the ability of central banks to have an impact on long-term real interest rates is reduced. Particularly detrimental developments would be protracted deflation and the spread of negative inflation expectations, in which case expected real interest rates would begin to rise. The consequence would be a protracted recession due to excessively high real interest rates.

In order to prevent the liquidity trap and deflation spiral, central banks have sought to cut their interest rates rapidly all the way to the zero lower bound. Even thereafter, central banks have access to a range of measures to ease monetary policy. These have begun to be referred to as non-standard measures.

A central bank can have an impact on interest rate expectations by committing to low interest rates for a longer period. It can also operate directly in the market for longer-term loan papers with or without risk so as to affect their price and thereby the yield curve. Reduction of the risk premium in a distressed market is in effect tantamount to a policy rate cut.

Monetary policy can also be eased by broadening the monetary base, in which case the balance sheet of the central bank grows on the liabilities side. This is known as quantitative easing, and was pursued by the central bank of Japan at the beginning of the present decade. Lately, the Bank of England has announced measures that can be considered quantitative easing. In contrast, the fact that many central banks – including the Eurosystem – have had to increase the level of

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additional reserves on their balance sheets to respond to the increased demand for liquidity in the banking system does not constitute quantitative easing.

When a central bank adjusts the assets side of its balance sheet, it is said to pursue a policy of credit easing. It may purchase securities from counterparty banks or other market participants. The purchased securities may be either public or private. These measures are intended to have an impact on the relative prices of different categories of securities.

The Eurosystem has adopted non-standard measures with careful consideration and selection. The ECB's monetary policy framework has proven to be sufficiently flexible to manage the liquidity crisis in the interbank market. Migration to fixed-interest-rate full-allotment auctions played a key role in this respect. Utilisation of the normal monetary policy instruments also included the widening of longer-term operations and extension of their maturity to up to 12 months (Chart 1).

In May 2009, the Governing Council announced that national central banks belonging to the Eurosystem may begin purchasing covered bonds at a date to be agreed on later. With regard to the ECB's monetary policy instruments, this can be considered a non-standard measure.

Keywords: monetary policy, monetary policy strategy, financial crisis

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