The ECB's Monetary Policy Strategy: Lessons From the Financial Crisis, Debt Crisis and Coronavirus Crisis

Petra Geraats
University of Cambridge and IMFS

The ECB and Its Watchers Conference
30 September 2020
Goethe University, Frankfurt

Lessons From Financial Crisis: Use of LTROs

European Central Bank (ECB) response to 2008-2009 financial crisis:

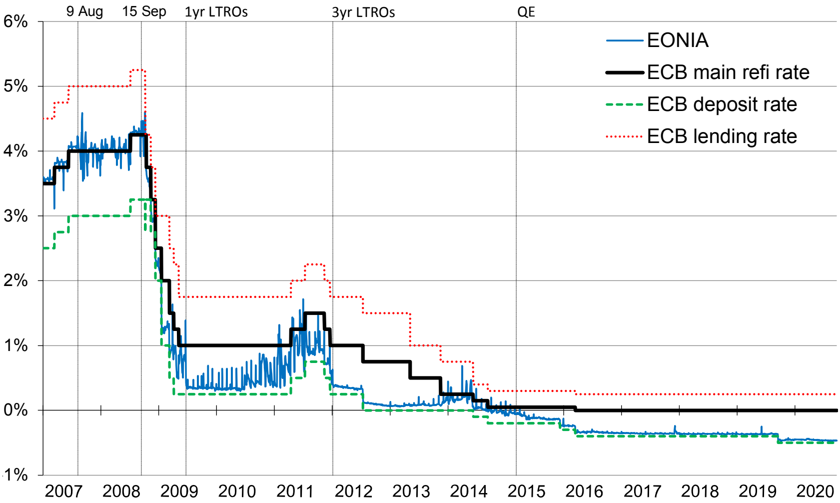
× 'Quantitative Easing' (QE) thru large-scale asset purchases (LSAPs)

✓ Large-scale liquidity operations thru fixed-rate full-allotment Longer-Term Refinancing Operations (LTROs)

Fixed-rate full-allotment LTROs:

+ Provide cheap and ample liquidity for banking sector.
+ Have fixed horizon while allowing for gradual or natural unwinding (e.g. thru shorter-term roll-overs or early repayments).
- Liquidity may not be passed on to bank lending and real economy, and could increase financial fragility (e.g. thru purchase of euro-area periphery sovereign debt!) $\rightarrow$ Targeted LTROs (TLTROs)
- Liquidity has pushed interbank rates close to ECB deposit rate, so ECB's main refinancing (refi) rate no longer indicates monetary policy stance, leading to 'monetary policy easing by stealth'
  - ▶ Move from de facto to formal 'floor system'

ECB Monetary Policy Easing by Stealth



Notes: EONIA and ECB main refinancing rate, deposit rate and lending rate, 02-01-2007 - 24-09-2020. Source: ECB

Negative Interest Rates and ECB Asset Purchase Program

ECB has had negative deposit rate since June 2014,
leading to negative overnight interbank rate (EONIA).
Negative yields on euro area sovereign debt, common since 2015, also driven by ECB's Asset Purchase Program (APP), announced 1/2015.

Negative deposit rate and yields:

+ Reduce appreciation pressure on currency.
± Alleviate burden of sovereign debt, which could lead to moral hazard.
– Effectively are tax on banking system → Tiered rates (since 9/2019)
– May not stimulate economy with positive 'reversal rate'.
– Could endanger financial stability (e.g. due to 'search for yield' and risk of bursting bond market bubble)
  - ▶ Careful unwinding of negative rates and APP (& PEPP) vital, and effective macroprudential policy needed

ECB Monetary Policy Transparency

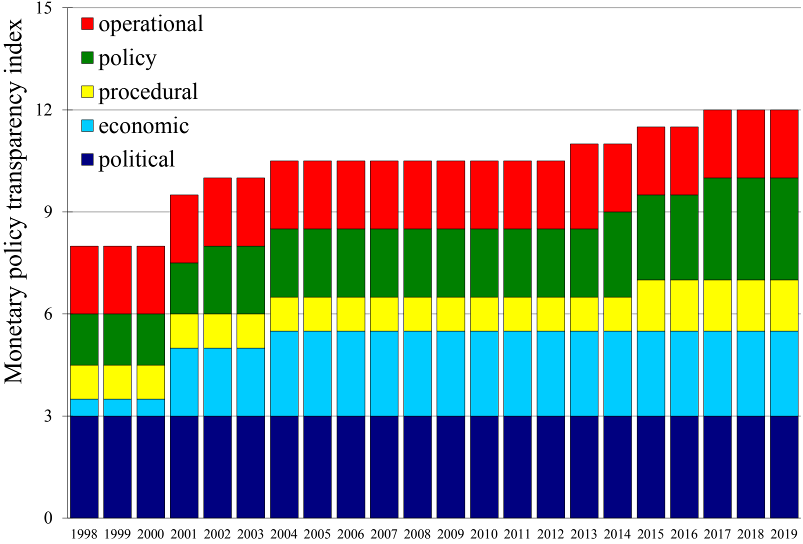
ECB has significantly improved its monetary policy transparency during last two decades, including publication of [since year]:

+ Staff macroeconomic projections (quarterly) [2000 (2004)]
+ ECB's euro-area-wide macroeconomic model [2001]
+ Minutes ('account') of monetary policy meetings [2015]
+ Explicit (quantitative) forward policy guidance [2013 (2016)]

However, still plenty scope for transparency improvements:

- Clarity about fuzzy goal of inflation 'below, but close to, 2%'.
- Timely release of account of monetary policy meetings ($\leq$ 2 weeks).
- Disclosure of voting balance for monetary policy decisions.
- Publication of projected policy path, with scenario analysis.
- Annual evaluation of staff projections and ECB monetary policy.

ECB Monetary Policy Transparency



Source: Dincer, Eichengreen and Geraats (2020)

Lessons From Debt Crisis: Power of Central Bank Communications

During euro area sovereign debt crisis:

+ President Draghi (26-07-2012): ECB will 'do whatever it takes' within its mandate to preserve euro as single currency.
+ Announcement of Outright Monetary Transactions (OMT) program (9/2012) of potentially unlimited sterilized debt purchases.

→ Communications so effective that periphery bond yields declined while OMT program still unused!

Euro area is definitely not 'optimum currency area',
but multi-country monetary union facing fragmentation risk
due to (potentially self-fulfilling) differences in spreads.

▶ Credible backstop and regular reassurance vital

ECB Forward Guidance

Since financial crisis, ECB has often provided forward guidance about liquidity measures, but was slow to use it explicitly for monetary policy.

Explicit forward policy guidance [first use by ECB]:

- Qualitative: key interest rates expected "to remain at present or lower levels for an extended period of time" [7/2013]
- Calendar-based: intended (minimum) horizon for monthly asset purchases [1/2015] and low interest rates [7/2016]
- Threshold guidance based on inflation outlook "robustly" converging "sufficiently close to, but below, 2% within its projection horizon", and "consistently reflected in underlying inflation dynamics" [9/2019]
  → State-contingent guidance flexible, but fuzzy formulation

Lessons From Coronavirus Crisis: Need for Effective Monetary, Macroprudential and Fiscal Policy

Big response by ECB, including:

- Pandemic Emergency Purchase Programme (PEPP) up to €1,350bn
- Fixed-rate full-allotment Pandemic Emergency Longer-Term Refinancing Operations (PELTROs)
- More generous conditions on TLTRO III with rates of -0.5% to -1%

However, monetary policy poorly equipped to address coronavirus crisis.

- Effective fiscal policy response vital to support real demand, and macroprudential policy seriously tested by high debts and loan losses.

ECB Monetary Policy Strategy: From Two-Pillar Strategy to Average Inflation Targeting??

ECB's initial 'two-pillar' strategy (based on economic and monetary analysis) was opaque, but 2003 revision clarified role of each pillar.

Following financial crisis, euro area inflation dropped from average of 2.2% to 1.2%, due to failing policy strategy or structural forces?

Adopting average inflation target attractive in theory, but

- Aiming for higher inflation may be hard to achieve (e.g. Japan).
- Creates uncertainty about size and duration of inflation overshoot.
- Risks unanchoring inflation expectations, further increasing volatility.
- Inflationary supply shocks would require more painful tightening.

- ECB should first focus on improving fundamentals of EMU including:
  - Proper banking union with effective supervision and resolution.
  - Macroprudential policy to manage risks of loose monetary policy.
  - Fiscal policy with greater flexibility and more public investment.