

# **The Monetary Policy of the European Central Bank**

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# History of the ECB

- The ECB started on 1 January 1999
  - Fixing of exchange rates of currencies of Member States
  - Conduct of a single monetary policy
  - Euro cash was introduced on 1 January 2002
- Outcome of long process that started in June 1988
  - European Council commission report by Jacques Delors
  - Delors report proposed gradual approach
  - Three stages to Economic and Monetary Union (EMU)
  - Stage three was the beginning of the ECB

# Member States of the euro area

- Initial 11 participating Member States
  - Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal, and Finland
- Other 8 Member States joining afterwards
  - Greece, Slovenia, Cyprus, Malta, Slovakia, Estonia, Latvia, and Lithuania

# Governance of the ECB

- The Governing Council is the main decision-making body
  - 6 members of the Executive Board
  - 19 governors of the national central banks of the euro area
  - Monetary policy meetings every six weeks
  - Rotation system of voting rights

# Monetary policy strategy

- Original strategy of monetary policy
  - Agreed by the Governing Council in 1998
  - Marginally modified in 2003
- Revision of the strategy
  - Agreed by the Governing Council on 8 July 2021
  - Long overdue: 17 years without formal changes
  - But many significant changes in these years

# Original monetary policy strategy

- A quantitative definition of price stability
  - Maintain inflation rates (measured by the HICP) below but close to 2% over the medium term
- Two pillar approach
  - Economic pillar: Focus on short to medium-term determinants of price developments
  - Monetary pillar: Focus on longer-term horizon, exploiting long-run link between money and prices.

# Anomalies of the original strategy (i)

- Definition of price stability
  - Ambiguity of “below but close to 2%”
  - Possibly deflationary bias in monetary policy
  - Contrast with the clarity of strategy of other central banks
- Rather disappointing performance
  - Average inflation rate since 2008: 1.2% (<< 2%)
  - Including negative inflation rates at some dates

## **Anomalies of the original strategy (ii)**

- Monetary pillar
  - Residue of glory days of monetary targeting (1980s)
  - Deviates attention towards largely irrelevant variables
  - Contrast with the strategy of other central banks
- Breakdown of relationship between money and prices
  - Huge increase in money supply in recent years
  - Low (even negative) inflation



# Some significant changes

- Greater reliance on economic pillar
  - Monetary pillar shifted towards credit developments
- New Unconventional Monetary Policy (UMP) tools
  - Asset purchases (Quantitative Easing or QE)
  - Forward guidance
  - Lending tools (Long-term refinancing operations)
  - Reserves tools (Interest on excess reserves, tiering)
  - Negative interest rates

# **New monetary policy strategy (i)**

- New definition of price stability
  - Aim for 2% inflation rate over the medium term
  - Positive and negative deviations equally undesirable
- Abandon two pillar approach: two interdependent analyses
  - Economic analysis
  - Monetary and financial analysis

# **New monetary policy strategy (ii)**

- Other significant changes
  - Include costs related to owner-occupied housing in HICP
  - Incorporate unconventional monetary policy tools
  - Take account of financial stability where appropriate
  - Incorporate implications of climate change
  - Improve communication towards the wider public
  - Schedule next review in 2025

## **Assessment of new strategy (i)**

“The review sheds many of the idiosyncrasies that had made the ECB so different from other major central banks.”

“The review gets rid of many things that made the ECB stand out like a sore thumb, in particular those features that fuelled perceptions that the Frankfurt-based institution had a deflationary bias.”

Martin Sandbu, Financial Times, 14 July 2021

## **Assessment of new strategy (ii)**

“It is debatable whether a change in the inflation objective by itself would have material implications for the inflation outlook or markets, given the subdued inflation dynamics and the lack of effective tools.”

Ebrahim Rahbari, Citigroup, 8 July 2021

# My assessment

- Strategy change aligns “formal” with “real” strategy
  - Long overdue and most welcome
  - Improved communication of monetary policy decisions
- Effects are likely to be small but non-negligible
  - Especially over the medium run

# Some specific topics

- Negative interest rates
- Monetary policy and financial stability

# **Topic 1**

## **Negative interest rates**



# Negative interest rates

- In recent years several central banks have set negative rates
  - with the aim of raising inflation rate towards the objective
- Some side-effects
  - On income distribution: bad for savers, good for borrowers
  - On bank profitability: negative effect when negative rates are not translated to deposit rates

# Reversal interest rate (i)

- Possible negative effects on lending and economic activity?
  - Brunnermeier and Koby (2018): “Reversal interest rate”
  - Rate at which accommodative monetary policy reverses its effect and becomes contractionary for lending
- BK mechanism
  - Lower rates reduce bank profitability
  - Lower bank profitability reduces bank capital
  - Lower bank capital reduces lending

# Financial Times

Can further monetary stimulus still be effective?

Central banks should not fear 'reversal rate'

**MARTIN SANDBU**



The ECB: it is likely the debate will shift from the need for policy action to the effectiveness of any further monetary loosening © AP

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## Reversal interest rate (ii)

- Limited empirical evidence
  - Relative effects of lower (negative) rates
  - High deposit banks lend less than low deposit banks
  - Heider, Saidi and Schepens (2019)
- Questions about theoretical mechanism
  - Only relevant for high deposit banks
  - Only when they are not able to pay negative deposit rates
  - Repullo (2020)

## **Topic 2**

# **Monetary policy and financial stability**

# Risk-taking channel

- Lower rates may have negative effect on financial stability
  - Risk-taking channel of monetary policy
  - Borio y Zhu (2012)
- Some empirical evidence
  - Lower rates increase risk-taking incentives
  - Jiménez, Ongena, Peydró and Saurina (2014)
- Some theoretical analyses
  - Lower rates increase risk-taking incentives
  - Martinez-Miera and Repullo (2017)

# Macroprudential policy

- What could be done?
  - Tinbergen rule: as many instruments as objectives
  - Need additional policy tool
- Macroprudential policy
  - Tighten capital requirements for banks
  - Tighten credit requirements for borrowers
  - Martinez-Miera and Repullo (2019)

# Final comment

- Monetary policy is an exciting field of economics
  - Connecting (theoretical & empirical) models with central bank policies
- Many interesting issues going forward
  - Design of Central Bank Digital Currencies (CBDCs)
- I hope that some of you will eventually contribute to it
  - Best wishes for your endeavors!



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