IN-DEPTH ANALYSIS

Requested by the ECON committee

European Parliament

Recommendations for the ECB's Monetary Policy Strategy Review

Policy Department for Economic, Scientific and Quality of Life Policies
Author: Professor Karl Whelan
Directorate-General for Internal Policies
PE XXX.XXX - September 2019

EN

DO NOT DELETE PAGE BREAK

Recommendations for the ECB's Monetary Policy Strategy Review

Abstract

A review into monetary policy strategy, tools, and communications is underway at the Federal Reserve. The ECB's new President has signalled support for a review of this sort for the Eurosystem. This paper considers five areas where a review of ECB monetary policy strategy could focus and makes recommendations in relation to each area. The five areas are price stability, the monetary pillar, liquidity provision, balance sheet risk and communications. Most importantly, it is recommended that the ECB adopt a 2 percent average inflation rate as its definition of price stability and remove the monetary pillar from its official monetary policy strategy.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

AUTHORS
Karl WHELAN, University College Dublin

ADMINISTRATOR RESPONSIBLE
Dario PATERNOSTER

EDITORIAL ASSISTANT
Janetta CUJKOVA

LINGUISTIC VERSIONS
Original: EN

ABOUT THE EDITOR
Policy departments provide in-house and external expertise to support EP committees and other parliamentary bodies in shaping legislation and exercising democratic scrutiny over EU internal policies.

To contact the Policy Department or to subscribe for updates, please write to:
Policy Department for Economic, Scientific and Quality of Life Policies
European Parliament
B-1047 Brussels
Email: Poldep-Economy-Science@ep.europa.eu

Manuscript completed in Noember 2019
© European Union, 2019

This document is available on the internet at:
http://www.europarl.europa.eu/committees/en/econ/monetary-dialogue.html

DISCLAIMER AND COPYRIGHT
The opinions expressed in this document are the sole responsibility of the authors and do not necessarily represent the official position of the European Parliament.
Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the European Parliament is given prior notice and sent a copy.

CONTENTS

EXECUTIVE SUMMARY 4

1. INTRODUCTION 5

2. PRICE STABILITY 6

2.1. Defining Price Stability 6

2.2. Approach to Volatile Prices 8

3. THE MONETARY PILLAR 9

4. CHANGES TO LIQUIDITY PROVISION 12

4.1. Provision of Liquidity to the Banking Sector 12

4.2. Emergency Liquidity Assistance 13

4.3. Helicopter Money? 14

5. BALANCE SHEET RISKS 15

6. COMMUNICATIONS 17

6.1. Monetary Policy 17

6.2. The ECB's Broad Mandate 18

7. CONCLUSIONS 19

REFERENCES 20

EXECUTIVE SUMMARY

- A review into monetary policy strategy, tools, and communications is underway at the Federal Reserve. The ECB's new President has signalled support for a review of this sort for the Eurosystem.

- This paper considers five areas where a review of ECB monetary policy strategy could focus and makes recommendations in relation to each area. The five areas are price stability, the monetary pillar, liquidity provision, balance sheet risk and communications.

- The paper recommends that the ECB adopt a 2 percent average inflation rate over a relatively long period as its inflation target.

- The ECB should also consider clarifying its approach to the swings in volatile components of the consumer price indices, such as food and energy.

- The ECB should remove the monetary pillar from its official monetary policy strategy. There is no good statistical evidence that measures of the money supply are useful in forecasting inflation and the focus on monetary analysis and "cross checking" waste valuable time in Governing Council press conferences on unimportant issues.

- The ECB should announce that it will permanently adopt the fixed rate full allotment approach to the provision of liquidity to banks.

- The provision of Emergency Liquidity Assistance (ELA) should also be reformed with assistance being instigated and decided on solely at Governing Council level and profits and losses from these operations being shared across the Eurosystem.

- A review of monetary policy strategy should clarify the ECB's policy on how much risk it is willing to take on its balance sheet. If it is not willing to raise its current self-imposed issuer limits for sovereign bond purchases, the ECB will need to consider whether it wishes to prioritise the Asset Purchase Programme or maintaining sufficient room for an effective Outright Monetary Transactions (OMT) tool.

- ECB should consider adopting the FOMC's approach to forecasting future economic data and policy. Specifically, they should consider having each Governing Council member provide forecasts for inflation, output and the ECB's policy rates for the next few years and also for the longer run.

- The ECB should devote more effort to communicating the broadness of its mandate. The ECB is required by the European Treaties to support high levels of employment and other policy goals such as a high-quality environment, provided actions it take in support of these goals does not endanger price stability. In the current environment, with inflation falling short of the ECB's target levels, there is room for new and innovate ECB policies to support the EU's policy goals.

1. INTRODUCTION

The past decade has been an extraordinary one for central banking around the world. Central banks have introduced a wide range of ground-breaking monetary policy tools while also becoming more involved in the oversight of financial stability issues. However, despite these unprecedented efforts to provide monetary stimulus, central banks around the world are struggling to meet their inflation targets, raising questions about the effectiveness of these new tools. This is particularly true for the ECB, which has consistently failed to meet its own inflation target of "close to but below 2 percent."

With the global financial crisis receding but questions remaining about the measures brought in since 2008, it is a good time to review the evidence of the last decade and consider whether the lessons learned can help revise monetary policy strategy. A review into monetary policy strategy, tools, and communications is underway at the Federal Reserve and a similar review is taking place at the Bank of Canada. The new President of the ECB, Christine Lagarde, and the ECB's chief economist, Philip Lane, have both signalled their support for a review of the ECB's monetary policy strategy. It seems likely then that such a review, which would be the first formal review of monetary policy strategy since 2003, will take place at some point over the next year.

This paper considers five areas where a review of ECB monetary policy strategy could focus and makes recommendations in relation to each area. The five areas are as follows.

First, price stability. The ECB should adopt a clear and symmetric definition of its price stability goal. I recommend the ECB define price stability as inflation of around 2 percent "on average" over a specific, relatively long, period. The ECB should also consider formalising its policy in relation to fluctuations in inflation caused by volatile and perhaps temporary movements in food and energy prices. The Federal Reserve focuses closely on the index for personal consumption expenditures excluding food and energy and refers to this measure in its Federal Open Market Committee (FOMC) statements. The ECB's attitude to the volatile components of consumer price indices is less clear.

Second, the ECB should re-examine its "two pillar" analysis of macroeconomic developments. I recommend adapting this element of the strategy to be a simple statement that it will review all available indicators, without giving any special mention to measures of the money supply. The President's statement after Governing Council meetings should also remove references to "monetary analysis" and "cross checking" unless there is something of genuine economic importance to relate about the recent movements in the money supply.

Third, the ECB should clarify some key aspects of its operational strategy in relation to supplying liquidity to the banking sector. It should announce the permanent adoption of its fixed price full allotment approach to the provision of liquidity. It should also "regularise" the provision of Emergency Liquidity Assistance (ELA) by moving to decisions about emergency liquidity being taken by the ECB Governing Council and profits or losses from these operations being shared across the Eurosystem.

Fourth, the ECB should clarify its policies in relation to the extent of financial risk it is willing to take via unconventional monetary policies such as its Asset Purchase Programme (APP) and the influence of this decision on its Outright Monetary Transactions (OMT) programme.

Fifth, the ECB can improve its communications strategy. The ECB Governing Council should give clearer indications of what they view as the "equilibrium real interest rate" for the euro area and consideration should be given to copying the FOMC by having members provide a set of macroeconomic forecasts for inflation and other variables including the ECB's key policy rate (currently the interest rate paid to banks for deposits with the Eurosystem) . The ECB should also provide more

clarifications that its primary goal of price stability does not and should not prevent it from providing support for a wide range of European economic policy initiatives.

The paper devotes a section to each of these five areas and concludes with some broader thoughts about the ECB's legal mandate.

2. PRICE STABILITY

In this section, I discuss how the ECB should consider revising its approach to price stability.

2.1. Defining Price Stability

The European Treaties give the ECB and national central banks a primary goal of price stability but do not define what is meant by the phrase "price stability". At the time of the launching of the euro in 1999, the ECB Governing Council defined price stability as inflation within a range of zero to 2 percent over the medium term. A review of the monetary policy strategy in 2003 saw this definition refined to clarify that the ECB would aim for an inflation rate of close to but below 2 percent.

This definition of price stability is likely to be a key item for discussion in any forthcoming review of monetary policy strategy. I recommend two changes be made.

First, the ECB should adopt a clear inflation target, i.e. have an actual number for its inflation target. "Close to but below two" is not a number. Given that price stability is the ECB's key goal, it does not make sense to be imprecise about how exactly it interprets this goal. The key point here is to decide on a specific number, rather than what the number is. One option is to stick with the spirit of the current definition and announce an inflation target of say, 1.85 percent, thus revealing exactly what "close to but below" finally means. However, for the purposes of explaining policy to the public, a figure like this would be unhelpful. A better approach would be for the ECB adopt a 2 percent inflation target.

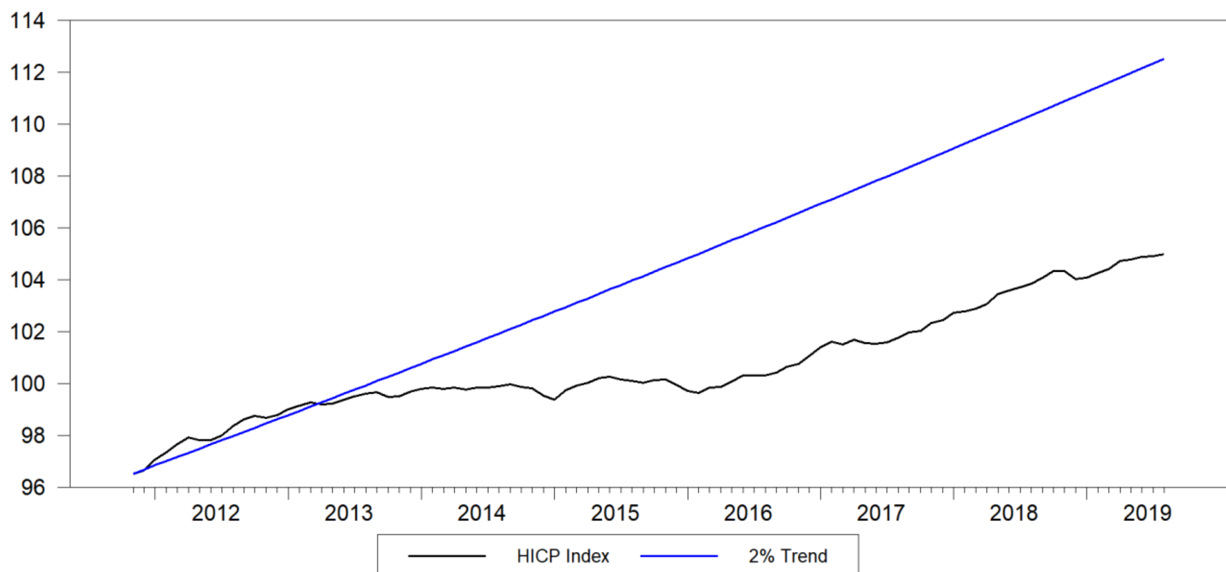
One caveat to recommending a 2 percent inflation target is that there are arguments in favour of considering a higher rate. There are no results from academic economics suggesting 2 percent is somehow an "optimal" inflation rate—its emergence as a consensus among modern central banks seems to be a form of social convention rather than an evidence-based development. However, we have seen that central banks that pursue a 2 percent target tend to end up with policy rates at zero and pursuing unconventional policies once their economy goes into recession. A predictable price level that grows at an approximately steady 4 percent rate could possibly be considered a form of price stability while allowing the ECB to have more room for manoeuvre during recessions. However, this is perhaps stretching the interpretation of "price stability" a bit far for most members of the Governing Council and the debate is likely to focus mainly on whether or not to adopt a clear 2 percent target.

Second, the ECB should end the debates about the question of its "symmetry" relative to an inflation target by providing a definitive position. Mario Draghi's Sintra speech earlier this year argued that the ECB has "clarified" that it treats its inflation goal in a symmetric manner, commenting that "*our medium-term orientation implies that inflation can deviate from our aim in both directions, so long as the path of inflation converges back towards that focal point over the medium-term policy horizon*." Unfortunately, the credibility of this position has been undermined by the fact that other members of the Governing Council disagree with him. Bundesbank President, Jens Weidmann, has recently said

"*Regarding our definition of price stability, the current formulation of the target is not symmetric in my view*".[1] It has also been undermined by the ECB's consistent inability in recent years to get inflation close to 2 percent.

The reason there is room for disagreement and confusion here is that the ECB's own definition of price stability is insufficiently clear on this question. I recommend the Governing Council adopt the proposal of Grégory Claeys, Maria Demertzis and Jan Mazza (2018) to define its price stability goal as being an inflation rate of 2 percent "on average" over a long period, perhaps corresponding to a full business cycle. With such a definition in place, it would be clear (for instance from the calculations shown below in Figure 1) that inflation could be above 2 percent for a number of years in the future without the ECB failing to meet its price stability goal. As Figure 1 shows, dating back to November 2011 (the beginning of Mario Draghi's term as President) the HICP is a cumulative 7 percent short of the value it would have taken if it had grown at a steady two percent rate.

Figure 1: The HICP Index Relative to a 2% Trend Since November 2011



Source: Author's calculations based on data from ECB Statistical Data Warehouse.

[1] See https://uk.reuters.com/article/uk-germany-ecb-economy/ecbs-weidmann-sees-no-need-for-economic-stimulus-newspaper-idUKKCN1VE0FF

2.2. Approach to Volatile Prices

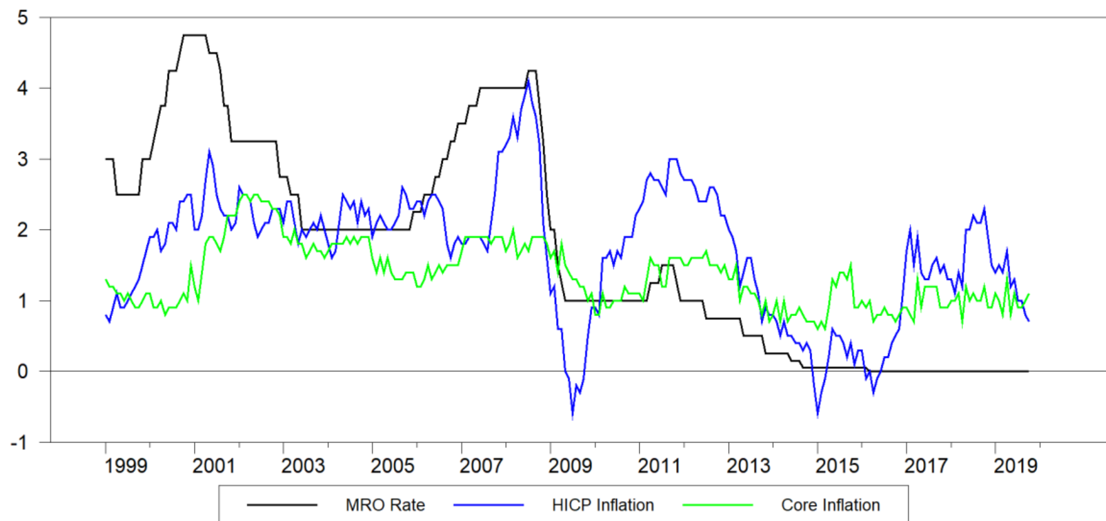
A lower priority issue that may still be worth addressing in a review of monetary policy strategy is the ECB's attitude to temporary fluctuations in volatile prices. To give an example of practice elsewhere, while the Federal Reserve is clear that its 2 percent inflation target refers to the prices for all consumer expenditure items, its communications regularly refer to inflation for items other than food and energy, i.e. core inflation. As can be seen from Figure 2, a significant amount of the short-term volatility of euro area price inflation stems from fluctuations in food and energy prices. These tend to be driven by short-term price level movements, so periods in which food and energy prices trigger inflation above 2 percent tend to be followed by periods when the cause inflation to be below 2 percent.

The ECB does not use the phrase "core inflation" but its communications regularly refer to "underlying inflation" and ECB staff have done a lot of work in trying to identify useful measures corresponding to this concept.[2] One idea to consider is for the ECB to adopt an explicit shorter-term target such as HICP excluding food and energy or HICP excluding unprocessed food and energy and announce a 2 percent medium-term goal for this measure as part of its overall strategy of keeping overall inflation near its target over the longer term.

One advantage of a medium-term focus on core inflation would be to avoid having the ECB over-react to short-term fluctuations in volatile prices. There have been decisions made by ECB in the past that now look like over-reactions temporary movements in food and energy prices. To give a specific example, in July 2008, right on the eve of the explosion of the global financial crisis, the ECB raised its Main Refinancing Operation (MRO) policy rate by 25 basis points to 4.25 percent explicitly because of higher food and energy prices. President Trichet acknowledged that these price increases had not translated into higher core inflation but that the Governing Council decision "*was taken to prevent broadly based second-round effects and to counteract the increasing upside risks to price stability over the medium term*." Even without the benefit of hindsight, this seems to have been a questionable decision and a more explicit shorter-term focus on core inflation trends could help avoid such mistakes in the future.

[2] See, for example, Ehrmann, Ferrucci, Lenza and O'Brien (2018).

Figure 2: The ECB Main Refinancing Operation (MRO) Rate (Black), HICP Inflation (Blue) and HICP Inflation Excluding Food and Energy (Green).



Source: Author's calculations based on data from ECB Statistical Data Warehouse

3. THE MONETARY PILLAR

The next aspect of the ECB's monetary policy that should be considered for review is its "monetary pillar."

The original monetary policy strategy adopted by the ECB was announced in the ECB's monthly bulletin as follows:

> "*The strategy consists of three main elements: (i) a quantitative definition of the primary objective of the single monetary policy, namely price stability; and the "two pillars" of the strategy used to achieve this objective: (ii) a prominent role for money, as signaled by the announcement of a reference value for the growth of a broad monetary aggregate; and (iii) a broadly based assessment of the outlook for future price developments and the risks to price stability in the euro area as a whole …. To signal the prominent role it has assigned to money, the Governing Council has announced a quantitative reference value for monetary growth as one pillar of the overall stability oriented strategy*."

The reference value for M3 was set at a 4.5% annual rate and this figure was used to calculate a "monetary overhang". This measured the cumulative difference between actual M3 growth and the reference value, with higher numbers supposedly representing risks for medium term inflation. The reference value figure was to be reviewed an annual basis.

This "prominent role for money" appeared to reflect the strong influence of the Deutsche Bundesbank in the original design of the ECB's strategy. The pre-EMU Bundesbank had placed a strong emphasis on the role of the money supply in its communications about monetary policy, though opinions differ about how important money supply statistics really were when it came to setting policy. A fair

assessment appears to be that the Bundesbank was not a strict monetary targeter but did consider money supply growth when setting policy as well as other variables like inflation and conditions in the real economy.[3]

However, by 1999, the Bundesbank's focus on money growth as a useful indicator of inflation already ran counter to the practice elsewhere. Other central banks such as the Federal Reserve had tried monetary targeting in the late 1970s and early 1980s, inspired by Milton Friedman's monetarist policy recommendations, but had given up on monetary targeting during the 1980s and measures of the money supply barely featured in their formulation of monetary policy by 1999.

The early years of the ECB did nothing to suggest that the prominent role for money was a useful part of the monetary policy strategy. Money growth steadily exceeded price inflation and a surge in money growth during 2001 was not matched by any contemporaneous or subsequent increase in inflation. (See Figure 3). The "monetary overhang" indicator was growing by the month and yet the inflation stubbornly refused to conform to the ECB's model's predictions. As former ECB vice-president Vitor Constancio said in a 2018 speech: "*The continuous need to try to explain away the growing monetary overhang without corresponding inflation in the horizon, was turning into an embarrassing exercise*."

The failure of the prominent role for money appears to have been a principal motivation for the 2003 monetary policy review. This review provided a new format for the analysis underlying Governing Council monetary policy decisions. The annual review of the reference value was dropped and this value has not been mentioned or used in monetary policy making since 2003. Monetary analysis was clearly relegated in the presentation of monetary policy decisions, with the review indicating that it would "*mainly serve as a means of cross-checking, from a medium- to long-term perspective, the indications coming from the economic analysis*."

Formally, the ECB still has a "monetary pillar" but the evidence in the years since 2003 has not improved the case for its existence. As Figure 3 shows, money growth has outstripped inflation in almost every year of the ECB's existence, often by a large amount, and there is no statistical evidence that it works as a useful leading indicator of inflation. The figure does show some co-movement, particularly with the decline in money growth during the global financial crisis happening at the same time as a decline in inflation. However, this likely reflects a common third cause rather than any causation from money to inflation. Money growth is generated by the expansion of credit by the banking sector and this declined during the recession just as a weaker economy also reduces price inflation.

The attitude of leading researchers on central banking to the use of money growth as a key indicator has also hardened in the time since the ECB's last review. Paul de Grauwe (2007) advised "*It is time for the ECB to stop worrying about a variable that has played no useful role in the past and is unlikely to do so in the future*." Michael Woodford (2008) conducted a wide-ranging analysis of the potential role for monetary aggregates when setting policy. His conclusions began as follows:

> "*I have examined a number of leading arguments for assigning an important role to tracking the growth of monetary aggregates when making decisions about monetary policy. I find that none of*

[3] See Geberding, Seitz and Worms (2005)

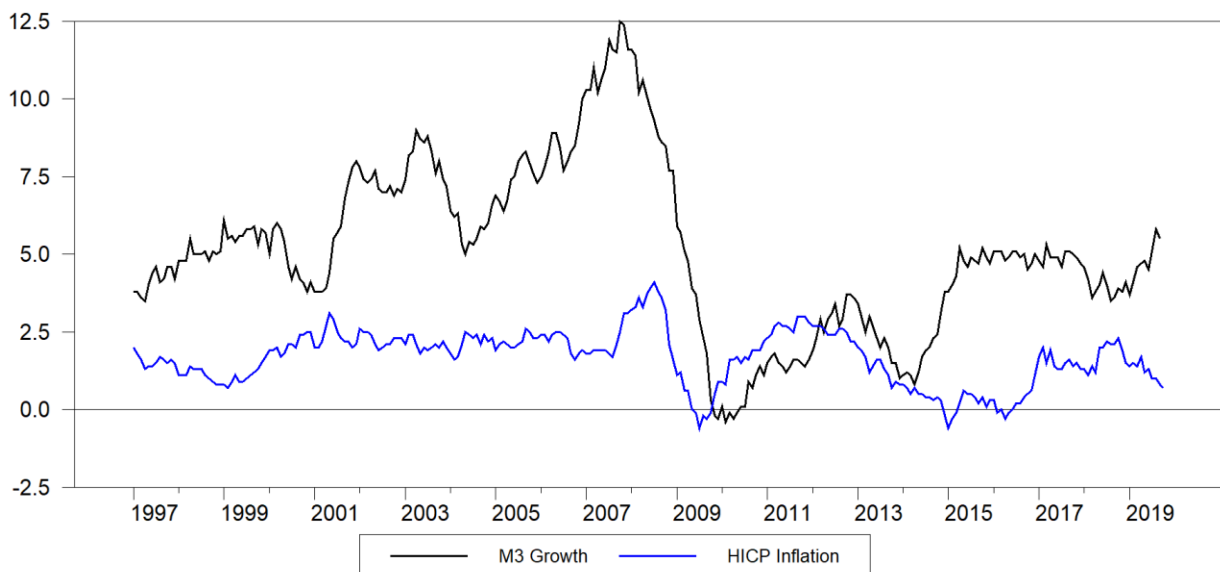
> *them provides a convincing argument for adopting a money growth target, or even for assigning money the "prominent role" that the ECB does, at least in its official rhetoric."*

Consistent with these beliefs, the Federal Reserve decided in 2006 to stop measuring M3, the ECB's preferred measure of the money stock.

In light of the evidence, the time has come for the ECB to officially drop the reference value for money growth and also to reduce the prominence given to monetary analysis in its post-meeting press conferences. It is clear that monetary analysis has played relatively little role in decision making in recent years and the ritualistic invocation of the "monetary analysis" and then "the cross-checking" doesn't add anything and reduces the effectiveness of the ECB Presidents communication of policy decisions.

In making this recommendation, I am not arguing that the ECB should give up measuring or analysing money supply statistics. And there is no doubt that central banks need to pay close attention to developments relating to the supply of credit. But money supply indicators should be given no special place of prominence than other potential indicators of inflation. If the behaviour of these indicators is of note and plays a role in the thinking of the Governing Council in taking its decisions, then they should certainly discuss this. But pretending an indicator plays an important role when it actually does not represents a poor communication strategy and undermines the ECB's credibility.

Figure 3: M3 Growth (Black) and HICP Inflation (Blue).



Source: Author's calculations based on data from ECB Statistical Data Warehouse

4. CHANGES TO LIQUIDITY PROVISION

Here, I discuss how a review of the ECB's monetary policy strategy can address two aspects of its provision of liquidity to the financial system.

4.1. Provision of Liquidity to the Banking Sector

The global financial crisis of 2008 saw an important change to the way the ECB provided liquidity to the banking sector. Prior to Autumn 2008, the ECB's procedures had focused on the provision of fixed amounts of liquidity each week in its Main Refinancing Operation. This liquidity was auctioned off via a process in which the ECB would announce a minimum acceptable interest rate and the funds were provided to those banks that tendered the highest bids for the interest rate to be paid.

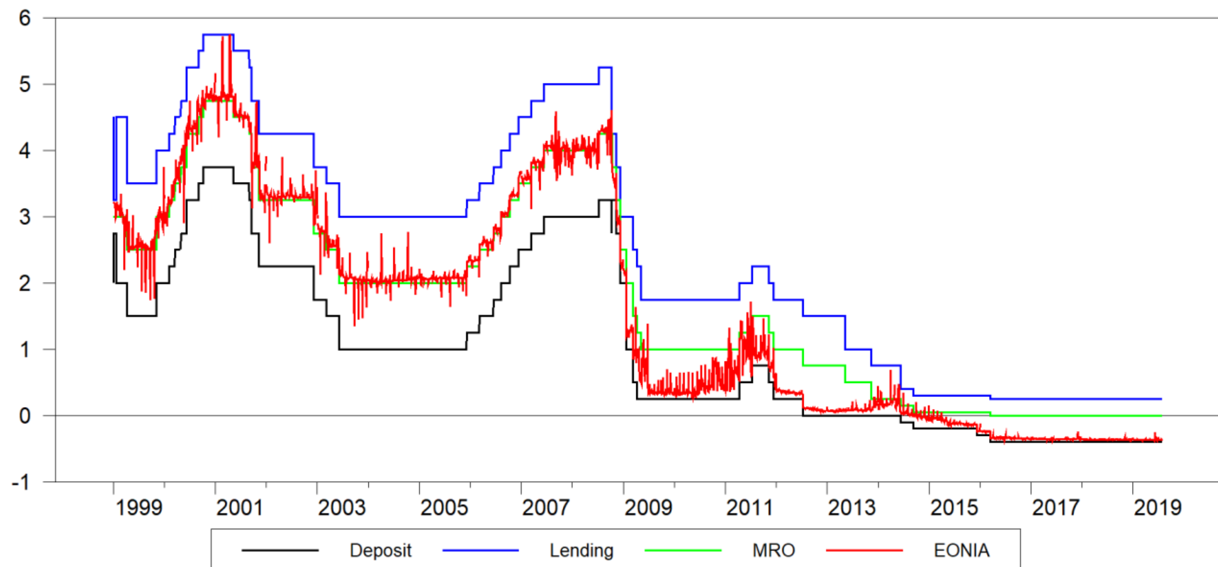
This approach may have been motivated by the belief that the ECB should maintain control of the monetary base and that perhaps this could see it have some control over broader monetary aggregates such as M3. However, international experience has shown the relationship between the monetary base and the broader money supply to be an unpredictable one and this is one of many reasons central banks across the world have abandoned monetary targeting.

An alternative motivation for auctioning off fixed amounts of liquidity was the concern that the provision of too much liquidity to the banking sector would lead to money-market rates falling below the ECB's target levels. This could only ever have been a minor concern, however, given that the ECB has always been able to use its deposit rate to place a floor on market interest rates. As can be seen from Figure 4, while the ECB succeeded during the period prior to 2009 in keeping money market rates (as measured here by EONIA) close to the MRO's minimum bid rate most of the time, its lending and deposit rates functioned effectively to keep market interest rates within the "corridor" defined by these rates.

The crisis that emerged in late 2008 saw a breakdown in the functioning of global money markets and placed many banks under severe liquidity pressures. The ECB changed its policies at this time to a "fixed rate full allotment" basis, meaning banks could borrow as much as they wanted from the Eurosystem, provided they had enough eligible collateral to secure these loans. The list of collateral that can be used in Eurosystem refinancing operations has been expended considerably in the years since the crisis.

This change in procedures meant the ECB now allows the actions of the banking system to play a key role in determining the size of the monetary base. However, since the link between the monetary base and broader monetary aggregates is unpredictable and the ECB should in any case remove targeting of broad monetary aggregates from its monetary policy framework, this should not be a source of concern. The change in operational procedures has not affected the ECB's ability to control market interest rates. While the large supply of liquidity—at first through refinancing operations and later through Eurosystem asset purchases—has meant that market interest rates have fallen below the MRO rate, these rates have instead closely tracked the deposit rate, showing that ECB maintains tight control of short-term market rates.

Figure 4: EONIA and the ECB's Policy Interest Rates



Source: Author's calculations based on data from ECB Statistical Data Warehouse

The Federal Reserve has also been debating its approach to liquidity provision over the past year, with the FOMC announcing in January that "*The Committee intends to continue to implement monetary policy in a regime in which an ample supply of reserves ensures that control over the level of the federal funds rate and other short-term interest rates is exercised primarily through the setting of the Federal Reserve's administered rates, and in which active management of the supply of reserves is not required*."[4] Despite this announcement, US financial markets still went through a short period in September where there was a shortage of liquidity and the Fed is now reassessing the underlying demand for the liquidity in the banking system.

The ECB should announce that its future operational policy will involve continuing to provide liquidity via fixed rate full allotment procedures. Its fixed-rate full allotment procedures and broad collateral framework are well designed to avoid the kind of financial market disruptions that occurred in US markets in September and it should announce, no later than the end of a monetary policy strategy review, that it intends to permanently retain its current operational framework.

4.2. Emergency Liquidity Assistance

While the ECB's move towards a more expansive approach to liquidity provision in its refinancing operations has been positive, its approach to providing liquidity to banks that have run out of eligible collateral, i.e. emergency liquidity assistance (ELA), has been fraught with problems. As I have written about on several occasions (Whelan, 2014, 2015, 2016) there have been a number of controversies associated with how ELA programmes have been operated. There have been examples of lending to severely insolvent banks, a lack of clarity surrounding the terms under which the Eurosystem caps or

[4] https://www.federalreserve.gov/newsevents/pressreleases/monetary20190130c.htm

withdraws ELA and a series of decisions made where the granting or curbing of ELA appeared to be directly related to political developments in various countries. I will not repeat these examples here but will note merely that the uncertainty surrounding the ECB's performance of its role as lender of last resort to the banking system has tended to worsen banking crises and that the politicisation of this role has damaged the reputation of the ECB as an institution in a number of member states.

A small amount of progress has been made in recent years in clarifying the procedures surrounding ELA. The ECB first published a short document describing these procedures in 2013 and updated it in 2017.[5] These documents are clear that ELA should not be provided to insolvent banks and with the Single Resolution Board in place, there is no reason why the ECB should provide liquidity in this situation. So hopefully, some of the more serious errors in this area—such as the credit provided to Laiki Bank and Anglo Irish Bank—will not be repeated.

That said, the guidelines for providing ELA to banks remain *ad hoc* and rely on a complex set of arrangements in which ELA is granted by the national country central banks but ELA programmes then need to be continually renewed by the ECB Governing Council with a two-thirds majority required to stop a programme. Given the importance of a well-functioning lender of last resort function to any banking system, I recommend the ECB adopt a new policy structure in this area. Since ECB is now the supervisor for all of euro area banks and the importance of "legacy issues" has begun to recede, there is also a stronger moral argument than in the past that decisions about emergency liquidity should be taken at a central level and profits or losses from these operations should be shared. The ECB should also announce procedures for providing a dedicated lending facility for financial institutions undergoing (or recovering from) a resolution process.

4.3. Helicopter Money?

A broad ranging review of the ECB's monetary policy strategy should be willing to address some of the more "left field" options that are being discussed in public debates. In relation to the provision of liquidity, a more radical option than the current approach is to move beyond providing loans to the banking sector and to direct provision of money to the private sector. This idea is known sometimes as "helicopter drops" or "QE for the people". A number of academics and commentators have called for this as a more effective approach to monetary stimulus than asset purchase programmes and Mario Draghi commented in March 2016 that it was "an interesting concept".

While I have no objection to such an approach in theory, it seems unlikely to be practical and may well be inconsistent with the European Treaty. The practical problems become obvious as soon as you start trying to turn this idea into a plan. Who does the central bank give this "free money" to? The ECB does not have a register of everyone living in the euro area or a list of bank accounts that could be credited. It seems most likely such a programme would have to work through national governments identifying people to receive the free money but this would look a lot like a tax cut and thus pure monetary financing.

Eurosystem operating procedures would also mean that if successful, an operation of this sort could have long-run costs for the taxpayer. Like QE programmes, a programme of this sort would result in an expansion of the amount of money that commercial banks have on deposit with the Eurosystem and,

[5] The current ELA agreement is available at https://www.ecb.europa.eu/mopo/ela/html/index.en.html

under normal ECB operational policies, these deposits are compensated with interest income (as opposed to at the present situation in which banks pay money to the ECB for holding these deposits). Under these conditions, the Eurosystem would incur additional longer-term costs from this programme without obtaining additional assets to cover these costs.

These considerations mean that, at least under current Eurosystem operational procedures, the proposed "free money" programmes wouldn't turn out to be completely free and would reduce the remittances of central bank profits to national treasuries. For this reason alone, this suggestion seems likely to contradict the monetary financing clause in TFEU. It seems likely that this is also the position of the ECB Governing Council. Given the relatively widespread popular discussion of this kind of option, it would be useful for the ECB to articulate exactly why it objects to this idea.

5. BALANCE SHEET RISKS

An important issue that has arisen for the ECB Governing Council that required little consideration in its 2003 review is the extent to which it can take risks with its balance sheet. The Eurosystem's loans to banks are, as required by European law, secured by collateral and thus relatively low in risk. However, the Eurosystem is now exposed to more risk via the large quantity of assets that it has acquired via the Asset Purchase Programme (APP) in recent years. There is also the potential for further credit risk should the ECB activate its Outright Monetary Transactions (OMT) programme.

Limiting the level of credit risk associated with bond purchases is clearly a concern of the current ECB Governing Council. The Council set limits on how the amount of sovereign bonds it would buy from national governments and these limits—33 percent for each issuer as well a 33 percent limit for each specific bond issued—are in some cases being reached. These limits are designed to prevent the Eurosystem from becoming a "blocking minority" if a country proposes a debt restructuring which its bondholders then vote on via a Collective Action Clause (CAC). There are concerns that failure to use a blocking minority to prevent debt restructuring could be viewed as illegal monetary financing.

In reality, the legal issues here complex. Questions about whether the ECB would accept losses on sovereign bonds have been an issue ever since the ECB purchased Greek sovereign bonds as part of its ill-fated and poorly-thought-out Securities Market Programme (SMP). When Greek bonds were being restructured, the ECB used its considerable influence to ensure that it received new "clone" bonds with the same terms as the ones it had purchased, rather the newly-issued restructured bonds.

However, when introducing the OMT programme, the ECB assured markets that "*it accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through Outright Monetary Transactions, in accordance with the terms of such bonds*."[6]

There were good reasons for this decision. If the ECB were to insist on a *de facto* senior creditor position, then losses for private sector bondholders would increase in any restructuring. In this case, the triggering of an OMT programme could make investors more concerned about holding a country's debt rather than less concerned. Mario Draghi acknowledged this in December 2014 when answering a

[6] https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

question about future asset purchases by saying "*we don't want to cause unintended monetary policy tightening in choosing forms of seniority which would be counter-productive*."

In its OMT ruling, the ECJ acknowledged the ECB was taking on risk in purchasing sovereign bonds but that such risks were not illegal. The judgement included the following[7]

> *"It should also be borne in mind that a central bank, such as the ECB, is obliged to take decisions which, like open market operations, inevitably expose it to a risk of losses and that Article 33 of the Protocol on the ESCB and the ECB duly provides for the way in which the losses of the ECB must be allocated, without specifically delimiting the risks which the Bank may take in order to achieve the objectives of monetary policy. Furthermore, although the lack of privileged creditor status may mean that the ECB is exposed to the risk of a debt cut decided upon by the other creditors of the Member State concerned, it must be stated that such a risk is inherent in a purchase of bonds on the secondary markets, an operation which was authorised by the authors of the Treaties, without being conditional upon the ECB having privileged creditor status."*

The key phrase here that suggests CACs may raise a legal issue is "*a debt cut decided upon by the other creditors."* By focusing solely on a "debt cut" imposed on the Eurosystem by other creditors, it could be interpreted that the ECJ has implicitly assumed that, once given the opportunity to vote on a potential restructuring, the ECB would be under an obligation to use a blocking minority position to prevent a debt restructuring.

I suspect there is less here than meets the eye in terms of restrictions on the future Eurosystem purchases. For starters, the ECB could decide to focus its purchases on bonds issued prior to 2013, when CACs became standard in euro area sovereign debt contracts. It is also unclear whether CACs would actually be the mechanism employed by future governments to restructure debt.[8] For example, the Greek government restructured its debt via a unilateral act of the Greek parliament, and this may be the approach taken by future European governments when defaulting on debt. Finally, should a CAC-driven restructuring ever become a likelihood, the Eurosystem could sell enough bonds prior to the restructuring to get below the blocking minority limit. It would be likely that losses would made on these sales, so this would affect the legalities of the situation rather than the underlying economics.

One issue this debate raises is whether or not one of the ECB's programmes—the APP—is undermining another one—OMT. Mario Draghi's "whatever it takes" speech and the subsequent announcement of the OMT programme had a profound effect in convincing financial markets that euro-denominated sovereign debt in countries such as Italy were again relatively safe instruments. At present, there is no sign that the sovereign bond purchases under APP have undermined what was seen by many to be two key features of OMT: The ECB's ability to make very large purchases and its willingness to be treated

---

[7] http://curia.europa.eu/juris/document/document.jsf;jsessionid=60A4861245325B97FFF1DF45DFC3F00F?text=&docid=165057&pageIndex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=2814192

[8] See Gelpern and Gulati (2013) for a sceptical discussion of euro area CACs from two of the leading academic experts on sovereign debt law.

equally as a creditor when making these purchases. But a decision to stick to the one-third issuer limit could signal an unwinding of the positive effects that OMT had on sovereign bond yields.

My preference would be for the ECB to adopt a more aggressive approach to asset purchases, perhaps raising the self-imposed issuer limit to a threshold of just below 50 percent, including for bonds with CACs, while signalling the ECB had no plan to agree to facilitate restructurings via CAC negotiations. Mario Draghi's comment in Sintra in June that "*the limits we establish on our tools are specific to the contingencies we face*" clearly suggests he supports raising these issuer limits. However, this is another issue that could be addressed as part of the monetary policy strategy review. If the ECB believes it needs to stick to its current policy on issuer limits, then it needs to debate the relative importance to its monetary policy strategy of the APP versus OMT. Given the important impact the OMT announcement had on sovereign bond markets, it may be the more important programme.

6. COMMUNICATIONS

A final set of issues relate to how the ECB communicates about monetary policy and about its broader mandate beyond price stability issues.

6.1. Monetary Policy

For most of the past decade, financial markets and central bankers assumed that low policy rates and unconventional monetary policies were a temporary phenomenon and debate focused on when there would be a return to "normal" monetary policies and how that would be communicated to the public. Increasingly, however, it seems as though we are settling into a "new normal" in which extremely low interest rates will be commonplace.

There are various explanations for this apparent change but the principal one is likely to be a reduction in the potential growth rate of modern economies and a consequent reduction in the equilibrium real interest rate.[9] This idea has been put forward most notably by Larry Summers (2014) in his various contributions related to so-called "secular stagnation" but can also be seen in technical econometric work by Federal Reserve staff such as Holston, Laubach and Williams (2017).

This phenomenon is likely to play an important role should the ECB reach a point where it wishes to raise its policy rates above zero. The ECB has had two previous "tightening cycles" and its main refinancing rate peaked during those cycles at 4.75 percent in October 2000 and at 4.25 percent in July 2008. If financial markets start to believe that a similar amount of tightening was going to happen in the next cycle, this could be reflected in a sharp rise in long-term interest rates once policy rates began to rise, perhaps sharper than the ECB would like. It will become increasingly important for the ECB to signal to the public where it thinks rates will settle down in a "normal" economic environment.

In this area, the ECB should consider following the Fed's example. There has been an intensive discussion within the Fed system of the likely future "neutral" or "equilibrium" real rate and a considerable amount of signalling to the public that this rate is lower than it was in the past. In addition to speeches, the Fed provides another useful guide to the public of where interest rates are likely to go via a set of macroeconomic forecasts that are provided by members of the FOMC.

[9] See Whelan (2018) for a discussion of these issues.

These forecasts include the committee members' estimates of the "longer run" levels of both inflation and the federal funds rates, this providing an implicit estimate of what the members believe to be the equilibrium real rate. The longer-run forecasts of inflation of committee members have not changed much in recent years, remaining at about 2 percent. However, there has been a large decline in the implicit equilibrium real rate. In January 2012, the median estimate of the long-run federal funds rate was 4.25 percent, implying an equilibrium real rate of 2.25 percent.[10] By September 2019, however, the median estimate of the long-run federal funds rate had fallen to 2.5 percent, implying an equilibrium real rate of just 0.5 percent.[11]

The ECB does not provide forecasts from Governing Council members but does provide a set of official staff forecasts. However, the time horizon for these forecasts is one year shorter than the FOMC projections and they do not contain any "longer run" forecasts. It is unclear to what extent these forecasts are endorsed across the Governing Council and they omit any direct reference to the future path of policy rates, instead providing forecasts of three-month Euribor rates as a proxy.

A monetary policy strategy review should consider the advantages (and possible disadvantages) that would come with adopting the Fed's more transparent strategy to signalling future expectations about monetary policy. In a world where much of the power of monetary policy comes via its ability to influence longer-term rates, the gains seem to me to be higher than any potential losses.

6.2. The ECB's Broad Mandate

A final area for consideration is whether the ECB should devote more of its communications to explaining to the public how broad its mandate is. It is common to see commentary insisting that "the ECB is straying beyond its strict price stability mandate" or that certain actions of the ECB are "not monetary policy and thus stray beyond its mandate". However, these comments generally reflect a misunderstanding of the mandate of the ECB as outlined in the European Treaties.

They key item setting out the ECB's mandate is Article 127 of the current Treaty on the Functioning of European Union, which is repeated in full below:

> *The primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119.*

Article 3 in turn states:

> *"The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market*

[10] https://www.federalreserve.gov/monetarypolicy/files/FOMC20120125SEPcompilation.pdf

[11] https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20190918.htm

economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance"

This means there is a legal obligation on the ECB to act to promote full employment and other social goals such improvements in the quality of the environment—provided the actions taken to support those goals do not endanger price stability. At a time like the present, when the ECB has repeatedly failed over the a number of years to achieve its own definition of price stability, this means not only that the current set of unconventional monetary policies are legal but that a wide range of not-yet-considered possible interventions could be consistent with the ECB's mandate.

I will give one hypothetical example. The ECB could consider loaning a large amount of funds to the European Investment Bank at the same (potentially negative) rates that it currently provides to banks under its Targeted Long-Term Refinancing Operation scheme in return for delivery of an agreed large programme of public infrastructure and green energy investments across the euro area.[12] These investments could stimulate the economy, thus helping to push inflation back towards its target rate and would also represent the ECB obeying its mandate to support the general economic policies of the Union.

7. CONCLUSIONS

Like most central banks, the ECB is a conservative institution and it has generally faced the challenges of the past decade in a relatively slow and reluctant fashion. A full review of its monetary policy strategy provides a good opportunity for the ECB to clarify its message to the public about its monetary policy and the breadth of its mandate, to retain and build upon the new policy tools that it has introduced and to streamline its operational procedures.

There are limits, however, to how far an ECB review of its monetary policy can go. The ECB cannot consider any changes that are incompatible with current EU law. Despite the many difficulties associated with changing the EU treaties, there is still an argument for using the experience of the past decade to debate whether the ECB's legal mandate should be adjusted.

For example, would an ECB that had a Fed-style dual mandate to minimise both inflation and unemployment have reacted faster and more efficiently to the severe slump that affected the euro area from 2008 to 2012? Now that the ECB is the supervisor of the euro area's banks, would a revised mandate that placed financial stability on an equal footing with price stability—as recommended by Eichengreen et al (2011)—be worth considering? With the expansion of the ECB's powers and policy tools, is there a need for a greater role for the European Parliament in holding the ECB to account?

The ECB monetary policy strategy review will not debate these questions but academics, policy makers, politicians and the wider public should.

[12] This is feasible because the EIB is an eligible counterparty of the ECB. See https://www.ecb.europa.eu/press/pr/date/2009/html/pr090507_1.en.html

REFERENCES

- Claeys, Grégory, Maria Demertzis and Jan Mazza (2018). A Monetary Policy Framework for the European Central Bank to Deal with Uncertainty , briefing paper for European Parliament Committee on Economic and Monetary Affairs, available at http://www.europarl.europa.eu/RegData/etudes/IDAN/2018/626100/IPOL_IDA(2018)626100_EN.pdf
- Constancio, Vitor (2018). Past and future of the ECB monetary policy. Speech available at https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180504.en.html
- De Grauwe, Paul (2007). The eurozone is missing the point, Financial Times. Available at https://www.ft.com/content/b02005aa-2efa-11dc-b9b7-0000779fd2ac
- Draghi, Mario (2019). Twenty Years of the ECB's monetary policy. Speech available at https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp190618~ec4cd2443b.en.html
- Ehrmann, Michael, Gianluigi Ferrucci, Michele Lenza and Derry O'Brien (2018). Measures of underlying inflation for the euro area. *ECB Economic Bulletin*. Available at https://www.ecb.europa.eu/pub/economic-bulletin/articles/2018/html/ecb.ebart201804_03.en.html
- Eichengreen, Barry et al. *Rethinking Central Banking.* Committee on International Economic Policy and Reform. Available at https://faculty.chicagobooth.edu/raghuram.rajan/research/papers/Rethinking%20Central%20Banking.pdf
- Gelpern, Anna and Mitu Gulati (2013). "The Wonder-Clause," *Journal of Comparative Economics*, Vol. 41, pp. 367-385, 2013
- Gerberding, Christina, Franz Seitz and Andreas Worms (2005). "How the Bundesbank *really* conducted monetary policy," *North American Journal of Economics and Finance*, Volume 16, 277–292.
- Kathyrn Holston, Thomas Laubach and John C. Williams (2017). "Measuring the Natural Rate of Interest: International Trends and Determinants," *Journal of International Economics*, Volume 108, supplement 1 (May): page S39–S75.
- Summers, Lawrence (2014). "U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound", *Business Economics*, Volume 49, pages 65-73. Available at http://larrysummers.com/wp-content/uploads/2014/06/NABE-speech-Lawrence-H.-Summers1.pdf
- Whelan, Karl (2014). The ECB's Collateral Policy and Its Future as Lender of Last Resort, briefing paper for European Parliament Committee on Economic and Monetary Affairs, available at http://www.europarl.europa.eu/cmsdata/106744/COMPILATION_587.299%20-%20Online.pdf
- Whelan, Karl (2015). The ECB and Financial Assistance Programmes: Has ECB Acted Beyond its Mandate?, briefing paper for European Parliament Committee on Economic and Monetary Affairs, available at http://www.europarl.europa.eu/cmsdata/105467/IPOL_IDA(2015)569963_EN.pdf
- Whelan, Karl (2016). "Banking Union and the ECB as Lender of Last Resort" *in Filling the Gaps in Governance: The Case of Europe* edited by Franklin Allen, Elena Carletti, Joanna Gray and Mitu Gulati, Robert Schuman Centre for Advanced Studies, EUI Florence.

- Whelan, Karl (2018). Monetary Policy in an Era of Low Average Growth Rates, briefing paper for European Parliament Committee on Economic and Monetary Affairs, available at http://www.europarl.europa.eu/cmsdata/157018/Whelan%20final%20publication.pdf

- Woodford, Michael (2008). "How Important is Money in the Conduct of Monetary Policy?" *Journal of Money, Credit and Banking*, Volume 40, pages 1561-1598.