

Inflation is Bad: The ECB
Maha Pasha/Bryan Kim

Legal basis for a single, centralised monetary policy was established in the treaties that created the European Union (EU) and the organisations that support the union. The European Central Bank (ECB) was formed to take responsibility for monetary policy throughout the Euro area. 11 national central banks joined as charter members on January 1st, 1999 by relinquishing monetary responsibility to the ECB. Since then, 6 EU countries have joined the 11 charter members as participants in the ECB, collaboratively deciding upon the monetary policy for the Euro Area.

Recognising the supranational nature of the ECB, the bank is organised as to encourage collaborative decision-making. Two decision-making bodies govern the policy decisions of the ECB: the executive board and the governing council. The Executive Board is comprised of six members: the president, vice president, and four other members; the European Council appoints all members of the executive board. The Governing Council consists of the Executive Board in conjunction with the governors of the 17 Euro area national central banks. The Executive Board is responsible for the actual implementation of monetary policy as decided by the governing council. A third group, the “general council” consists of the governing council in conjunction with the 10 EU countries that have not yet adopted or otherwise do not use the Euro. The existence of the general council is important because although the 10 non-euro countries have monetary regimes independent of the ECB, ECB decisions have the potential to influence all of the European Union.

When a country joins the ECB, they forfeit domestic interest and exchange rate policies as separate policy instruments, instead adopting the ECB policies as dictated by the governing

council. ECB member states retain fiscal policy instruments, but are bound by a set of EU guidelines as to maintain stability and coordination throughout the EU area. This guideline of centralised monetary policy and largely decentralised yet restricted fiscal policy is designed to maintain price stability in the Euro system.

The ECB's policy is dictated by a clear and unambiguous focus on maintaining the purchasing power of the Euro by ensuring a level of price stability throughout the Euro system, influenced by the painful lessons learned from hyperinflation in the Weimar Republic. This focus on price stability is mandated and affirmed by multiple treaties of the European Union. The ECB defines price stability as a, "year-on-year increase in the Harmonised Index of Consumer Prices for the euro area of below, but close to, 2% over the medium term." The ECB's quantitative definition of price stability contains several nuanced layers that have implications for how monetary policy is formed and implemented in the Euro system. Monetary policy is required to have a Euro area-wide focus; accordingly, price stability is assessed on the basis of aggregate price level in the Euro area. Therefore, decisions regarding monetary policy changes cannot be made targeting one country or even a group of countries; monetary policy must be uniformly created. Second, monetary policy must focus upon the medium term, because there is general consensus that monetary policy cannot, and therefore should not, fine tune short run developments in prices or inflation.

The ECB views price stability as the main mechanism by which higher standards of living and overall economic health is achieved. First and foremost, price stability ensures that price signals remain undistorted by maintaining the general price level, thus improving the allocation efficiency of the economy and welfare of consumers. Second, price stability reduces risk premia on Euro system investments, increasing incentives for creditors to invest in Euro system industries

and increasing economic welfare. Lastly, maintaining a stable price level makes it less likely that firms and consumers will engage in unnecessary hedging behaviours, preventing hindrance to economic growth due to inflation related stockpiling.

The main mechanism by which ECB monetary policy affects member states is through the transmission mechanism of monetary policy. At the very apex of this mechanism is the key interest rate that the ECB sets on: (a) main refinancing operations (which provides the bulk of liquidity to the banking system), (b) the deposit facility (which credit institutions can use to make overnight deposits with national central banks in the Euro system), and (c) the marginal lending facility (which credit institutions can use to get overnight credit from national central banks within the Euro system). By setting this key interest rate, the ECB directly affects money market interest rates, which eventually trickles down to all levels of the economy.¹

The protocols establishing singular monetary policy focused on price stability also establish the ECB's political independence from its member states. This political independence is extremely important to ensuring that the ECB is able to enact effective and unbiased monetary policy that will improve the overall economic health of the

A significant proportion of countries in the European Union experiencing sovereign debt crises are also part of the Euro area; the ECB is therefore unavoidably involved in the Euro Crisis. As the sole arbiter of monetary policy for its 17 member countries, the ECB has found itself in the difficult position of trying to prevent sovereign debt crises in select countries from causing the whole Euro area to experience financial strain. The ECB must also attempt to alleviate those countries with the worst financial outlooks by enacting efficacious yet selective monetary policy whilst maintaining a modicum of uniformity throughout the Euro Area. To

¹ See Figure I

achieve this end, the ECB has employed both standard and non-standard monetary policies aimed at improving the overall economic health of the Euro area.

In a fairly standard monetary policy response to a recession, the ECB has set the key interest rates on main refinancing operations, the marginal lending facility, and the deposit facility at historical lows in order to maintain well functioning credit markets. Low interest rates in the marginal lending facilities and main refinancing operations have encouraged banks to improve their asset positions by either requesting liquidity directly from the ECB (marginal lending facility), or by putting up acceptable collateral at the ECB in exchange for a cash loan in a short term repurchasing agreement (main refinancing operations). Furthermore, the ECB has set the key interest rate for the deposit facility at 0.00%, removing any interest incentive for central banks to park their money at the ECB.

The European Union has also approved the formation of a European Financial Stability Facility, specifically created to deal with the Euro crisis. The EFSF is primarily designed to handle any possible bailouts of countries with default level sovereign debt. Furthermore, the EFSF is able to intervene in the primary and secondary debt markets following due diligence and participate in the recapitalization of financial institutions.

In addition to the mandated price stability, the ECB has specifically focused on counteracting funding constraints and maintaining liquid markets. To handle these issues, the ECB has implemented nonstandard policy responses meant to work in conjunction with standard policy measures. Nonstandard policy measures are meant to be temporary and presently most are in their phasing out period.

The ECB has offered unlimited liquidity to banks with adequate collateral. Recognizing that collateral may be hard to come by, the ECB has also expanded the definition of what can be

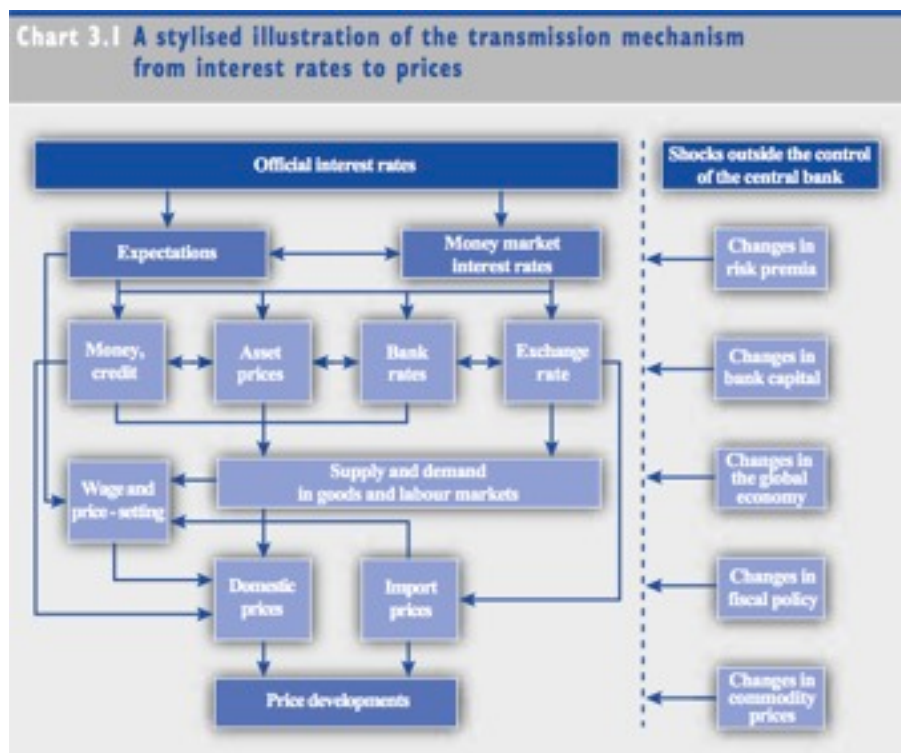
used as collateral, allowing more banks to receive aid. The ECB has also employed long term refinancing operations (LTRO) to offer banks a more certain medium term funding situation. Banks are able to borrow virtually unlimited amounts for three years at a rock bottom 1% interest rate with no stipulations, allowing banks to use said liquidity in any manner that they see fit. The LTRO program is intended to stave off a credit crunch that could prolong the painful economic recession in the euro area by bolstering bank's asset positions and allowing them to make decisions as to how to lend out the new influx of liquidity.

The Securities Market Program (SMP) has been a crucial nonstandard measure. Unlike the Federal Reserve System of the US, the ECB controls the money supply by employing various refinancing facilities. Bonds sold and bought through these refinancing facilities are either collateralized loans or short term repurchasing contracts. The SMP was employed in the earlier stages of the Euro crisis to purchase government bonds from countries experiencing great financial hardship, therefore assuming any risks associated with their weakened economy. This assumption of risk was intended to maintain the financial stability by reducing speculation on weak economies and by stabilizing the central banks of countries with sovereign debt issues. The key justification for the entire program is to ensure liquidity in a slowly deteriorating market. The SMP essentially allowed the ECB to assume the sovereign debts of member countries if need be. Recently, the ECB has announced a new program entitled "Outright Monetary Transactions," designed to handle bond purchases from Euro area members. This program is set to eventually eclipse the SMP. The OMT program is quite similar to SMP, but the key difference is that the OMT program has no expiry date and has no size constraints. Furthermore, the OMT program lays out specific criteria for bonds the ECB is to purchase them. Participating countries must also agree to financial restructuring as mandated by the ECB. Government cooperation in the OMT

program is expected to be strong, and the ECB expects that the program will artificially create market demand for bonds, therefore increasing bond prices and allow for the issuance of new debt, allowing member states to enact efficacious fiscal policy to solve recessionary crises.

Relevant Figures

Figure 1



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