

IN-DEPTH ANALYSIS

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Challenges ahead for the European Central Bank: Navigating in the Dark?

Monetary Dialogue September 2019



Policy Department for Economic, Scientific and Quality of Life Policies
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Abstract

Monetary policy must reinvent itself in the wake of the crisis. Reinvention is particularly important because the system is riddled with uncertainties and the scope for applying conventional and unconventional instruments is limited. The architecture of Economic and Monetary Union makes the challenge even greater, because alignment of preferences and policies only goes so far. The European Central Bank (ECB) will have to be clearer on what it can do, while remaining flexible in order to manage uncertainties and unknowns. While the ECB's main objective is price stability, it will also have to contribute to the identification of, and response to, financial imbalances, while preserving its independence.

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LIST OF ABBREVIATIONS

€STR	Euro short-term rate
ABSPP	Asset-Backed Securities Purchase Programme
CBPP	Covered Bond Purchase Programme
CSPP	Corporate Sector Purchase Programme
ECB	European Central Bank
EMU	Economic and Monetary Union
EONIA	Euro Overnight Index Average
ESCB	European System of Central Banks
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
GDP	Gross Domestic Product
LTROs	Longer-term refinancing operations
MROs	Main refinancing operations
OMT	Outright Monetary Transactions
PSPP	Public Sector Purchase Programme
QE	Quantitative easing
SMP	Securities Market Programme
TLTROs	Targeted long-term refinancing operations

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EXECUTIVE SUMMARY

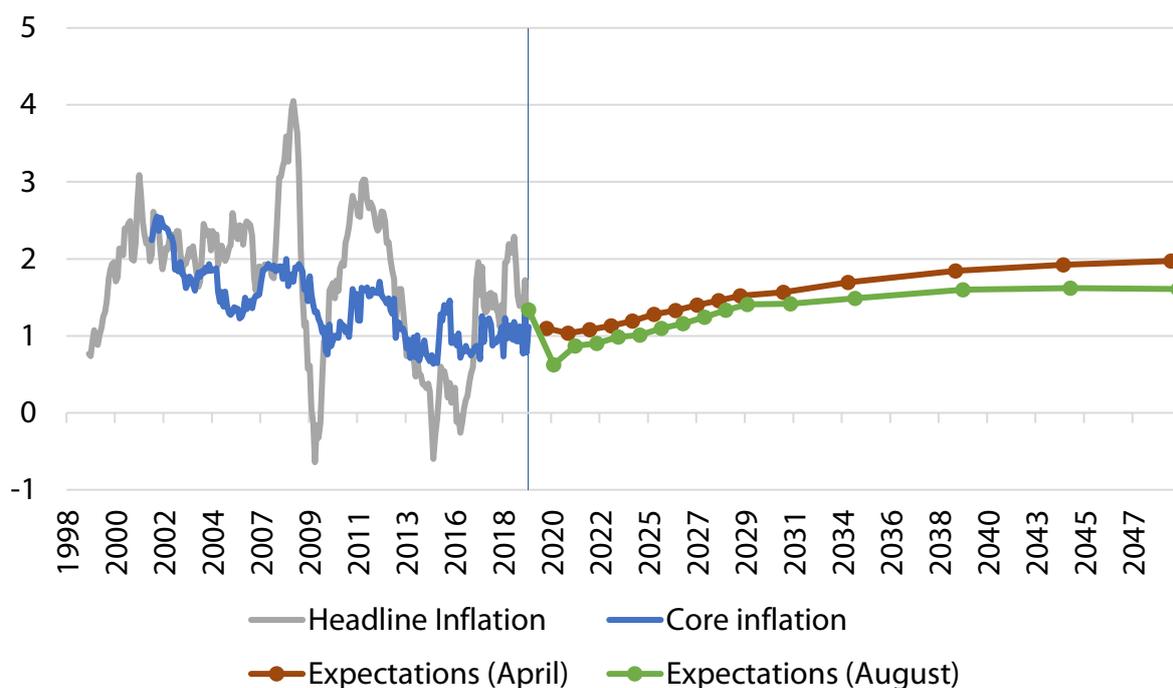
- The European Central Bank (ECB) has faced major challenges in the last decade: the global financial crisis, the Great Recession and the euro crisis, resulting in the worst economic situation since the Great Depression. These events made it difficult for the ECB to fulfil its price stability mandate as deflation risks mounted (especially after the double-dip recession) and transmission channels were broken because of the banking crisis and the sovereign debt crisis in some euro-area countries.
- The ECB responded to the events of the last ten years by expanding its toolbox significantly with the introduction of negative rates, generous long-term refinancing operations for banks, forward guidance, massive asset purchases, and tools to restore the transmission channel in all countries (Securities Markets Programme and Outright Monetary Transactions).
- As a result, the situation has improved in the euro area: deflation risks have abated, the economic recovery that started in mid-2013 has accelerated, investment has picked up, and unemployment has fallen considerably in the euro area as a whole.
- However, since the second half of 2018, signs of a slowdown have been piling up, as the euro area – which has become very vulnerable to external shocks because of its reliance on exports in recent years – has been heavily affected by global trade tensions. Major euro-area countries including Germany and Italy might already be in a recession. After peaking at around 2 percent at the end of 2018, headline inflation has decelerated again in recent months, market expectations have decreased to near their lowest historical levels, and core inflation is still stuck at around 1 percent.
- The ECB enters this potentially difficult period with limited space to cut rates and a large balance sheet, making it more difficult to use its current conventional and unconventional tools. In addition, the marginal return on these tools might be diminishing. This represents a major challenge for the ECB which will have to review its strategy and toolbox, and innovate further in the next few years to be able to fulfil its mandate.
- Another major challenge for the ECB is the peculiar, incomplete nature of monetary union, in which coordination between monetary and fiscal policy is flawed. There is no fiscal tool at the euro-area level, and national fiscal policies are under greater market scrutiny than in other jurisdiction because of the prohibition of monetary financing, which can result in self-fulfilling liquidity crises, especially in countries with more fragile debt situations. This gives the ECB a crucial role to play in the euro-area architecture.
- A third challenge is the lack of understanding of what the ‘new normal’ looks like. Neutral rates, which are an important guide for policy rates, have probably declined, but the estimates are poor and it is difficult to know if the current historically low level of rates are a short-term phenomenon or a secular one. More generally, this shows that the central banks’ underlying models – their interpretation of how the economy works – are also poor.
- To be able to face these challenges, we urge the ECB to review its strategy and framework, including the way its target is precisely defined.
- We also urge the ECB to be ready to apply all the tools at its disposal if the economic situation deteriorates (quantitative easing, generous refinancing operations, forward guidance, etc) and to start thinking about other potential tools if the current ones are insufficient (e.g. helicopter money, etc). But the ECB must also be ready to use Outright Monetary Transactions (OMT) in case sovereign debt markets face new liquidity crises.

- Finally, despite the primacy of its price stability mandate, the ECB will have to play an important role in promoting financial stability. Low rates for a long period, which are necessary to bring inflation back to 2 percent and support growth, could nevertheless have some financial stability implications, meaning the ECB could face some dilemmas in the future. This means that macro-prudential measures will have to be the first line of defence against financial imbalances. The current institutional setup in the euro area might not be capable of doing that. Therefore, the ECB should contribute to stronger analytical foundations for these policies, make proposals to improve the European framework and monitor carefully the financial stability risk to alert the institutions responsible for implementing these policies.

1. THE LEGACY OF THE CRISES AND OF MARIO DRAGHI'S PRESIDENCY

On 1 November 2019, the new President of the European Central Bank (ECB), Christine Lagarde, will take over responsibility for price stability in the euro area at a time of a slowing and uncertain recovery. Unemployment has fallen rapidly since 2015, and deflation fears have receded as headline inflation has slowly increased (even if, at 1 percent in August 2019, it is still remote from the ECB's target). However, core inflation has persisted at around 1 percent for the last five years, and wages still only partially reflect better employment conditions. Meanwhile, global geopolitical risks and digitalisation add to the unknowns. Markets have little faith that the ECB will manage to bring inflation back to its close to 2 percent target in the next 10 years. More worryingly these expectations have decreased further in recent months (Figure 1). How can the new ECB President convince markets otherwise?

Figure 1: Euro-area inflation, core, headline and market expectations (year-on-year, %)



Source: Bruegel based on Bloomberg.

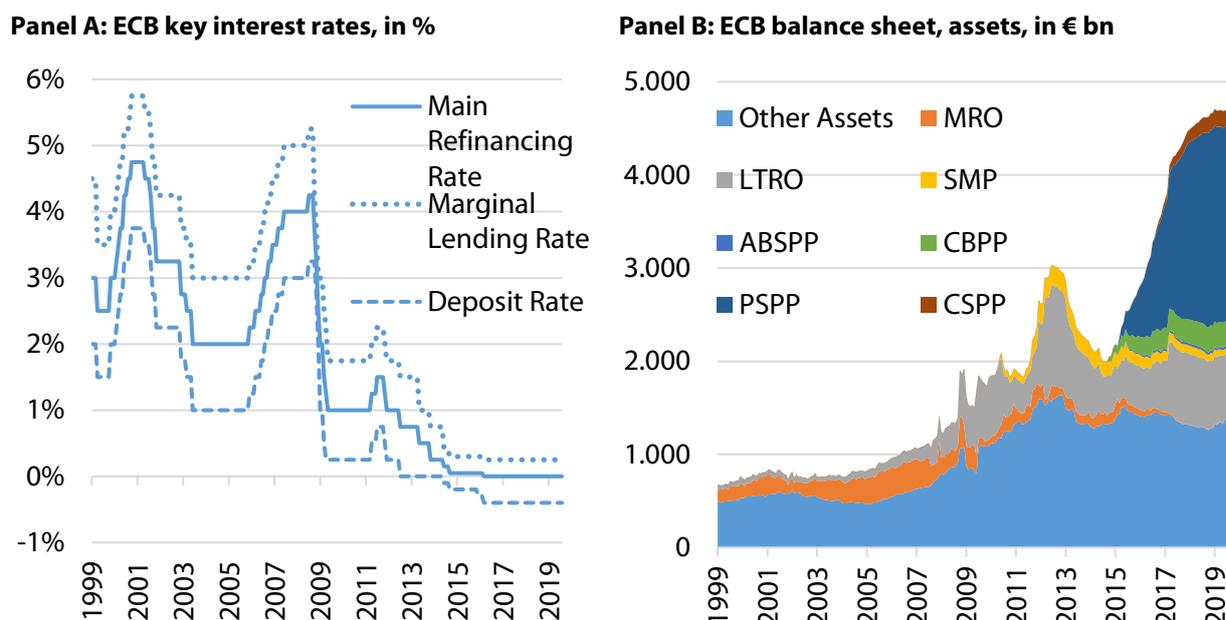
Note: Inflation expectations as of April and August 2019, derived from inflation zero-coupon swaps of different terms (1 year, 2 years, up to 30 years), which provide information on market expectations of average yearly inflation over the contract term. Expectations for 2020 inflation, for instance, are derived from expected inflation over the next year (2019), given by the 1 year swap, and expected inflation over the next two years (2019 and 2020), given by the 2 year swap. Expectations are related to the Eurostat Harmonised Indices of Consumer Price (HICP) excluding tobacco.

The new ECB President will inherit the legacy of the Great Recession and of the policies put in place by her predecessor, Mario Draghi. During the last eight years, the ECB was confronted with tough challenges: inflation volatility, risk of deflation visible in the downward trends in both actual and expected inflation, and a break in the monetary-policy transmission mechanism as a result of the banking crisis and the emergence of redenomination risk during the sovereign debt crisis. While inflation might not be as volatile today, all other issues remain very relevant. In particular, recent data

shows that the euro area has clearly been slowing down since the end of 2018, which could mean that the ECB will have to relax again the monetary policy stance in the near future.

In response to these challenges, the ECB sharply reduced its interest rates, even into negative territory, and committed, via forward guidance, to staying there (Figure 2 panel A). However, constrained by the lower bound on interest rates and the resulting difficulty of lowering further the whole yield curve, the ECB, like other advanced-economy central banks, resorted to balance-sheet management (Figure 2 panel B), culminating in quantitative easing (QE) – the purchasing of covered bonds, asset-backed securities, public-sector bonds and corporate bonds.

Figure 2: ECB monetary policy since 1999



Source: ECB via Bloomberg.

In parallel, the ECB introduced tools to restore the transmission mechanism of monetary policy, first through the Securities Market Programme (SMP) in 2010 and, second – and more successfully – through the announcement and specification of the Outright Monetary Transactions (OMT) programme in 2012.

Table 1 summarises the main changes to the ECB’s original toolbox and the new instruments introduced by the ECB since the financial crisis.

Table 1: Summary of the changes to the ECB's toolbox during the crisis

	Instrument	Pre-crisis	In 2019
Open Market Operations	Main refinancing operations	Variable-rate, limited quantity tenders, minimum bid rate	Fixed-rate full-allotment tenders (since 2008)
	Long term refinancing operations	Max 3-month maturity	Fixed-rate full-allotment tenders (since 2008), increased length up to 3 years (2008-12), Longer-term refinancing operations (LTROs) up to 4-year maturity (since 2014)
	Collateral		Extension of eligibility (since 2008)
	Forward guidance	-	Ex-ante announcement about rate level or use of unconventional policies (since 2013)
Standing Facilities	Deposit Facility	Policy rate channel defined as Main refinancing operations (MRO) +/-1%	Compressed corridor (since 2009) and increased role of deposit rate
	Marginal Lending Facility		
Reserve requirements	Minimum reserves	2% of deposits, debt securities <2 years	1% of deposits, debt securities <2 years (since 2011)
Asset Purchase Programmes	Securities Market Programme (SMP) / Outright Monetary Transaction (OMT) Programme	-	SMP (2010-12), OMT (2012, but never used)
	Covered Bond Purchase Programme (CBPP)	-	CBPP1 (2009), CBPP2 (2011), CBPP3 (2014)
	Corporate Sector Purchase Programme (CSPP)	-	CSPP (2016)
	Public Sector Purchase Programme (PSPP)	-	PSPP (2015)
	Asset-Backed Securities Purchase Programme (ABSPP)	-	ABSPP (2014)

Source: Bruegel based on ECB.

As a result, the new ECB President will start her term with a large balance sheet (that represents around 40 percent of euro-area Gross Domestic Product (GDP)), an interest rate with limited space for further downward movement and a system in need of reassurance that the OMT is ready to be used, if need be.

Looking back at macroeconomic policies implemented in the course of the last decade, it is our view that the ECB was forced to play a disproportionate role in dealing with the crisis. As the 'only game in town', the ECB had to act in ways that arguably brought it to the limits of its competences. The borders between fiscal and monetary policy have been blurred, adding to the complexity deriving from the fact that the ECB operates in a monetary union of 19 fiscal preferences that are only partly aligned. At the

same time, the persistence of low rates implies that their distributional consequences have become more visible, subjecting the ECB, its policies and even its independence to greater scrutiny.

This picture has not really changed much and the ECB could again be confronted with fiscal 'inaction' in the next recession, in which case it will have to respond, again, with more force than what a fully coordinated fiscal-monetary action would dictate. However, this time, the ECB will have limited room to use its current tools.

2. MAIN CHALLENGES FOR THE NEW ECB PRESIDENT

The new ECB President will face three main challenges.

The ECB will continue to operate in an incomplete monetary union. The single currency is unique in terms of its governance and the tools available to manage it. This requires a degree of adaptability from the ECB that is not asked of other similar institutions.

The first consequence of this incompleteness is that the coordination of fiscal and monetary policy in normal times is at best imperfect, given that the former happens at national level and the latter at euro-area level. There is no tool to carry out fiscal policy at euro-area level in combination with monetary policy to manage the cycle. This has put the burden on monetary policy, a reality the ECB will also probably be confronted with in the next recession. But this time the space to manoeuvre with the tools currently available will be considerably more limited. Reducing this risk will require Christine Lagarde to play an active role in Eurogroup meetings. She will have to try to inform debates in order to help align national fiscal policies with one another and with monetary policy. Meanwhile, she will have to safeguard the ECB's independence from political pressure that would have the ECB deviate from its Treaty-based mandate.

Timeliness of decision-making is equally important. The multi-country nature of monetary union implies that policies like QE might be delayed because they are more politically difficult to implement than in the United States or the United Kingdom. Indeed, the ECB started its programme six years after the Federal Reserve and the Bank of England. The new ECB President will need to ensure timely responses to shocks.

The euro crisis also revealed the vulnerability of the Economic and Monetary Union (EMU) architecture and the crucial role the ECB must play to deal with this. Given the prohibition of monetary financing, the issuance of debt to implement national fiscal policy comes under greater market scrutiny. We saw this during the crisis, when some countries were cut off from the markets. But market scrutiny does not always differentiate between a shortage of liquidity and an unsustainable fiscal debt. Thus, the provision of ample liquidity at early stages of stress, after a technical and political agreement that the debt is sustainable, is crucial to prevent liquidity crises from developing into solvency crises for euro-area members.

President Draghi's 2012 "*whatever it takes*" promise, and its formalisation through OMT, has proved effective in dealing with this problem and became a pivotal piece of the euro architecture during the crisis. OMT has not had to be deployed so far. Nevertheless, should a euro-area country experience difficulties, the ECB must be prepared to apply it in full.

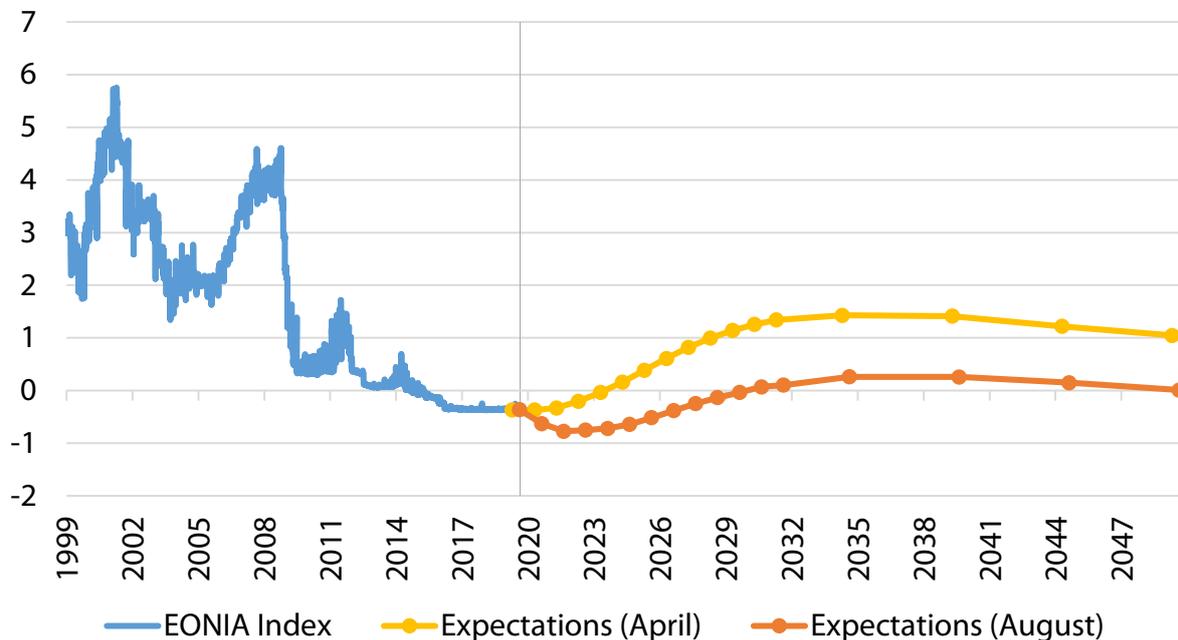
Last, the composition of the Governing Council and the ECB decision-making process are also direct reflections of the incomplete monetary union. Taking monetary policy decisions by unanimity, or at least by consensus, was deemed necessary at the start of the monetary union to ensure that the ECB speaks with one supra-national voice. But during the crisis, an increasing number of decisions were taken by majority (Claeys and Linta, 2019). The new ECB president will have to contain disagreements so that they do not undermine Governing Council decisions.

The second challenge the ECB will face in the next few years is the significantly reduced scope to apply its current tools. In terms of tightening policy rates, there is no constraint, but there is limited room to ease monetary policy further, given that nominal interest rates are at their lowest level for more than two centuries and probably ever (Papadia and Valimaki, 2018). In addition, interest rates are expected to stay at very low levels for the next three decades. After a new fall in recent months,

financial market participants now expect nominal short-term rates in the euro area to be still around 0 percent in 2049 (Figure 3).

It is important to try and understand the economic and financial drivers behind this situation, whether it is a short-lived phenomenon or whether this long-term picture is accurate.

Figure 3: Short-term interest rates and market expectations (%)



Source: Bruegel based on Bloomberg.

Note: Interest rate expectations as of April and August 2019, derived from Euro Overnight Index Average (EONIA) zero-coupon swaps of different terms (1 year, 2 years, up to 30 years), which provide information on market expectations of the compounded overnight EONIA over the contract term. Expectations for 2020 interest rate, for instance, are derived through expected compounded EONIA over the next year (2019), given by the 1-year swap, and expected compounded EONIA over the next two years (2019 and 2020), given by the 2 year swap.

What this picture does however suggest is that the ECB will have to rely more on balance-sheet management and less on interest-rate changes to deal with the next recession. This poses two challenges: first, while QE has helped to reduce the risk of deflation, asset purchases are more difficult to calibrate than rate cuts, and their macroeconomic effects are less clear. Second, when the ECB stopped its net purchases at the end of 2018, it had reached the 33 percent issuer limit for sovereign bonds for some jurisdictions (Claeys *et al*, 2018), which it put in place when it started its sovereign asset purchase programme. The rationale for this limit was that the ECB did not wish to have the power to block the restructuring of a euro-area country's debt, because not blocking such a restructuring might be interpreted as monetary financing. Combined with the rule requiring purchases to be proportionate to the shares of different national central banks in the ECB's capital, this limit reduces the scope of asset purchases.

At the same time, the very low interest rates raise financial stability concerns. Persistently low interest rates can lead financial institutions to search for yield by pursuing excessive risk taking (Dell'Ariccia *et al*, 2017). Though the problem of non-performing loans is being reduced, households and firms in the euro area already have high levels of indebtedness. Extra debt, encouraged by low interest rates, can

increase the debt overhang and financial vulnerabilities, all other things being equal. There is the risk therefore that the ECB could be torn between wanting to raise rates for financial stability reasons while needing to keep them low for price stability purposes¹.

The obvious solution to this dilemma should come from macro-prudential measures, and indeed a number of euro-area countries have resorted to such measures to deal with local issues. There are doubts, however, whether macro-prudential tools can address financial instability effectively. First, there is a cumbersome division of responsibilities between national authorities, the ECB and the European Systemic Risk Board (ESRB). Second, macro-prudential measures are intrinsically prone to regulatory arbitrage. Third, the analytic apparatus guiding the adoption and calibration of macroprudential measures is still under development.

The third challenge the ECB will be confronted with in the coming years is our lack of understanding of what a new ‘economic normal’ looks like. Some characterise this lack of knowledge of the new steady state, and therefore the lack of understanding of what the new equilibrium will be, as fundamental uncertainty. How can the ECB decide on its policy response if it does not know where it is heading? It is in the nature of fundamental uncertainty that it is not measurable. But in internal deliberations, the ECB’s staff will present the new President with a number of arguments that will point in the direction that we are indeed operating in an environment of fundamental uncertainty.

First, while most economists argue that the neutral interest rate has decreased, econometric estimates of this rate are very poor (Beyer and Wieland, 2019). This implies that underlying models – our interpretation of how the economy works – are also poor². In fact, Figures 1 and 3 considered together indicate the unusual result that markets believe that in the long run (i.e. in equilibrium), the real interest rate is negative (as expected inflation is well below 2 percent and the nominal interest rate is 0 percent by 2049). Here the challenge is to plan for contingencies: if the low market expectations shown in Figures 1 and 3 prove wrong and inflation and policy rates move back towards 2 percent and 4-5 percent respectively, monetary policy would again have space to manage both sides of the business cycle. In this scenario, the ECB will have to manage and communicate the means and timing of its exit from negative rates and, if necessary, of a gradual reduction in the Eurosystem balance sheet.

However, if market expectations turn out to be correct and the neutral rate remains very low or even negative, as suggested also by Holston *et al* (2017), the difficulty for the ECB will be of a different order of magnitude, as we discussed when we described the limited scope for using its tools.

Second, the link between employment and wage developments appears to have weakened (it is possible that the Phillips curve might have flattened in some countries, see Bonam *et al*, 2018, or have at least become more difficult to identify, see Moretti *et al*, 2019), while the relationship between wage and price developments has also become less certain. Critical variables, such as that for the non-accelerating inflation rate of unemployment, have become difficult to gauge. So, it appears there is both less space for monetary policy and its effect might be smaller. Darvas (2019) showed that the ECB’s inflation projections in recent years have been systematically wrong. Such observations imply that we understand much less well the monetary-policy transmission channel. This could jeopardise monetary-policy effectiveness and threaten the ECB’s credibility.

Last, broader developments render the shape and form of this new normal unknown. The digital transformation, the emergence of China, trade wars and the risk of the collapse of the multilateral

¹ This dilemma becomes even more acute if one also considers that the ECB, through the Single Supervisory Mechanism, is the supervisor of systematically relevant banks in the euro system.

² And there is even a view that the neutral rate is not even relevant for policy (Borio *et al*, 2017).

system indicate that the past is not necessarily going to be a good predictor of the future. The challenge will be to navigate those waters, partly in the dark, to achieve and maintain price stability and contribute to financial stability.

3. RECOMMENDATIONS

Our main recommendation for the new ECB President is to start her term by reviewing the ECB's monetary policy framework. The Bank of Canada decided to review its monetary policy framework in late 2018, ahead of the 2021 renewal of the inflation control agreement³. The United States Federal Reserve Board at around the same time reached a similar conclusion⁴. As the ECB faces significant challenges that call for more than just small changes, it should also thoroughly review its own framework and toolbox. The appointment of a new President and the renewal of two thirds of the Governing Council between 2018 and 2019 present a good opportunity to reflect on whether the current framework is well suited for the uncertainties of the future.

High uncertainty, in terms of both the environment in which the ECB will have to operate and the effectiveness of the available tools, requires that monetary policy design pay attention to both robustness and flexibility.

Robustness implies that policy design cannot be based solely on what is best in the baseline scenario. The ECB will rather have to design policies that can deliver as good a performance as possible across a range of possible scenarios. In other words, the ECB should not rank its policy alternatives in terms of what performs best for the most likely circumstances, but should rather rank them in terms of whether they do well enough for the most varied circumstances (Ben-Haim and Demertzis, 2016).

At the same time, the ECB must use flexibility to adapt its operations as it increases its knowledge about the new economic environment and the effectiveness of its tools. But this must be combined with sufficient consideration for continuity, in order to make monetary policy as transparent and as predictable as possible, in order to manage expectations effectively. Last, communication will also have to reflect the lack of knowledge that uncertainty implies. More than about monetary policy intentions, communication should be about how monetary policy is able to deal with the possibility of adverse outcomes.

What next for monetary policy?

If inflation convincingly moves towards its close to 2 percent target, the ECB should communicate the modalities of a return to positive interest rates, and start to plan for its optimal balance sheet size in the long run and its preferred operational framework. If, on the contrary, there is no progress towards the inflation target and, even more, if the euro area faces a protracted period of low growth and low inflation – as recent data seems to indicate – the ECB should be ready to apply forcefully a range of tools. Our main recommendations in this case are that:

- The ECB could cut its key rates, in particular its deposit rate, deeper into negative territory than it has so far (at time of writing it is fixed at -0.5 percent) to reduce further short-term market rates. However, recent data released by the ECB (2018) shows that there are signs of cash hoarding by banks as a result of negative deposit rates – even if the sums at stake are still small compared to the overall amount of excess reserves. This suggests that the ECB might already be near its effective lower bound and that it might be difficult to go well below it in the future (especially if banks have already built up the capacity to store cash in order to avoid the negative deposit rate). Potential solutions to these problems include taxing paper currency (as suggested by Agarwal and Kimball, 2015; or Kimball, 2015) or abolishing it altogether (Rogoff, 2016). But these solutions are extreme and highly unpopular in some Member States. Also, the potential side-effects on bank profitability

³ <https://www.bankofcanada.ca/2018/11/bank-review-monetary-policy-frame-work-ahead-2021/>.

⁴ <https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm>.

and lending capacity could reduce such an instrument's effectiveness in stimulating growth and inflation in a bank-based financial system. One way to mitigate these side effects is to put in place a tiering system (such as the ones that exist in Switzerland, Denmark and Japan) in which only part of the excess reserves is subject to the negative deposit rate. The ECB decided to introduce a two-tier system on 12 September 2019 by exempting a significant portion of the excess reserves from the deposit rate. The ECB will have to be careful to find the right balance between providing some relief for banks and ensuring that short-term market rates (EONIA and €STR in the future) stay near the deposit rate, so that a cut in the latter lowers the yield curve.

- The ECB should maintain generous refinancing operations and balance-sheet management in its monetary policy toolbox. The ECB announced, on 7 March 2019, that it will launch a third wave of 2-year targeted long-term refinancing operations (TLTROs) at a borrowing rate that will possibly be as low as 10 basis points above the average deposit facility rate over the life of each operation if banks fulfil their lending benchmarks. As a result of the current slowdown, the ECB decided on 12 September 2019 to loosen the modalities of these operations – the borrowing rate will be as low as the deposit rate – and to increase their length to 3 years. One possibility – advocated for instance by Lonergan (2019) – to boost the effectiveness of TLTROs in the future would be to lend to banks at an interest rate below the deposit rate to give banks a strong incentive to lend (conditional on lending targets and on them passing part of the negative rates to the borrowers so that they also have a strong incentive to borrow).
- In order to restart its asset purchase programme, the ECB should be ready to update its self-imposed constraints (i.e. the 33 percent issuer limit and/or the capital key distribution) and/or include other asset classes in its purchases, such as bank loans and possibly equities. One could consider whether the 33 percent limit achieves the right balance between the risk of monetary financing and the risk of not meeting the price stability objective. For instance, the risk of monetary financing of an AAA-rated government appears currently to be negligible and should not act as a constraint on the implementation of the asset purchase programme and the fulfilment of the ECB's mandate. In order to facilitate the implementation of its QE programme, should it need to use it again, the ECB should thus relax the limit, at least for highly-rated countries⁵.
- Last, the ECB should also start to evaluate potential new tools in case the current ones prove insufficient to regain and maintain price stability. Direct injections of cash into the economy by the central bank (i.e. helicopter money) or interventions in other markets (e.g. the market for inflation derivatives⁶, see Papadia, 2015) should not be discarded without careful evaluation. Given the limited space the ECB has, new tools should be studied so that, if needed, they can be applied with adequate knowledge of what they might achieve and at what risk.

⁵ The Court of Justice of the European Union in 2018 seemed to imply that the relevant limit of the public sector purchase programme is not to buy all the bonds issued, as it states that the European System of Central Banks (ESCB) is "not permitted to buy either all the bonds issued by such an issuer or the entirety of a given issue of those bonds" and that monetary financing is avoided when "a private operator necessarily runs the risk of not being able to resell them to the ESCB on the secondary markets, as a purchase of all the bonds issued is in all cases precluded".

See the judgement in case C-493/17, 11 December 2018, available at:

<http://curia.europa.eu/juris/document/document.jsf?text=&docid=208741&pageIndex=0&doclang=EN&mode=req&dir=&oc-c=first&part=1&cid=6032640>.

⁶ The underlying logic is that firms would be more willing to give larger wage increases to their workers if they could buy protection (via options or swaps) from the ECB that inflation would not be too low (i.e. below its target). As a result, if enough companies participate in the scheme, larger wage increases could then push up inflation back to 2 percent.

More broadly, when reviewing its framework, the ECB should consider two issues:

- First, the ECB should reinforce the message that the 2 percent inflation objective is the best quantification of the Treaty mandate of price stability. Providing some clarity through precision is however crucial. This is particularly relevant given the other uncertainties we have described. If a statistically measured 2 percent inflation means that, in reality, prices are stable, then any rate lower than that means prices are falling. On the other hand, raising the target above 2 percent, even if it increases the policy space, would imply that the ECB would no longer aim strictly at price stability, as required by the Treaty, not to mention that in the current circumstances a higher target seems difficult to attain. In order to reap the benefits of an effective *focal point*, in other words an explicit, clear and well-understood numerical inflation target, the ECB should consider introducing explicitly defined tolerance bands around a precise numerical target, which has been shown to reinforce credibility via accountability (Demertzis and Viegi, 2008, 2010).
- Second, the ECB could also consider modifying other elements of its price stability definition: it could put more emphasis on core inflation and consider targeting inflation on average over, say, the business cycle instead of 'over the medium term'. This could help prevent rushed policy reversals and could have helped to avoid the erroneous interest rate increases of 2011 (Claeys *et al*, 2018).

Last, the new ECB President will have to manage decision making in the governing council. In doing this she should try as much as possible to foster convergence in the governing council, free from national considerations. However, she should not try to reach unanimity or consensus at all costs, as this could lead to timid or late decisions that could damage the euro-area economy.

The ECB's crucial role in the euro-area architecture

An important role that the ECB has had to play and might have to play again is to provide policy certainty when other forms of uncertainty prevail. The "*whatever it takes*" speech of President Draghi provided this clarity when the level of uncertainty threatened the euro's existence. While the announcement of OMT convinced the markets that the ECB had both the tools and the willingness to intervene, the ECB needs to re-examine the framework behind this programme and ensure that it serves its purpose of reducing uncertainty as much as possible.

Our main recommendations here are that:

- The new President of the ECB should reconfirm that it is ready to use the OMT programme to avoid liquidity crises in the sovereign debt markets of euro-area members.
- Important steps have been taken to ensure the soundness of the OMT's architecture: the involvement of a European Stability Mechanism (ESM) programme as a precondition necessary to avoid moral hazard requires a neutral assessment by the European Commission of the sustainability of the fiscal position, and the political commitment to back it up provided by the ESM board, i.e. the euro-area finance ministers. In further considering the role of the ESM, the ECB should clarify the unnecessary ambiguity in its original OMT press release (ECB, 2012) and state that an ESM Precautionary Conditioned Credit Line, which is the natural candidate to be used in liquidity crises, should be considered sufficient as a pre-condition to access an OMT programme (Claeys and Mathieu Collin, 2018).
- Another important element to reduce the fragility of sovereign debt in the euro area would be for the ECB to re-examine its collateral framework to make sure it does not participate in compromising the safe-asset status of the sovereign bonds of euro-area members (Claeys and Goncalves Raposo,

2018). The ECB should also increase its transparency when it comes to these potentially controversial and crucial decisions.

The ECB's role in promoting financial stability

Low interest rates for a long time might contribute to the build-up of financial imbalances⁷ that might be difficult to identify in real time but could have very unpredictable consequences. As we have noted, there is a risk that policy and market rates in the euro area will remain low for a very long time. This implies that financial instability will remain a significant threat to the system, even if we cannot precisely predict in what form. It is doubtful that, with the current institutional framework and given the uncertainty about their effectiveness, macro-prudential measures can provide effective protection against financial instability. While we do not believe that monetary policy should directly target financial stability at the detriment of price stability (Agur and Demertzis 2019), the ECB does have a role to play in the pursuit of financial stability. We recommend that:

- The ECB should contribute to deeper analytical foundations for macro-prudential policies as a first line of defence against the build-up of financial stability risks; cooperation with the European Systemic Risk Board should be enhanced on this issue.
- The ECB should make proposals for the establishment of a better institutional set-up for the use of macro-prudential tools, so that it can act in a timely and effective way.
- The ECB should monitor carefully financial stability risk in the euro area, and alert the relevant institutions responsible for implementing macro-prudential policies when it identifies signs of build-up of financial imbalances.

⁷ Zero interest rate means that asset prices become very volatile as any change in future returns of these assets, even if 20 years ahead, is not discounted. So, volatility necessarily increases for rates equal to zero.

QUESTIONS FOR MEPS

1. Headline inflation is going down and is now at 1%, core inflation has been stuck around 1% for 5 years, market expectations are also falling, what is the ECB going to do to fulfil its mandate and reach its target in the next few months?
2. Do you think your current tools (negative rates, asset purchases) have reached the point where they have diminishing/negative returns? In that case, what other unconventional tools could be introduced to fulfil the ECB's mandate?
3. Has the ECB been working on other unconventional tools such as helicopter money, and on how it could be implemented in the Eurozone (from a technical but also from a legal perspective)?

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Monetary policy must reinvent itself in the wake of the crisis. Reinvention is particularly important because the system is riddled with uncertainties and the scope for applying conventional and unconventional instruments is limited. The architecture of Economic and Monetary Union makes the challenge even greater, because alignment of preferences and policies only goes so far. The European Central Bank (ECB) will have to be clearer on what it can do, while remaining flexible in order to manage uncertainties and unknowns. While the ECB's main objective is price stability, it will also have to contribute to the identification of, and response to, financial imbalances, while preserving its independence.

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