Monetary policy

Monetary policy in the euro area and the sovereign debt crisis

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Outline

1. ECB's monetary policy decision-making bodies
2. Treaty of Lisbon dispositions
3. Objectives of Monetary Policy
4. The importance of fiscal discipline in a Monetary Union
5. The ECB's recent response
6. The reform of the fiscal side

ECB's monetary policy decision-making bodies

- The **Governing Council** of the ECB (17 Members from National Cental Banks (NCBs) + 6 from the ECB) - Adopts the guidelines, ensures the performance of the tasks entrusted to the Eurosystem and formulates monetary policy for the euro area as a whole
- The **Executive Board** (6 ECB) - Prepares Governing Council meetings and manages ECB and implements monetary policy for the euro area (separation principle)
- Portugal does not have autonomous monetary policy since 1999. Banco de Portugal is member of the Eurosystem (=17 NCBs+ECB). The Governor of Banco de Portugal is member of ECB Governing Council

Separation of fiscal and monetary policy

- Governments in charge of both fiscal and monetary policy **have incentives to generate inflation** (Kydland and Prescott, Barro and Gordon)
- This **time inconsistency** issue has been addressed by giving central banks a clear mandate (to achieve price stability) and strict independence from governments including the prohibition of monetary financing.
- In the case of the euro, **fiscal discipline** is particularly important

Why is fiscal discipline so important in a Monetary Union?

- The single monetary policy cannot respond to **country-specific shocks**.
- Unsound fiscal policies in some countries (even small ones!) can have **spill-over effects** on all member states through financial markets.
- Financial markets may not exert the necessary discipline on fiscal policies in a Monetary Union.

Thus, strong binding mechanisms for national governments, such as the **no bail out clause** and the **Stability and Growth Pact** (which has to be reformed), are crucial.

Treaty provisions: objectives of Monetary Policy

Article 127 (Treaty of Lisbon)

> *The primary objective of the European System of Central Banks (...) 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 (...)*

The objectives of the Union are inter alia to ensure:

- A high level of employment
- Sustainable and non-inflationary growth
- A high degree of competitiveness and convergence of economic performance

Other important Treaty of Lisbon articles

- *Article 130* - Grants **independence** to the ECB and national central banks from Union institutions, Member State governments or from any other body.
- *Article 123* - **Prohibits monetary financing**, i.e. the ECB or NCBs cannot provide credit or buy debt instruments directly from governments (i.e. in primary markets).
- *Article 125* - **No bail-out clause**: responsibility for repaying public debt remains national (but mutual financial guarantees for specific purposes are allowed).

The Stability and Growth Pact

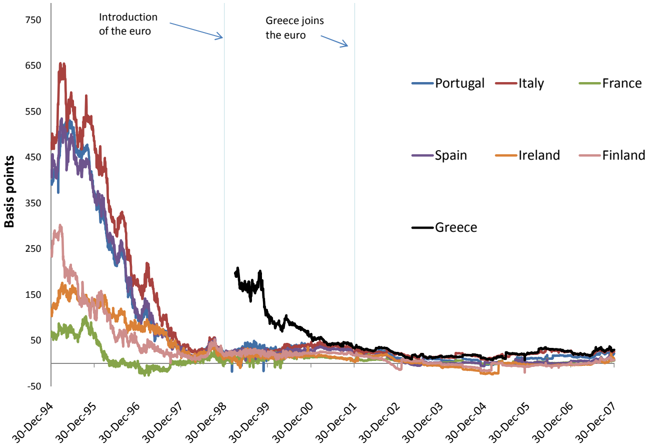
Article 126, Treaty of Lisbon - The Commission should start and **Excessive Deficit Procedure** if:

- The ratio of the planned or actual government deficit to GDP **exceeds 3%**
- The ratio of government debt to **GDP exceeds 60%**, unless it is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Exceptional and temporary deviations of the deficit over the reference value may not be considered excessive (for instance due to a large recession), but only if the deficit remains close to the reference value.

Market discipline did not prevent unsound fiscal policies...

Figure: 10 year government bond yield spreads relative to Germany



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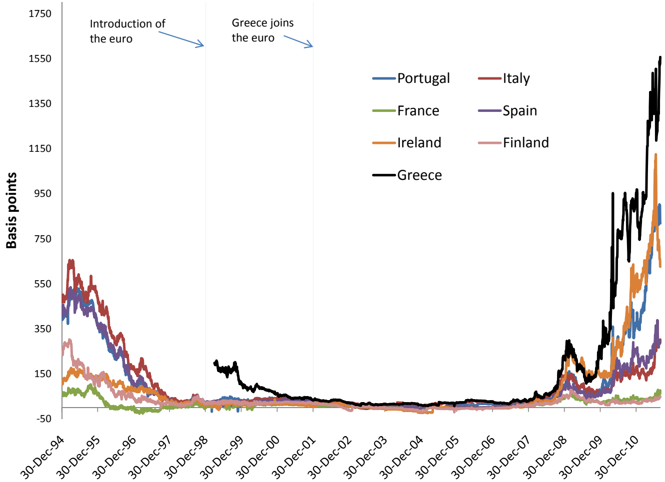

The ECB's recent response

The ECB responded to the crisis using two main approaches

- Lowering interest rates - The ECB reduced interest rates from 4.25% in 2008 to around 1% since 2009
- Increasing liquidity provision
- Long-term refinancing operations with a maturity of three years
- Allow banks to use loans as collateral with the Eurosystem
- Reduce the required reserves ratio from 2% to 1%

Recent ECB decisions: objectives

- Prevent price stability deflation with interest rate cut
- Restore the flow of credit to the economy, in particular to SMEs
- Reduce pressure both on banks regarding their capital basis (EBA) and funding conditions (long-term)

The reform of the fiscal side

- The countries concerned have to put their public finances back in order
- Include rules in the primary legislation
  - Golden rule - annual structural deficit should not exceed 0.5% of nominal GDP.
  - Numerical benchmark for annual debt reduction to reduce debt levels.
  - Automatic sanctions to euro area Member States in breach of the 3% reference value for deficits.
- Enact firewalls
  - Leveraging of the European Financial Stability Facility (EFSF)
  - Creation of the European Stability Mechanism (July 2012)