Monetary Policy at the Zero Lower Bound: The European Central Bank in the Realm of Politics

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Disclaimer: The views expressed are my own and should not be reported as representing the views of the ECB.

Organisation

Motivation for this paper:

…the relationship between central banks and their governments might well have changed, with central banks "crossing the line" into the political realm more often than in the past.

Quote from Blinder et al. (2017, p.707).

This paper reviews the political economy aspects of the ECB's non-standard monetary policy measures during the low-inflation episode of 2013-18:

1. ECB non-standard monetary policy in the realm of politics
2. Political interest in the fiscal-like side effects of easy money
3. Political interference as an endogenous outcome
4. Political integration as alternative to political dominance

ECB non-standard monetary policy in the realm of politics

For 20 years, the ECB has been a 'lonely' central bank in a politically fragmented Economic and Monetary Union: no euro area treasury as a counterpart.

When the euro area economy stalled and inflation dropped to a very low level in 2014, the ECB president called for a united economic policy response from the 19 member countries to support the single monetary policy when it had reached the zero lower bound for its key interest rates.

But their focus was on fiscal consolidation and avoiding structural reforms, instead of organising an area-wide fiscal expansion to support demand and a higher pace of reforms to strengthen supply.

As this 'game of chicken' was lost, the ECB remained the 'only game in town' and stretched monetary policy to the limit of its mandate.

The non-standard monetary measures supported an economic recovery and a pick-up in inflation but caused (academic, legal and political) controversies over their legitimacy and may have contributed to more political fragmentation.

ECB exceptional monetary measures during 2013-18

Non-standard negative money market rates to stimulate the supply of bank credit:

- ECB deposit facility rate was cut to -0.4%; this negative interest rate was applied to banks with (required and excess) reserve balances ('tax on liquidity')

Non-standard credit operations to enhance the supply of bank credit:

- continued fixed rate full allotment (FRFA) of ample low-cost liquidity to banking system
- two series of targeted, medium-term and ultra-cheap ('subsidised') refinancing (TLTROs)
- continued acceptance of collateral at less stringent conditions subject to risk mitigation

Non-standard asset purchases to ease general financing conditions:

- Public Sector Purchase Programme (PSPP) treats nearly all government securities as equal, subject to ECB capital key, issue and issuer limits, with risks assigned to NCBs
- PSPP also includes national public sector agencies and supranationals in the euro area
- Various private sector asset purchases (CBPP, ABSPP, CSPP)

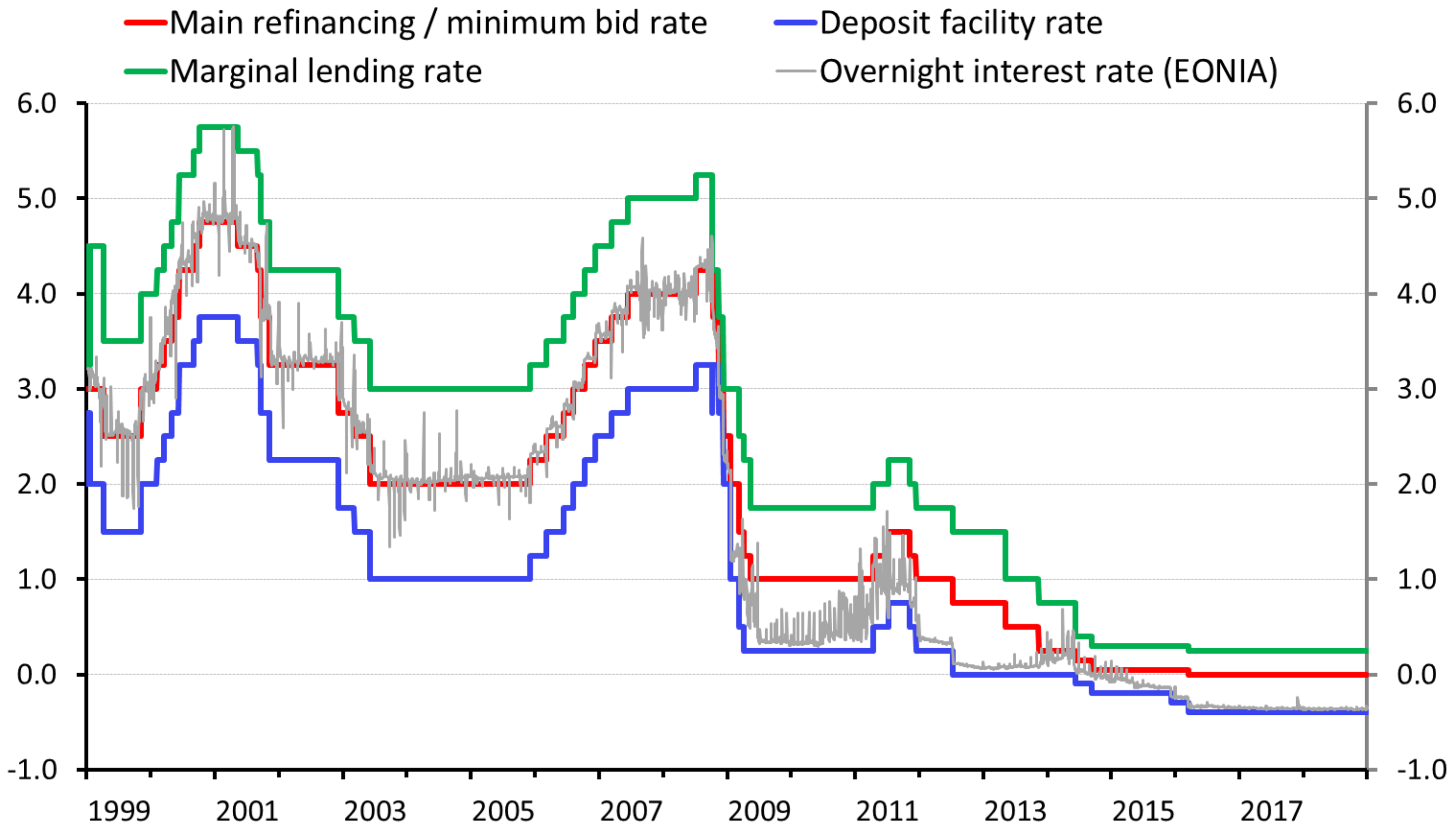
Non-standard explicit communication about future monetary policy intentions

- Forward guidance: the monetary policy stance will stay very accommodative for long

ECB steered money market rates below zero

ECB key interest rates and EONIA

(percent per annum, 1 Jan. 1999 – 31 Dec. 2018)

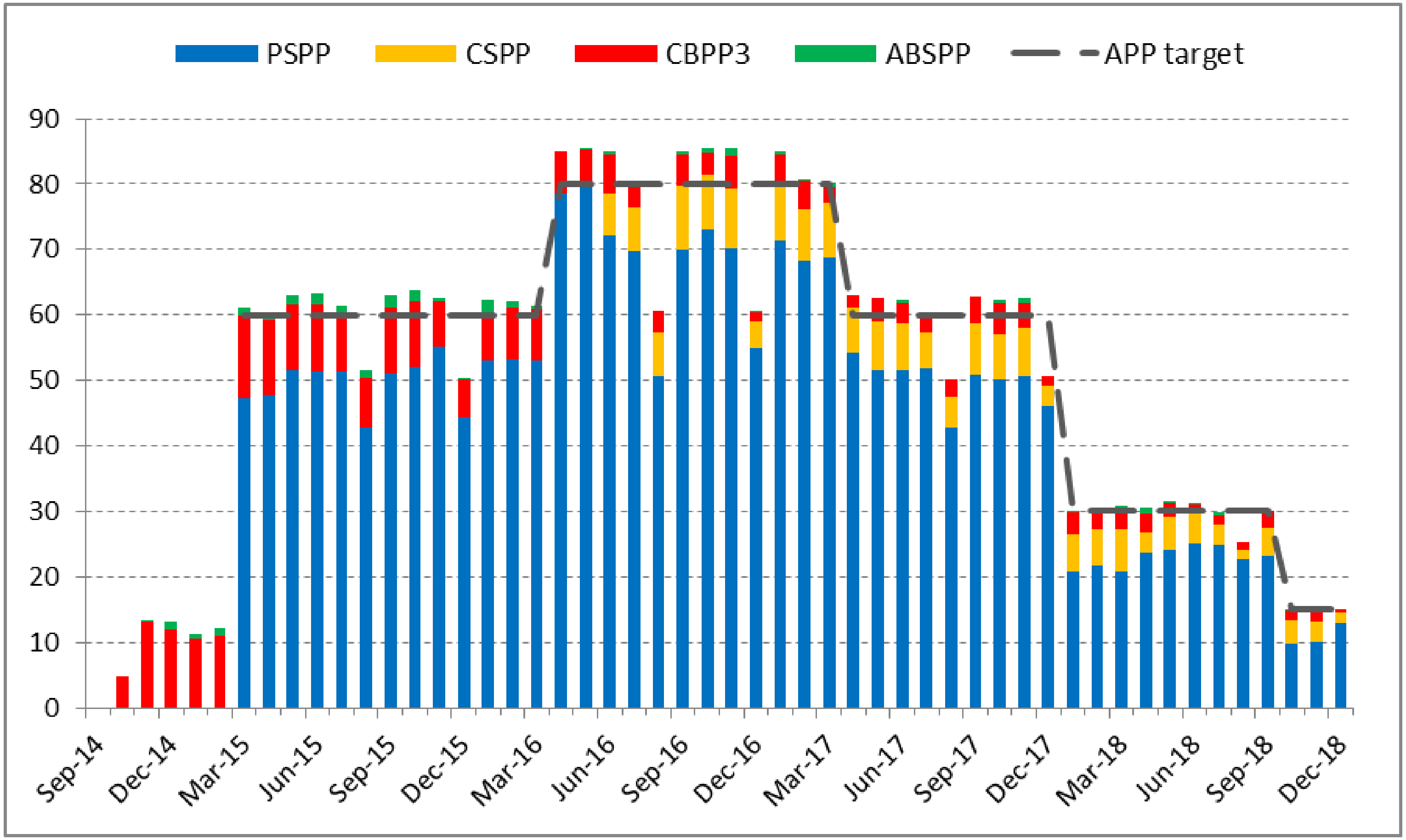


Source: ECB.

Large-scale public and private sector asset purchases

The asset purchase programme of the Eurosystem

(monthly net asset purchases Oct. 2014 – Dec. 2018, € billions)

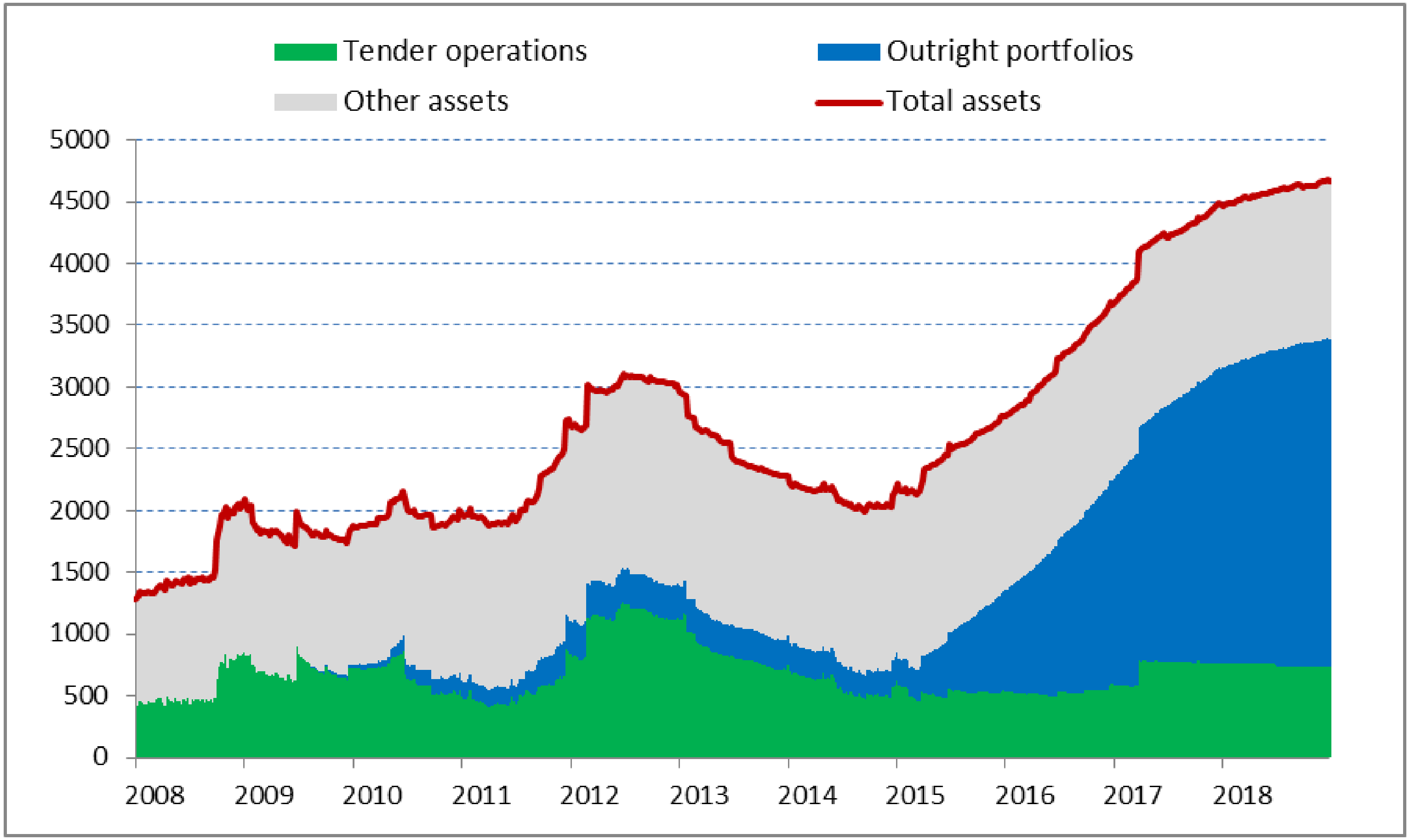


Source: ECB. Note: The asset purchase programme (APP) comprises the asset-backed securities purchases programme (ABSPP), the third covered bond purchases programme (CBPP3), the public sector purchase programme (PSPP) and the corporate sector purchase programme (CSPP). Monthly net asset purchases cover gross purchases, redemptions and reinvestments.

Rapid expansion of the Eurosystem balance sheet

Eurosystem balance sheet: total assets and monetary policy assets

(weekly data Jan. 2008 – Dec. 2018, € billions)



Source: ECB. Note: Tender operations = Lending to euro area credit institutions against eligible collateral. Outright portfolios = Public and private sector securities bought in the capital market for monetary policy purposes. Other assets = Gold and gold receivables; claims on non-euro area residents; claims on euro area residents, credit institutions and governments held for non-monetary policy purposes; and remaining assets.

The main intended and unintended effects of easy money

Positive economic effects:

- easier private financing conditions and favourable wealth effects
- broad-based economic expansion and falling unemployment
- prevention of deflation and on track for sustained return to price stability

Fiscal side effects:

- complicated coordination issues with public debt managers
- significant budgetary advantages for all euro area governments
- distorted price signals along the entire sovereign yield curve may reduce fiscal discipline

Financial side effects:

- higher profits against risk of valuation losses and credit impairments for ECB and NCBs
- investors search for extra yield in more risky markets and bid up asset prices
- forbearance on non-performing bank loans and survival of less productive firms

Distributional side effects:

- regional differentiation in tax and subsidy effects of ECB refinancing for banks
- large firms enjoyed easier access to market credit, SMEs dependent on bank response
- redistribution of income and wealth at the expense of creditors and small savers

Growing political interest in the conduct of ECB monetary policy

ECB could direct credit to favoured destinations at affordable low interest rates

- public sector bond purchases could be exploited to ‘neutralise’ market impact of public debt, reduce sovereign bond yields, create fiscal space, facilitate compliance with SGP
- Italian election idea to let ECB cancel € 250 bn. of public debt held by Banca d’Italia
- MEPs asked that corporate sector bond purchases promote EU goals on climate change and sustainable finance, called for credit facilities that ease access to finance for SMEs

Profit and loss aspects of a large balance sheet expose the ECB to political pressure

- European Commission proposed to earmark part of NCBs’ seigniorage income for EU budget (€ 10.5 – 56 bn.), in particular to fund a common investment facility
- NCBs’ large exposure to national public sector credit risk and shared corporate sector credit risk raised political concerns about possible need for recapitalisation

Connection with euro-sceptic populists and market fears that the euro might fall apart

- German MoF blamed excessive monetary easing for half of the rise in support for AfD
- Argument that hasty reversal of quantitative easing could give ammunition to populist parties of vulnerable countries, such as Italy, that want to leave the euro
- ECB called upon to ensure that sovereign bond spreads will stay small, also when political risks rise and market volatility increases.

Political interference as endogenous outcome of ECB actions

The more non-standard monetary policy similar to financial repression becomes the ‘new normal’, the more politicians could criticise the ECB for the fiscal-like side effects of its actions and the missing democratic legitimacy: this may trigger calls to limit or revoke ECB independence as a result of its own extraordinary actions.

A prolonged monetary easing makes the economy addicted to ultra-low interest rates

- a political bias towards low-for-longer interest rates, also to contain populist forces
- it constrains ECB in making an independent decision on its monetary exit strategy

An accumulation of fiscal and quasi-fiscal side effects raises political controversies

- either the ECB may be criticised for overstepping its mandate with fiscal-like measures,
- or it could face pressure to support EU public policy goals beyond price stability
- conflicts on the net benefits of the single monetary policy may fuel euro scepticism

Non-standard monetary policy akin to financial repression as the ‘new normal’

- euro area leaders may force ECB to pursue a more politically motivated monetary policy,
- and turn ECB into a central planner of the eurozone to serve a variety of EU goals

Conclusions

ECB monetary policy at the age of 20 finds itself between a rock and a hard place:

- some politicians welcome the revival of the euro area economy engineered by the ECB,
- others criticise the fiscalisation of monetary policy and contest the ECB in court

The growing political demands on the ECB:

- politicians are attracted by the opportunity of exploiting non-standard monetary measures for their own allocative, financial and distributional objectives
- the addiction to ultra-low interest rates complicates a future monetary exit: QE forever?

The endogenous risk of political interference:

- fiscal-like side effects of non-standard measures creates split views over the net benefits of the single monetary policy and could undermine support for ECB independence
- using these ‘financial repression tools’ as the new standard could trigger an attack on ECB independence to align its monetary policy with EU objectives beyond price stability

Political integration as alternative to political dominance:

- a euro area fiscal counterpart could support the ECB at the zero lower bound by making the aggregate economic policy stance consistent with a constrained use of exceptional monetary measures while taking responsibility for non-monetary policy objectives
- this would reduce the burden put on the ECB and enhance democratic accountability

Thanks for your kind attention!

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