

The ECB's Instruments for Crises and Normal Times

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Multiple challenges

- ▶ Ongoing policy strategy review a unique opportunity for ECB to examine how to best employ its immense power to serve the people of Europe.
- ▶ Two main challenges for ECB monetary policy strategy:
 - ▶ Policy in a low interest rate environment. (Common with other CBs.)
 - ▶ Incomplete EMU. (Unique to ECB.)
- ▶ Two key problems since euro crisis—still unresolved:
 - ▶ Lowflation.
 - ▶ Impairment of monetary policy transmission mechanism.
- ▶ Does the ECB lack the authority or instruments to fulfil its mandate?
- ▶ What needs to be done ... and when?



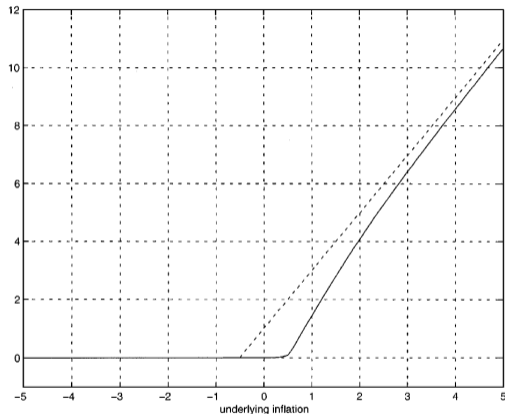
Background

- ▶ “Efficient Monetary Policy Design near Price Stability,” JJIE, 2000. (With Volker Wieland.)
<https://doi.org/10.1006/jjie.2000.0452>
- ▶ “Options for the ECB’s Monetary Policy Strategy Review,” Study for ECON Committee, European Parliament, Sept. 2020. (With Yvan Lengwiler.)
[https://www.europarl.europa.eu/RegData/etudes/STUD/2020/652753/IPOL_STU\(2020\)652753_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2020/652753/IPOL_STU(2020)652753_EN.pdf)

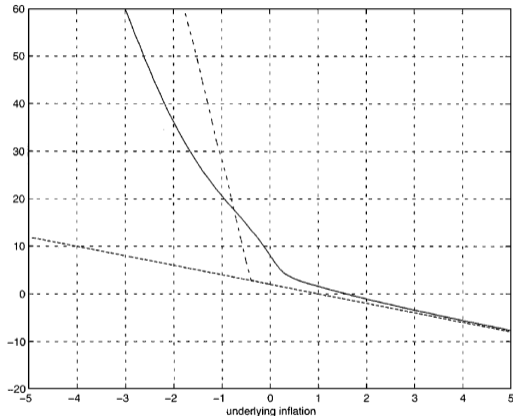


Efficient response to ZLB challenge

Overnight interest rate



Size of balance sheet

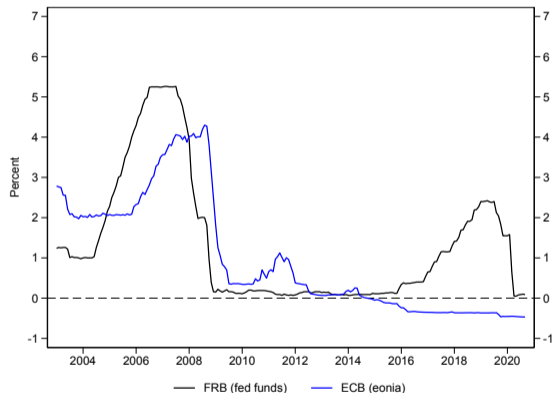


- ▶ ZLB calls for prompt and decisive action in response to a recession.
- ▶ Substitute QE for rate cuts—systematically aim to achieve π^* , on average.
- ▶ Asymmetry in risks implies action even before ZLB is encountered.

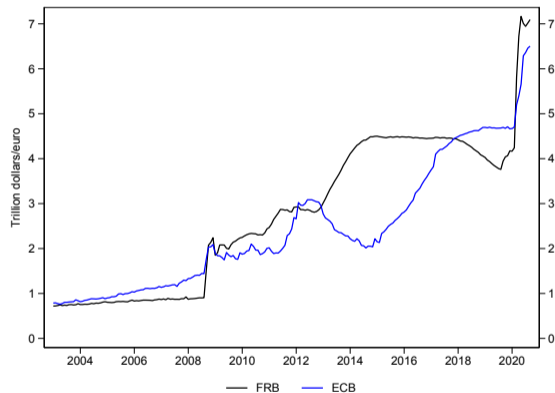


ECB monetary policy compared to Federal Reserve

Overnight interest rate



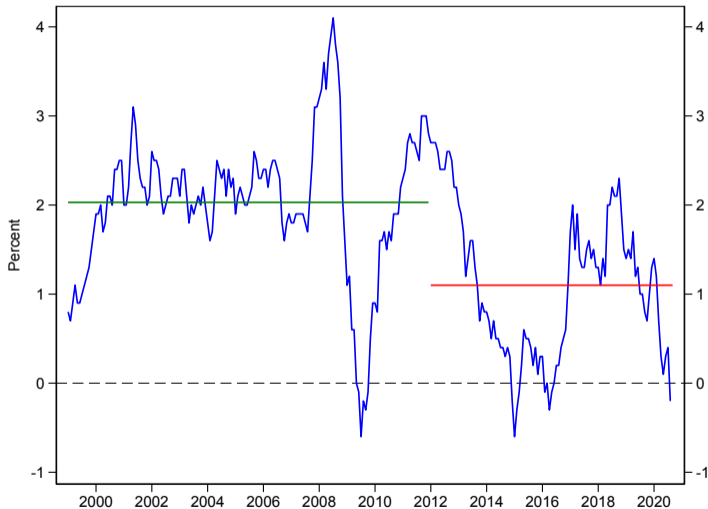
Size of balance sheet



- ▶ Fed: Substitute QE for rate cuts—systematically aim to achieve π^* , on average.
- ▶ ECB: Erratic and timid QE relative to Fed, better response to 2020 pandemic.



The ECB's lowflation policy: 2012 – ?

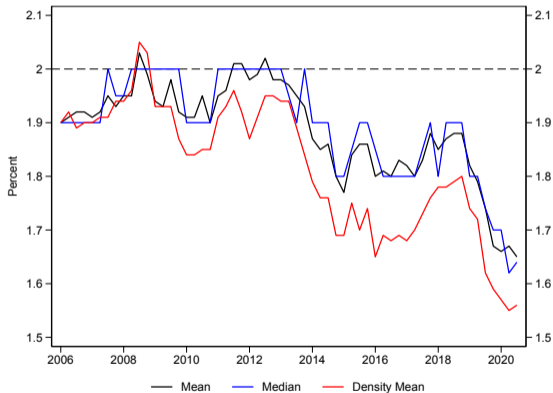


HICP, monthly data. Mean, 1999-2011 = 2.0. What is ECB's π^* since 2012?

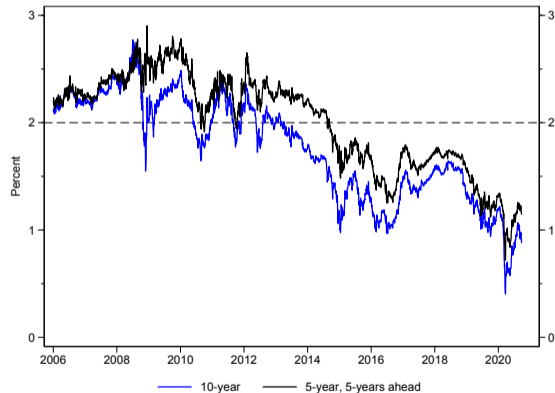


Disanchoring of inflation expectations

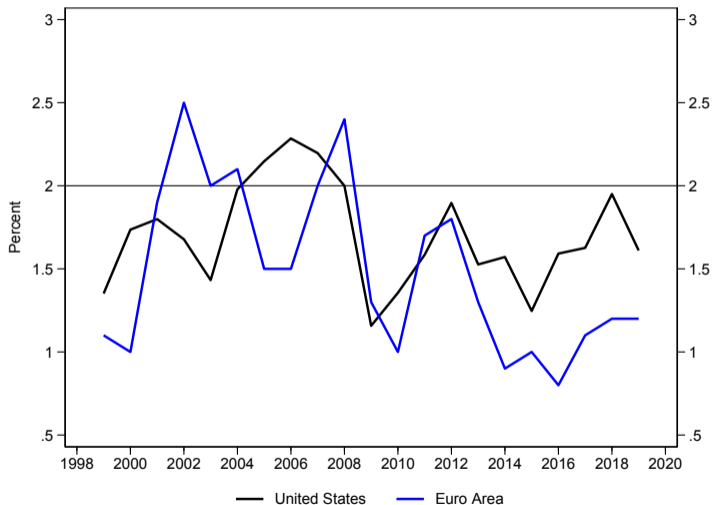
Long-term survey expectations



Inflation swaps



The role of a clear, symmetric 2% inflation goal

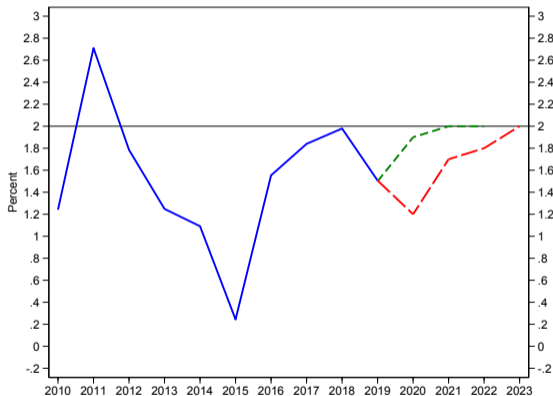


Core inflation (PCE/HICP), y-o-y annual data, 1999-2019.

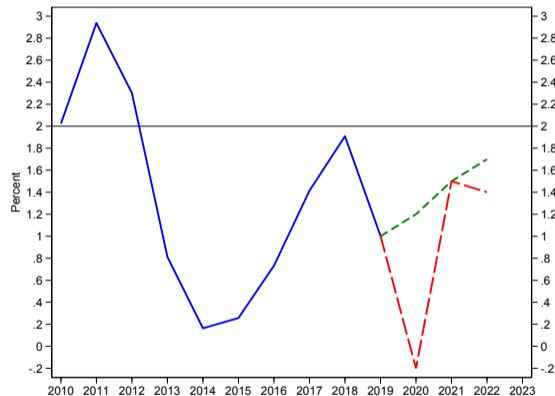


Response to pandemic: Inflation projections

Fed (PCE)



ECB (HICP)



Blue: Q4/Q4 inflation data.

Green: Q4/Q4 inflation projection, December 2019.

Red: Q4/Q4 inflation projection, September 2020.

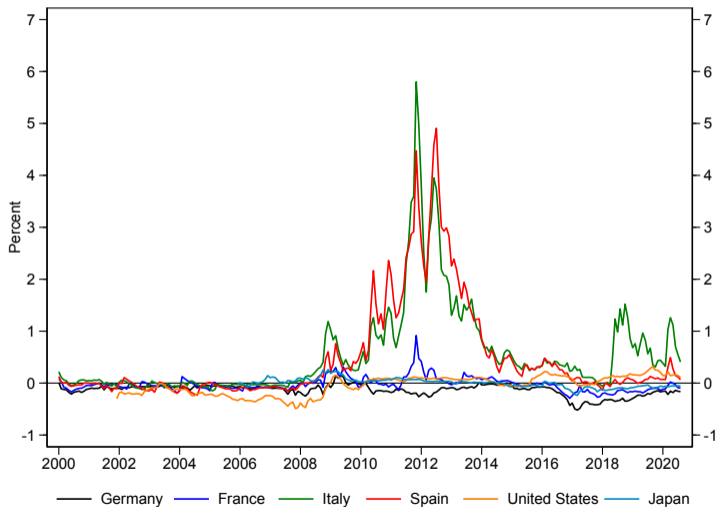


Does the ECB lack the authority to do its job?

- ▶ The ECB may: “operate in the financial markets by **buying and selling outright** (spot and forward) or under repurchase agreement ... ” (Art. 18.1, Statute.)
- ▶ The ECB may: “conduct credit operations with credit institutions and other market participants, with lending being based on **adequate collateral**.” (Art. 18.1.)
- ▶ “The ECB **shall establish general principles** for open market and credit operations ...” (Art. 18.2.)
- ▶ “The Governing Council may, by a majority of two thirds of the votes cast, decide upon the use of such other operational methods of monetary control **as it sees fit**, respecting Article 2.” (Art. 20.)



The impairment of the monetary policy transmission mechanism



Spreads of two-year sovereign yields from OIS rate in corresponding currency.

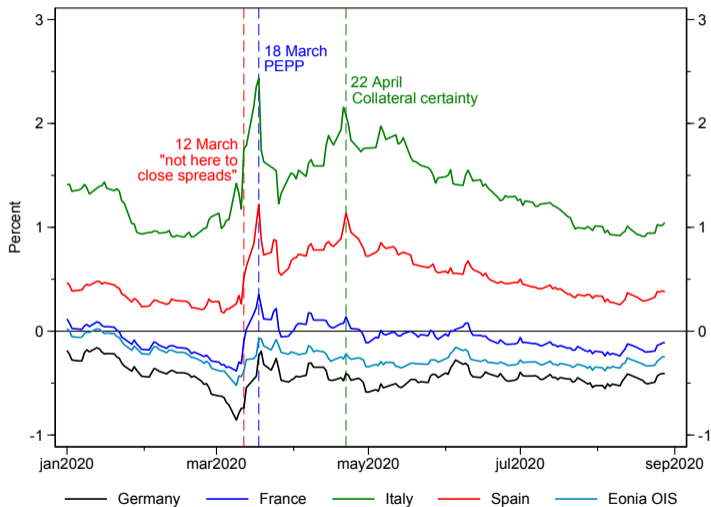


Problems with ECB's monetary policy implementation strategy

- ▶ Excessive reliance on “markets” and private credit rating agencies.
 - ▶ Cliff effects in collateral framework.
 - ▶ Improper interest rate assumptions in DSA.
- ▶ Inadvertent consequences since euro crisis:
 - ▶ Induce debt roll-over crises.
 - ▶ Validate adverse expectational equilibria in sovereign debt markets.
- ▶ Has the ECB made satisfactory use of the authority delegated to it?
 - ▶ Since the euro crisis?
 - ▶ Since start of pandemic?



The response to the pandemic: Three episodes



Ten-year yields on sovereign debt and OIS rate



What needs to be done ... and when?

- ▶ Before pandemic, ECB embarked on welcome strategy review:
“As our economies are undergoing profound changes, it is the time for a strategy review to ensure we deliver on our mandate in the best interest of Europeans.” (ECB, 23 January 2020.)
- ▶ The pandemic delayed some of the work on the review, but it also made improvements to the pre-pandemic monetary policy strategy more urgent.
- ▶ Should corrections to known flaws in the ECB’s monetary policy strategy wait another year?
- ▶ To limit the lasting damage from pandemic, improvement of ECB’s policy strategy is **a matter of urgency**.



Two urgent matters

- ▶ Adopt a clear, symmetric 2% inflation goal.
 - ▶ Calibrate QE in a systematic manner to achieve and maintain 2% goal.
 - ▶ Guidance with ECB Governing Council inflation projections.
 - ▶ Focus on anchoring inflation expectations in line with 2% goal.
- ▶ Correct fragility-inducing aspects of ECB's policy implementation strategy.
 - ▶ Draw on success of *temporary* measures adopted in response to pandemic.
 - ▶ Eliminate cliff effects in collateral framework, *on a permanent basis*.
 - ▶ End delegation of policy implementation to private credit rating agencies.

