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THE EUROPEAN CENTRAL BANKS AND ITS (UN)CONVENTIONAL MONETARY POLICY

The beginnings of the European Union (EU) extend back to the period of the first attempts at cooperation among the countries of the "Old World" in the late 1940s and the 1950s. It is an economic and political grouping which today comprises 28 countries (including the Czech Republic), making up the majority of the European continent. The official currency is the Euro, which is, as of **2002**, legal tender and in order to function, it also requires the existence of the **European Monetary Union** (EMU), in which the System of Central Banks operates (ESCB), headed by the **European Central Bank** (ECB), which was established 1st January 1999. The central bank was created from the original central banks of the member countries of the euro area, or the Eurozone. (Revenda, 2011)

1 The banking system in the European Union

The banking system in the European Union is unique in that there is a European Central Bank, and national central banks and commercial banks in each country. The European Union banking system is general and has two levels. It follows the harmonised legal standards governing the field of banking, where the same conditions also exist for the granting of a banking licence to commercial banks. All deposits within the EU are insured and there is a single monetary policy. The European Central Bank is a supranational European institution and independent legal entity. The Eurosystem consists of the ECB and all national central banks whose countries have adopted the euro. The Eurosystem is therefore composed of the ECB and the 18 national central banks of Belgium, Estonia, Finland, France, Ireland, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Portugal, Romania, Slovakia, Slovenia, and Spain, as well as Latvia, which became a new member of the Eurozone on 1st January 2014. These countries have renounced their jurisdiction over national monetary policies, which have been delegated to the ECB, which implements a specific monetary policy in a specific economic area.

This group of central banks, through their representatives, creates and implements monetary policy in the Eurozone.

The administrator of monetary policy in the European Union is the **European Central Bank**. A common monetary policy is implemented only in countries that use the euro as their official currency. Countries that are members of the EU but do not belong to the Eurozone are the **United Kingdom** (permanent exemption), **Denmark** (permanent exemption), **Sweden**, **Poland**, the **Czech Republic**, **Hungary**, **Croatia**, **Romania** and **Bulgaria**.

1.1 Ensuring Price Stability

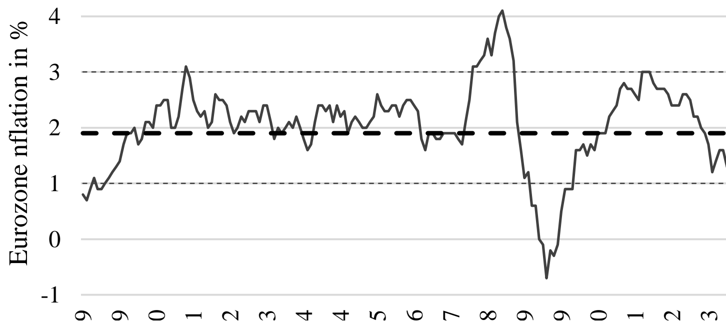
In order to **define the ECB's objectives**, we must look to the **Treaty on the Functioning of the European Union**, specifically Part 3, Title VIII, Chapter 2, Article 127, which states that the **primary objective of the ECB is to maintain price stability**. Apart from the objective of price stability, the ESCB has the task of supporting general economic policies in the EU (such as sustainable development of Europe based on balanced economic growth and price stability, focusing on full employment and social progress). Article 127 also defines the tasks of the ESCB, which are defining and implementing monetary policies of the Union, carrying out foreign exchange operations, managing official foreign currency reserves of the Member States and supporting the smooth operation of payment systems. (Hayo, 2003)

For a more precise definition of the objectives it is necessary to define price stability. Based on numerous meetings of the Governing Council, a definition of price stability (i.e., a quantitative definition of stability) was thus established, which can be expressed as follows: "Price stability is defined as an annual increase in the Harmonised Index of Consumer Prices (HICP) amounting to just under 2%". This threshold was determined based, inter alia, on the need for a sufficient level of reserves against deflation, and taking into account the fact that the HICP is overvalued against actual inflation. (European Central Bank: Eurosystem, 2016) The Harmonised Index of Consumer Prices is based on the fact that the same calculation methodology is used in all Member States.

2 Monetary Policy of the European Central Bank

The current monetary policy of the ECB is still directly related to the recent global mortgage crisis. The basic objective of the ECB is price stability, or a threshold of just under 2% of the HICP. In order to understand the monetary policy is currently practiced in the ECB, we should first take a quick look into the past (Figure 1).

Figure 1: Inflation in the Eurozone, 1999 – 2016

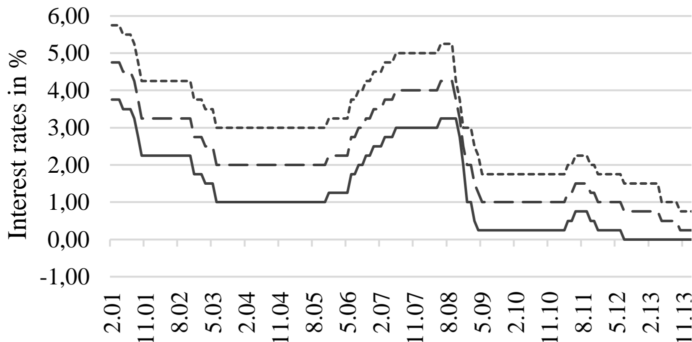


Source: HICP - Overall index. European Central Bank: Eurosystem.

As can be seen here, in the first years of the 21st century, the ECB managed to maintain a constant level of inflation, with values between 1 – 3% of the inter-annual changes in the HICP. However, in 2008 a mortgage crisis broke out, which caused a significant change in the HICP and thus increased volatility of the curve (Figure 1).

In order to ensure price stability, the ECB decided to achieve this goal by means of an **expansionary monetary policy for the use of interest rates**. A change (decrease) in interest rates was intended to prevent deflation (Figure 2). The mortgage crisis, which broke out in July 2008, is shown here in the abrupt drop of key ECB interest rates.

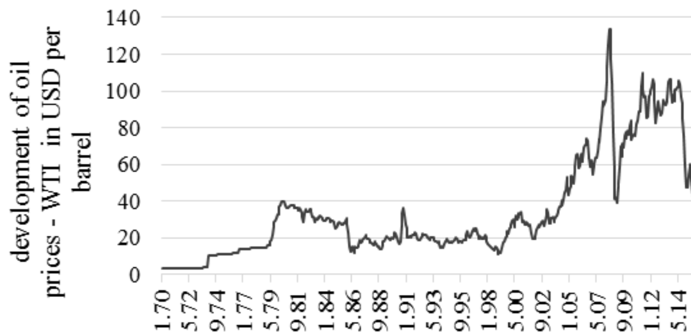
Figure 2: Main interest rates of the ECB, 2001 – 2016



Source: Key ECB interest rates

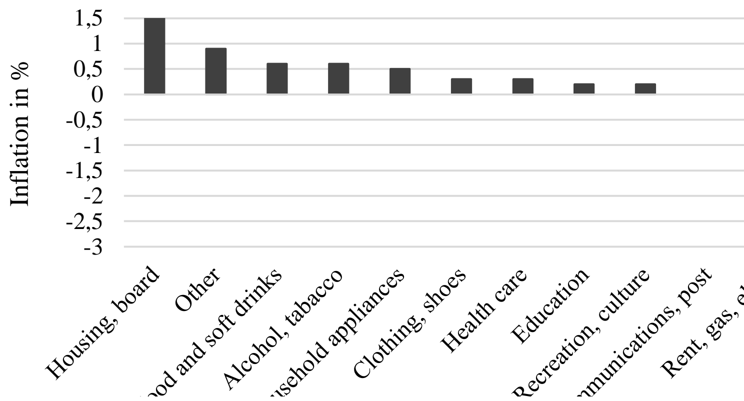
Figure 2 shows the subsequent efforts of the ECB to slightly "tighten" this policy by the end of 2011. At that time, the ECB was the only Western central bank to do so. Neither the USA nor the UK attempted to restrict monetary policy. However, there was another monetary expansion later through another rate reduction. According to the predictions of the ECB at the time (September 2011), annual inflation for the rest of the year would fluctuate in the range of **2.5 − 2.7%**; in 2012, it would fall and fluctuate in the desired range of **1.2 − 2.2%**. (Central bank monitoring – September 2011) In view of our present knowledge of events it seems perhaps comical that the ECB expected the inflation rate to stay above two percent based on **high energy prices** and increases in indirect taxes in some Eurozone countries. At the beginning of 2013, the inflation forecast for that year was 1.2% to 2%, and for 2014 it was between 0.6% and 2% - the expected inflation showed a downward trend. (Central bank monitoring – June 2013) In March 2014, HICP was expected to be at 1% for the year, 1.3% for 2015 and **1.5% for 2016, rising to 1.7% by the end of the year** (the actual value in March 2016 was - 0.2%)**.** (Central bank monitoring - March 2014) The difference between the expected and actual HICP inflation rate, however, was not caused by any poor judgment of the ECB, but the extreme fall in the price of oil, which could not have been foreseen and which gradually took place right from the beginning of 2014 (Figure 3).

Figure 3: Past development of oil prices - WTI (1970 – 2016) in USD per barrel



Source: Global price of WTI. The Federal Reserve Bank of St. Louis

Figure 4: Effects of individual "baskets" on overall inflation in the EU (January 2016)



Source:HICP - Overall index. European Central Bank: Eurosystem

The reason for understanding the current monetary policy of the ECB is a necessary to understand the extent of the importance of oil prices (such as WTI, or West Texas Intermediate, American "light" oil) on the price level (and thus price stability). HICP is in fact made up of a basket of goods and services, in which goods for which are paid more bear a greater weight (e.g., fuel was 15.1%) and goods for

which are paid less bear less weight (e.g., postage stamps, 3.2%). Figure 4 should present a better overview, which shows the distribution of overall inflation for January 2016 at 0.3%. At first glance it is obvious that most of the items are showing growth in the price level, but despite this fact, the overall HICP is approaching deflation. (European Central Bank, 2016)

2.1 Quantitative Easing in the Plan of the European Central Bank

Quantitative easing (QE) is an unconventional tool of the central banks used to stimulate the economy if the standard tools of monetary policy prove to be less effective. Unconventional monetary policy takes many forms, as it is defined by what it is not rather than what it is. In some cases (for instance Denmark), it involves the use of negative interest rates. Some commentators advocate suspension or changes to inflation targets. The more common forms of unconventional monetary policy involve massive expansion of central banks' balance sheets and attempts at influencing interest rates other than the usual short-term official rates. (Joyce, Miles, Scott, and Vayanos, 2012). This unconventional set of monetary policies was inspired from the experience of Japan's deflationary period. (Albu, Lupu, Călin and Popovici, 2014) The main essence of quantitative easing is the purchase of financial assets by the central bank from commercial banks or other private institutions. This step seeks to expand the monetary base (the amount of money in circulation) and lower interest rates to stimulate the economy. It should be distinguished from standard quantitative easing of monetary policy instruments, which constitute mainly the purchase and sale of government bonds in order to keep market interest rates at a desired level. Expansionary monetary policies of central banks typically involve the purchase of short-term government bonds in order to lower market interest rates.

However, in a situation where interest rates are already at very low levels (or zero), traditional monetary instruments of the central banks fail and are no longer effective in reducing interest rates. In this case, it is appropriate to use only quantitative easing and attempt to purchase financial assets from private institutions. This leads to a reduction in interest rates at the far end of the yield curve.

Quantitative easing increases the prices of purchased assets, thereby reducing their yield. QE can be used to prevent deflation pressures and maintain inflation above the required level. QE in itself, however, carries considerable risks. These are above all a question of accelerating inflation and a possible failure to stimulate the real economy. This occurs when commercial banks are reluctant to lend money into the economy, mainly because of low confidence in the market. A major difficulty is the delay that accompanies every step of the central bank. Between the decisions, QE applications, and appearance of the consequences, there is often a long delay, during which the situation may change significantly.

Since the ECB interest rates were technically zero, even though neither HICP nor oil prices showed any upward trend, it was forced to accept the use of so-called unconventional monetary instruments, or quantitative easing.

Quantitative easing was used for the first time in the EU in May 2009 when the ECB announced its first covered bond purchase programme in a volume of 60 billion Euros. This corresponds to 0.6% of the GDP of the Eurozone. The Eurosystem began its covered bond purchase programme in July 2009 and the program was terminated in June 2010. In May 2010 the Eurosystem central banks began buying bonds from the central governments, public units and private units of the Eurozone in the Securities Markets Programme. The volume of bonds to be purchased had not been determined. The largest volume of bonds purchased was made in January 2012, when securities worth 219 billion Euros were purchased. In August 2012, the program was replaced with outright monetary transactions, which are intended for the purchase of bonds from the central governments. In November 2011 the Eurosystem began to implement the covered bond purchase programme 2 in a volume of 40 billion Euros. The program was terminated in November 2012, and was implemented only in a limited extent in a volume of 16 billion Euros. (Krishnamurthy and Vissing-Joregensen, 2011) In comparison with the US Central Bank and the Bank of England, the extent of quantitative easing conducted by the European Central Bank was minuscule (totalling about 300 billion Euros, which corresponds to

about 3% of GDP). The ECB implemented this policy in a situation where short-term interest rates did not fall to 0%.

In January 2015 the **ECB** planned purchases of securities of the public and private sector at **60 billion Euros per month**. These investment securities, issued by national governments and agencies in the Eurozone and by EU institutions, were purchased **on the secondary market** with the original pledge at least to September 2016. The QE was further extended from **60 to 80 billion Euros per month**. Also, the purchase period was extended to March 2017, when one of the original policies was cancelled – this resulted in increased limits on issuers from **33% to 50%**. A decision was also made on listing assets eligible for regular purchases of securities issued by **non-bank businesses established in the Eurozone**. Another unconventional monetary policy instrument of the ECB was "TLTRO" (Targeted Longer-Term Refinancing Operations). Re-introduction of the long-term refinancing operations was launched in June 2016 in a series of four operations with a maturity of **4 years**, when the interest rate for TLTRO II will be the rate of the **main refinancing operations** of the Eurosystem. (European Central Bank: Eurosystem, 2016)

The following interest rates were further determined:

- **The discount rate** (deposit rate) was reduced to **-0.4%,**
- **The Lombard rate** (marginal lending rate) was **reduced from 0.3% to 0.25%,**
- **The main interest rate** (main refinancing rate), which, within the ECB, is particularly a one-week repo operation (MRO - main refinancing operations) was **reduced from 0.05% to 0.00%.**

Summary

The current monetary policy of the ECB shows that it is still influenced by the global financial crisis. In situations where low interest rates led to an increase in the HICP, the ECB had to accede to unconventional monetary policy instruments. In conclusion, it can be said in general that the long-term main trend of the ECB's monetary policy is monetary expansion mainly executed through a zero interest rate policy and quantitative easing.

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