Yves Mersch: Scope and limits of monetary policy

Introductory remarks by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the panel "Europe's Economic and Monetary Policy" during the Ambrosetti Conference on the Outlook for the Economy and Finance, Villa d'Este, Cernobbio, 9 April 2016.

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Ladies and Gentlemen,

Over recent years, the role of the ECB's monetary policy has been more actively debated than ever before, and its measures have become the subject of heightened scrutiny. This examination often addresses the limits of monetary policy. Some have argued that monetary policy is running out of instruments; others, by contrast, have asserted that the ECB, by making use of a plethora of instruments, is over-stretching its remits.

So let me enter this discussion and focus on the scope and limits of monetary policy.

To give you the main message upfront: the legal framework of the European Economic and Monetary Union assigns the ECB's monetary policy with the primary objective of maintaining price stability. It outlines the set of monetary policy instruments in general and provides the Governing Council with broad discretion in the choice of these instruments to achieve its objective.

At the same time, the framework sets limits of what monetary policy must *not* do and pursue – in particular prohibiting monetary financing of governments. Acting within this framework, our measures taken over the last years have shown that we are not short of instruments: the scope of monetary policy instruments is wide and flexible enough to effectively fulfil our mandate. Acting within this framework also ensures that we do not encroach upon the area of economic policy. This constraint has recently been confirmed by the Court of Justice of the European Union in the OMT case.

Objective and instruments

The ECB's objective is to ensure price stability in the medium term. The standard instruments that the ECB deploy are its key interest rates. These are adjusted to provide or withdraw monetary stimulus to achieve the objective. Such changes in policy rates are transmitted via financial market prices, wages, households' and firms' inflation expectations, etc. Under normal conditions, this transmission follows predictable patterns which allow calibrating the stimulus. In highly perturbed conditions, however, transmission might become impaired. The policy implementation process needs to be altered as a consequence.

Indeed, we have been facing unprecedented challenges to which we had to respond with non-standard instruments. Let me give you some examples of the past:

- Impairments of the transmission process, in particular related to tensions in certain sovereign debt market segments, led us to announce targeted bond market interventions under the SMP and, later, the OMT programmes.
- Signs of credit crunch were addressed by a number of credit easing measures, e.g. targeted long-term re-financing operations and asset purchases in the covered bond and ABS markets.
- The need for additional monetary policy accommodation in a phase of falling inflation rates and destabilising inflation expectations when short-term interest rates were already extremely low led to large-scale purchases of private and public-sector debt instruments.

- The impact of large-scale liquidity provision has been reinforced by venturing into the territory of negative interest rates.

This "instrument independence" proved crucial in responding to the various threats to price stability that we were facing over recent years.[1]

Selecting the effective tool was essential: a restriction of instruments – for instance, by restraining the central bank to the use of key interest rates as the sole monetary policy tool – would have possibly he led to a disastrous outcome for euro area.

Principle of proportionality in the design of instruments

Having a large degree of discretion in the choice of instruments comes with the obligation to respect certain principles and select those instruments carefully. In legal parlance, Article 127 of that Treaty states for example that in pursuing its objectives, the Eurosystem "(…) shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources (…)".

Moreover, the ECB must always observe the principle of proportionality laid down in Article 5(4) of the Treaty on the European Union when exercising its mandate. Specifically, this implies that our measures need to be suitable, necessary and proportionate *stricto sensu*.

- For an instrument to be *suitable*, it needs to be able to address the respective risk to price stability.
- For an instrument to be *necessary*, we must lack an alternative instrument, which could achieve the same result.
- For an instrument to be *proportionate stricto sensu*, its expected benefits should outweigh its costs.

Let me apply these three criteria to one of the ECB's most-debated instrument, namely the purchases of public-sector debt instruments, i.e. the PSPP part of our extended asset purchase programme, APP.

- First, purchases in government bond markets are a *suitable* tool. By easing the financing conditions of the private sector and expanding the monetary base, the PSPP makes it cheaper for households and firms to borrow. This can encourage them to borrow and expand consumption and investment. By eroding economic slack, such boost to demand helps to bring inflation back to levels below, but close to 2%. Between end-August 2014, when markets had started to price in larger-scale ECB asset purchases, and February 2016, the GDP-weighted average of euro area 10-year sovereign bond yields has fallen by about 70 basis points. Over the same period, bank lending rates to euro area companies – a key indicator of financing conditions in a bank-centred economy such as the euro area – have decreased by a similar magnitude. A sizeable fraction of this easing in financing conditions can be attributed to our monetary policy measures in general and the PSPP in particular. But here again, there are boundaries and limits. Although it is intended to lower the bond yields of sovereigns as a major determinant for bank lending rates to companies, it is not only undesirable to wipe out the credit risk premium investors

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[1] "Instrument independence" has gained currency as a common expression in the economic literature on central bank independence and is understood as "the central bank's ability to freely adjust its policy tools in pursuit of the goals of monetary policy", see Debelle, Guy and Stanley Fischer (1994), "How Independent Should a Central Bank Be?" in Jeffrey C. Fuhrer (ed.), "Goals, Guidelines and Constraints Facing Monetary Policymakers.", Federal Reserve Bank of Boston, pp. 195–221. However, it is not a well-defined legal term. In the legal doctrine, one would rather refer to "discretion" regarding the choice of instruments.

ask from sovereign issuers, it would moreover raise serious legal concerns as to whether this would not enter the remit of economic policy.

- Second, with key ECB interest rates already very low, and the CBPP3 and ABSPP having insufficient scope to address severe downside risks to price stability given their limited market size, purchases of investment-grade bonds of euro area sovereigns were considered a *necessary* instrument to provide additional monetary stimulus. In particular, there was no other asset class with comparable risk characteristics and with a similar potential for easing private-sector borrowing conditions.
- Third, PSPP purchases expose the Eurosystem balance sheet to a certain risk. These risks are mitigated because PSPP-eligible bonds need to satisfy minimum credit quality requirements. Overall, a proper weighting of costs and risks vs benefits must take into account that the maintenance of price stability is the primary objective for monetary policy.[2] Accordingly, PSPP is also *proportionate stricto sensu*.

Monetary financing prohibition as strict and important limit

The principle of proportionality works as a disciplining device for the ECB in choosing the instruments. In addition, however, the legal framework provides further, and even stricter, limits. An important case in point is the prohibition of monetary financing as enshrined in Article 123 of the Treaty.

While this reads *prima facie* as a constraint on monetary policy, it may also strengthen the maintenance of price stability. In fact, historical evidence has pointed to the negative consequences which historically have been associated with central banks' attempts to minimise the financing burden of governments. And literature has shown that high inflation, which can arise from such subordination of monetary policy to fiscal needs, is in turn detrimental for growth.[3] Therefore, the monetary financing prohibition rules fiscal considerations out which could distract the Governing Council from its core monetary policy task. It helps to protect the ECB from political pressures.

The ECB's purchases of public-sector debt instruments as part of the APP are a good example how this prohibition is applied:

First of all, we do not buy government bonds in the primary market – which is explicitly forbidden under Article 123 – but only in the secondary market.

Purchases of public-sector bonds in the secondary market in turn are forbidden, if they circumvent the monetary financing prohibition, i.e. have an effect equivalent to that of purchases in the primary market. We have made sure that this is not the case by putting in place several safeguards[4]. As one of these safeguards, PSPP purchases adhere to a black-out period, i.e. the Eurosystem does not buy around the date of a new issuance, which facilitates the formation of market prices for PSPP-eligible securities. Furthermore, the relevant securities are also subject to an issue share limit and an issuer limit, which preserve market functioning. These features are compliant with the requirement to act in accordance with the principle of an open market economy.

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[2] When weighting the "benefit", though, one may consider that as the usage of these instruments is expanded to very high proportions, they may start to display diminishing returns at some point.

[3] See Stanley Fischer, 1993, The Role of Macroeconomic Factors in Growth, *Journal of Monetary Economics* 32(3): 485–512 and Stephanie Kremer, Alexander Bick and Dieter Nautz, 2013, Inflation and Growth: New Evidence From a Panel Threshold Analysis, *Empirical Economics* 44(2): 861–878.

[4] https://www.ecb.europa.eu/ecb/legal/pdf/en_dec_ecb_2015_10_f_.sign.pdf.

All this ensures that PSPP purchases are not being perceived as a circumvention of the monetary financing prohibition.

When the central bank makes “proportionate” use of its instruments, as I described earlier, this is akin to prudently driving a car: depending on road and weather conditions, we use different tyres, we accelerate or use the brakes, and thus strive to always travel at an optimal speed. The monetary financing prohibition, by contrast, is a traffic rule: a clear stop sign that needs to be obeyed whatever the weather and street conditions. The overt monetary finance of an increase in fiscal deficits to stimulate aggregate demand would legally not be feasible even amid a liquidity trap.

Conclusion

The Eurosystem enjoys broad discretion in the choice of its instruments. But we are responsible to use our measures proportionately and to obey the well-defined boundaries set by the legal framework. The flexible choice of instruments was crucial in addressing the headwinds to price stability over recent years: the ECB’s monetary policy measures have prevented inflation from falling much further and probably helped avoiding a deflationary spiral.

At the same time, there are limits to what central banks like the ECB can achieve. The euro area’s recovery is indeed in need of supportive actions from the side of “Economic Policy”. These include structural reforms, a more growth-friendly composition of fiscal policies, while remaining in compliance with the fiscal rules of the Stability and Growth Pact, and the provision of an adequate public infrastructure. All these economic policy measures are vital to increase investment and boost job creation. With other economic policy areas contributing decisively to the recovery, they also help the euro area reap the full benefits from the ECB’s monetary policy measures.