Yves Mersch: Monetary policy in the euro area – scope, principles and limits

Keynote speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Natixis Meeting of Chief Economists, Paris, 23 June 2016.

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Ladies and gentlemen,

The past few years, not to speak of present days, have been challenging ones for central banks worldwide, and the euro area has been no exception. The ECB's monetary policy decisions have come under greater scrutiny than ever before. Some commentators have argued that the ECB does not have sufficient tools to counter deflationary pressures in the euro area. Others contend that by using a wider range of instruments than in normal times, the ECB has exceeded its remit.

Neither view is correct. Our Statute allows us to use a wide range of tools to meet our mandate, and those tools are sufficient for that purpose.

But it *is* correct that there are limits on how far monetary policy can go. The ECB cannot, will not, and need not exceed these limits. Our framework requires that unconventional tools are used for no longer than necessary, and no more intensively than necessary. Within these limits we independently decide on how best to comply with our price stability mandate.

Today, all major central banks have clear price stability mandates and can discharge them with a large measure of independence. In the ECB's case, our price stability mandate is enshrined in the Treaty,[1] and we have been given "instrument" independence in how we carry it out. We cannot decide *whether* we achieve our objective – we have to obey the law – but we can decide *how* we do so.

This position has been confirmed by the European Court of Justice, which ruled that the ECB can deploy any available instrument which is explicitly mentioned in the Statute to ensure price stability. But the discretion we have over how we use our instruments, though wide, is not unlimited "whatever it takes" is qualified by "within our mandate". Independence must not be confused with arbitrariness.

The Treaties also set out a number of restrictions and principles that guide our monetary policy. There are three in particular that stand out.

First is the prohibition on monetary financing laid down in Article 123, which prevents the central bank from taking actions which would directly finance government spending.

We are prohibited from monetary financing for good reasons. If a central bank systematically finances government budgets, it can fall prey to so-called "fiscal dominance" and fail its price stability mandate. That is because, when inflation starts to rise, the central bank is in a lose-lose situation: it can either continue financing the deficit and risk overshooting its objective, or it can refuse to finance the deficit and risk a deflationary government default. But if the central bank is ex ante forbidden by law from monetary financing, the incentives are stronger for governments to run sound fiscal policies in the first place – and the independence of the central bank is preserved. "Monetary dominance" prevails over "fiscal dominance". Fiscal soundness is an essential feature of a monetary union with a single monetary policy and national fiscal policies are necessary even if we were to achieve a fiscal union.

What is more – and this is specific to the euro area – monetary financing could imply a redistribution of wealth among Member States, thus undermining the spirit of the "no bailout

[1] Article 127.1, Treaty on the Functioning of the European Union (TFEU).

clause" (Art. 125 TFEU). If the central bank were to facilitate a regime of unsound fiscal policies and inflationary government deficits, it would inevitably expose itself to losses – either real losses through the inflation tax, or nominal losses through a reduction in the principal amounts it was owed. That would be tantamount to deliberate fiscal redistribution between different sets of taxpayers via the central bank's balance sheet, which is not permissible in a monetary union that is not a fiscal union. In other words, the prohibition of monetary financing is the monetary counterpart of the "no bailout clause".

Second are the principles of judicial control: principle of conferral and principle of proportionality laid down in Article 5, which requires that our actions are limited to what is essential to achieve the objectives of the Treaties. Specifically, this means that our measures need to be suitable, necessary and proportionate *stricto sensu*.[2]

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 a viable alternative instrument. For an instrument to be *proportionate stricto sensu*, its expected benefits should outweigh its costs.

Third is the requirement to act according to the principle of an open market economy favouring an efficient allocation of resources.[3]

All monetary policy measures have allocative and distributive effects. Cutting interest rates, for example, has a redistributive impact on savers and borrowers, since it encourages borrowing and discourages saving. Moreover, in certain situations – for instance a panic-induced freeze in interbank markets – central bank intermediation may be critical to *restore* market functioning and support an efficient allocation of resources. But this must always be embedded in the understanding, which underpins the Treaty, that general markets distribute resources more efficiently than public authorities, and hence central bank actions should not blunt price signals or overwhelm market forces. Indeed, central banks should be marginal actors, steering marginal decisions, not resource allocation mechanisms. That has to be reflected in the design and implementation of our monetary policy tools.

In the pre-crisis period, when we used conventional measures, i.e. interest rate policy, nobody had doubts that it was straightforward for us to respect these three operating principles set out in the Treaty:

- By mainly implementing our policy through refinancing operations with commercial banks, we were not accused of monetary financing.
- Our track record shows that raising and lowering rates was effective to maintain price stability.
- And though all monetary policy, including interest rate policy, has allocative and distributive effects, those effects were contained and predictable.

Our recent monetary policy measures respect the law

Since the onset of the crisis, however, we have had to adopt new, unconventional tools to fulfil our mandate – and this has naturally brought the question of the scope and limits of monetary policy more to the fore. Clearly, restricting ourselves *only* to the instruments used in normal times would have been a breach of our mandate. It could have had disastrous consequences for the euro area economy, and threatened our ability to achieve price stability. But that does not imply the reverse – i.e. that *every* conceivable tool would have been justified.

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[2] Article 5 (4), Treaty on European Union.

[3] Article 127.1, TFEU.

In line with our mandate, we have used a broad range of our instrument independence to confront downside risks to inflation and achieve price stability. But equally, we have deployed only tools that are in line with our legal framework. And that has been possible because we have specifically designed our instruments so as not to exceed the three limits I outlined. Take our asset purchase programme (APP) – which includes both public and private sector bonds – as an example.

First, the APP respects the prohibition on monetary financing, since we have placed a number of safeguards on our interventions.

We do not buy government bonds in the primary market, which is explicitly forbidden under Article 123. And neither do we act in the secondary market in a way which could be perceived as equivalent to acting in the primary market. The Eurosystem has put in place a blackout period, and so does not buy in periods around the date of a new issuance. Purchases are also subject to an issue share limit and an issuer limit. These limits ensure that we would not constitute a blocking minority for collective action clauses if such clauses were ever triggered. The European Court of Justice explicitly highlighted these limits when deciding upon the lawfulness of our actions.

Second, it is proportionate, in the sense that it is both necessary and suitable to secure our price stability objective.

As short-term interest rates move closer to their effective lower bound, it inevitably becomes harder for central banks to steer the economy by means of conventional policy. So if inflation is too low for too long – as is the risk in the euro area today – other tools become *necessary*. Two years ago, the Governing Council introduced several non-standard measures to unclog the transmission mechanism and avoid a credit crunch. We coined these measures "credit easing package".

In January last year, we finally opted for large-scale asset purchases when faced with a period of weak growth, when already low inflation rates were falling further and we saw risks of inflation expectations destabilising. Like our previous measures, these purchases belong to the category of credit easing.

To fulfil our mandate we need to make use of all instruments at our disposal. The APP is a *suitable* tool because it acts directly on financing costs in the real economy. Rather than attempting to boost the economy only through the short end of the curve, it directly lowers yields at longer maturities, decreasing them by compressing the term premium, which in turn influences the cost of credit for firms and households.

Third, we have designed the programme to limit distortions in relative prices which might have unwanted allocative and distributional consequences.

With our government bond purchases we "mirror the market", which means that our interventions are spread across issuers from the various euro area countries on the basis of the ECB's capital key. Together with the issuer limits, this ensures breathing space within and across markets for efficient price discovery. Indeed, even though yields are very low for certain sovereign issuers, issuers have been able to place new securities in the market in large volumes, which suggests that liquidity has not been materially affected by our actions.

Thus the most difficult part of our programme is our corporate bond purchases, since they extend into less liquid markets and increase the risk of distortions in relative prices – in particular between larger and smaller firms. But our activities cannot be evaluated in separation; they must be judged in a holistic manner. Indeed, up to now the decline in bank lending rates for small loans to euro area companies – which are mainly for small and medium-sized enterprises (SMEs) – has been stronger than for large loans to bigger companies. This suggests that bank lending conditions have improved disproportionately for euro area SMEs since the announcement of our credit easing measures two years ago. As a result, fewer SMEs are reporting that credit has been a limiting factor for their businesses. This should only continue as our measures are fully rolled out and reach their maximum impact. In other words, the APP, coupled with our other credit easing measures, has reduced distortions caused by market fragmentation in the euro area.

Still, we know that the longer unconventional policy lasts, the greater the risk of distortions appearing and diminishing its effectiveness over time. The principle of proportionality also implies that we should only use such measures for as short a time as is necessary to fulfil our mandate. That is why, when the economy improves and inflation returns to our objective, we will have to reassess, adjust and ultimately phase out our purchase programmes and other non-standard measures.

But the surest way to reach that point is to stay true to the course we are on now. If we were to change speed or direction too soon, it would only set back the recovery of inflation and delay the day that interest rate normalisation can happen. We will decide upon this in full independence, in the interests of price stability, impervious to the wishes of any interest group with any partial agenda.

Other policies can support the speed with which inflation returns to 2%

Can other policies help in this endeavour?

In the inflationary days of the 1970s, some central bankers were so hesitant about the scope of their responsibility that they let price stability depend on others. For example, in the late 1970s the then Fed Chairman reported to the FOMC that *“inflation is going to be left to the Federal Reserve and that’s going to be bad news. An effective program to reduce the rate of inflation has to extend beyond monetary policy and needs to be complemented by programs designed to enhance competition and to correct structural problems”.*[4]

But central banks have come a long way over the past half century. Today central banks take ownership of their mandates and we do not depend on others. For example, if we were to run into headwinds created by other policies, such as necessary fiscal consolidation, we could increase our policy stimulus to compensate. But if other policies undermined the *effectiveness* of our policy by disrupting or slowing down the monetary transmission mechanism, responding to that scenario would be more difficult. In such a situation we can only repeat that the support of other policies would speed up the return of inflation to 2%.

But this must not be seen as a call for an ex ante policy mix with a monetisation of public debt or mutualisation of debt via Eurobonds under the present Treaty. This would mean giving up monetary dominance.

Rather, economic and institutional policies can help accelerate the impact of our measures. Structural reforms can reduce the transmission lag of our policy, since a more flexible, more responsive economy is likely to transmit monetary impulses faster. And institutional reforms can reduce uncertainty about the future setup of the euro area, which weighs on expectations and holds back investment. Indeed, as we can see increasingly in Europe today, strengthening confidence in the future trajectory of our Union is perhaps the most decisive contribution we could make to growth.

Conclusion

Let me conclude.

The Eurosystem has broad discretion over the tools it can use to deliver its primary objective of price stability. That objective guides the decision on which tools to use, and when to use them, and defines the boundaries set out in our legal framework.

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[4] Federal Open Market Committee meeting, Transcript, 21 March 1978.

The use of additional tools in recent times reflects the ECB's commitment to delivering its mandate. Such tools have been suitable to achieve our objectives and have been necessary to combat deflationary headwinds.

Still, we are aware that – while justified – our latest non-standard measures are on a significant scale. This is why our non-standard measures cannot last forever. They are defined as unconventional and not designed for the long term. The goal of these measures is that they make themselves redundant.