Monetary Law and Monetary Policy

4b. Monetary policy – instruments and policies Part 2

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Unconventional tools

- crisis-related, extremely expansionary monetary policy in order to stimulate economic growth
- applied when interest rate cuts have failed to stimulate monetary expansion („pushing on a string”) and further cuts are next to impossible (zero or negative interest rates)
- asset purchases – quantitative easing (QE)
- liquidity support – e.g. Emergency Liquidity Assistance (acting as „lender of last resort”)
- commitment to further actions

Quantitative easing

- Central banks purchase large volume of financial assets (mostly Treasury bonds) from banks, creating new money to pay for them.

- Direct effects of QE:
  - **Raising** the prices of those financial assets and **lowering** their yield while simultaneously increasing the monetary base[

- Result: large expansion of the monetary base (M0)

- first applied in Japan since 2001, then by several central banks after 2007

QE and the prohibition of monetary financing

- As banks buy Treasury bonds in order to re-sell them to the central bank, QE is sometimes considered to circumvent the prohibition on monetary financing (lending by the central bank to the Treasury), especially if public sector commercial banks are involved.
- Simplified structure:

Bonds: GOVT → COMMERCIAL BANKS → CENTRAL BANK

Money: CENTRAL BANK → COMMERCIAL BANKS → GOVT

- Purchases of Treasury bonds by the central bank are considered legal if occuring on the **secondary market**, but **prohibited on primary market** (directly from the Treasury).
- Condition: the decision to apply them needs to be taken by a central bank independently, in view of its price stability mandate → it needs to be intended as a monetary policy measure, not a measure of financial assistance to the govt

ECB expanded asset purchase programme (APP)

- started in January 2015
- average monthly asset purchases amounting to €60 bn/€80 bn
- from January 2018 monthly asset purchases cut to €30 bn, then from September 2018 to €15 bn
- each extension announcement: "intended to last at least until [month YYYY], in any case until the inflation is considered to move towards the inflation target (below but close to 2%)"
- assets purchased include bonds issued by euro area central governments, agencies and European institutions, in addition to private sector assets
- justified by the need to „address the risks of a too prolonged period of low inflation" → i.e. the ECB's price stability mandate
- monetary stimulus to the economy also mentioned

APP – „tapering"

- „**tapering**" – gradual withdrawal from the QE
- 2018-19: signs of economic recovery → purchases stopped after the end of December 2018, re-started from 1 November 2019 at a monthly pace of €20 billion
- 2020: pandemic → „temporary envelope" of additional net asset purchases of €120 bn added from March 2020 until end 2020
- 2022: increase in inflation led to a tightening of monetary policy → net purchases under the APP stopped from July 2022
- cumulative net purchases under the APP: €3434 bn (as of Sep 2022)

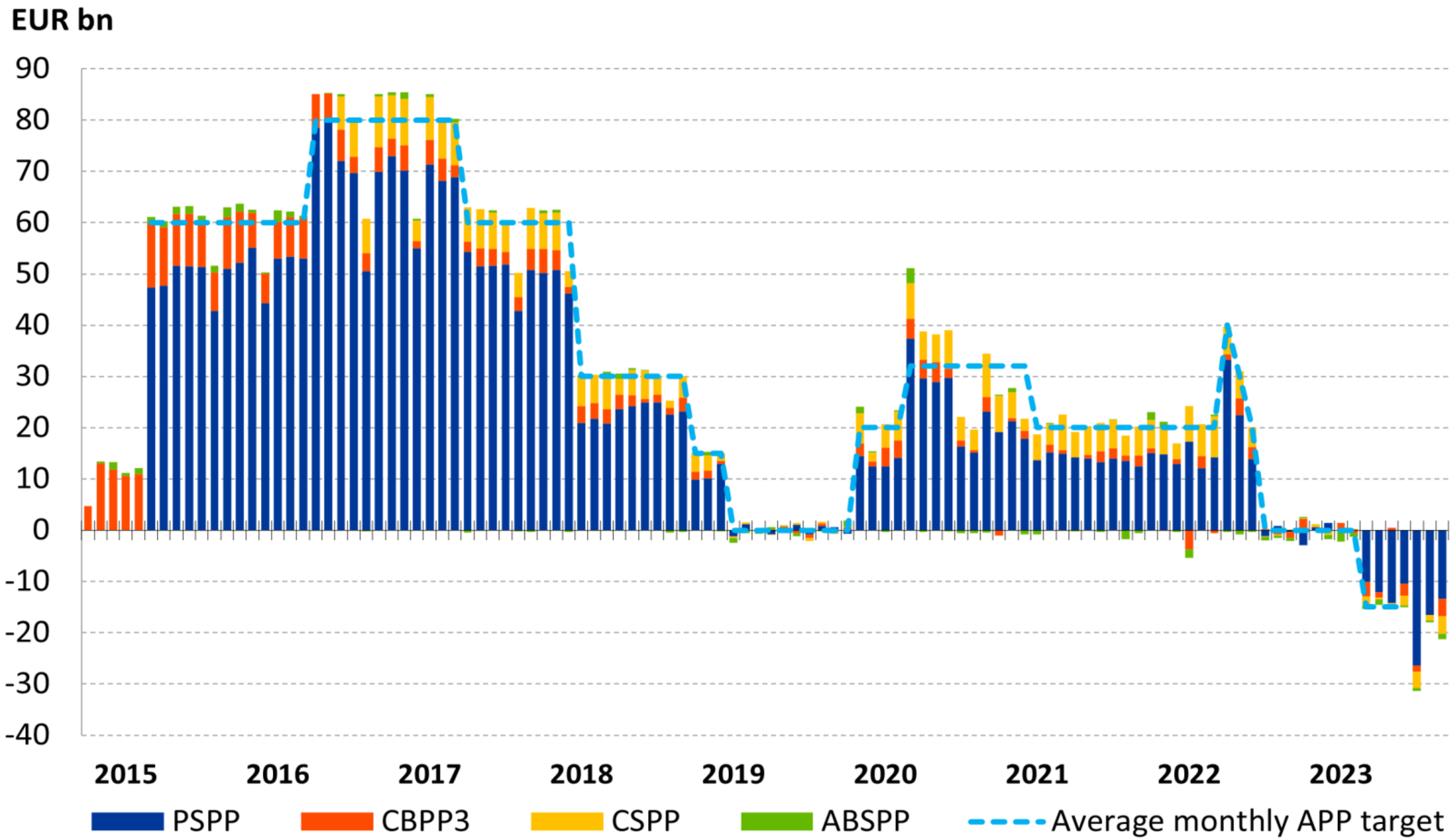
APP – withdrawal

- since the stopping of net purchases under the APP in July 2022 until March 2023 redemptions were reinvested →

i.e. payments received by the ECB at maturity dates of bonds held in the APP portfolio were used to purchase new bonds, in order to maintain a stable level of APP investments

- from March to June 2023 redemptions were only partly reinvested → ECB stock of assets purchased under the APP started to decrease → gradual reduction of the monetary base (unwinding of the previous QE)
- from July 2023 redemptions are not reinvested anymore → reduction of the monetary base
- as of Sep 2023 asset holdings under the APP decreased to €3109 bn

Net asset purchases under APP
(source: ECB website)



ECB pandemic emergency purchase programme (PEPP)

- an additional temporary asset purchase programme of private and public sector securities announced on 18.03.2020 to address the economic shock resulting from the covid-19 pandemic
- initial planned volume of €750 bn, on 4.6.2020 and 10.12.2020 increased to a new total of €1850 bn
- purchases discontinued at the end of March 2022. The maturing principal payments from securities purchased under the PEPP to be reinvested until at least the end of 2024.
- covers asset categories eligible under the previous APP, with expanded range (including a waiver for Greek govt bonds; expanding the range of eligible corporate sector assets)
- intended „to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the coronavirus (COVID-19) outbreak"
- as of end of September 2023 asset holdings under the PEPP amounted to €1668 bn

ECB asset purchase programmes

See more:

APP

http://www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html (initial announcement of the APP)

https://www.ecb.europa.eu/mopo/implement/app/html/index.en.html (general information on the APP)

PEPP

https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html (initial announcement of the PEPP)

https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html (general information on the PEPP)

Will QE cause inflation?

- Does QE mean „printing money”?
- QE and other forms of unconventional monetary policy result in a large expansion of central banks’ balance sheets → expansion of monetary base (M0)
- However, inflation results from the increase of **total money supply**, including not only M0 but mostly money created by commercial banks (M1, M2).
- As banks mostly deposited additional funds obtained from QE as deposits in the central banks (excess reserves), lending expansion did not occur and there was no increase in total money supply.

Will QE cause inflation? 2

- As long as commercial banks do not start credit expansion using the expanded monetary base, overall money supply remains low and inflation does not result.
- Once credit expansion exceeds a certain degree, central banks would need to restrict monetary policy, including shrinking the monetary base in order to avoid inflation („**exit strategy**”).
- **Too early tightening** of the monetary policy could push the economy into **deep recession.**
- In case of a **too late tightening**, **inflation can result** from expanded monetary base being used to finance lending.
- Solution: "**tapering**" – a gradual withdrawal from QE (see example above)

Liquidity support

- **secondary lending or liquidity support**
- Central bank acts as „lender of last resort" **providing liquidity** to disstressed (but solvent) banks.

– Eurosystem: Emergency Liquidity Assistance (ELA)

- providing liquidity to solvent banks facing temporary liquidity problems (e.g. withdrawal of deposits, lack of access to interbank lending).
- function: preventing bank runs.
- Not applicable to insolvent banks which should be subject to bank resolution tools or insolvency proceedings.
- See https://www.ecb.europa.eu/mopo/ela/html/index.en.html

Liquidity support – example

- *On 21.3.2013 the ECB announced that Emergency Liquidity Assisstance to Cypriot banks would be continued only until 25.3, unless a programme to ensure their solvency is put in place.* *http://www.ecb.europa.eu/press/pr/date/2013/html/pr130321.en.html*
- *On 25.3 a bailout deal was reached between Cyprus and the Eurogroup (Eurozone finance ministers).*
- *On 25.3 the ECB decided to continue providing ELA to Cypriot banks, based on the assumption that the bailout maintained their solvency.* *http://www.ecb.europa.eu/press/pr/date/2013/html/pr130325.en.html*

Commitment to further action

- **Function: sending signals to the markets**
- Example: speech by Mario Draghi, President of the ECB, on 26.7.2012 „Within our mandate, the ECB is ready **to do whatever it takes** to preserve the euro. And believe me, it will be enough." http://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html
- Understood as commitment to unlimited asset purchases.
- Effect: calming the market, Italian govt bond yields decreased to a level considered sustainable
- Follow-up: launch of Outright Monetary Transactions on 6.9.2012 (never actually used)
- http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

Communication with the public and managing expectations

- In order to be efficient, monetary policy needs to be predictable.
- explaining monetary policy in detail to the general public
- publishing long-term strategies and policies
- declaring „approaches” in monetary policy
- regular meetings of the rate-setting bodies, followed by press conferences
- publication of minutes of discussion of the rate-setting bodies

Communication – examples

- „Monetary Policy Guidelines” – a yearly strategy document by the NBP

https://nbp.pl/en/monetary-policy/mpc-documents/monetary-policy-guidelines/

- ECB press releases:

https://www.ecb.europa.eu/press/pr/html/index.en.html

Additional reading and reference materials (to presentations 4a and 4b)

- F. Mishkin, The Economics of Money, Banking, and Financial Markets, Pearson, 13th ed. 2022
- monetary policy tools, p. 416-432
- price stability and other goals: Chapter 17, p. 435-463

- ECB website http://www.ecb.europa.eu/mopo/html/index.en.html https://www.ecb.europa.eu/mopo/decisions/html/index.en.html
- NBP website https://nbp.pl/en/monetary-policy/
- Fed website https://www.federalreserve.gov/monetarypolicy.htm
- For Polish readers: A. Sławiński (red.), Polityka pieniężna, Warszawa 2011