

# Rotation of voting on the ECB Governing Council: more than symbolic?

By [Sandrine Levasseur](#)

[Lithuania's adoption of the euro](#) on 1 January brought the number of euro zone members to nineteen, the threshold at which the voting system in the European Central Bank (ECB) Governing Council has to be changed. While this change took place almost unnoticed in France, things were different in Germany and Ireland, where the introduction of the system of rotation in the voting that decides the euro zone's monetary policy has raised concern and even opposition. Is this reaction justified? Here we propose some food for thought and reflection.

## 1) How will the system of rotation function?

Until now, at the monthly meetings of the ECB Governing Council that decides monetary policy (policy rates, unconventional policies) in the euro zone, the principle "one country, one vote" applied. In other words, each country had, through the Governor of its central bank, a systematic right to vote. To the votes of the 18 Governors were added the votes of the six members of the ECB Executive Board, for a total of 24 votes.

From now on, with the entry of a 19th member into the euro zone, the countries are classified into two groups, in accordance with the Treaty[\[1\]](#). The first group consists of the 5 "largest" countries, as defined by the size of GDP and the financial sector, with respective weights in the criterion of 5/6 and 1/6. The second group consists of the other countries, currently numbering 14 [\[2\]](#). Each month the group of five "big" countries has 4 votes and the Group of 14 "small" countries 11

votes (Table 1). The voting within the two groups is organized according to a principle of rotation defined by a [precise schedule](#): the Governor of each “big” country will not vote one time out of every five, while the Governor of each “small” country will not vote 3 times out of 14. However, the 6 members of the ECB Executive Board will continue to benefit from a systematic monthly right to vote. So every month, the conduct of the euro zone’s monetary policy will be decided by 21 votes, while under the old principle, that of “one country, one vote”, 25 votes were cast.

All the Governors will continue to take part in the Council’s two monthly meetings, whether or not they take part in the voting.

**Table 1. Rotation group and participation in the ECB's capital**

	GPD* (bn euros)	Bank assets (BA)	Criteria for membership in a vote rotation group (GDP 5/6; AB 1/6)	Rotation group	ECB capital****	
Euro zone (19 countries)					Share in %	Million euros
Germany	2 718	7 682	3 545	Group 1 (5 countries/4 votes) The governor of each country votes 80% of the time	18.0	1 948.2
France	2 044	8 229	3 074		14.2	1 534.9
Italy	1 560	4 127	1 988		12.3	1 332.6
Spain	1 023	3 287	1 400		8.8	957.0
Netherlands	602	2 339	892		4.0	433.4
Belgium	380	1 071	496	Group 2 (14 countries/11 votes) The governor of each country votes 78.6% of the time	2.1	228.2
Austria	311	922	413		2.0	212.5
Ireland	164	1 049	312		1.2	125.6
Finland	193	523	248		1.3	136.0
Portugal	164	517	223		1.7	188.7
Greece	182	421	221		2.0	220.1
Luxembourg	45	944	195		0.2	21.9
Slovakia	72	60	70		0.8	83.6
Slovenia	35	49	38		0.3	37.4
Lithuania	34	25	33		0.4	44.7
Cyprus	17	91	29		0.2	16.4
Latvia	23	28	24		0.3	30.5
Estonia	18	19	18		0.2	20.9
Malta	7	55	15		0.1	7.0
	GPD* (bn euros)	Bank assets (BA)	Criteria for membership in a vote rotation group (GDP 5/6; AB 1/6)	Rotation group	ECB capital****	
Other EU members					Share in %	Million euros
Potential members of the euro zone:						
Poland	388	361	384	Timetable abandoned	5.1	20.8
Republic Czech	150	192	157	Timetable abandoned	1.6	6.5
Romania	139	89	131	2019	2.6	10.6
Hungary	99	116	102	Timetable abandoned	1.4	5.6
Croatia	43	59	46	Timetable abandoned	0.6	2.5
Bulgaria	40	49	41	Timetable abandoned	0.9	3.5
Countries with opt-out clause:**					0.0	
United Kingdom	1 916	9 146	3 121	Never	13.7	55.5
Sweden	420	1 238	556	Never	2.3	9.2
Danmark	248	1 065	384	Never	1.5	6.0
European Union (28 countries)	13 036	43 753			100	10 825.0

\* At end September 2013.

\*\* Explicit (United Kingdom and Denmark) or implicit (Sweden).

\*\*\* As announced by the national authorities.

\*\*\*\* The contribution to ECB capital is based on the country's GDP and population (1/2; 1/2). The key can be different from the amount actually paid into the ECB capital. The net profits and losses of the ECB are not allocated to countries that are not members of the euro zone.

Source: Eurostat and ECB; author's calculations.

Why change the system of voting rights? The objective is clear and justified: it is to [maintain the decision-making capacity of the Governing Council](#) as the number of countries joining the euro zone increases.

The new system of voting rights [clearly benefits the members of the ECB Executive Board](#), which now have 28.6% of the voting

rights (6/21), while the old system would have given them “only” 24% (6/25). The group of “big” countries has 19% (against 20% in the old system). The group of “small” countries gets 52% (11/21) of the voting rights, whereas it would have had 56% (14/25) if the old voting system had been maintained. The group of “small” countries loses relatively more voting rights than the group of “large” countries, to the advantage of the ECB Executive Board.

## **2) The arguments of German and Irish opponents of the system of rotation**

The arguments of German opponents of the new system, beyond just a loss of prestige, are that the largest economy in the euro zone and also the largest contributor to the ECB’s capital (Table 1) must necessarily take part in the votes deciding the zone’s monetary policy. To ensure that Germany’s interests are not neglected, when Germany doesn’t vote its Governor should have a veto. This veto would also be justified by the principle that you should be responsible only for your own decisions.

In Ireland, according to the opponents of the new system, the myth of equality between the countries of the euro zone is finished: the introduction of a rotation system that favours the big countries is formalizing the lack of equality between the zone’s countries. Ireland has thus been explicitly relegated to being a second tier country. Furthermore, Ireland’s influence in the decision-making process will be reduced even further as the euro zone continues to expand.

The introduction of the rotation system doesn’t seem to have aroused as much resentment from politicians or civil society in other countries in the euro zone.

## **3) Do the German and Irish arguments make sense?**

As is well known, Germany has a culture of stability all its own, in particular due to its history a strong aversion to

inflation. In contrast, the countries of southern European are reputed to have a much less marked aversion to the “inflation tax”. It is this difference in the degree of “acceptable” inflation that has led to modelling the statutes of the ECB more or less on those of the Bundesbank, which was considered the only way of securing Germany’s participation in the euro zone. Today, however, the issue of inflation is no longer posed since the euro zone is entering into deflation, a situation that some think could last for years[\[3\]](#).

Today, it is much more the *methods* the ECB is using to conduct monetary policy that are being questioned in Germany by some of the country’s politicians, economists and citizens. The arguments being made by opponents of the rotation system, based on contributions to the ECB’s capital and more generally being Europe’s leading economic power, echo the policies that have been pursued in recent years by the ECB (e.g. easing eligibility criteria for securities deposited as collateral at the ECB, purchase of securitized assets) but also the future policy of purchasing sovereign bonds. These policies have raised fears in Germany that the ECB balance sheet will contain too much “toxic” debt that sooner or later could be dropped, with the cost of this being borne by the Bank’s principal funder.

Is it really believable that Germany’s interests wouldn’t be taken into account?

There are three arguments for answering “no”. First, even when the German Governor doesn’t vote, Germany will still have a “representative” on the Executive Board (currently Sabine Lautenschläger)[\[4\]](#). In theory, of course, the members must consider the interests of the euro zone when they vote and not just the interests of their own country, but the reality is more complex[\[5\]](#). Furthermore, the Governors, even when they do not vote, still have a [right to speak](#), and therefore some power of persuasion. Finally, more generally, the [desire for a consensus](#) will make it necessary to take into consideration

the opinion of the Governors who are not voting.

How justifiable are the arguments of the Irish opponents of the rotation system? It is clear that the counter-arguments developed above (concerning the right to speak and the need for a consensus) that apply to the Germans also apply to the Irish.

However, it is true that Ireland, like all the countries in Group 2, will see its voting rights [further diluted as the euro zone expands](#). When the euro zone is comprised of 20 members, the 15 Group 2 countries will have to share 11 votes (Table 2, [source: p. 91](#)). When the euro zone expands again to 21 members, 16 Group 2 countries will still have to share 11 votes ... At 22 members, the creation of a [third group](#) will result in further dilution of the voting rights of groups 2 and 3, but not of group 1, the group of “large” countries, which will still continue to vote 80% of the time.

The question that is posed for Ireland but also for all the countries currently in Group 2 concerns the future expansion of the euro zone. To date, all the countries of Central and Eastern Europe (CEE) that have not yet adopted the euro have abandoned a timetable for joining the euro zone (Table 1). The only exception is Romania, which has proposed 2019 for joining[\[6\]](#). Though the prospects of the other countries have not been abandoned, they nevertheless appear very distant[\[7\]](#). The likelihood that the euro zone will soon include 21 members is rather low, and the probability of exceeding 22 members even lower. Anyway, whatever the configuration, Ireland will never be part of group 3. It is thus the countries that are lagging in today’s group 2 (Malta, Estonia, Latvia, etc.) that have the most to lose in terms of the frequency of voting.

**Table 2. Rotation system (first and second steps)**

Total no. of governors	Group 1			Group 2			Group 3		
	Governors	Votes	Frequency of vote	Governors	Votes	Frequency of vote	Governors	Votes	Frequency of vote
<b>First step: euro zone from 19 to 21 countries</b>									
19	5	4	80%	14	11	79%			
20	5	4	80%	15	11	73%			
21	5	4	80%	16	11	69%			
<b>Second step: euro zone from 22 to 27 countries</b>									
22	5	4	80%	11	8	73%	6	3	50%
23	5	4	80%	12	8	67%	6	3	50%
24	5	4	80%	12	8	67%	7	3	43%
25	5	4	80%	13	8	62%	7	3	43%
26	5	4	80%	13	8	62%	8	3	38%
27	5	4	80%	14	8	57%	8	3	38%

Source: ECB (2009).

## Conclusion

There can be no talk of a unified Europe while explaining that there are several categories of countries. How can there be congratulations for the euro zone gaining new members while at the same time explaining that only certain members can or should participate in its decision-making. In a unified Europe it is not acceptable for there to be a vote in the Council that is systematic only for certain Governors (but not all) or a right of veto that only a few Governors can exercise. Each country loses its monetary sovereignty by joining the euro zone: why should some countries lose more than others? But is it really desirable to go back to the old system of “one country, one vote”? No. The new voting system in the Governing Council is a good compromise between the need to maintain the Council’s decision-making capacity (and therefore have a reduced number of voters) and the need to allow each Governor to vote on a regular basis. From this point of view, the rotation system used in the euro zone is more balanced than that used in the United States, where some members may not vote for one, two or even three years[8]. In the euro zone, the length of time that a Governor does not vote on monetary policy will not exceed one month for Group 1 countries, and for countries currently in Group 2, it shall not exceed three months (so long as the euro zone consists of just 19

countries).

At least in theory. Because, in practice, while the Governing Council will continue to meet twice a month, the vote on the conduct of monetary policy will now take place only every six weeks ... (previously every four). The voting abstention time will thus be (slightly) longer than what is stated in the official documents of the ECB and the euro zone's national central banks...

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[\[1\]](#) More specifically, on 21 March 2003 the European Council amended Article 10.2 of the statutes of the Eurosystem in order to allow the establishment of a system of rotation in the ECB Governing Council. The amended article provided that the rotation system could be introduced from the entry of the 16th member into the euro zone and at the latest upon the entry of the 19th member.

[\[2\]](#) The Treaty provides for the creation of a third group upon the entry of a 22<sup>nd</sup> country.

[\[3\]](#) For the first time since 2009, consumer prices fell, with prices falling -0.2% year on year.

[\[4\]](#) The other members of the Governing Council are from Italy (Mario Draghi, President of the ECB). Portugal (Vítor Constâncio, Vice-President of the ECB), France (Benoît Cœuré), Luxembourg (Yves Mersch) and Belgium (Peter Praet).

[\[5\]](#) The experience of the US Federal Open Market Committee shows that there is a regional bias in the way the Governors vote (Meade and Sheets, 2005: "Regional Influences on FOMC Voting Patterns", *Journal of Money Credit and Banking*, 33, pp.



661-678).

[\[6\]](#) It will in any case have to respect the Maastricht criteria (criteria on the public deficit, interest rates, inflation, etc.).

[\[7\]](#) This shift is due in part to the fact that many of the Central and East European countries have benefited from the depreciation of their currencies against the euro. They have thus understood that joining the euro zone would not just bring them benefits. In addition, it is assumed here that the United Kingdom, Denmark and Sweden will never join the euro zone because of their opt-out clause.

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## Is the ECB impotent?

[Christophe Blot](#), [Jérôme Creel](#), [Paul Hubert](#) and [Fabien Labondance](#)

In June 2014, the ECB announced a set of new measures (a detailed description of which is provided in a special study entitled, [“How can the fragmentation of the euro zone banking system be fought?”](#), Revue de l’OFCE, No. 136, in French) in order to halt the lowering of inflation and sustain growth. Mario Draghi then clarified the objectives of the ECB’s monetary policy by indicating that the Bank wanted to expand its balance sheet by a trillion euros to return to a level close to that seen in the summer of 2012. Among the measures taken, much was expected from the new targeted long-term refinancing operation (TLTRO), which gives banks in the euro zone access to ECB refinancing with a maturity of 4 years in return for providing credit to the private sector (excluding

mortgages). However, after the first two allocations (24 September 2014 and 11 December 2014), the picture has become rather complicated, with the amounts allocated well below expectations. This reflects the difficulty the ECB is having in fighting effectively against the risk of deflation.

Indeed, having allotted 82.6 billion euros in September (versus anticipations of between 130 and 150 billion), the ECB granted “only” 130 billion on December 11, *i.e.* once again a lower amount than had been anticipated. So we are a long way from the maximum amount of 400 billion euros that had been evoked by Mario Draghi in June 2014 for these two operations. Moreover, these first two allotments were clearly insufficient to boost the ECB’s balance sheet significantly (Figure 1), and all the more so as banks are continuing to reimburse the three-year loans that they received in late 2011 and early 2012 in the very long-term refinancing operation (VLTRO) [\[1\]](#). What explains the banks’ reluctance to make use of this operation, even though it allows them to refinance the loans granted at a very low rate for a 4 year term?

The first is that the banks already have very broad and very advantageous access to ECB liquidity through the monetary policy operations already implemented by the ECB [\[2\]](#). These operations actually offer a lower interest rate than does the TLTRO (0.05% against 0.15%). Similarly, a TLTRO is not more attractive than some long-term market financing, especially since many banks do not have financing constraints. TLTRO is thus of marginal interest, due to the maturity of the operation, and more restrictive because it is conditioned on the distribution of credit. For the first two operations conducted in September and December 2014, the allotment could not exceed 7% of outstanding loans to the non-financial private sector in the euro zone, excluding loans for housing, as of 30 April 2014. A new series of TLTRO will be conducted between March 2015 and June 2016, on a quarterly basis. This time the maximum amount that can be allocated to the banks

will depend on the growth in outstanding loans to the non-financial private sector in the euro zone, excluding loans for housing, between 30 April 2014 and the date of the operation in question.

The second explanation is that the weakness of credit in the euro zone is not simply the result of supply factors but also demand factors. Sluggish activity and private agents' efforts to shed debt are holding back lending.

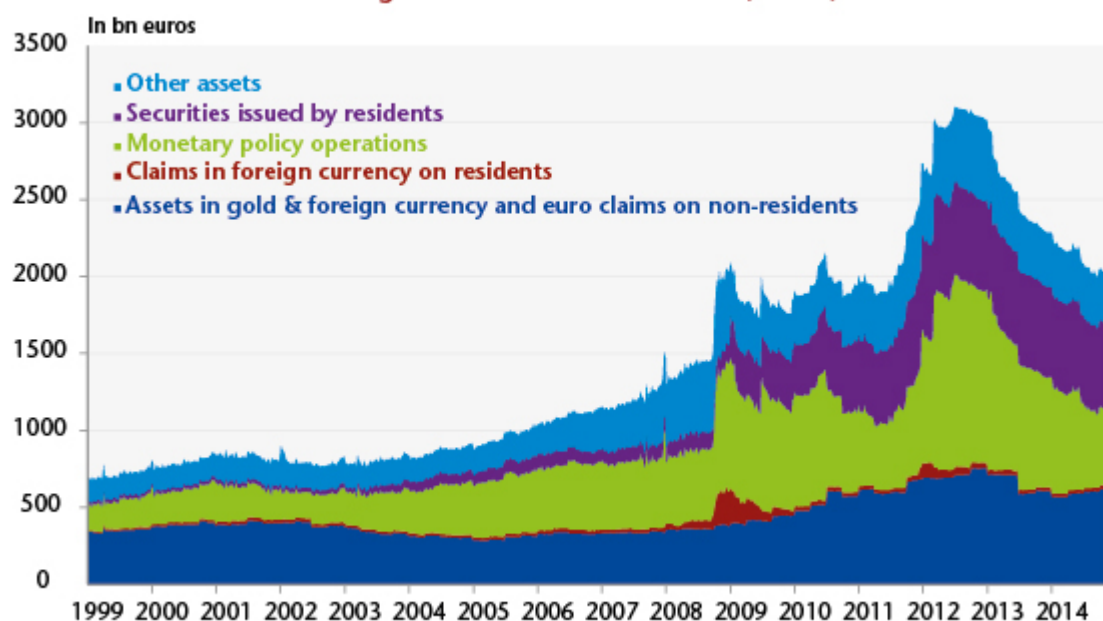
Third, beyond banks' ability to find refinancing, it is also possible that they are trying to reduce their exposure to risk. The problem is thus related to their assets. However, non-performing loans are still at a very high level, especially in Spain and Italy (Figure 2). In addition, although the Asset Quality Review (AQR) conducted by the ECB has revealed that insolvency risks are limited in the euro zone, the report also points out that some banks are highly leveraged and that they have mainly used the available liquidity to buy government bonds in order to meet their capital requirements. They are then reducing their balance sheet risk by limiting loans to the private sector.

Finally, two uncertainties are also reducing the banks' participation in the TLTRO. The first concerns the stigma attached to the conditionality of the TLTRO and to the fact that banks that do not meet their commitments on the distribution of credit will be required to repay the financing obtained from the ECB after two years. So banks facing uncertainty about their ability to increase their lending may very well wish to avoid the prospect of having to repay the funds sooner. The second factor concerns uncertainties about the programs for purchasing ABS and covered bonds<sup>[3]</sup>. The banks could also turn to these programs to get cash in exchange for the sale of assets that they would like to get rid of.

Has monetary policy become totally ineffective? The answer is

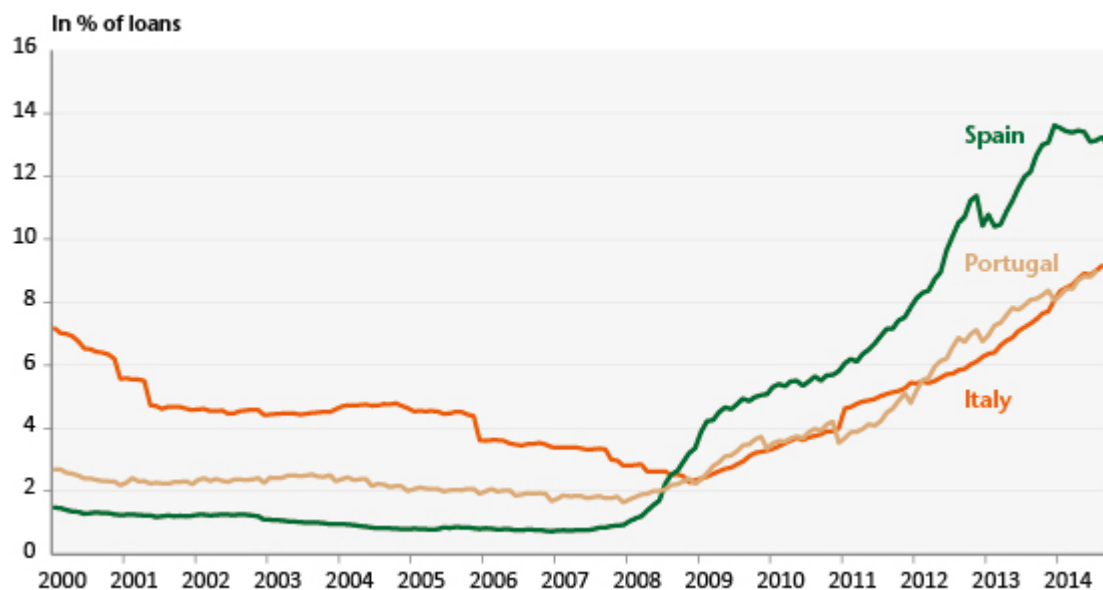
certainly no, since by giving banks a guarantee that they can refinance their activity through various programs (TLTRO, ABS, covered bonds, etc.), the ECB is reducing the risk that credit will be rationed due to the deteriorated state of some banks' liabilities. Monetary policy is thus helping to free up the credit channel. But its effects are nevertheless limited, as is suggested by [Bech, Gambacorta and Kharroubi \(2012\)](#) , who show that monetary policy is less effective in periods of recovery following a financial crisis. Can we get out of this impasse? This observation on the effectiveness of monetary policy shows that the ECB should not be viewed as the be-all and end-all. It is still essential to complement its support for activity through an expansionary fiscal policy across the euro zone. This point was also reiterated by the President of the ECB during this summer's [conference at Jackson Hole](#): "Demand side policies are not only justified by the significant cyclical component in unemployment. They are also relevant because, given prevailing uncertainty, they help insure against the risk that a weak economy is contributing to hysteresis effects."

**Figure 1. ECB balance sheet (assets)**



Source: ECB.

Figure 2. Bad debt



Source: National central banks.

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[1] See the special study in the *Revue de l'OFCE* no. 136, "[Comment lutter contre la fragmentation du système bancaire de la zone euro?](#)" for an examination of the various monetary policy measures taken by the ECB since the onset of the financial crisis and an estimate of their impact on the real economy.

[2] This includes standard monetary policy operations as well as the VLTRO operation through which the ECB provided liquidity for an exceptional term of 3 years in December 2011 and February 2012.

[3] This involves programs for the purchase of securities in the market and not cash distributed directly to the banks. The covered bonds and ABS are securities pledged on assets whose remuneration depends on that of the underlying asset, which is by necessity a mortgage in the case of covered bonds and which

in the case of ABS may include other types of loans (credit cards, cash loans to businesses, etc.).

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# The official introduction of the euro in Lithuania: does it really make no difference?

[Sandrine Levasseur](#)

On 1 January 2015, Lithuania adopted the euro *officially*, becoming the 19th member of the euro zone. The adoption was in reality formal, as the euro was already (very) present in Lithuania. For example at the end of 2014, over 75% of loans to Lithuanian businesses and households were denominated in euros, as were 25% of bank deposits.

The use of the euro alongside Lithuania's national currency, as a currency for loans, a means of savings and for invoicing, is neither an anomaly nor simply an anecdote: this practice concerns or concerned a number of countries in the former communist bloc. "Euroization" [\[1\]](#) is the result of economic and political events that, at one time or another in these countries' histories, have led them to use the euro in addition to their own currency. So given this context, will the official introduction of the euro in Lithuania really not change anything? Not exactly. Lithuania will see some changes, admittedly minor, as will the decision-making bodies of the ECB.

**The euroization of loans and deposits: the case of Lithuania,**

## neither anomaly, nor anecdote ...

If we exclude the principalities, islands and States (Andorra, San Marino, the Vatican, etc.) that have negotiated the adoption of the euro with the European authorities but without joining the European Union together with the countries that have adopted the euro unilaterally (Kosovo and Montenegro), there is in addition a whole set of countries that use the euro alongside their own currency. These countries are mostly from Central and Eastern Europe, the Balkans or the Commonwealth of Independent States (CIS). For example, in 2009, before Estonia and Latvia officially joined the euro zone (in 2011 and 2013, respectively), lending by private agents in the three Baltic states was mainly denominated in the euro, reaching a level of almost 90% in Latvia (Figure 1). Countries such as Croatia, Romania, Bulgaria, Serbia and Macedonia were not far behind, with over 50% of their loans denominated in euros. The figures for deposits in euros are somewhat less striking (Figure 2), but still raise questions as to the attraction that the euro exerted in some countries as a payment or reserve currency or for precautionary savings.

Figure 1. Share of loans to the private sector denominated in euros (emerging Europe, 2009)

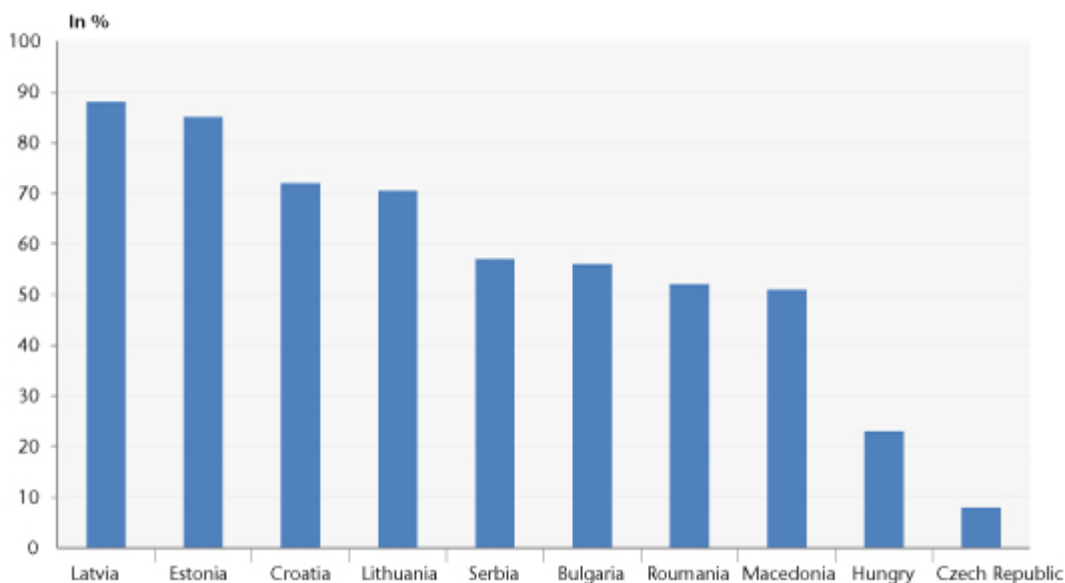
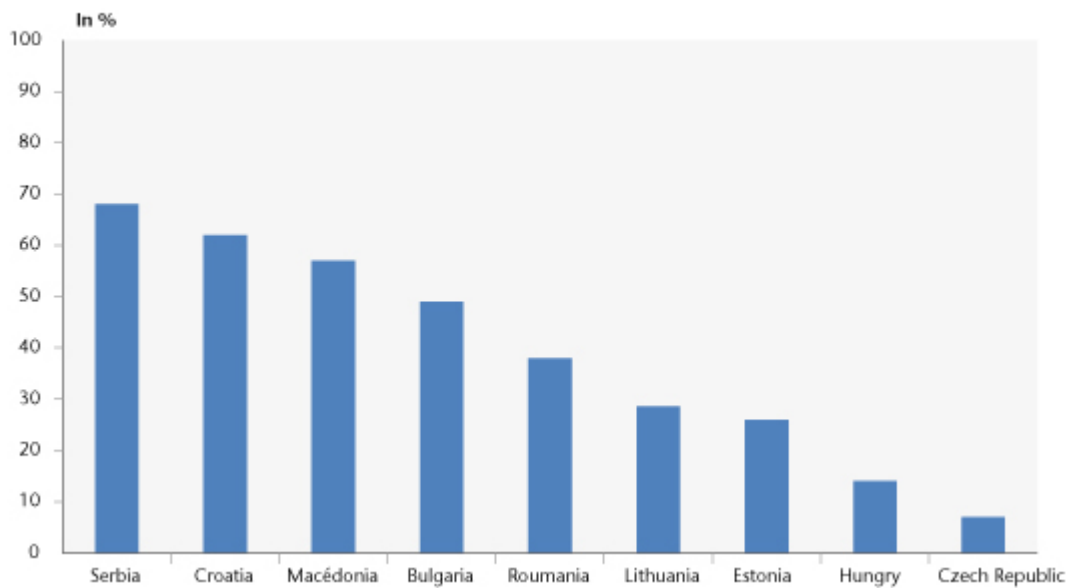


Figure 2. Share of private sector deposits in euros (emerging Europe, 2009)



There are a number of reasons why these countries have used the euro in addition to their own currency:

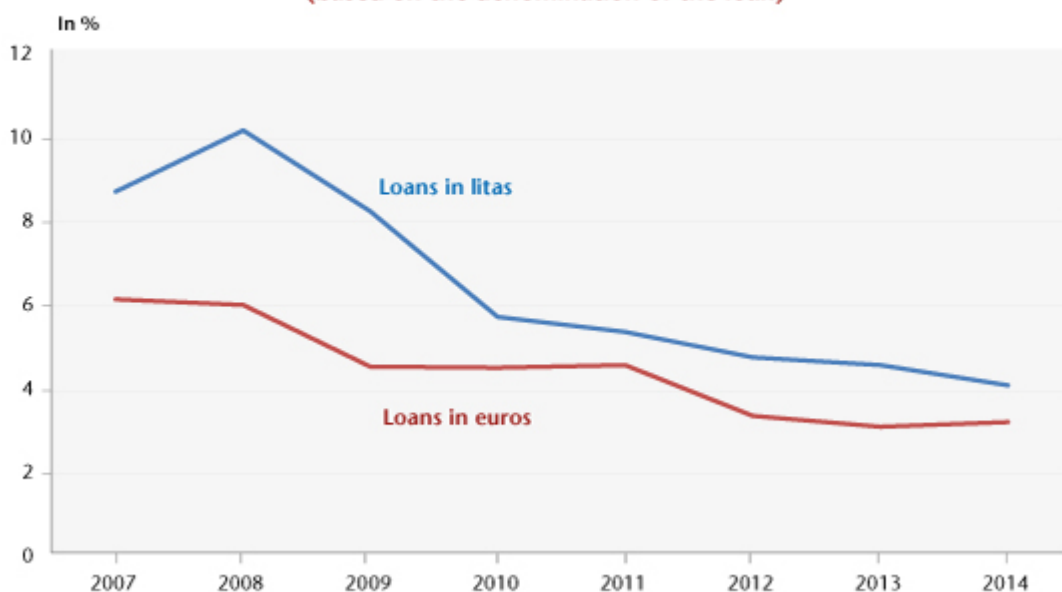
- **The existence of fixed** (or relatively fixed) **exchange rates** against the euro, which protects borrowers against the risk that their euro-denominated debt will grow heavier (since the likelihood of a devaluation / depreciation of the national currency is considered to be low);
- **A lower interest rate on loans denominated in euros** than when the loans are denominated in the national currency;
- **A strong presence of multinational companies (particularly in the banking sector)** that have not only funds in euros but also the “technology” to lend / borrow in euros;
- For loans in euros, **the ex ante existence of bank deposits in euros**, which is itself linked to [multiple factors](#) (e.g. the credibility of the monetary authorities, a strong presence of multinationals, revenue from migration coming from countries in the euro zone) .

These factors have been present to a greater or lesser extent in the different countries. In Lithuania, the existence of a [Currency Board \[2\]](#) vis-à-vis the euro since 2002 has generally



contributed to the economy's "euroization". This system of fixed exchange rates has enjoyed great credibility, prompting the country's businesses and consumers to borrow in euros, particularly since these benefited from very low interest rates (Figure 3). The presence of multinational companies in a number of sectors strengthened the use of the euro as a benchmark currency for different functions (billing, deposits and savings). The importance to Lithuania of banks from the euro zone should nevertheless not be overestimated: [the three largest banks operating in Lithuania are from Sweden and Norway](#). The risk of loans in euros thus involves, beyond the risk associated with the value of the Lithuanian lita, a risk associated with the value of a third currency. ... This risk will obviously not disappear with Lithuania's formal adoption of the euro.

**Figure 3. Interest rates on loans to the private sector  
(based on the denomination of the loan)**



### **What changed on 1 January 2015?**

Four changes can be highlighted:

(1) The euro now circulates in Lithuania in the form of notes and coins, whereas previously it existed primarily in the form of bank money (bank deposits and euro-denominated loans); the euro is the legal tender and will be used for all

transactions; and the lita will disappear after dual circulation for a fortnight.

(2) Changes to the price labels for goods will result in additional inflation, due to more frequent rounding off upwards rather than downwards. However, this phenomenon, which has been seen in all countries during the transition (official) to the euro, should have only a [minor impact](#). Experience shows that in general [perceived inflation is higher than actual inflation](#).

(3) Lithuania is adhering *de facto* to the [banking union](#), which can provide benefits in the financial sector (e.g. opportunities for additional collaboration in a common monetary and banking space, existence of an orderly resolution mechanism in case a bank runs into difficulty).

(4) The Governor of Lithuania's Central Bank is now a member of the ECB Governing Council and therefore participates in decision-making on euro zone monetary policy, whereas previously, under its Currency Board system[\[3\]](#), Lithuania's Central Bank had no choice but to "follow" the decisions taken by the ECB in order to maintain parity with the euro. It could be argued that in any case Lithuania will not carry much weight in the ECB's choice of monetary policy due to the size of its economy. Note, however, that Lithuania's entry into the euro zone is bringing changes to the way decisions are made by the ECB Governing Council. The principle of "one country, one vote" that prevailed until now is being abandoned [in accordance with the Treaties](#), due to the entry of a 19th member into the euro zone. Henceforth, the five "major" countries in the euro zone (defined by the weight of their GDP and their financial system) have now four voting rights, while the other fourteen countries have eleven votes. The vote in each group is established according to a [rotation principle](#), which displeases the [Germans](#), but [not just them](#). In practice, however, it is not certain that [this change in the voting system will affect many decisions](#). For example, while the

governor of Germany's central bank now has only [80% of its voting right](#), it still has 100% of its right to speak... Will not voting one month out of five really mean that it loses its power of persuasion?

On 1 January 2015, the official adoption of the euro by Lithuania was thus not at all amount to a Big Bang. However, it is very symbolic for Lithuania, further demonstrating how much it is anchored in both Europe and the euro zone. This shows once again that despite all the turmoil the zone has experienced, it still has its supporters. The most striking result of Lithuania's accession to the euro zone is probably the change in the ECB's system of voting rights: here too the symbolic meaning is heavy, as it sounds the death knell of the principle, "one country, one vote".

**For more on the issue of euroization, readers can see:**

Sandrine Levasseur (2004), Why not euroization ? *Revue de l'OFCE*, [Special Issue "The New European Union Enlargement"](#), April 2004.

**For more on the system of rotating voting rights in the ECB, see:**

Silvia Merler (2014), Lithuania changes the ECB's voting system, [Blog of Bruegel](#), 25 July 2014.

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[\[1\]](#) Strictly speaking, euroization refers to the adoption of the euro as legal tender by a country without its being given permission by the issuing institution (i.e. the European Central Bank) or the decision-making authorities (i.e. the heads of State of the European Union member countries). Euroization is then said to be [unilateral](#). It differs from the

phenomenon discussed here, where the euro is used in conjunction with the national currency, but only the national currency constitutes [legal tender](#).

[\[2\]](#) A currency board involves a system of fixed exchange rates in which the central bank simply converts foreign exchange inflows and outflows into the local currency at the pre-defined parity. A central bank that adopts this system gives up the tool of autonomous monetary policy: its role is reduced to that of a “cashier”.

[\[3\]](#) See footnote 2.

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# Banking Europe: Strength in the Union?

By [Céline Antonin](#) and [Vincent Touzé](#)

On 4 November 2014, the European Central Bank became the single supervisor of banks in the euro zone. This was the first step in the banking union.

The economic and financial crisis that started in 2007 has exposed several European weaknesses:

1. The national bank markets, though seemingly compartmentalized, proved to be highly interdependent, as was seen in the high level of propagation-contamination;
2. There was often a lack of coordination in the national support provided;
3. Given the context of high public indebtedness, State support for the bank system led to a strong correlation

between bank risk and sovereign risk;

4. The absence of fiscal transfer mechanisms strongly limited European solidarity.

In 2012, the idea of a banking union arose out of a triple necessity: to break the link between the banking crisis and the sovereign debt crisis by enabling the direct recapitalization of troubled banks through the European Stability Mechanism; to prevent bank runs; and to prevent the euro zone banking markets from fragmenting.

The banking union is being built on three pillars: a single supervision mechanism (SSM); a single resolution mechanism (SRM), with a resolution fund and a bail-in process; and a single deposit guarantee system with a guarantee fund.

The banking union sets out new solutions. Nevertheless, grey areas remain, and the European solidarity provided by the banking union could prove insufficient to deal with major shocks.

The latest [\*Note de l'OFCE\*](#) (no. 46 of 18 November 2014) reviews the context surrounding the establishment of the banking union and takes stock of the advantages and limitations of the progress made in constructing the union. This Note was produced as a special study entitled [\*“Comment lutter contre la fragmentation du système bancaire de la zone euro?”\*](#), [How can the fragmentation of the euro zone banking system be fought?] *Revue de l'OFCE*, no. 136 (2014).

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# What options for the European Central Bank?

By [Paul Hubert](#)

All eyes are now on the ECB, whose recent statements indicate that it is concerned about the risk of deflation in the euro zone. The further downturn in inflation in May to 0.5% year on year is a reminder that this risk [is increasing](#). This could lead the ECB to take action at the monthly meeting of the Board of Governors being held today, or in the months to come. This post provides a brief summary of the possible options available to the ECB.

1. To lower the key interest rate (main refinancing operations rate, the MRO rate), which is currently 0.25%. The consensus in the financial markets is for a reduction of around 10 to 15 percentage points, which would further cut financing costs for banks that are still dependent on ECB liquidity. However, this would have a marginal impact on the rates of refinancing operations (MRO and long-term refinancing operations, or LTRO), which would not have much influence on financing conditions and thus not much benefit for Spanish and Italian banks (the main users of this option).

2. To lower the deposit facility rate from zero to a negative rate (again by 10 to 15 percentage points). This option has been largely anticipated by the financial markets. A negative interest rate on deposits should also be accompanied by a change in the policy on the ECB's excess reserves by capping the amount of commercial banks' excess reserves on the ECB's balance sheet or by applying the same negative rate to excess reserves. Otherwise the banks would simply transfer their funds from deposit accounts to excess reserves. A combination of these two policies should lead to a lower Euro OverNight Index Average (EONIA) rate of between zero and 0.05%. The

incentive for banks to keep their cash at the ECB would thus be reduced, thereby stimulating the distribution of credit to the non-financial sector.

3. An extension of the policy of providing liquidity in unlimited amounts at a fixed rate (fixed-rate full allotment) from mid-2015 to late 2015 or even mid-2016 is considered by most to be an easy and quick option that would provide additional assurance on the markets before the LTRO deadlines in early 2015. This kind of measure would ensure the liquidity of the banking system but its impact on activity and inflation could be limited, in so far as the banks would prefer to place their cash with the central bank.

4. An ECB announcement of the end of sterilization through the Securities Markets Programme (SMP), a programme for purchasing the sovereign bonds of euro zone countries in difficulty. The markets seem divided on this issue. The ECB has not managed to attract sufficient demand to completely sterilize this operation in the last eight weeks. This would add 164.5 bn euros (the SMP target amount) of liquidity to the system and take the EONIA rate to zero or even into negative territory, and could reduce the volatility that has appeared in recent months. This measure would therefore also cut the interbank refinancing rate, which would more or less amount to the first option.

5. A conditional and targeted LTRO programme could see the light of day. This would consist of copying the Funding for Lending Scheme (FLS) set up by the Bank of England, in which cheap financing is arranged for banks in exchange for granting new loans to the real economy. However, it would take time to implement this, and even more before there is any real impact on the economy. It would nevertheless probably be the most effective way to stimulate activity, because it would go beyond interbank operations in influencing refinancing conditions.

In any event, the economic situation in the euro zone for both the business outlook as well as for the situation on the labour market calls for a strong response from the ECB so as to ensure that the euro zone does not incur deflation. The effect of the signal may be just as important as the measure actually implemented by the ECB. By demonstrating in today's meeting that it is active, the ECB would show its determination to fight against the risk of deflation, which could at least change agents' expectations. While any action by the ECB would be welcome, it is still the case that the current economic situation is also the result of the restrictive fiscal policies that have hit activity (see [here](#)).

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## The ECB – or how to become less conventional

By [Jérôme Creel](#) and [Paul Hubert](#)

The gloomy economic situation in the euro zone and the deflationary risks it is facing are leading the members of the European Central Bank (ECB) to consider a new round of quantitative easing, as can be seen in [recent statements by German, Slovakian and European central bankers](#). What might this involve, and could these measures be effective in boosting the euro zone economy?

Quantitative easing (QE) includes several different types of unconventional monetary policy. To define them, it is necessary to start by characterizing conventional monetary policy.

*Conventional* monetary policy involves changing the key interest rate (the rate for so-called medium-term refinancing



operations) by what are called open market operations so as to influence financing conditions. These operations can change the size of the central bank's balance sheet, including by means of money creation. So there is a stumbling block in distinguishing between conventional and unconventional policy: increasing the size of the central bank's balance sheet is not sufficient in itself to characterize an unconventional policy.

In contrast, strictly speaking an unconventional quantitative easing policy gives rise to an increase in the size of the central bank's balance sheet but without any immediate additional money creation: the extra liquidity provided by the central bank to the commercial banks serves to increase their reserves with the central bank, so long as these reserves are ultimately used for the subsequent acquisition of securities or to grant loans. These reserves, which are the commercial banks' safe assets, help to consolidate their balance sheets: risky assets decrease in proportion, while safe assets increase.

Another type of unconventional monetary policy, qualitative easing, consists of modifying the structure of the central bank's balance sheet, usually on the assets side, but without changing the size of the balance sheet. This may mean that the central bank purchases riskier securities (not AAA rated) to the detriment of safer securities (AAA). In doing this, the central bank reduces the amount of risk on the balance sheets of the banks from which it has acquired these higher-risk securities.

A final type of unconventional monetary policy involves conducting an easing policy that is both qualitative and quantitative: credit easing, *i.e.*, the size of the balance sheet of the central bank and the resulting risk increase in concert.

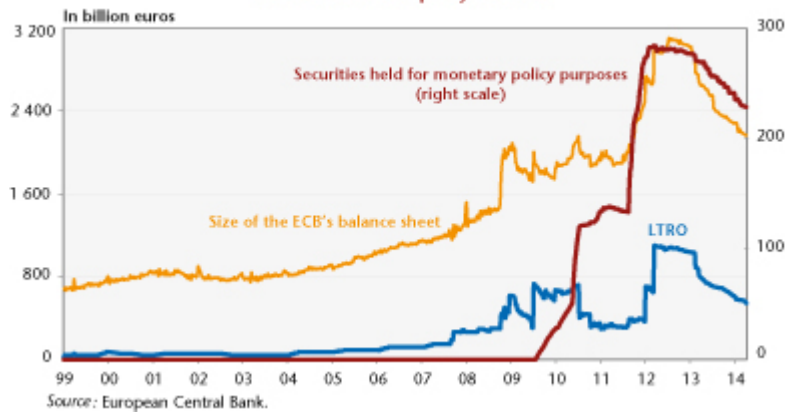
Unconventional monetary policies that are often attributed to the ECB include operations to provide long-term liquidity (3

years) at low interest rates, as was done in November 2011 and February 2012, and which were described as very long-term refinancing operations (VLTRO). But were these really unconventional large-scale operations? On the one hand, these operations involved not trillions of euros but an amount closer to 500 billion, which is not negligible after correcting for bank repayments to the ECB. On the other, the LTRO operations are part of the ECB's conventional policy arsenal. Finally, these operations were partially sterilized: the loans granted by the ECB to the commercial banks were offset by sales of securities by the ECB, thereby altering the structure of its assets. So we can conclude that the VLTRO operations were in part "conventional" and in part "unconventional".

The situation is different for the Securities Market Programme mechanism, which consisted, on the part of the ECB, of purchasing government debt on the secondary markets during the sovereign debt crisis. This mechanism led to increasing the size of the ECB's balance sheet, but also the risk involved: the policy of credit easing has indeed been an unconventional policy.

Given the different definitions of unconventional policy in current use, it is helpful to recall that the ECB explicitly indicates the amounts it has agreed within the framework that it sets for its unconventional policies, which are called Securities held for monetary policy purposes. These amounts are graphed in the figure below. They show the frequency and magnitude of the monetary activities that the ECB itself defines as unconventional.

Figure. Size of the ECB's balance sheet and values of its unconventional policy measures



The three different measures shown in the figure (size of the ECB's balance sheet, LTRO amounts, and amounts of Securities held for monetary policy purposes) are expressed in billions of euros. The first two went up in the fourth quarter of 2008 after the bankruptcy of Lehman Brothers, whereas the third measure of unconventional policy started only in June 2009. We then see a new joint deepening of these measures at end 2011. Following this episode, the amount of LTRO operations came to 1090 billion euros, which represented about 50% of euro zone GDP (2,300 billion euros), i.e., about one-third of the ECB's balance sheet, while the amount of Securities held for monetary policy purposes was only 280 billion euros, or 13% of euro zone GDP, about a quarter of the LTRO operations. It is interesting to note that the ECB's monetary policy, which depends on the banks' demand for liquidity, changed in 2013. One can interpret the reduction in the balance sheet size as a sign of a less expansionary policy or as a reduction in the demand for liquidity from the banks. In the first case, this would indicate that the strategy for ending the monetary easing policy probably came too early in terms of the European economy – hence the recently evoked recourse to new unconventional measures.

Until then, these measures had been formally introduced to restore the channels for transmitting the ECB's monetary policy to the real economy, channels that in some euro zone countries have been scrambled by the financial crisis and the

euro zone crisis. The way to restore these channels was to inject liquidity into the economy and to increase the reserves of the banking sector in order to encourage banks to start lending again. Another objective of these policies was to send a signal to investors about the central bank's ability to ensure the stability and sustainability of the euro zone, as reflected in Mario Draghi's famous "whatever it takes" [\[1\]](#) statement on 26 July 2012.

In a recent working paper with Mathilde Vienneot, we consider the effectiveness of conventional and unconventional policies during the financial crisis. We estimate how much the conventional instrument and the purchases of securities held for monetary policy purposes under the ECB's unconventional policies have affected interest rates and the volumes of new loans granted in various markets: loans to non-financial corporations, to households and on the sovereign debt market, the money market and the deposit market.

We show that unconventional policies have helped to reduce interest rates on the money market, on the government securities market and on loans to non-financial companies. These policies have not, however, affected the volume of loans granted. At the same time, it turns out that the conventional instrument, whose lack of effectiveness was one of the justifications for implementing unconventional measures, had the expected impact on almost all the markets surveyed, and more so in the southern euro zone countries than in the northern ones on the market for 6-month sovereign debt and for real estate loans to consumers.

So it seems that unconventional policies have had a direct impact on the sovereign debt market as well as indirect effects, helping to restore the effectiveness of the conventional instrument on other markets. One of the reasons that helps to explain the weak impact of both instruments on the volumes of loans granted is the need facing the commercial banks [\[2\]](#) to shed debt and reduce the size of their balance

sheets by adjusting their portfolio of risk-weighted assets, which has pushed them to increase their reserves rather than to play their intermediation role and to demand relatively higher compensation for each exposure taken.

Though legitimate, this behaviour is affecting the transmission of monetary policy: interest rates fall but lending doesn't restart. It thus seems important that monetary policy is not based exclusively on the banking sector. If there is a new round of unconventional operations, it should be focused directly on the acquisition of sovereign or corporate debt in order to bypass the banking sector. This workaround would undoubtedly lead to amplifying the transmission of monetary policy to the real economy. And it would be welcomed for helping to avoid the risk of deflation in the euro zone.[\[3\]](#)

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[\[1\]](#) "The ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

[\[2\]](#) The reasoning behind unloading debt also applies to their customers: the non-financial agents.

[\[3\]](#) See the [post](#) by Christophe Blot on this subject as well as the recent [Council of Economic Analysis \(CAE\) report](#) by Agnès Bénassy-Quéré, Pierre-Olivier Gourinchas, Philippe Martin and Guillaume Plantin.

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# And what if the ECB respected its mandate!

By [Christophe Blot](#)

Article 127 of the Treaty on the Functioning of the European Union (TFEU), *i.e.* former Article 105 of the Maastricht Treaty, states clearly that “the primary objective of the European System of Central Banks ... shall be to maintain price stability”. However, no precise quantification of this goal is given in the Treaty. The European Central Bank has interpreted this by stating that it would target inflation that is below, but close to, 2% over the medium term. Furthermore, Article 127 of the TFEU adds that, “without prejudice to the objective of price stability , the [European System of Central Banks ] shall support the general economic policies in the Union, as laid down in Article 3 ...”, which includes in particular the sustainable development of Europe based on balanced economic growth and price stability, full employment and social progress. It is therefore clear that the goal of growth and employment is not abandoned but subordinated to the goal of price stability. Starting from this review of the definition of the ECB’s objectives, what conclusion can we draw on the orientation of monetary policy in the euro zone?

Since the end of 2013, a few signs of economic recovery have appeared in the euro zone. Initial estimates of growth in the fourth quarter of 2013 have confirmed that the recession is ending, with GDP up 0.3%. Nevertheless, the economy is still in poor health. As proof, simply recall that 12% of the labour force is currently unemployed, which is the highest level since 1993 (see chart). Growth is expected to accelerate in 2014 and 2015. According to the ECB forecasts announced in March 2014, growth will hit 1.2% in 2014 and 1.5% in 2015, a pace that is still insufficient to lead to a rapid or significant reduction in the unemployment rate. In addition,

since the end of 2013 inflation has dropped below the threshold of 1% and is coming dangerously close to a point where deflation is a risk. Furthermore, still according to the ECB forecasts, inflation should not exceed 1.0% in 2014, before pushing up to 1.3% in 2015 and 1.5% in 2016. It is in any case far from the mid-term target of 2%. The objective of price stability as defined by the ECB will therefore not be met. At his press conference in March, Mario Draghi announced that the maintenance of the ECB key interest rate [\[1\]](#) at 0.25% and the absence of additional (so-called unconventional) measures could stimulate the euro zone. The status quo was justified by the absence of signs of a more rapid fall in inflation. By taking this stand, the ECB President is indicating that he is satisfied with a situation where inflation remains permanently below the 2% level and where the euro zone is marked by persistent mass unemployment. Are we therefore supposed to reinterpret the definition of price stability invoked by the ECB and accept that the term *below* is more important in the eyes of the members of the ECB Governing Council than the term *close to 2%*? The answer to this question is obviously not neutral, since it would reflect a certain asymmetry in the central bank's reaction to inflation, with the ECB reacting more quickly when inflation exceeds 2% than when it falls below 2%, including over the forecast horizon of its own team. But however its main objective is interpreted, the fact remains that the risk to price stability is not currently a barrier to the implementation of a more expansionary monetary policy. In these conditions, the ECB has all the room it needs to be actively concerned about its other objectives, including first of all growth and unemployment.

So what tools does the ECB have available, knowing that with the benchmark rate at 0.25% it has only very limited manoeuvring room for a downward adjustment? The ECB must therefore use other levers. Communication by the central banks has played an increasing role in the implementation of monetary policy, as this can be used to influence agents'

expectations and hence the impact of decisions on inflation and growth. In this respect, the central bank has recently (July 2013) engaged in what is called forward guidance by stating that the key rate will be maintained at a low level for an extended period [\[2\]](#). The ECB could go further by conditioning a hike in the key interest rate on a target unemployment rate, as both the Bank of England and the Federal Reserve have done; this would give added substance to its objectives on employment and growth. In addition, unconventional measures could be used to strengthen the expansionary character of monetary policy. This mainly means measures that alter the size or composition of the central bank's balance sheet, which would supplement the role of the reduction in short-term rates in influencing financing conditions. A recent report by France's Council of Economic Analysis (see [here](#)) points in this direction, and in particular proposes that the ECB should purchase securitized small and medium enterprises' (SME) loans in order to reduce the cost of business financing. The Outright monetary transactions (OMT) programme [\[3\]](#) could have been activated to support the reduction in long-term sovereign rates. The announcement of this measure did indeed contribute to lowering long-term sovereign rates in Spain and Italy, in particular because it sent a signal that the risk of collapse of the euro zone was being averted. Up to now, the ECB has not intervened in the markets to buy government securities. Yet given its unlimited capacity for intervention, doing this would help to reduce long-term rates. Note, however, that the OMT programme is currently being challenged by Germany's Constitutional Court in Karlsruhe, which has questioned the programme's constitutionality, with the case being referred to the European Court of Justice. A rejection or restriction of the ECB's actions in this matter would be unfortunate. The ECB's scope for intervention does of course need to be clarified. But it is also essential to retain the objectives of price stability and growth. The judges in Germany and at the European Court of Justice would be well advised to keep this



in mind.



## The chiaroscuro of the ECB's "forward guidance" \*

By [Paul Hubert](#) and Fabien Labondance

"The Governing Council expects the key interest rates to remain at present or lower levels for an extended period of time." With this pronouncement on 4 July 2013 at the press conference following the monthly meeting of the European Central Bank Board of Governors, Mario Draghi initiated the adoption by the ECB of a new communication strategy called "forward guidance". Since then these words have always been included in his speech following announcements of the ECB's monetary policy, and he has repeated them again [today \[1\]](#). What should we expect? Forward guidance has recently been adopted by several central banks, but the methods chosen by the ECB differ and indicate that this measure will have only

limited effectiveness in the euro zone.

Communication has become an integral part of the conduct of monetary policy since interest rates have been kept at a minimum level. More specifically, forward guidance consists of announcing and making a commitment to the future path of key interest rates. By doing this, the central banks want to increase the transparency of their activities and anchor expectations. The aim is to clarify both their strategy and their predictions about trends in the economy. In the present case, the central banks want to affirm their desire not to raise interest rates in the near future. They also hope to influence private expectations about short-term rates, and thus long-term rates, in order to strengthen the transmission of monetary policy, and thus support the economy.

### **From the theory...**

The promoters of the forward guidance strategy, foremost among them Eggertsson and Woodford (2003), suggest that monetary policy can be made more effective by adopting a policy of stable interest rates that is well known in advance. This proposal is justified by the fact that demand for credit is highly dependent on expectations of long-term interest rates, which depend on expectations of short-term rates. Hence, by announcing the future levels of interest rates in advance, the central bank declares its intentions and dispels any uncertainty about its future decisions. This strategy is especially relevant in a situation of a liquidity trap, when nominal interest rates are close to zero, as is the case today. The traditional tool of central banks is then constraint, as nominal interest rates cannot be negative. Central banks can thus no longer influence the cost of the loans granted, but they can on the other hand influence volumes through unconventional measures [\[2\]](#). The channel of expectations and the transmission of signals to private agents then become paramount and complement quantitative easing.

It is important to note that the effect of forward guidance on long-term rates and thus on the economy passes through the term structure of the interest rates. Several theories attempt to explain how rates vary in accordance with the term. The term structure of interest rates can be considered from the viewpoint of the theory of expectations, which assumes that long-term rates reflect a combination of expected future short-term rates, and thus that the different maturities are perfect substitutes. For its part, the theory of a liquidity premium implies that long-term interest rates include a premium linked to the existence of one or more long-term risks. Finally, another theory is based on the assumption of market segmentation and stipulates that financial instruments with different maturities cannot easily be substituted and that their prices move independently. If investors wish to hold liquid assets, they will prefer short-term instruments over long-term ones, and their prices will vary in opposite directions. Only in the case of the first two theories will forward guidance have the desired effect on long-term rates.

### **...to the practice**

This kind of strategy had already been implemented by some central banks even before the 2008 financial crisis, in particular in New Zealand since 1997, in Norway since 2005, and in Sweden since 2007. The United States also implemented this communication strategy several times when rates were very low. The Federal Open Market Committee (FOMC) implicitly introduced forward guidance in its communications in August 2003. At a time when its target rate was at a historic low, the FOMC stated that “...policy accommodation can be maintained for a considerable period”. This terminology, specific to forward guidance, remained in FOMC communiqués until the end of 2005. It reappeared in December 2008, and in greater detail in August 2011, when Ben Bernanke, chairman of the US Federal Reserve (or the “Fed”), announced that economic conditions warranted maintaining the federal funds rate at a low level

until at least mid-2013. Since then, the announcement on 13 September 2012 that the Fed will not raise its rates before mid-2015 continues this same strategy.

To understand what impact the ECB's forward guidance might have, it is important to distinguish two types of forward guidance: one for which the action of the central bank is subject to a time period, and another which depends on economic variables, including thresholds that trigger an action on the bank's part. In the case of the Fed, the first statements mentioned above refer to a period of time, but since December 2012 it has conditioned its commitment to future rate changes on cyclical thresholds that act as triggers. The Fed has also announced that "this exceptionally low range for the [Fed Funds](#) rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored". The arrival of new FOMC members in January 2014 could, however, change the timing of the next monetary tightening. Likewise, in August 2013 Mark Carney, Governor of the Bank of England (BoE), set out a forward guidance strategy indicating his intention not to raise rates so long as the unemployment rate had not fallen below 7%. This commitment is nevertheless conditional on containing inflation, on stable inflation expectations and on the neutral impact of this commitment on financial stability.

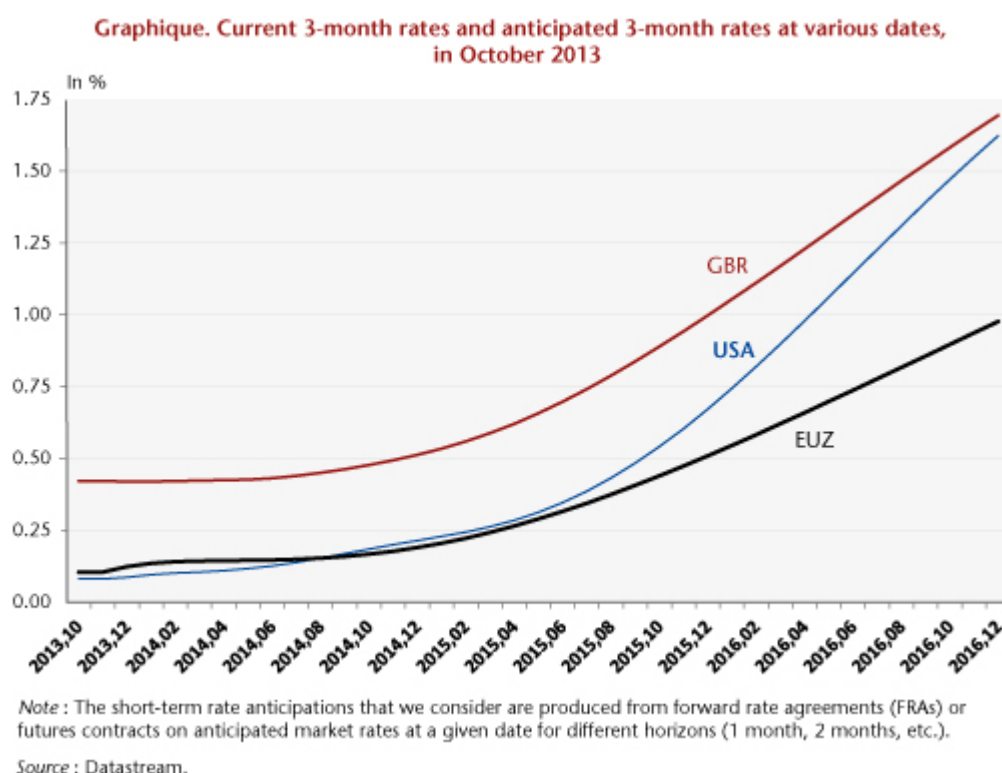
There is a major disadvantage to conditioning forward guidance on a time period, as has been adopted by the ECB (and as will be described later): changes in economic conditions over the time period in question could render the commitment obsolete. The announcement thus has very little credibility. Conditioning forward guidance on thresholds for economic variables does not have this drawback. One criterion for the credibility of commitments conditioned on thresholds is,

however, that the underlying variables chosen are observable (GDP rather than output gap) and that they do not suffer from measurement errors (inflation rather than inflation expectations), so that private agents can assess whether the central bank is acting in accordance with its commitments. Then and only then will the agents have confidence in the declarations and will the central bank be in a position to influence expectations of long-term rates. The relative advantages and disadvantages of the two types of forward guidance explain why the Fed switched from one to the other and why the BoE has also made  $\pi$  a commitment linked to thresholds.

The establishment of forward guidance conditioned on a threshold for a macroeconomic variable may, however, contribute to muddying the waters on the ranking of the central bank's objectives. If several variables are targeted simultaneously and they begin to diverge, what will the bank decide? The Fed does not prioritize its objectives. As the economy emerges from crisis it is quite possible that the Fed may decide to ensure the strength of GDP, or to lower unemployment rather than inflation. For its part, the BoE follows a strategy of inflation targeting. It has therefore defined conditions ("knockouts") on inflation, inflation expectations and financial stability, which, when they are not met, will lead to an end to forward guidance and therefore to any commitment to keep rates unchanged. The hierarchy of objectives would thus be well respected and the BoE's credibility maintained.

How effective can forward guidance be? Kool and Thornton (2012) express serious doubts as to the results obtained through forward guidance. They assess the predictability of short-term and long-term rates in countries where this strategy has been adopted and show that forward guidance improves the ability of private agents to forecast future short-term rates only for periods of under one year, without

improving the predictability of rates in the longer term. The chart below shows the expectations of 3-month rates by the financial markets in October 2013 for the coming months. Since benchmark rates change by a minimum of 0.25%, this figure indicates that no change in rates is expected for the time being, apart perhaps from the United States for the one-year horizon.



## The timid adoption by the ECB

With regard to the ECB, which for its part sets a hierarchy of goals by giving priority to inflation, the introduction of forward guidance constitutes a conditional commitment to a period of time (“... for an extended period of time”) without any reference to thresholds. From this point of view, it goes against the current of the Fed and the BoE, which adopted conditional commitments to numerical thresholds. For the record, prior to July 4<sup>th</sup> the ECB gave clues to its decision in the following month in the form of expressions that were easily recognizable to observers. Thus, the insertion of the

word “vigilance” in the ECB President’s speech at his press conference announced a probable tightening of monetary policy [\[3\]](#). By adding forward guidance to its basket of tools, the ECB wants to be less enigmatic. In particular, it seems that it wanted to respond to concerns over a possible rise in interest rates.

However, Benoit Coeuré, a member of the ECB Executive Board, said that this strategy does not call into question the rule, repeated many times at press conferences, that the ECB will never commit to future policies (“no pre-commitment rule”) and that forward guidance is to be re-evaluated at each meeting of the Board of Governors. Jens Weidmann, a member of the ECB’s monetary policy committee as president of the Bundesbank, confirmed that the ECB’s forward guidance “is not an absolute advanced commitment of the interest rate path”, while Vitor Constancio, ECB Vice-President, added an extra dose of confusion by saying that the ECB’s forward guidance “is in line with our policy framework as it does not refer to any date or period of time but is instead totally conditional on developments in inflation prospects, in the economy and in money and credit aggregates – the pillars of our monetary strategy”.

So how effective can a policy be that is poorly defined, that does not seem to have a consensus within the ECB Governing Council, and whose key to success – the credibility of the commitment – is openly questioned? Not very effective.

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\* This text draws on a study, “Politique monétaire: est-ce le début de la fin?” [“Monetary policy: Is it the beginning of the end?”], forthcoming in [The OFCE outlook for the global economy in 2013-2014 \[in French\]](#).

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[1] Today’s 25-basis point cut in the benchmark rate is consistent with the ECB’s strategy of forward guidance.

[2] Unconventional measures refer to monetary policy practices that are not classified as traditional policy (*i.e.* changes in interest rates). These are measures that result in a change in the content or magnitude of the central bank balance sheet through purchases of government or private securities, which is generally referred to as “quantitative easing”.

[3] Rosa and Verga (2007) offer a description of these expressions.

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# Monetary policy and property booms: dealing with the



# heterogeneity of the euro zone

By [Christophe Blot](#) and Fabien Labondance

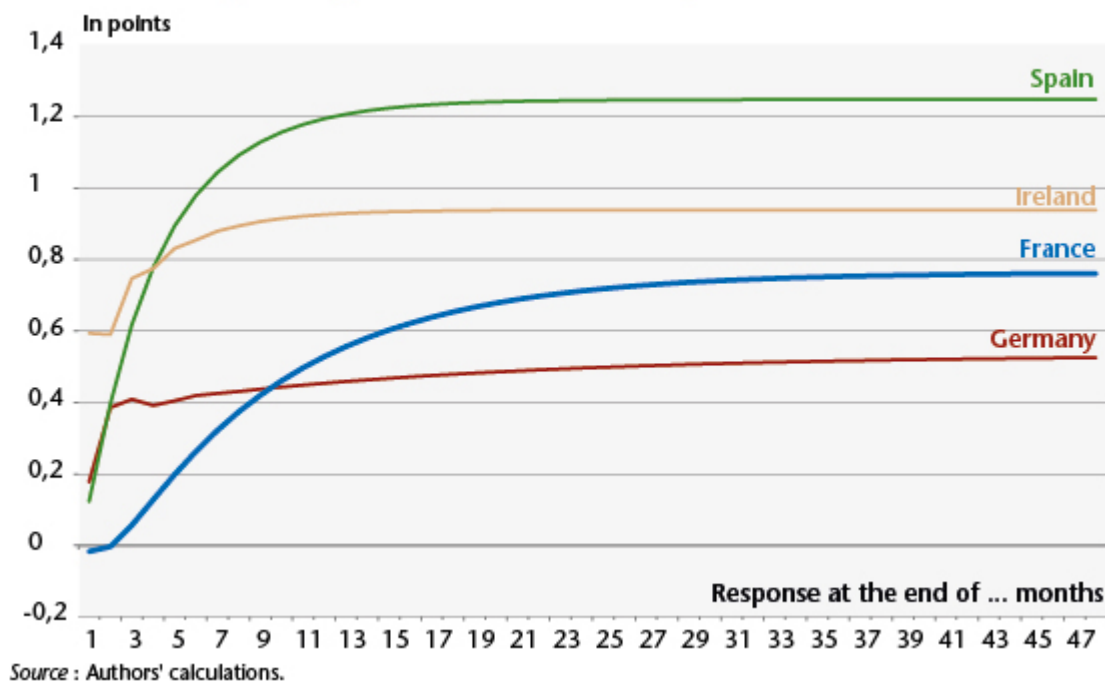
The transmission of monetary policy to economic activity and inflation takes place through various channels whose role and importance depend largely on the structural characteristics of an economy. The dynamics of credit and property prices are at the heart of this process. There are multiple sources of heterogeneity between the countries of the euro zone, which raises questions about the effectiveness of monetary policy but also about the means to be used to reduce this heterogeneity.

The possible sources of heterogeneity between countries include the degree of concentration of the banking systems (*i.e.* more or fewer banks, and therefore more or less competition), the financing arrangements (*i.e.* fixed or variable rates), the maturity of household loans, their levels of debt, the proportion of households renting, and the costs of transactions on the housing market. The share of floating rate loans perfectly reflects these heterogeneities, as it is 91% in Spain, 67% in Ireland and 15% in Germany. In these conditions, the common monetary policy of the European Central Bank (ECB) has asymmetric effects on the euro zone countries, as is evidenced by the divergences in property prices in these countries. These asymmetries will then affect GDP growth, a phenomenon that has been observed both “before” and “after” the crisis. These issues are the subject of an article that we published in the OFCE’s [Ville et Logement](#) (Housing and the City) issue. We evaluated heterogeneity in the transmission of monetary policy to property prices in the euro zone by explicitly distinguishing two steps in the transmission channel, with each step potentially reflecting different sources of heterogeneity. The first describes the impact of

the interest rates controlled by the ECB on the rates charged for property loans by the banks in each euro zone country. The second step involves the differentiated impact of these bank rates on property prices.

Our results confirm the existence of divergences in the transmission of monetary policy in the euro zone. Thus, for a constant interest rate set by the ECB at 2%, as was the case between 2003 and 2005, the estimates made during the period preceding the crisis suggest that the long-term equilibrium rate applied respectively by Spanish banks and Irish banks would be 3.2% and 3.3%. In comparison, the equivalent rate in Germany would be 4.3%. Moreover, the higher rates in Spain and Ireland amplify this gap in nominal rates. We then show that the impact on bank rates of changes in the ECB's key rate is, before the crisis, stronger in Spain and Ireland than it is in Germany (figure), which is related to differences in the share of loans made at floating rates in these countries. It should be noted that the transmission of monetary policy was severely disrupted during the crisis. The banks did not necessarily adjust supply and demand for credit by changing rates, but by tightening the conditions for granting loans. [1] Furthermore, estimates of the relationship between the rates charged by banks and property prices suggest a high degree of heterogeneity within the euro zone. These various findings thus help to explain, at least partially, the divergences seen in property prices within the euro zone. The period during which the rate set by the ECB was low helped fuel the housing boom in Spain and Ireland. The tightening of monetary policy that took place after 2005 would also explain the more rapid adjustment in property prices observed in these two countries. Our estimates also suggest that property prices in these two countries are very sensitive to changes in economic and population growth. Property cycles cannot therefore be reduced to the effect of monetary policy.

Figure. Impact on bank rates of a 1 point hike in ECB rates



To the extent that the recent crisis has its roots in the macroeconomic imbalances that developed in the euro zone, it is essential for the proper functioning of the European Union to reduce the sources of heterogeneity between the Member states. However, this is not necessarily the responsibility of monetary policy. First, it is not certain that the instrument of monetary policy, short-term interest rates, is the right tool to curb the development of financial bubbles. And second, the ECB conducts monetary policy for the euro zone as a whole by setting a single interest rate, which does not permit it to take into account the heterogeneities that characterize the Union. What is needed is to encourage the convergence of the banking and financial systems. In this respect, although the proposed banking union still raises many problems (see [Maylis Avaro and Henri Sterdyniak](#)), it may reduce heterogeneity. Another effective way to reduce asymmetry in the transmission of monetary policy is through the implementation of a centralized supervisory policy that the ECB could oversee. This would make it possible to strengthen the resilience of the financial system by adopting a means of regulating banking credit that could take into account the situation in each country in order to avoid the development of the bubbles that

pose a threat to the countries and the stability of the monetary union (see [CAE report no. 96](#) for more details).

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[1] [Kremp and Sevestre \(2012\)](#) emphasize that the reduction in borrowing volumes is not due simply to the rationing of the supply of credit but that the recessionary context has also led to a reduction in demand.

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## What monetary policy for the ECB in 2013?

By Paul Hubert

After the monthly meeting of the Board of Governors of the European Central Bank on 7 February 2013, the ECB decided to hold its key interest rate at 0.75%. The analysis of the economic situation by Mario Draghi made ☐ during the press conference afterwards pointed to contrasting developments justifying the status quo. In a recent study, we showed that the inflation forecasts of the ECB can shed new light on future trends in interest rates.

The status quo can be explained by a number of mutually offsetting factors. The banks have started to repay some of the cash obtained through the LTRO facility (140 billion euros out of 489 billion), which reflects an improvement in their financial position, while at the same time lending to non-financial firms is continuing to contract (-1.3% in December 2012) and consumer loans are still at very low levels.

From a macroeconomic viewpoint, the situation in the euro zone is not giving clear signals about future monetary policy: after shrinking by 0.2% in the second quarter of 2012, real GDP in the euro zone fell another 0.1% in the third quarter, while inflation, as measured on an annual basis, decreased from 2.6% in August 2012 to 2% in January 2013 and is expected to drop below the 2% mark in the coming months based on the figures for GDP growth and for current and anticipated oil prices.

Furthermore, the inflation expectations of private agents, as measured by the *Survey of Professional Forecasters*, remain firmly anchored around the ECB's inflation target. In the fourth quarter of 2012, expectations were for 1.9% inflation for the years 2013 and 2014. Given that the target of "below but close to 2%" has now been reached, and with a euro zone in recession and unemployment at record levels, the ECB could give a boost to real activity. However, it anticipates that economic activity should gradually pick up in the second half of 2013, partly due to the accommodative monetary policy being followed today.

Given expectations, and in light of the historically low levels of key interest rates and the lag in the transmission of monetary policy to the real economy [\[1\]](#), a future rate cut seems very unlikely. One final element is sending out mixed messages: the recent rise of the euro – though it is still far from record levels – could nip in the bud the weak economic recovery that is underway, and could in the eyes of some justify support for export sectors [\[2\]](#).

In a recent [OFCE working paper](#) (No. 2013-04), we discuss how the ECB could use its inflation forecasts to improve the implementation of its monetary policy. We propose a new element to shed light on future developments in interest rates, based on the macroeconomic projections published quarterly by the ECB. In this study on the effects of the publication of the ECB's inflation forecasts on the inflation

expectations of private agents, we show that a 1 percentage point reduction in the ECB's inflation projections is associated with a key interest rate cut by the ECB of 1.2 percentage points in the next two quarters. We conclude that the ECB's inflation forecasts are a tool that helps to better understand current monetary policy decisions and to anticipate future decisions.

The latest inflation projections, published in December 2012, were 1.6% and 1.4% for the years 2013 and 2014, respectively.

The publication on March 7<sup>th</sup> of new projections could provide a further indication of the direction monetary policy is likely to take in 2013.

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[\[1\]](#) On average, a change in the key rates is estimated to have an impact on inflation after 12 months and on GDP after 18 months.

[\[2\]](#) Remember, however, that about 64% of trade in the euro zone is conducted with euro zone partners, and thus is independent of fluctuations in exchange rates.