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## Is monetary policy of ECB the right response to the Eurozone crisis?

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### Abstract

The article presents monetary policy conducted by the European Central Bank in response to the financial crisis after the collapse of Lehman Brothers in September 2008 and, as a result, the debt crisis in the Eurozone. The author describes anti-crisis emergency measures that the ECB has introduced and compares them with monetary policies carried out by other world's major central banks (Federal Reserve, Bank of England, Bank of Japan). The main goal of the paper is to assess the adequacy of ECB's monetary policy taking into account the specific nature of the Eurozone crisis. The author attempts to evaluate the real potential of the ECB to prevent some Eurozone countries from insolvency crisis and the Eurozone itself from possible breakup as a result. At the end the author provides some remarks concerning the specific nature of the Eurozone crisis.

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*Keywords:* Crisis in the Eurozone; Central banks; unconventional monetary policy; zero lower bound.

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### 1. Introduction

Global recession after collapse of Lehman Brothers in 2008, rapid deterioration in many domestic labour markets, big increase in public debt have forced the main world's central banks to ease their monetary policies. Using only conventional monetary policy tools (base interest rates) turned out to be insufficient to support the weakening economy. Major central banks (Federal Reserve, Bank of England, Bank of Japan, European Central Bank) have started lowering their interest rates early reaching the zero lower bound (ZLB). Monetary authorities had to introduce some additional non-standard measures in order to alleviate financial distress and stimulate the economy.

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Central banks implemented new programmes of purchasing securities and increased the monetary base intending to reduce long-term interest rates. Extraordinary steps have been taken also in Europe.

In the theory of monetary policy central banks have some manoeuvre when they want to ease financial conditions and support the economy even if they face the ZLB (Mishkin, 1996). With nominal interest rates close to zero level monetary authorities can use some of the non-standard measures (Curdia & Woodford, 2010). The most typical tools are here: longer-term liquidity provisions, unconventional bank lending programs, outright asset purchases as well as forward guidance (commitment to be irresponsible) (Eggertsson, 2006). There is plenty of scientific research about the topic, both theoretical and empirical. For example Farmer (2012) provided evidence that the unconventional monetary policy is effective in stabilizing inflation expectations. Ito and Mishkin (2004) indicated that unconventional monetary policy is helpful and effective while ZLB. Modigliani and Sutch (1966) found evidence of moderately successful influencing the long end of yield curve by non-standard measures of monetary policy. Curdia and Woodford (2010) claimed that asset purchases programs are particularly likely to improve welfare when the ZLB on the policy rate is reached. Giannone, Lenza, Pill and Reichlin (2011) found evidence that Eurosystem's non-standard measures did support financial intermediation, credit expansion and economic activity in the euro area in the face of financial crisis.

The main non-standard monetary policy measures implemented by the ECB during the recent crisis in Europe were: fixed-rate full-allotment procedure for longer term refinancing operations (LTRO), Covered Bond Purchase Programme (CBPP), Securities Markets Programme and Outright Monetary Transactions (OMT) (Cour-Thiemann & Winkler, 2013)

The largest action taken by the ECB (considering the financial involvement) was 3Y LTRO launched in two rounds in December 2011 and February 2012 commonly amounting to 1bn EUR. The program consisted in injecting emergency liquidity to the European banking system using 3Y refinancing operations. The other unconventional measures introduced by the ECB focused on outright purchases of specific financial securities, mainly sovereign bonds. In that context ECB had reserved the right to conduct interventions in the European public and private debt securities by purchasing certain assets outright (instead of only accepting them as collateral). The official purpose of such operations was ensuring the proper transmission of monetary policy impulses to the broader economy (ECB, 2011). The ECB acted that way to achieve additional important goal which was lowering the borrowing costs of some indebted countries like Greece, Italy, Portugal or Spain (Buiter & Rahbari, 2012). Adopting such a strategy the ECB tried to avoid the worst-case scenario which could have been the insolvency of the Eurozone peripheral countries governments and possible breakup of the whole currency union in Europe.

The financial size of these monetary policy programs however turned out to be very limited. The ECB purchased covered bonds for 100 bn EUR and sovereign bonds for 220 bn EUR up to the end of 2012. All that operations accounted for only 3,5% of the Eurozone's GDP. Comparing it to other central banks policies the ECB's non-standard monetary action clearly seemed to be moderate. Only up to the end of 2012 the Fed spent for asset purchasing programs as much as 3 152 bn USD (22,1% GDP), BoJ 186 930 bn JPY (37,3% GDP) and BoE 379 bn GBP (26,3% GDP) (Fawley & Neely, 2013).

The European conservative approach in adopting emergency measures in monetary policy during the recent crisis is significant. Steps taken by other major central banks were much more aggressive. It is worth asking about the reasons of such a different ECB monetary strategy and whether it finally turned out to be the right response to the crisis in Europe.

## 2. Method

The analysis of the literature in the field of unconventional monetary policy of the main central banks was applied in the research as well as the empirical analysis showing the similarities and differences between monetary policy reaction and their effects.

To compare the approach in monetary policy between central banks author takes into account the real value of purchasing securities programmes introduced in US, UK, Japan and Eurozone in the period of 2008-2012 (nominal value and in relation to GDP). Afterwards the analysis focuses on detecting the reasons of relatively limited involvement of ECB in such programmes.

The second part of the analysis focuses on the assessment of the ECB monetary policy effects. In European conditions monetary authorities were intending to lower the market pressure reducing yields on government bonds (especially in southern European countries like Greece, Spain, Portugal and Italy). Avoiding the worst case scenario which would have been the insolvency of some peripheral European governments was the essential task for ECB at the peak of the crisis.

To assess the effects of the ECB actions author presents the yields of Italian and Spanish 10Y Treasury bonds before and after implementing the most important programmes (non-standard measures of monetary policy).

### **3. Results**

The ECB has introduced some non-standard monetary measures, but its policy turns out to be significantly more cautious compared with other central banks. First this is because of relatively little amount of assets purchased by the ECB comparing to other central banks, secondly due to ECB reluctance in bigger and regular involvement in sovereign debt interventions at least comparing it to the market expectations. Before announcing the OMT programme the ECB intervened in the European sovereign debt markets purchasing some amount of Treasuries, but that operations were relatively small, rare and without any regular and preannounced schedule (Gros, Alcidi & Giovanni, 2012). At the same time that operations were fully sterilised in Europe, differently than in case of other countries. It means that all non-standard asset purchases undertaken by the ECB did not impact the monetary base in the Eurozone.

The author finds such a different reaction of European monetary authorities justified. First of all the ECB has managed to avoid the worst-case scenario in Europe. All European countries remains solvent and the economic conditions are gradually improving. At the same time it was unrealistic to expect more action from the ECB. Monetary authorities of the Eurozone were acting in a very difficult legal and structural environment during the crisis facing obstacles in implementing more unconventional measures.

Why has the ECB not undertaken large scale asset purchases like it took place looking at other central banks? The one reason was the lack of political agreement between European countries in that matter. There were legal and political doubts particularly raised by Germany. It was a decisive obstacle for the ECB in their attempts of implementing more aggressive monetary operations. The second reason was a different model of financial markets in Europe and in US or UK for example. Bank-based financing of households and non-financial corporations is much greater in the Eurozone, whereas non-bank lenders and market-based financing and securitization are more common in the US or UK (Lenza, Pill & Reichlin, 2010).

Moreover, while the Fed, the BoE and the BoJ have the ability to purchase risk-free assets in their economies (i.e. the bonds of their respective governments) the existence of 17 sovereign governments is an important institutional barrier to undertake large scale operations in sovereign markets. Therefore, the ECB probably considered that direct purchases of securities would have been ineffective, and prefers to rely on direct bank lending (Antolin-Diaz, 2013).

The anti-crisis policy of the ECB was generally right and adequate response to what was happening in Eurozone. The main objective of programmes launched by ECB was reducing the risk on the European sovereign debt markets and thus helping the European governments to satisfy their borrowing needs. In such a context ECB intervention was effective, because yields have been lowered after introducing SMP, LTRO and OMT (the most important ECB programmes). These effects are shown in the figures below. In the middle of 2012, before the OMT was launched, yield on 10Y Spanish and Italian T-bonds reached 7% and 6,5% respectively. Such a level was considered as unsustainable for these governments causing increasing risks of insolvency. After announcing the OMT yields have dropped considerably.

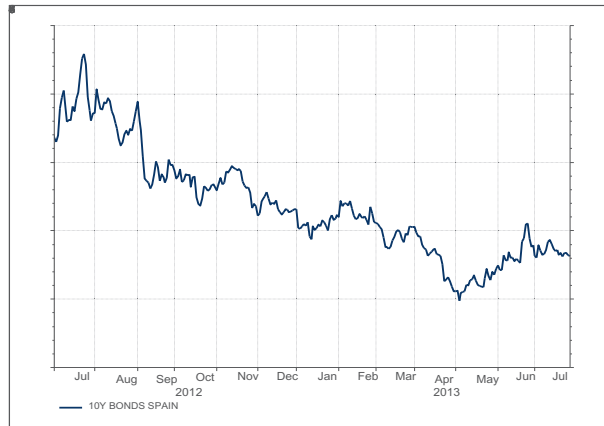


Fig. 1. 10Y Spanish government yield after introducing OMT (July 2012)

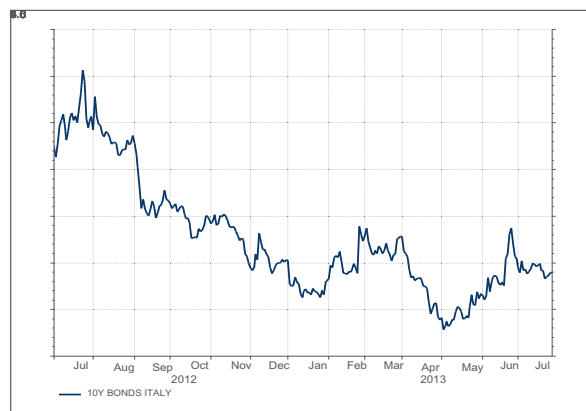


Figure 2. 10Y Italian government yield after introducing OMT (July 2012)

Regardless of such conclusion the ECB is not able to resolve all structural problems in the Eurozone economy. Although the ECB has so far played a key role in preventing the Eurozone from breakup, the future of common currency lies not only in its hands. In such a context the ECB rather contributes to creating a sound economic and financial environment for further economic reforms within the Eurozone. The main problems remain: fiscal imbalances especially in southern European countries and still increasing public debt. The easy monetary policy of the ECB makes borrowing easier for the European governments, but it does not solve the structural problem of fiscal imbalances. Sound economic policy and fiscal consolidation on the national level is necessary to get all European economies back on track (Feldstein, 2013).

The other serious problem for the Eurozone is still a big gap in competitiveness between the countries-members of the monetary union. Such divergence has resulted from the credit boom after adopting euro in 1999 in some less developed peripheral countries. It appeared because of the fall of nominal interest rates and spending expansion that in turn led to rapid increase in prices and wages, undermining competitiveness towards European core countries, particularly Germany – the economy that became a European benchmark for others. Getting back on track for Greek, Italian, Portuguese or Spanish economies requires some painful reforms, wage cuts and deleveraging after years of credit boom. The easy monetary policy of ECB is here helpful but it does not really solve the problem. The

final recovery and prosperity depends more on decisions of policymakers, flexibility of domestic economies as well as the future shape of European integration.

#### 4. Discussion

Although the ECB has so far played a key role in preventing the Eurozone from breakup, the future of common currency lies not only in its hands. The European crisis seems to be far from being resolved. The Eurozone is not the optimal currency area and that will lead to increasing tensions within the monetary union in Europe (Dannhauser, 2013).

The paper has answered the question about the differences in monetary policies of the ECB and other major central banks. Responding to the crisis all major central banks have launched non-standard measures in their monetary policies. The ECB response however was clearly more cautious comparing to Fed, BoE or BoJ. The paper aimed also to find out the reasons of such more conservative anti-crisis strategy adopted by the ECB. What mostly prevented the ECB from taking more aggressive steps was: constant disagreement among European politicians on that matter (especially strong German objection), defragmentation of European sovereign debt market and different pattern of financing in Europe (more bank-oriented and less market-based – unlike in US or UK).

The question that remains still unanswered concerns the assessment of monetary policies effects. The author in the text said that the ECB has done as much as possible and as it could have done looking at some institutional barriers in conducting more accommodative monetary policy. At the same time the US economy has started to perform better and we can assume that this is thanks to the incentives deriving from the Fed monetary policy. What could be very interesting as a research objective in the future is comparing both policies – the ECB and the Fed – the conservative approach and the more aggressive – after final withdrawing of exceptional monetary stimulus and coming back to conventional policies again. Achieving such conditions will only allow making a comprehensive and fully honest assessment of the Fed and ECB actions. US monetary policy seems to be more effective right now, but in the longer term it will be probably more complicated for the Fed to get back to conventional policies. This is because of the much larger scale of unconventional policies that have been implemented in the US. Therefore to get the whole picture of the monetary policies effects some additional analysis is needed in the future.

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