

# **The ECB 's experience with unconventional measures**

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**EUROSYSTEM**

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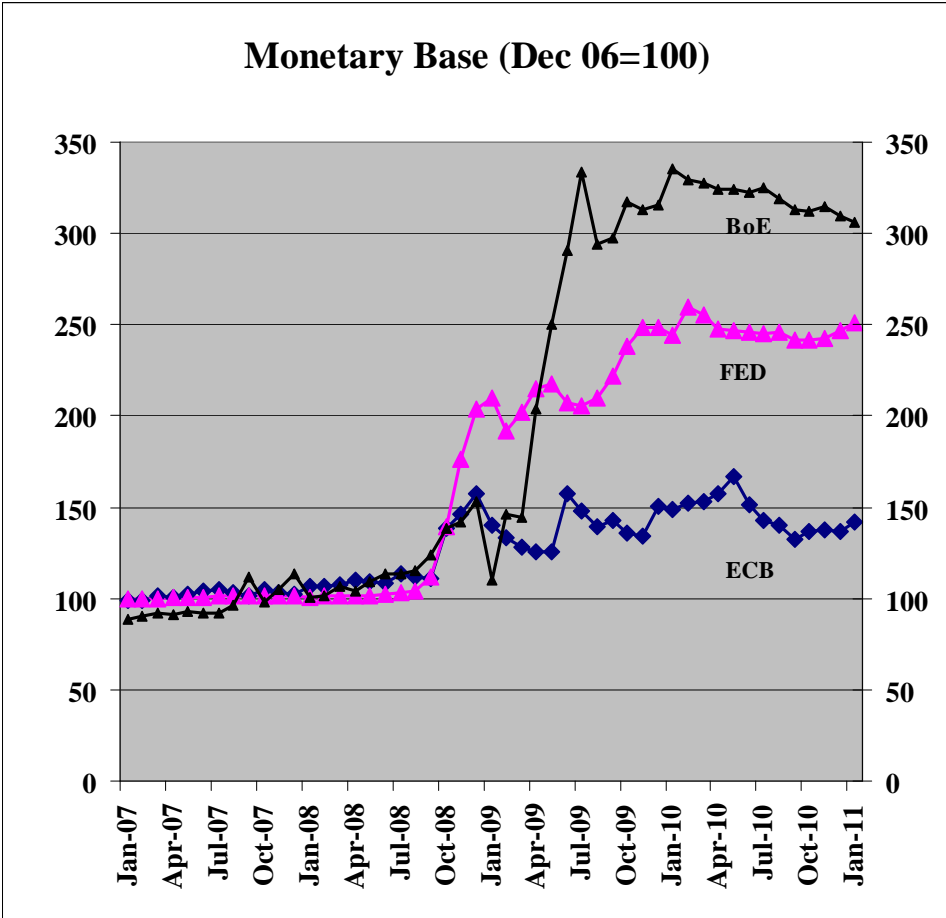
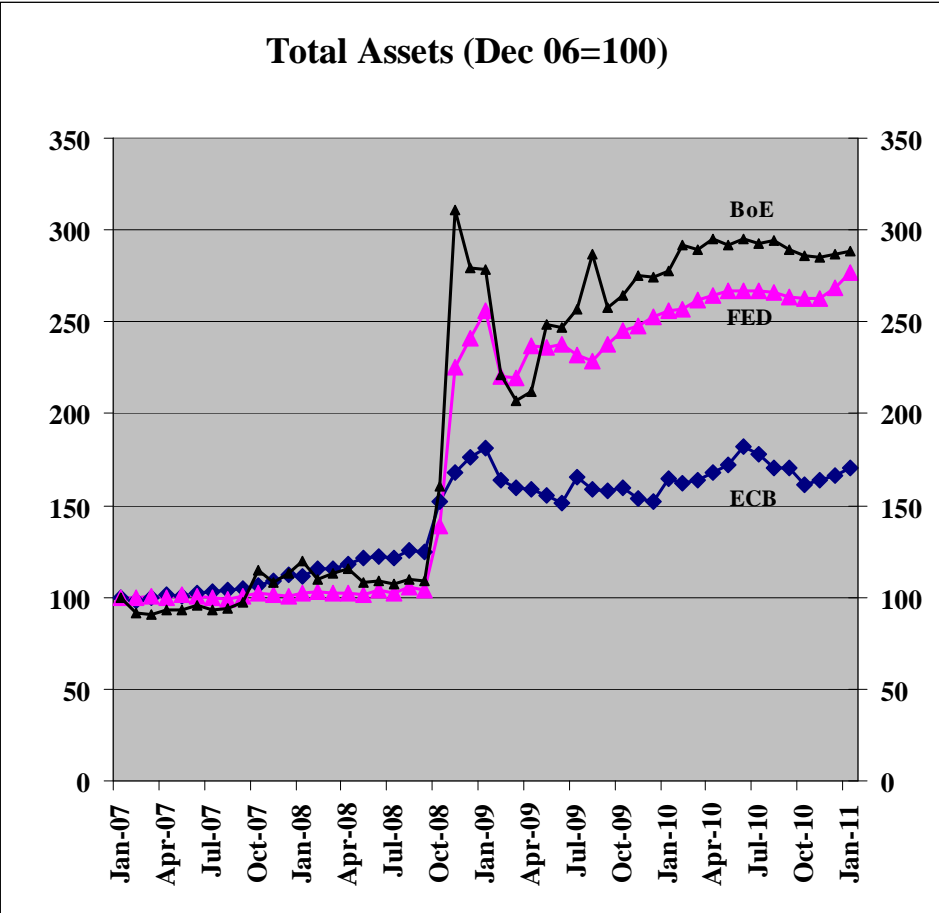
# Summary

- **1. Nature and size of the measures taken by central banks**
  - Liquidity provision and increased intermediation in the money market
  - Quantitative easing
  - Credit easing
- **2. Effects of measures**
- **3. Future challenges**
  - Exit to normal implementation of monetary policy
  - Continued regular use of unconventional measures?
  - Risks of overstepping to fiscal and distribution policies?

# 1. Nature and size of the measures taken by central banks

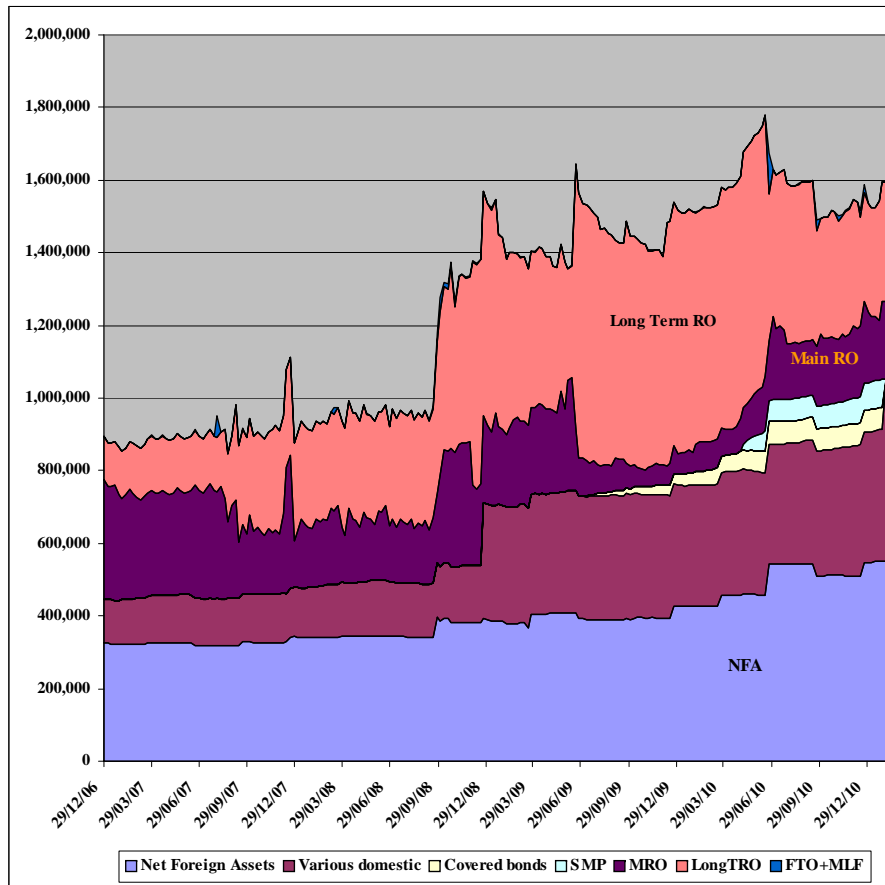
MEASURES	ECB	OTHERS
<b>1. Liquidity provision and increased role of intermediation in the money market</b>		
- Fixed rate full allotment (FRFA)	yes	no
- Broadening of eligible collateral	slightly	yes
- Long term repo operations	yes	yes
- Inter-central bank FX swap lines	yes	yes
- Modification of discount window facility	no	yes
- Broadening of counterparties	no	yes
- Securities lending, exchange with illiquid assets	no	yes
<b>2. Quantitative easing</b>		
- Outright purchases of assets to change their prices (yields)	no	yes
<b>3. Credit easing</b>		
- Credit and Purchase of assets of particular agents or market segments	Yes (2 small programs)	yes
<b>4. Commitment to future path of (low) interest rates</b>	No	Yes

# 1. Nature and size of the measures taken by central banks

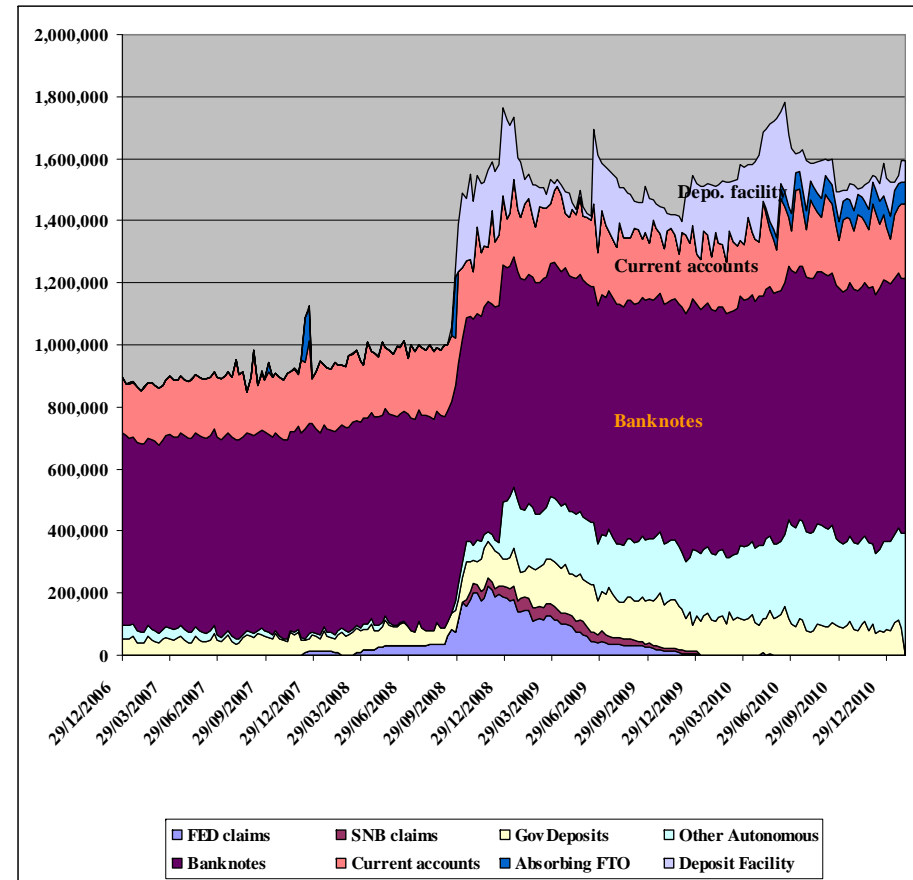


# 1. Nature and size of the measures taken by central banks

## ECB's ASSETS



## ECB's LIABILITIES

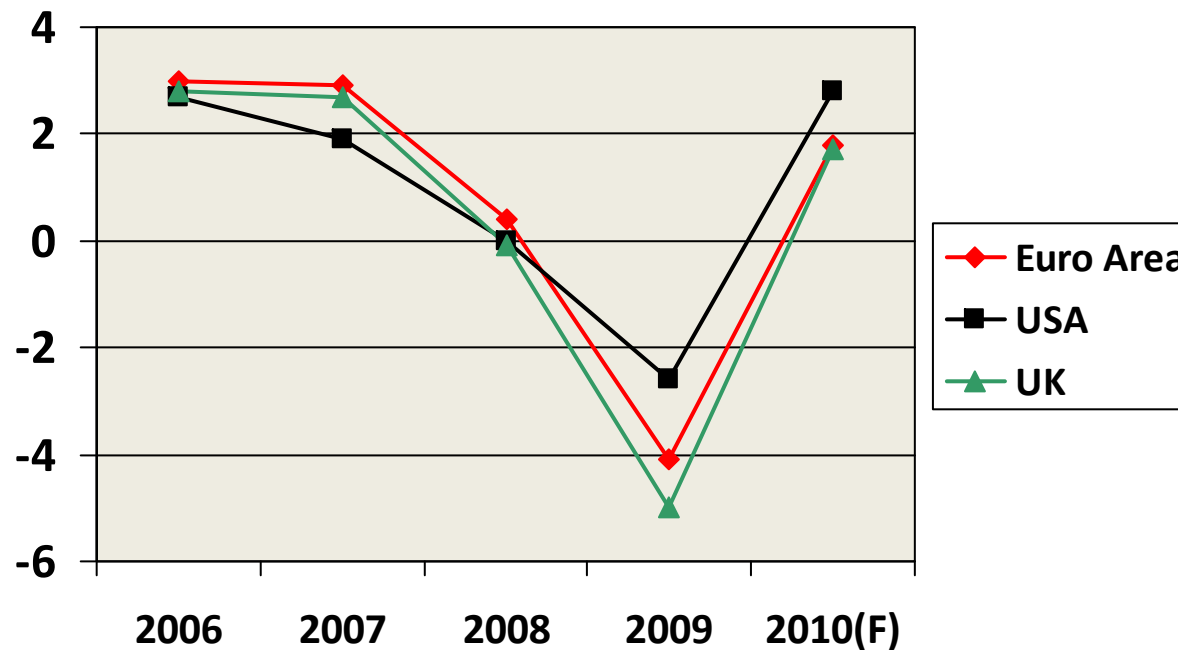


# Different measures, similar recovery

ECB's measures were concentrated on liquidity provision and increased intermediation with two programs to improve the transmission of monetary policy (SMP) and repair the functioning of one market segment (Covered bonds). No quantitative easing was used. The increase in the total balance sheet and liquidity provision was smaller than in other cases. The lower bound of interest rates was not reached.

Of course, fiscal policy and other measures also contributed to the recovery.

### GDP Growth Rates



## 2. Effects of the measures

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To assess the impact of the measures the problem is to identify the counterfactual.

So, a first line of analysis resorts to the event study methodology that tries to quantify the response of specific financial market variables to announcements and implementation of unconventional measures.

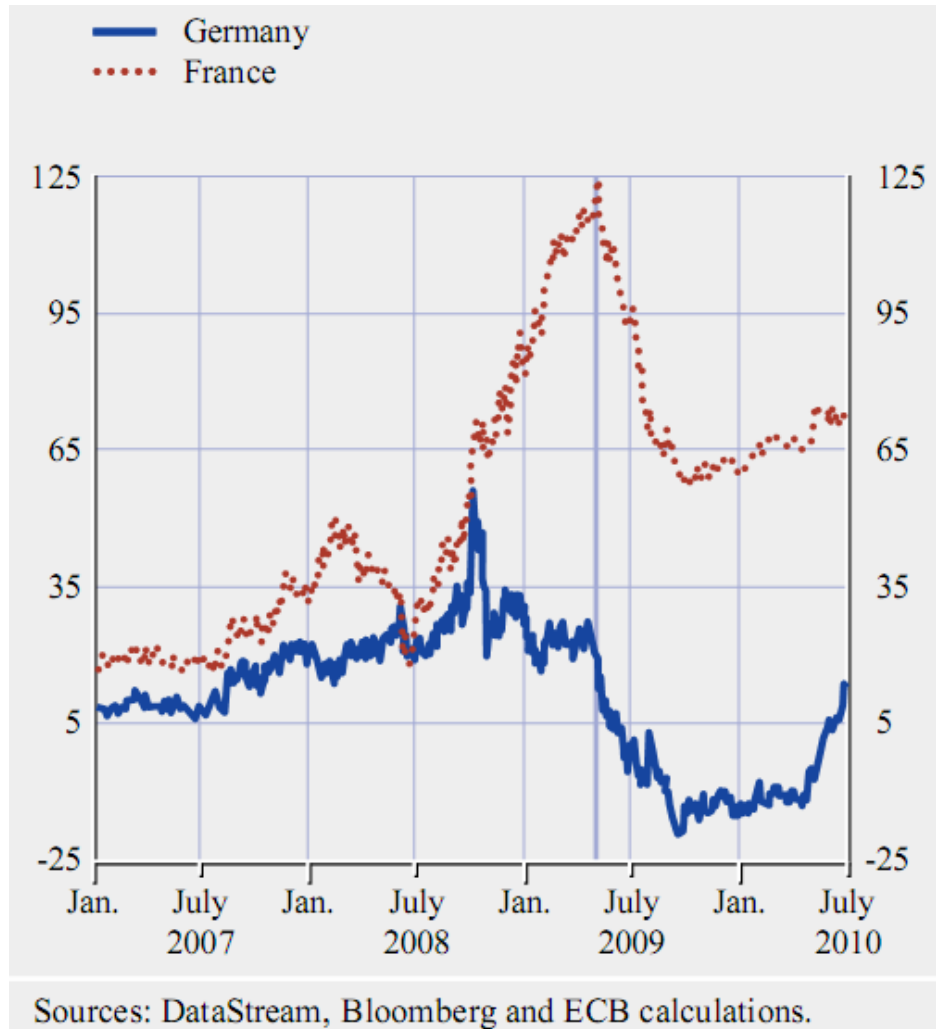
Most recently, the impact of QE on bond yields was assessed in the UK by Joyce et al (2010) and in the US by Gagnon et al (2010) indicating very sizeable impacts on bond yields. A similar type of analysis has been applied to the ECB Covered Bonds Purchase Program by Beirne et al (2011).

An alternative to the event study method is the use of models to simulate the counterfactual. Using a Bayesian VAR framework for the euro area, Giannone et al (2010) show that the ECB's standard and non-standard measures combined ensured that the paths of money and credit to non-financial corporations were in line with pre-crisis empirical regularities, indicating that that an exceptional deleveraging was avoided by the policy measures. This conclusion on the effectiveness of unconventional measures is confirmed by the analysis of Fahr et al (2010) using both a VAR analysis and a DSGE model with financial frictions.

## 2. Effects of the measures

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### Covered Bond spreads vis-à-vis public agencies yields (basis points)

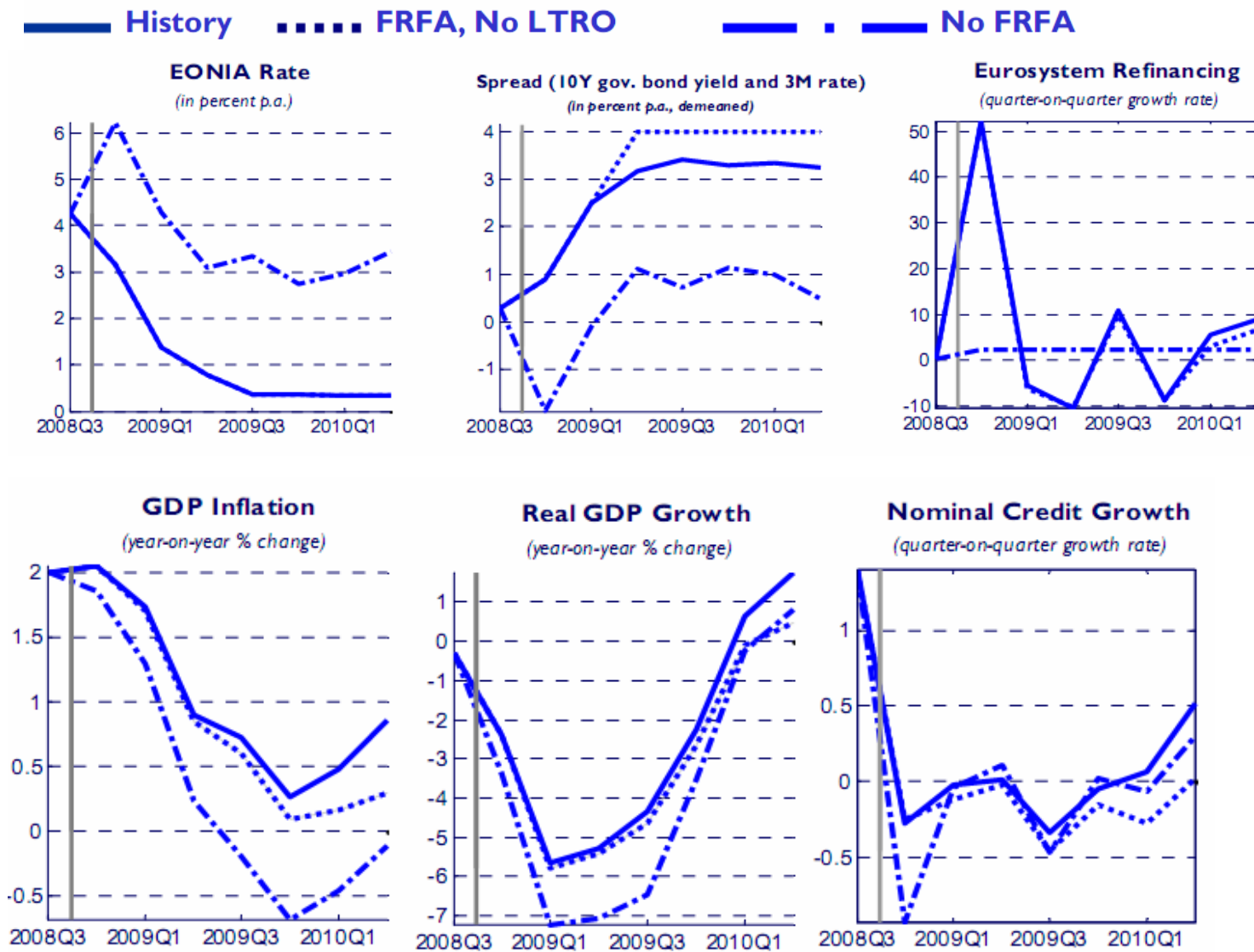


After the May 09 decision to start the covered bond purchase program of € 60 bn, the effects on the spreads over the yields of bonds of public agencies is visibly very significant

(In **Beirne, J. et al (2011)**)



## 2. Effects of the measures



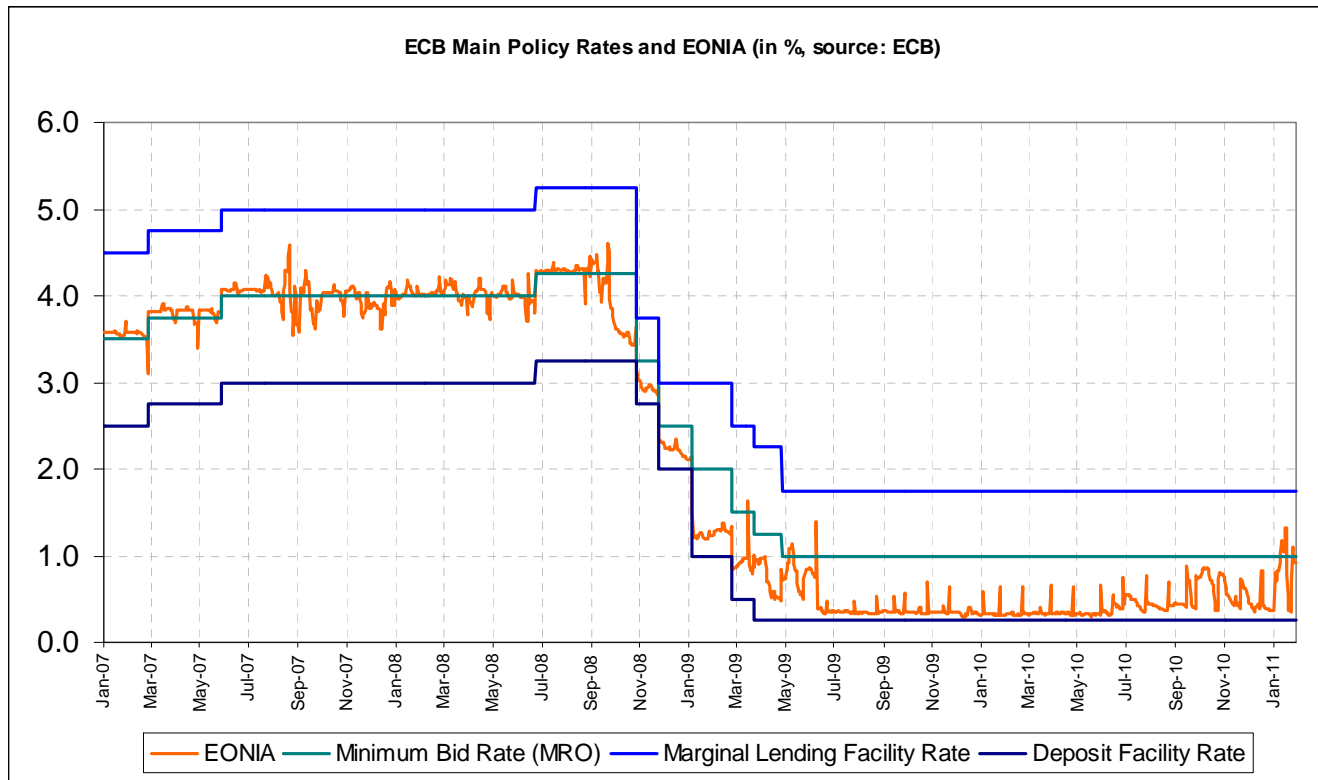
**Fahr et al (2010) conclude that the ECB's non-standard measures "played a non-negligible role in supporting the expansionary impact of the interest rate reductions, as well as a role in helping preserve credit flows to the euro area economy."**

Souce: Fahr et al (2010)

### 3. Future challenges

## 1. Exit to normal implementation of monetary policy

With full allotment the ECB could not control the market overnight rate and EONIA came down almost to the level of the deposit facility rate. An alternative way to steer EONIA would be to increase the deposit facility rate and reduce the «corridor» but that would not be market friendly as it would restrict money market activity with possible negative consequences for the future. The problem then is to regain control of the overnight market rate



### 3. Future Challenges

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#### 1. Exit to normal implementation of monetary policy

In the modern framework of conducting monetary policy with remunerated reserves and a “corridor” defined by two standing facilities, it becomes operational the so-called “decoupling principle” or “separation principle” .

This means that the “signal” of one particular announced policy rate can coexist with different levels of reserves, (i.e. is independent of that level) provided that the “liquidity management operations” ensure that the liquidity provided is not excessive or insufficient in relation to the demand by profit maximizing banks that react to the opportunity cost of reserves. This makes possible to steer the short-term market rate close to the policy rate.

This implies that the use of the Balance Sheet for unconventional measures (either QE or C. Easing) to achieve objectives in markets other than the market for reserves can be made independent from the monetary policy stance.

### 3. Future Challenges

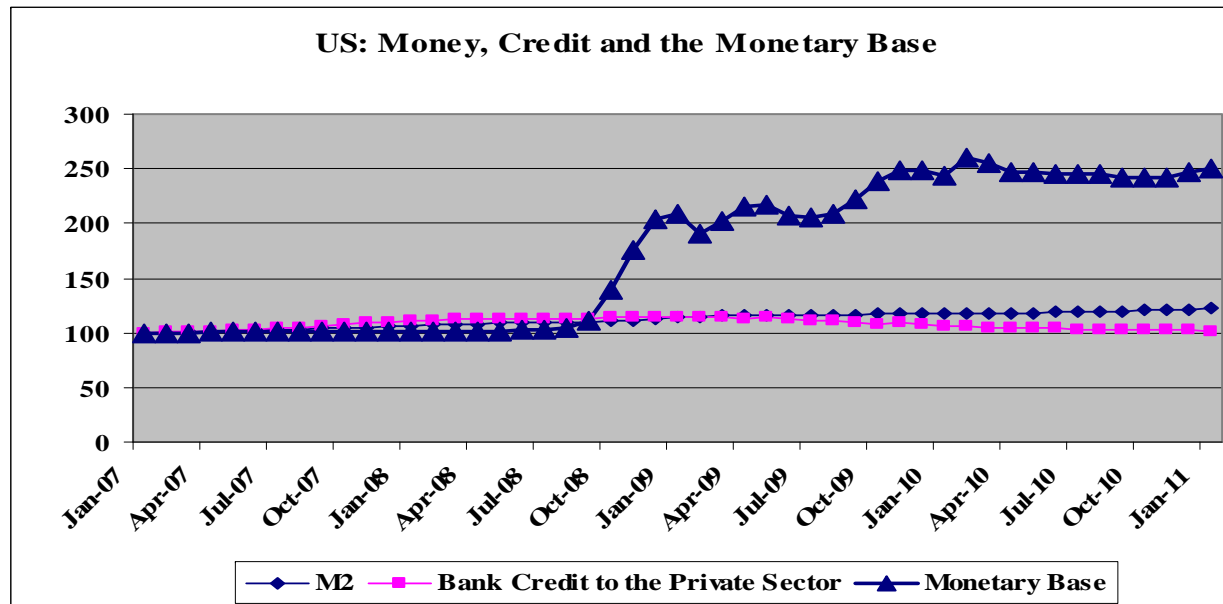
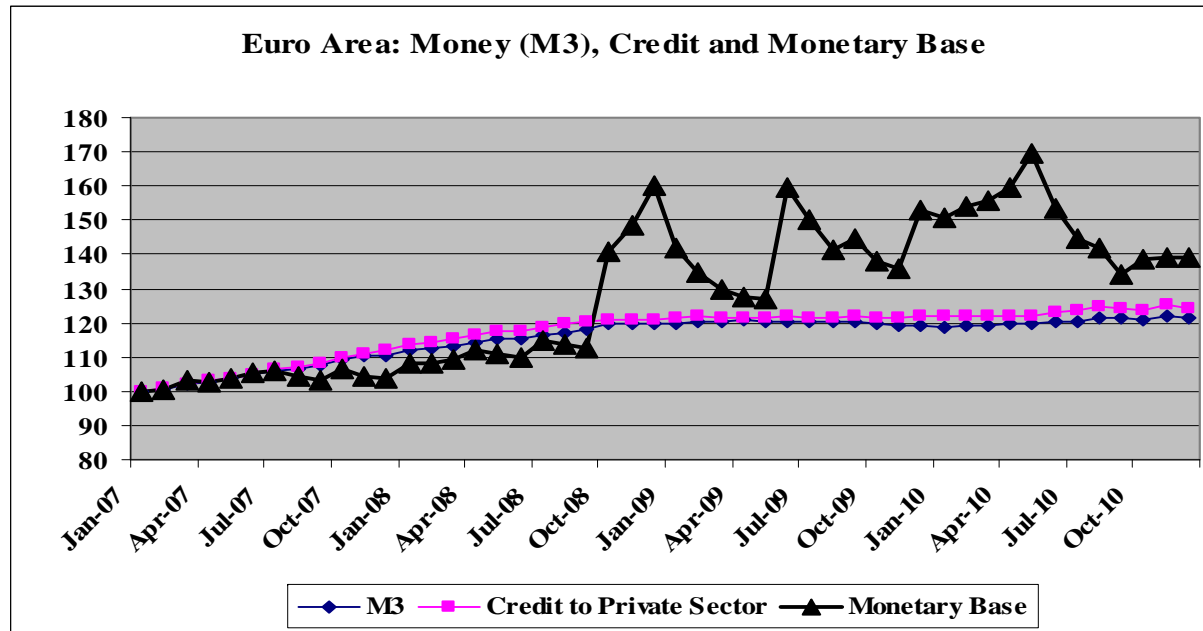
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#### 1. Exit to normal implementation of monetary policy

Interventions under the headings of QE or CE don't have more power because they have bank reserves as counterpart on the liabilities side. The increase in reserves (or monetary base) is not *per se* inflationary as it does not lead necessarily to higher credit or M2/M3 expansion . As underlined by Borio and Disyatat (2009): “ *In fact, the level of reserves hardly figures in banks’ lending decisions. The amount of credit outstanding is determined by banks’ willingness to supply loans, based on perceived risk-return trade-offs, and by the demand for those loans.* “

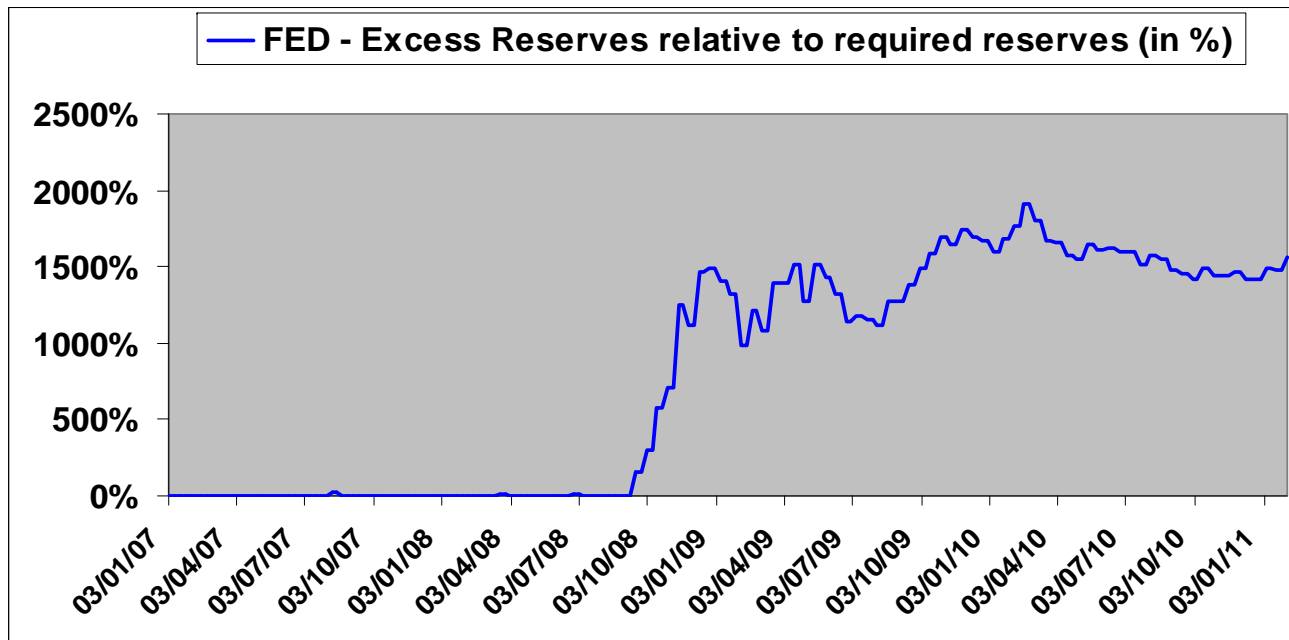
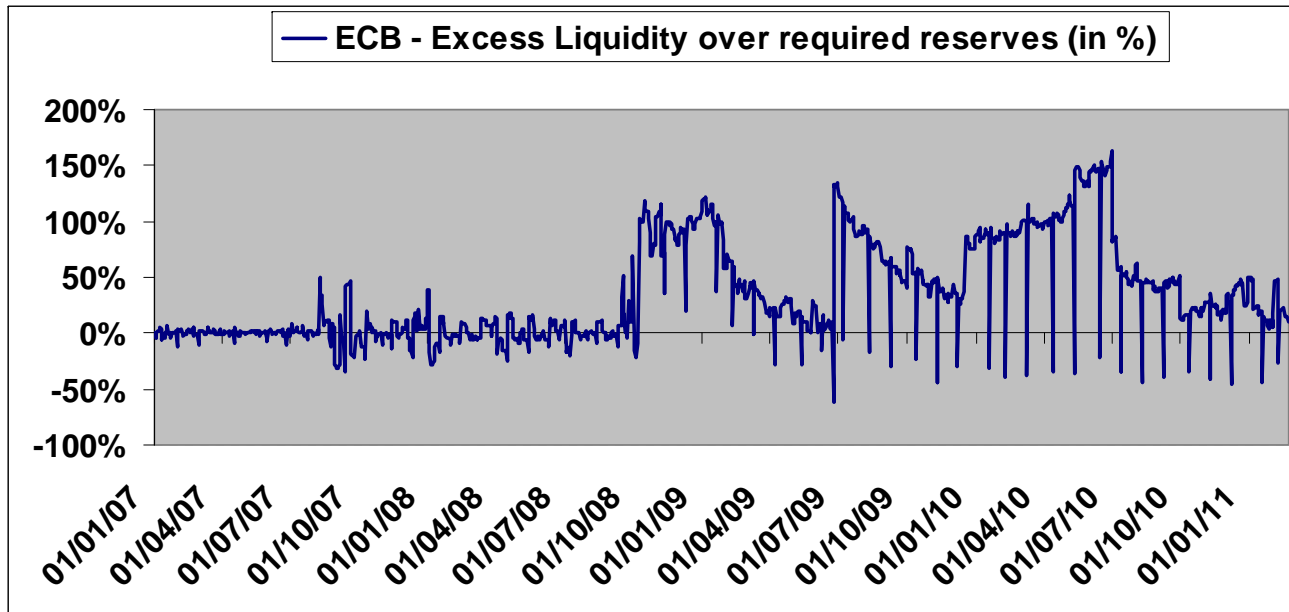
Nevertheless, to go back to normal implementation of monetary policy and be able to steer the short term money market rate close to the policy rate, there is the **NEED TO ABSORB EXCESS LIQUIDITY** and bring total reserves close to required reserves.

### 3. Future challenges



**Both charts illustrate the point that bank reserves don't lead necessarily to credit or monetary expansions. In spite of big increases in the Monetary base since 2008, there was no "multiplier" to Credit or Money.**

### 3. Future challenges



Regarding the need to have again total reserves close to required reserves, the ECB is already in a situation where excess liquidity has been practically normalized. The fact that the provision was done mostly through repo operations also facilitates the exit

### **3. Future Challenges**

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#### **2. Continued regular use of unconventional measures?**

**The type of measures used belong typically to exceptional circumstances. Central banks are not changing their basic objective function and will not start targeting medium term yields or prices of other assets. Transmission channels are not sufficiently well known. Short term interest rates will continue to be the instrument of choice of monetary policy. Nevertheless the use of unconventional measures should become more symmetric in relation to boom and bust situations**

#### **3. Risks of overstepping into fiscal and distribution policies?**

**Unconventional measures, like purchases of medium term assets or direct credit to non-financial firms, are not specific of central banks and can be seen as more akin to fiscal policy. More importantly though, such measures can distort relative prices and have distributional implications by benefiting particular economic agents. Central Banks in normal times should continue to operate only in the money market.**

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