

The ECB is extending its QE programme but mixes up its communications

By [Paul Hubert](#)

On Thursday, March 10, after the meeting of its Governing Council, the European Central Bank (ECB) announced a series of additional measures for the quantitative easing of monetary policy. The aim is to prevent the onset of deflation and to boost growth in the euro zone. The key innovation lies in the measure for bank financing at negative rates. While the measures were well received by the markets at the time of the announcement, a lapse in Mario Draghi's communications during the press conference following the Board of Governors meeting greatly undercut some of the impact expected from the decisions taken.

What decisions were taken?

– The three key rates set by the ECB were lowered. The main refinancing rate went down from 0.05% to 0%, while the marginal lending rate was cut from 0.30% to 0.25%. Finally, the [deposit facility rate](#), which compensates the excess reserves that banks hold on the ECB's balance sheets, is down from -0.30% to -0.40%. It thus now [costs a bank more](#) to have cash on the ECB's balance sheet.

– [Quantitative easing](#) (QE) has been extended in terms of its scale – securities purchases rose from €60 bn to €80 bn per month – but especially in terms of the types of securities eligible for purchase. While heretofore the ECB has bought government bonds (sovereign and/or local authority bonds), it will now buy high-quality corporate bonds, based on rating agency criteria. This measure is a direct response to the drying up of the supply of government securities and is

expected to directly influence the conditions for corporations active on the bond markets.

– The most significant innovation concerns the [new Targeted Longer-Term Refinancing Operations](#) (TLTRO), which are intended to reboot the channels of bank lending and to provide financing to banks *on the condition that* they finance the real economy. These loans to banks will be at a zero or even negative rate, based on various [criteria](#), including the amount of loans that the banks provide to households and businesses. In other words, the ECB will pay banks meeting these criteria, so that they in turn lend.

What is the expected impact?

The effect to be expected from these measures depends on the situation of the credit market. Numerous [studies](#) show that in normal times these measures have a positive effect on the economy. However, this holds true only if it is the *supply* of credit that is currently constricted in the euro zone. Conversely, if the problem lies in the demand for credit on the part of consumers and businesses who have poor prospects in terms of income and profits, then these measures will have little effect. In granting banks such favourable conditions, it is easy to imagine that the ECB is betting on increasing the solvent demand for credit, that is to say, that the ECB is providing banks with strong incentives to lend to households and individuals that might have appeared non-creditworthy in previous conditions. Another expected effect of the lower deposit facility rates and the increase in QE will pass through the channel of a lower exchange rate for the euro, which will promote euro zone exports and increase imported inflation, and therefore overall inflation in the euro zone. This channel is potentially even more important given that the US Federal Reserve has initiated a period of monetary tightening.

Nevertheless, a more relevant economic policy would be to make

use of fiscal policy to support demand, especially as the conditions for State financing are at historically low levels: the French state in 2016 is earning money from issuing [debt of less than 4 years](#). Monetary policy would then have all the more effect.

Why announce that there's no manoeuvring room left?

At the press conference following the meeting of the Governing Council, Mario Draghi announced that the ECB didn't expect "to reduce rates further", which had the effect of completely changing the financial markets' interpretation of the decisions announced just before that. While the aim of these very expansionary decisions is to further ease monetary and financial conditions and to lower the exchange rate for the euro, the announcement that future changes in the ECB's monetary policy could only be in a more restrictive direction transformed investor expectations.

As one of the main channels for the transmission of monetary policy involves expectations, several studies conducted on data from the US [\[1\]](#), Britain [\[2\]](#) and the euro zone [\[3\]](#) show that a central bank's communications need to be consistent with its decisions, otherwise the impact expected from monetary policy will be limited. This is called the "signal effect" of monetary policy. Mario Draghi's short statement is one such example. The following graph shows the exchange rate of the euro vis-à-vis the dollar during the course of 10 March. The sharp drop at mid-day corresponds to the publication of the decisions taken by the Board of Governors, while the equally sharp rise corresponds to the contradictory message issued a few minutes later at the press conference. We thus see that as a series of highly expansionary measures – one of whose goals is to push down the euro – was announced, the euro eventually rose vis-à-vis the US dollar as if restricting measures had been put in place.

This does not necessarily mean that these decisions will have

no effect, but that some of the effect will be lessened, or even disappear. [Some transmission channels other than the signal effect](#) remain operative. While the exchange rate channel has now been limited by the restrictive effect generated by the channel of expectations, we will see in the weeks and months to come whether capital movements induced by the decisions taken will have the effect expected on the euro exchange rate.

Figure. Euro-dollar exchange rate, day of 10 March 2016.



Source: Boursorama.

[1] Hubert, Paul (2015), "[The Influence and Policy Signalling Role of FOMC Forecasts](#)", *Oxford Bulletin of Economics and Statistics*, 77(5), 655-680.

[2] Hubert, Paul, and Becky Maule (2016), "[Policy and Macro Signals as Inputs to Inflation Expectation Formation](#)", *Bank of England Staff Working Paper*, No. 581.

[3] Hubert, Paul (2015), "[ECB Projections as a Tool for Understanding Policy Decisions](#)", *Journal of Forecasting*, 34(7), 574-587, or Hubert, Paul (2016), "[Disentangling Qualitative and Quantitative Central Bank Influence](#)", *OFCE Working Paper*, No. 2014-23.

Do QE programmes create bubbles?

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

Has the implementation of [unconventional monetary policies](#) since 2008 by the central banks created new bubbles that are now threatening financial stability and global growth? This is a question that comes up regularly (see [here](#), [here](#), [here](#) or [here](#)). As [Roger Farmer](#) shows, it is clear that there is a strong correlation between the purchase of securities by the Federal Reserve – the US central bank – and the stock market index (S&P 500) in the United States (Figure 1). While the argument may sound convincing at first glance, the facts still need to be discussed and clarified. First, it is useful to remember that correlation is not causation. Secondly, an increase in asset prices is precisely a transmission channel for conventional monetary policy and quantitative easing (QE). Finally, an increase in asset prices cannot be treated as a bubble: developments related to fundamentals need to be distinguished from purely speculative changes.

Higher asset prices is a factor in the transmission of monetary policy

If the ultimate goal of central banks is macroeconomic stability [\[1\]](#), the transmission of their decisions to the target variables (inflation and growth) takes place through various channels, some of which are explicitly based on changes in asset prices. Thus, the effects expected from QE are supposed to be transmitted in particular by so-called portfolio effects. By buying securities on the markets, the central bank encourages investors to reallocate their

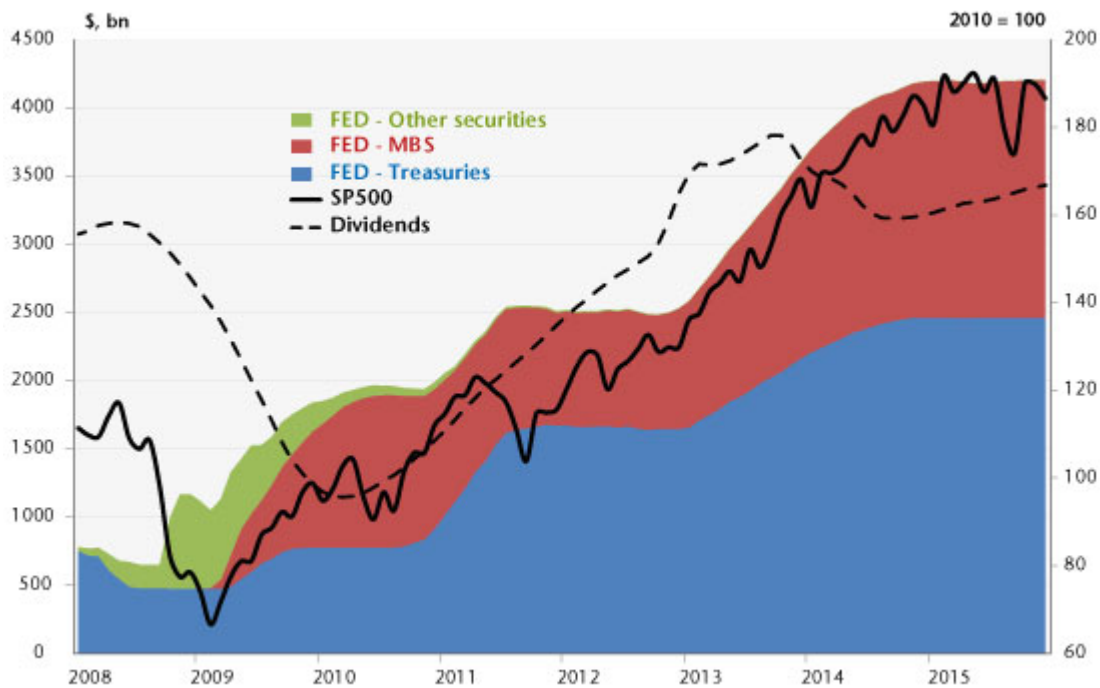
securities portfolio to other assets. The objective is to ease broader financing conditions for all economic agents, not just those whose securities are targeted by the QE programme. In doing this, the central bank's actions push asset prices up. It is therefore not surprising to see a rise in equity prices in connection with QE in the US.

Every increase in asset prices is not a bubble

Furthermore, it is necessary to make sure that the correlation between asset purchases and their prices is not just a statistical artefact. The increase observed in prices may also reflect favourable fundamentals and be due to improved growth prospects in the United States. The standard model for determining the price of a financial asset identifies its price as equal to the present value of anticipated income flows (dividends). Although this model is based on numerous generally restrictive assumptions, it nevertheless identifies a first candidate, changes in dividends, to explain changes in stock prices in the United States since 2008.

Figure 1 shows a clear correlation between the series of dividends [\[2\]](#) paid and the S&P 500 index between April 2010 and October 2013. Part of the rise in equity prices can be explained simply by the increase in dividends: the usual determinant of stock market prices. Looking at this indicator, only the period starting at the beginning of 2014 could then indicate a disconnect between dividends and share prices, and thus possibly point to an over-adjustment.

Figure 1. Quantitative easing and stock market prices in the US



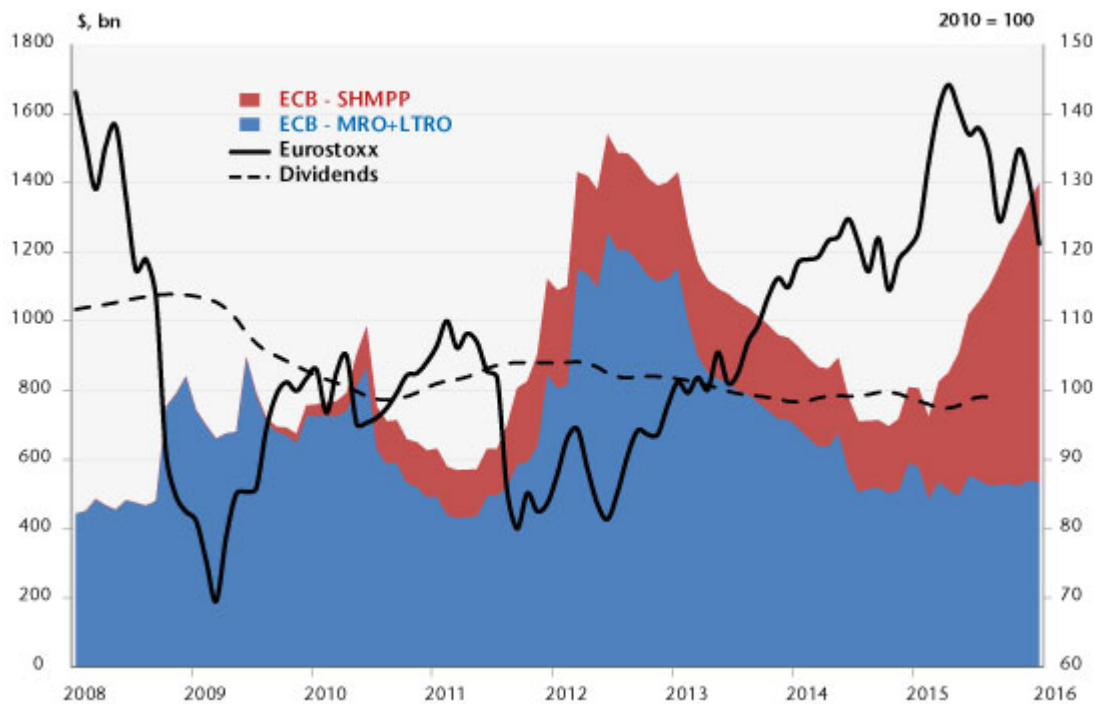
Sources: Datastream, Federal Reserve, and Bureau of Economic Analysis.

A correlation that isn't found in the euro zone

If the theory that unconventional monetary policies create bubbles is true, then it should also be observed in the euro zone. Yet performing the same graph as the one for the United States does not reveal a link between the liquidity provided by the European Central Bank (ECB) and the Eurostoxx index (Figure 2). The first phase in the increase in the size of the ECB's balance sheet, via its refinancing operations starting in September 2008, came at a time when stock markets were collapsing, following the bankruptcy of Lehman Brothers. Likewise, the very long-term refinancing operations carried out by the ECB at the end of 2011 do not seem to be correlated with the stock market index. The rise in share prices coincides in fact with Mario Draghi's statement in July 2012 that put a halt to concerns about a possible breakup of the euro zone. It is of course possible to argue that the central bank has played a role, but any link between liquidity and asset prices is simply not there. At the end of 2012, the banks paid back their loans to the ECB, which reduced the cash in circulation. Finally, the recent period is once again

illustrating the fragility of the argument that QE creates bubbles. It is precisely at a time when the ECB is undertaking a programme of large-scale purchases of securities, along the lines of the Federal Reserve, that we are seeing a fall in world stock indices, in particular the Eurostoxx.

Figure 2. Quantitative easing and the stock market index in the euro zone



Sources: Datastream, ECB, and Eurostat.

So does this mean that there is no QE-bubble link?

Not necessarily. But to answer this question, it is necessary first to identify precisely the portion of the increase that is due to fundamentals (dividends and companies' share prospects). A bubble is usually defined as the difference between the observed price and a so-called fundamental value. In a forthcoming working paper, we endeavour to identify periods of over- or undervaluation of a number of asset prices for both the euro zone and the United States. Our approach involves estimating different models of asset prices and thereby to extract a component that is unexplained by fundamentals, which is then called a "bubble". We then show that for the euro zone, the ECB's monetary policy broadly speaking (conventional and unconventional) does not seem to

have a significant effect on the “bubble” component (unexplained by fundamentals) of asset prices. The results are stronger for the United States, suggesting that QE might have a significant effect on the “bubble” component of some asset prices there.

This conclusion does not mean that the central banks and the regulators are impotent and ignorant in the face of this risk. Rather than trying to dissect every movement in asset prices, the central banks should focus their attention on financial vulnerabilities and on the ability of agents (financial and non-financial) to absorb sharp fluctuations in asset prices. The best prevention against financial crises thus consists of continuously monitoring the risks being taken by agents rather than trying to limit variations in asset prices.

[\[1\]](#) We prefer a broad definition of the end objective that takes into account the diversity of institutionalized formulations of the objectives of central banks. While the mandate of the ECB is primarily focused on price stability, the US Federal Reserve has a dual mandate.

[\[2\]](#) The series of dividends paid shows strong seasonality, so this has been smoothed by a moving average over 12 months.

Is missing disinflation a uniquely American phenomenon?

By [Paul Hubert](#), Mathilde Le Moigne

Are the dynamics of inflation after the 2007-2009 crisis atypical? According to Paul Krugman, “If inflation had responded to the Great Recession and aftermath the way it did

in previous big slumps, we would be deep in [deflation](#) by now; we aren't." In fact, after 2009, inflation in the US has remained surprisingly stable in terms of changes in real activity. This phenomenon has been called "missing disinflation". Can a phenomenon like this be seen in the euro zone?

Despite the worst recession since the 1929 crisis, the inflation rate has remained stable at around 1.5% on average between 2008 and 2011 in the US and 1% in the euro zone. Does this mean that the Phillips curve, which links inflation to real activity, has lost its empirical validity? In a [note](#) in 2016, Olivier Blanchard argued instead that the [Phillips curve](#), in its simplest original version, is still a valid instrument for understanding the relationship between inflation and unemployment, in spite of this "missing disinflation".

Blanchard nevertheless noted that the relationship between the two variables has weakened, because inflation increasingly depends on inflation expectations, which are themselves anchored to the inflation target of the US Fed. In an [article](#) in 2015, Coibion and Gorodnichenko explained this missing disinflation in the US by the fact that inflation expectations are influenced by variations in the most visible prices, such as fluctuations in the price of oil. Furthermore, since 2015 inflation expectations have declined concomitantly with oil prices.

The difficulty of accounting for recent trends in inflation through the Phillips curve led us to evaluate its potential determinants in a [recent working paper](#) and to consider whether this "missing disinflation" phenomenon was also present in the euro zone. Based on a standard Phillips curve, we did not come up with the results of Coibion and Gorodnichenko when the euro zone was considered in its entirety. In other words, real activity and inflation expectations do describe changes in inflation.

However, this result appears to come from an aggregation bias between the behaviours of national inflation within the euro zone. In particular, we found a significant divergence between the countries of Northern Europe (Germany, France), which demonstrate a general tendency towards *missing inflation*, and countries on the periphery (Spain, Italy, Greece), which exhibit periods of *missing disinflation*. This divergence nevertheless appears right from the start of our sample, that is to say, in the early years of the creation of the euro zone, and seems to reverse around 2006, without any significant change during the crisis of 2008-2009.

Unlike what happened in the US, it appears that the euro zone has not experienced missing disinflation as a result of the economic and financial crisis of 2008-2009. It seems instead that divergences in inflation in Europe preceded the crisis, and tended to subside with the crisis.

Financialisation and financial crisis: vulnerability and traumatic shock

By Jérôme Creel, Paul Hubert, Fabien Labondance

Since the mini-crash that took place in the Shanghai stock market in August, financial instability has resurfaced in the markets and the media and, once again, the link with financialisation has been evoked. The Chinese crisis resulted

from a combination of real estate and stock market bubbles that were fed by the abundant savings of a middle class in search of high-yield investments. It feels like we've gone back almost ten years when what is considered the excessive financialisation of the US economy – with abundant savings from the emerging countries enabling the build-up of widespread US consumer debt – is treated as the cause of the financial instability and crisis that was triggered in the summer of 2007.

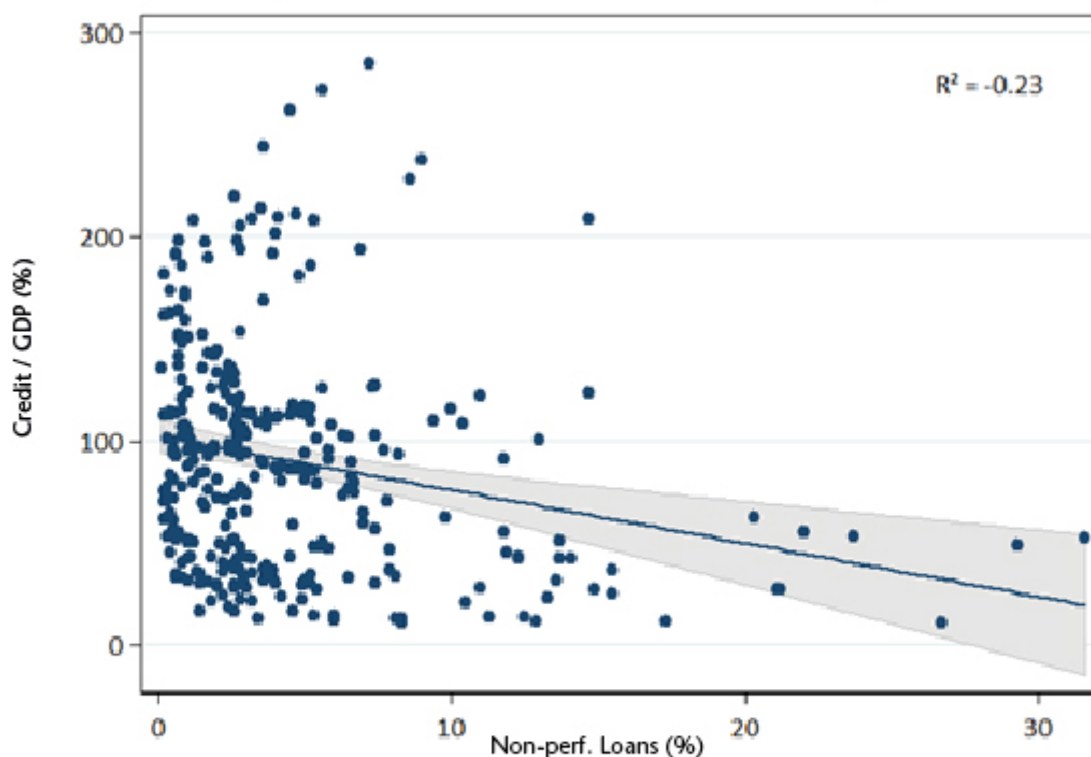
Is there really a link between, on the one side, increasing indebtedness and the great variety of financial investments, and on the other, volatile stock prices and a deterioration in the quality of bank loans? And if there is, what is the direction of the dynamics: from financialisation to financial instability, from financial instability to financialisation, or both at once? A rise in indebtedness could well lead to increasingly risky lending to agents who would not be able to repay them, which would then lead to a financial crisis: this is one possible case. The occurrence of a crisis would change the behaviour of households and firms, causing them to reduce debt: this is the second case, in which financial instability reduces the financialisation of the economy. Depending on which is the case, the public policies needed differ. In the first, we need to monitor the degree of the economy's financialisation and target, for example, a maximum ratio of bank credit to GDP in order to prevent the rise and bursting of speculative bubbles. In the second case, there are two possibilities: to treat the causes, and thus to monitor the quality of loans to households and business so as to ensure the proper allocation of capital in the economy; or to treat the consequences by supporting productive investment to annihilate any rationing of credit.

In the course of the debate on the links between financialisation and financial instability, and on the consequences to be drawn in terms of public policy, the

European situation is interesting for two reasons: the European Union has set up a system for monitoring external imbalances, including financial ones, from 2011, and a banking union since 2014. In a recent [working paper](#), we look at this debate for several groups of countries in the European Union over the period 1998-2012.

At first glance, the relationship between these two concepts is not easy to demonstrate, as can be seen in the graph below. It shows a scatter plot that for each year and for each European country gives the levels of financialisation (approximated here by the share of credits / GDP) and of financial instability (approximated here by non-performing loans). The correlation between these variables is -0.23 .

Figure. Financialisation and financial instability



Note: Non-performing loans, or bad debt, expressed as a percentage of total loans granted by banks.
Credit/GDP: total amount of bank credit expressed as a percentage of GDP.

Source : Creel et al. (2015) based on GFDD databases.

We test the two typical cases discussed above. We call the first case the vulnerability effect. As financialisation

develops, it engenders a sort of euphoria that leads to granting loans that are increasingly risky, which fosters financial instability. This hypothesis derives from the work of Minsky (1995) [\[1\]](#). We simultaneously test the potentially negative relationship between financial instability and financialisation, which we call the trauma effect. The very occurrence of financial instability as well as its impact encourages economic agents to take less risk and to shed debt. Our estimates show that the link between financial instability and financialisation is not uni-directional. Contrary to what is suggested by the simple correlation coefficient, the sign of the relationship is not the same when looking at the effect of one variable on the other, and vice versa. Both the vulnerability and the trauma effect have been at work in the European countries. A macro-prudential policy intended to monitor the policy on granting bank loans, in terms of their volume and quality, therefore does indeed seem necessary in Europe.

We also tested the possibility that these effects are non-linear, that is to say, that they depend on reference values. The vulnerability hypothesis depends both on the level of financialisation (the higher it is, the stronger the relationship) and on time. This last point shows us that the positive relationship between financialisation and financial instability shows up at the moment of crisis for countries that are already heavily financialised. Finally, in the countries on the EU periphery [\[2\]](#), long-term interest rates and inflation rates greatly influence the financial instability variable. Consequently, it seems that for these countries there is a need for strong coordination between banking supervision and macroeconomic surveillance.

[\[1\]](#) Minsky H. P. (1995), "Sources of Financial Fragility: Financial Factors in the Economics of Capitalism", paper prepared for the conference, *Coping with Financial Fragility:*

A Global Perspective, 7-9 September 1994, Maastricht, available at Hyman P. Minsky Archive. Paper 69.

[2] This group consists of Spain, Ireland, Italy, Greece, Portugal and the countries from the Eastern enlargements in 2004 and 2007. The establishment of this group is explained in the working paper.

The redistributive effects of the ECB's QE programme

By Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Xavier Ragot

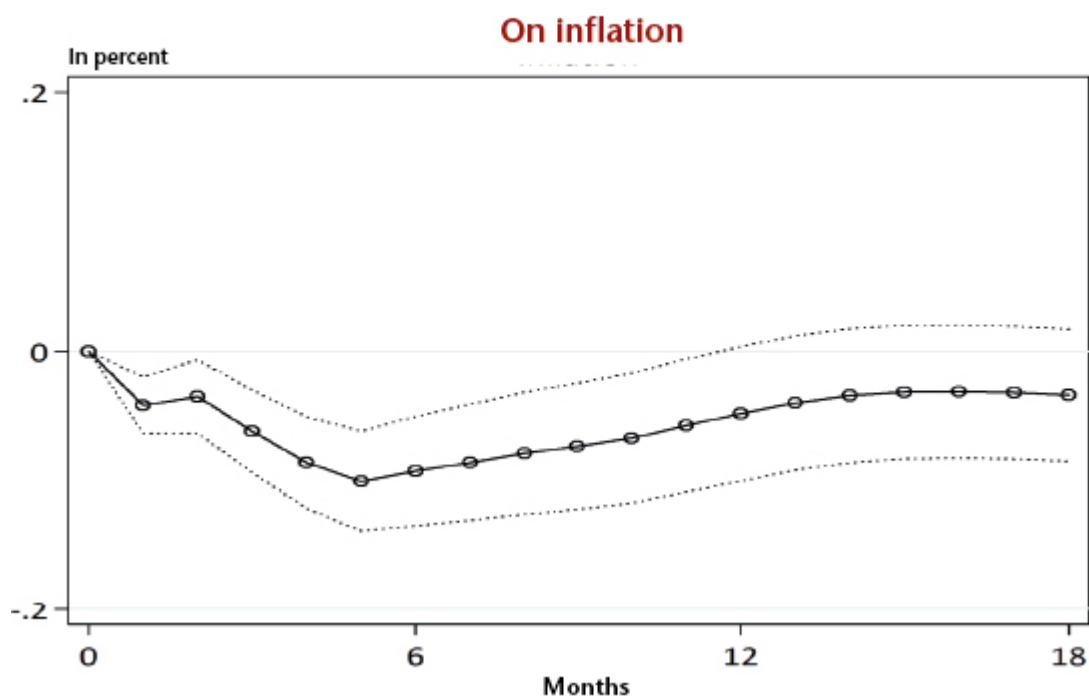
Rising inequality in income and wealth has become a key issue in discussions of economic policy, and the topic has inserted itself into evaluations of the impact of monetary policy in the US and Japan, the precursors of today's massive quantitative easing programmes (QE). The question is thus posed as to whether the ECB's QE policy has had or will have redistributive effects.

In a paper prepared for the European Parliament, [Blot et al. \(2015\)](#) point out that the empirical literature gives rise to two contradictory conclusions. In the US, the Fed's base rate cuts tend to reduce inequality. Conversely, in Japan an expansionary QE type policy tends to increase inequality. So what's the situation in Europe?

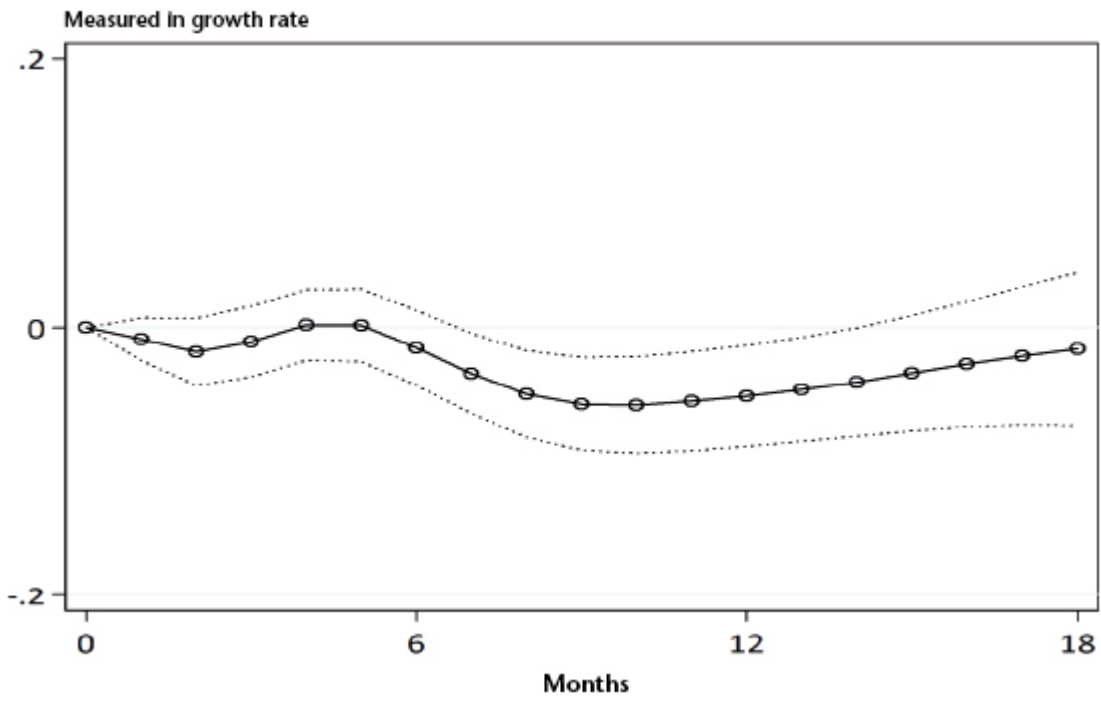
Based on macroeconomic data aggregated for the euro zone as a whole, Blot et al. (2015) show that while European monetary

policy, conventional and unconventional, have indeed had an impact on the unemployment rate, the number of hours worked and the rate of inflation (see graphs), this was limited. This result suggests that the ECB's expansionary monetary policy has tended to reduce inequality, but not by much. So when the ECB finally decides to wind up its expansionary policy, we can expect a slight increase in inequalities to follow. Because of this effect, though small, Blot et al. (2015) suggest that the ECB should be held accountable not just for price stability or economic growth, but also for the impact of its policies in terms of inequality and the mechanisms needed to take this into account.

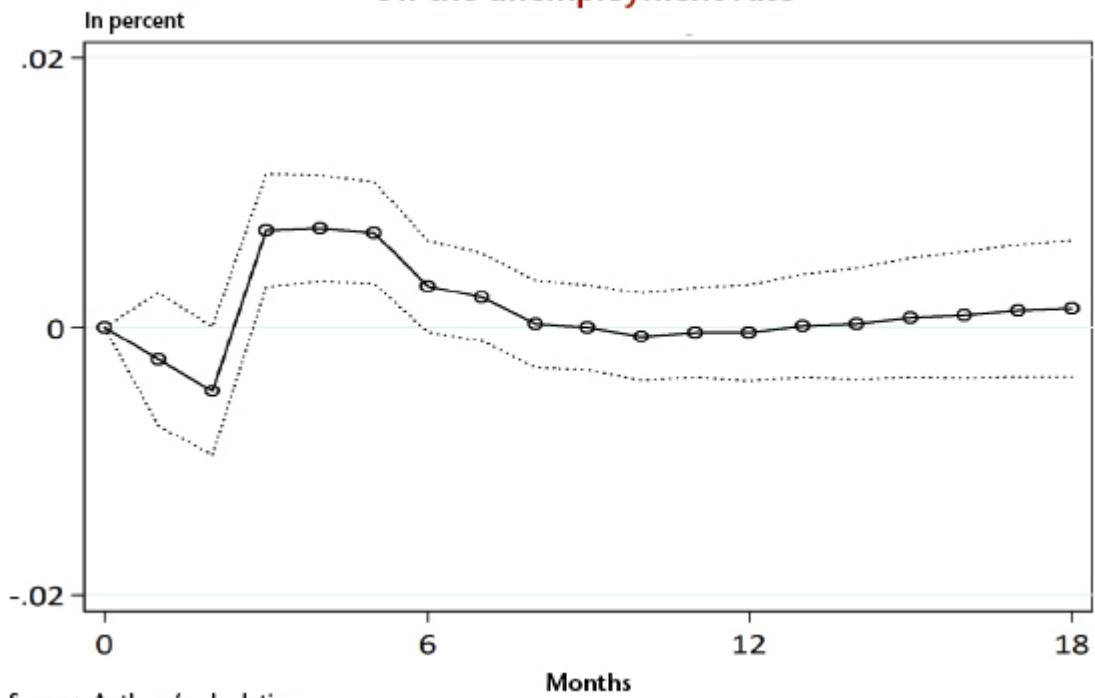
Figures. The impact of a restrictive monetary policy shock (0.2 percentage point hike in the implicit interest rate) in the euro zone...



On hours worked



On the unemployment rate



Source: Authors' calculations.

Does Price Stability entail Financial Stability?

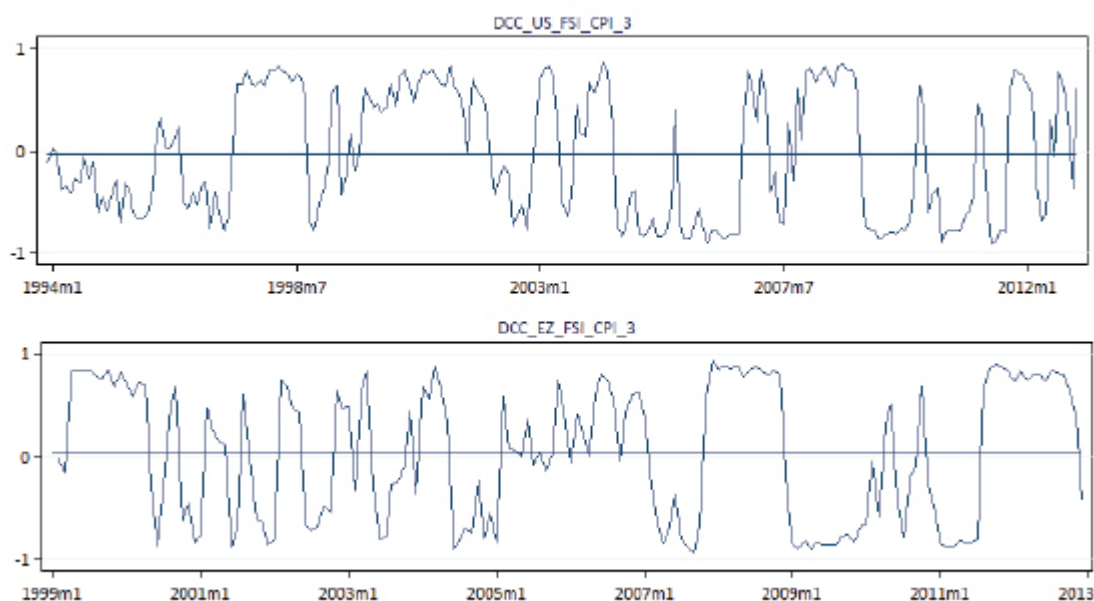
by [Paul Hubert](#) and [Francesco Saraceno](#) (@fsaraceno)

[Paul Krugman](#) raises the very important issue of the impact of monetary policy on financial stability. He starts with the well-known observation that, contrary to the predictions of some, expansionary monetary policy did not lead to inflation during the current crisis. He then continues arguing that tighter monetary policy would not necessarily guarantee financial stability either. If the Fed were to revert to a more standard Taylor rule, financial stability would not follow. As Krugman aptly argues, *“That rule was devised to produce stable inflation; it would be a miracle, a benefaction from the gods, if that rule just happened to also be exactly what we need to avoid bubbles.”*

Krugman in fact takes position against the “conventional wisdom”, which has been widespread in academic and policy circles alike, that a link exists between financial and price stability; therefore the central bank can always keep in check financial instability by setting an appropriate inflation target.

The global financial crisis is a clear example of the fallacy of this conventional wisdom, as financial instability built up in a period of great moderation. A [recent analysis](#) by Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Francesco Saraceno shows that the crisis is no exception, as over the past few decades, in the US and the Eurozone, the link between price and financial stability has been unclear and moreover unstable over time, as shown on the following figure.

Figure. Coefficient of correlation between consumer price index and financial stability index for the US (top) and the Euro area (bottom)



Source: Authors' computations. For more details on data and methodology, please refer to: <https://ideas.repec.org/a/eee/finsta/v16y2015icp71-88.html>

We therefore subscribe to Krugman's view that financial stability should be targeted by combining macro- and micro-prudential policies, and that inflation targeting is largely insufficient. In another [work](#), Christophe Blot, Jérôme Creel, Paul Hubert and Fabien Labondance argue that the ECB should be endowed with a triple mandate for financial and macroeconomic stability, along with price stability. They further argue that the ECB should be given the instruments to effectively pursue these three, sometimes conflicting objectives.

The ECB's quantitative easing exercise: you're never too young to start

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

The ECB decision to launch a quantitative easing (QE) programme was widely anticipated. Indeed, on several occasions in the second half of 2014 Mario Draghi had reiterated that the Governing Council was unanimous in its commitment to take the steps needed, in accordance with its mandate, to fight against the risk of a prolonged slowdown in inflation. Both the scale and the characteristics of the ECB plan announced on 22 January 2014 sent a strong, though perhaps belated signal of the Bank's commitment to fight the risk of deflation, which has been spreading in the euro zone, as can be seen in particular in inflation expectations over a two-year horizon (Figure 1). In a [special study entitled, "Que peut-on attendre du l'assouplissement quantitatif de la BCE?"](#) ["What can we expect from the ECB's quantitative easing?"], we clarify the implications of this new strategy by explaining the mechanisms for the transmission of quantitative easing, drawing on the numerous empirical studies on previous such programmes in the US, the UK and Japan.

Figure. Inflation expectations in the euro



Source : ECB (Survey of Professional Forecasters).

The terms of the quantitative easing decided by the ECB are indeed similar to those adopted by other central banks,

especially by the US Federal Reserve and the Bank of England, which make comparisons legitimate. It appears from the American, British and Japanese experience that the measures implemented have led to a decline in sovereign interest rates and more generally to an improvement in the financial conditions of the overall economy[1]. This has been the result of sending a signal about the present and future stance of monetary policy and a reallocation of investors' portfolios. Some studies [2] also show that the US QE caused a depreciation of the dollar. The transmission of QE from the ECB to this variable could be critical in the case of the euro zone. An analysis using VAR models shows that the monetary policy measures taken by the ECB will have a significant impact on the euro but also on inflation and inflationary expectations. It is likely that the effects of the depreciation of the euro on European economic activity will be positive (cf. [Bruno Ducoudré and Eric Heyer](#)), which would make it easier for Mario Draghi to bring inflation back on target. The measure would therefore have the positive effects expected; however, it might be regrettable that it was not implemented earlier, when the euro zone was mired in recession. Inflation in the euro zone has fallen constantly since late 2011, reflecting a gathering deflationary risk month after month. In fact, the implementation of QE from March 2015 will consolidate and strengthen a recovery that would undoubtedly have occurred anyway. Better late than never!

[1] The final impact on the real economy is, however, less certain, in particular because the demand for credit has remained stagnant.

[2] Gagnon, J., Raskin, M., Remache, J. and Sack, B. (2011). "The financial market effects of the Federal Reserve's large-scale asset purchases," *International Journal of Central Banking*, vol. 7(10), pp. 3-43.

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.

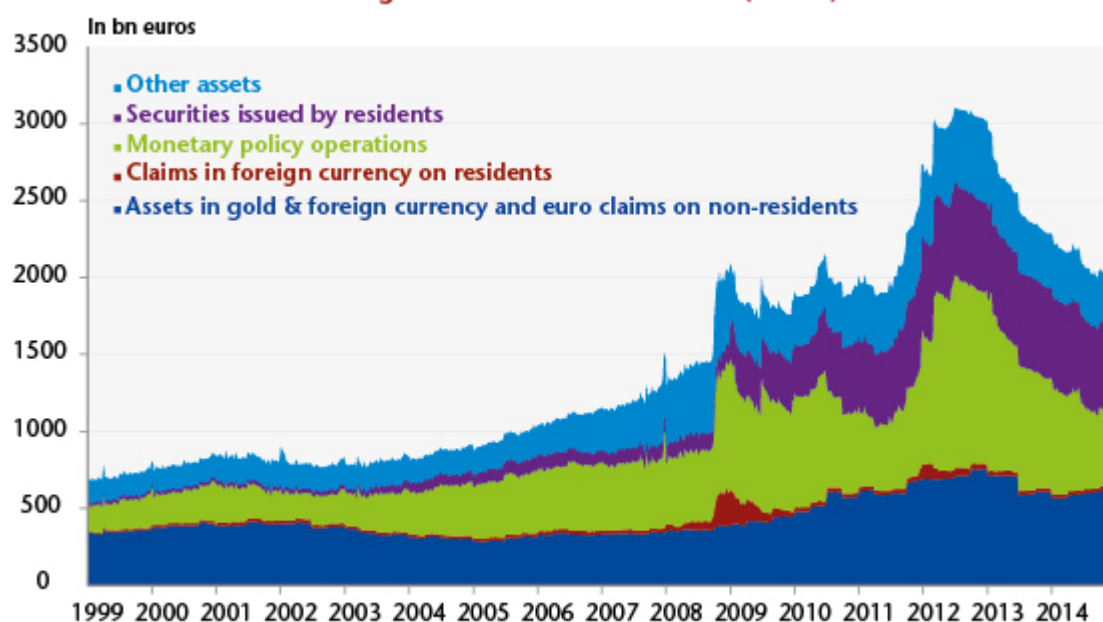
Third, beyond banks' ability to find refinancing, it is also possible that they are trying to reduce their exposure to risk. The problem is thus related to their assets. However, non-performing loans are still at a very high level, especially in Spain and Italy (Figure 2). In addition, although the Asset 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^[3]. 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

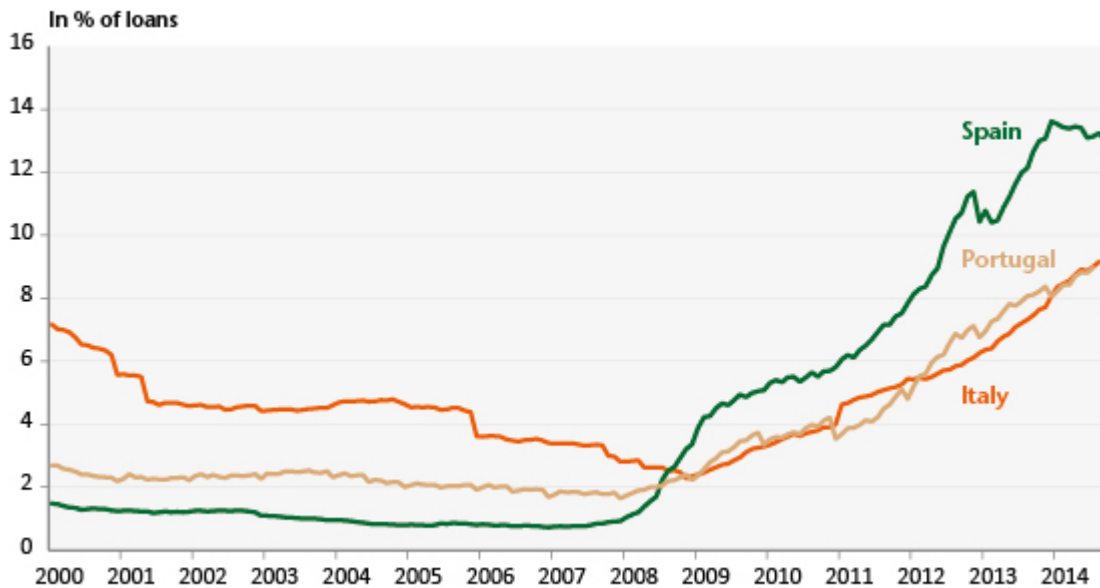
impasse? This observation on the effectiveness of monetary policy shows that the ECB should not be viewed as the be-all and end-all. It is still essential to complement its support for activity through an expansionary fiscal policy across the euro zone. This point was also reiterated by the President 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.

[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.).

Are the macroeconomic forecasts of the central banks better than those of private agents?

By [Paul Hubert](#)

Private expectations – about inflation, growth and interest rates – are a critical component of most modern macroeconomic models, as they determine the current and future realizations of these very variables. Monetary policy has been shaped more and more by the incorporation of these expectations in central bankers' calculations and the influence they have on private expectations through interest rate decisions and the way these are communicated. The establishment by the central banks of a forward-looking policy orientation, called “forward guidance”, has further reinforced the importance of central bank macroeconomic forecasts as a tool of monetary policy for influencing private expectations.

A recent article in the [Revue de l'OFCE \(no. 137 – 2014\)](#) evaluates the forecasting performance of the US Federal Reserve relative to that of private agents. This empirical review of the existing literature confirms that the Fed performs better than private agents in forecasting inflation, but not on GDP growth. Furthermore, the Fed does even better

over longer forecast horizons. Despite this, its superiority seems to have been declining in recent times, though it's still significant. This article highlights the potential reasons for the Fed's superior performance, and suggests that this could stem from better information about the shocks hitting the economy rather than from a better model of the economy. The publication of these macroeconomic forecasts therefore helps to disseminate information among economic agents and boosts the effectiveness of monetary policy by allowing private agents to better foresee trends and possible developments.

Dealing with the ECB's triple mandate

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

The financial crisis has sparked debate about the role of the central banks and monetary policy before, during and after the economic crisis. The prevailing consensus on the role of the central banks is eroding. Having price stability as the sole objective is giving way to the conception of a triple mandate that includes inflation, growth and financial stability. This is *de facto* the orientation that is being set for the ECB. We delve into this situation in one of the [articles](#) of the OFCE issue entitled *Reforming Europe* [\[1\]](#), in which we discuss the implementation of these three objectives.

The exclusive pursuit of the goal of price stability is now insufficient to ensure macroeconomic and financial stability.

[2] A new paradigm is emerging in which the central banks need to simultaneously ensure price stability, growth and financial stability. This has been the orientation of recent institutional changes in the ECB, including its new responsibility for micro-prudential supervision. [3] Furthermore, the conduct of the euro zone's monetary policy shows that the ECB has also remained attentive to trends in growth [4]. But if the ECB is indeed pursuing a triple mandate, what then is the proper relationship between these missions?

The crucial need for coordination between the different actors in charge of monetary policy, financial regulation and fiscal policy is lacking in the current architecture. Furthermore, certain practices need to be clarified. The ECB has played the role of lender of last resort (with banks and to a lesser extent States) even though it has not specifically been assigned this role. Finally, in a new framework in which the ECB plays a greater role in determining the euro zone's macroeconomic and financial balance, we believe it is necessary to strengthen the democratic accountability of the Bank. The definition of its objectives in the Maastricht Treaty in fact gives it strong autonomy in interpretation (see in particular the discussion by Christophe Blot, [here](#)). Moreover, while the ECB regularly reports on its work to the European Parliament, the latter does not have any way to direct this [5].

Based on these observations, we discuss several proposals for coordinating the ECB's three objectives more effectively henceforth:

1 – Even without modifying the treaties in force, it is important that the heads of the ECB be more explicit about the different objectives being pursued [6]. The declared priority of price stability no longer corresponds to the practice of monetary policy: growth seems to be an essential objective, as is financial stability. More transparency would make monetary policy more credible and certainly more effective in

preventing another financial and banking crisis in particular. The use of exchange rate policy [7] should not be overlooked, as it can play a role in reducing macroeconomic imbalances within the euro zone.

2 – In the absence of such clarification, the ECB's extensive independence needs to be challenged so that it comes up to international standards in this area. Central banks rarely have independence in deciding their objectives: for example, the US Federal Reserve pursues an explicit dual mandate, while the Bank of England's actions target institutionalized inflation. An explicit triple mandate could be imposed on the ECB by the governments, with the heads of the ECB then needing to make effective tradeoffs between these objectives.

3 – The increase in the number of objectives pursued has made it more difficult to deal with tradeoffs between them. This is particularly so given that the ECB has *de facto* embarked on a policy of managing the public debt, which now exposes it to the problem of the sustainability of Europe's public finances. The ECB's mandate should therefore explicitly spell out its role as lender of last resort, a normal task of central banks, which would clarify the need for closer coordination between governments and the ECB.

4 – Rather than calling the ECB's independence completely into question, which would never win unanimity among the Member States, we call for the creation *ex nihilo* of a body to supervise the ECB. This could emanate from the European Parliament, which is responsible for discussing and analyzing the relevance of the monetary policy established with respect to the ECB's expanded objectives: price stability, growth, financial stability and the sustainability of the public finances. The ECB would then not only be invited to report on its policy – as it is already doing to Parliament and through public debate – but it could also see its objectives occasionally redefined. This “supervisory body” could for example propose quantified inflation targets or unemployment

targets.

[1] *Reforming Europe*, edited by Christophe Blot, Olivier Rozenberg, Francesco Saraceno and Imola Strehö, *Revue de l'OFCE*, no. 134, May 2014. This issue is available in [French](#) and [English](#) and has been the subject of a post on the [OFCE blog](#).

[2] This link is examined in "[Assessing the Link between Price and Financial Stability](#)" (2014), Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Francesco Saraceno, *Document de travail de l'OFCE*, 2014-2.

[3] The implementation of the banking union gives the ECB a role in financial regulation (Decision of the Council of the European Union of 15 October 2013). It is henceforth in charge of banking supervision (particularly credit institutions considered "significant") in the Single supervisory mechanism (SSM). As of autumn 2014, the ECB will be responsible for micro-prudential policy, in close cooperation with national organizations and institutions. See the article by Jean-Paul Pollin, "Beyond the banking union", in *Revue de l'OFCE*, [Reforming Europe](#) .

[4] Castro (2011), "[Can central banks' monetary policy be described by a linear \(augmented\) Taylor rule or by a nonlinear rule?](#)", *Journal of Financial Stability* vol.7(4), p. 228-246. This paper uses an estimation of Taylor rules between 1991:1 and 2007:12 to show that the ECB reacted significantly to inflation and to the output gap.

[5] In the United States, the mandate of the Federal Reserve is set by Congress, which then has a right of supervision and can therefore amend the Fed's articles and mandate.

[6] Beyond clarifying objectives in terms of inflation and growth, the central bank's fundamental objective is to ensure

confidence in the currency.

[7] This issue is considered in part in a recent OFCE [post](#).