

HOW THE ECB'S MONETARY POLICY CONTRIBUTE TO EU INTEGRATION

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Abstract:

The paper presents in-depth analysis of European monetary policy; the main objective is to allow the reader to understand the behaviour of central banks and the effects of monetary policy on the economy. First it will be discussed the history and the evolution of monetary union and policy in Europe, then its conduct, the structure of monetary policy institutions, the description of the money supply process and the tools of the European Central Bank. In the paper, we analysed the speech by Yves Mersch about the past and the future of European monetary policy. The conclusion includes reflections and considerations about the topic.

Keywords: monetary policy, EU integration, European central bank, money supply, liquidity.

1. WHAT IS MONETARY POLICY AND HOW IT OPERATES

Monetary policy is how central banks manage liquidity to create economic growth. Liquidity is the amount of money that is readily available for investment and spending, in other words is how much there is in the money supply, that includes credit, cash, checks and money market mutual funds; the most important of these is credit, that includes loans, bonds and mortgages.

The primary objective of central banks is to manage inflation, i.e. to ensure *price stability*. The second is to reduce the unemployment rate to a pre-established goal rate. Central banks have many instruments that they can use to achieve their objectives, but the three main monetary policy tools are open market operations, the discount rate and the reserve requirement (Amedeo, 2018):

- *Open market operations*: when the central bank buys securities, it adds cash to the banks' reserves; that gives them more money to lend. When the central bank sells the securities, it places them on the banks' balance sheets and reduces its cash holdings: the bank now has less to lend. A central bank buys securities when it wants expansionary monetary policy; instead, it sells them when it executes contractionary monetary policy.
- For banks and depositories, the *discount rate* is the interest rate assessed on short-term loans acquired from regional central banks. The discount rate can be interpreted as the cost of borrowing from the bank.

When the central bank makes a change to the discount rate, economic activity either increases or decreases depending on the intended outcome of the change. When the nation's economy is stagnant or slow, the central bank may enact its power to reduce the discount rate in an effort to make borrowing more affordable for member banks. When banks can borrow funds from the central bank at a less expensive rate, they are able to pass the savings to banking customers through lower interest rates charged on personal, auto or mortgage loans. This creates an economic environment that encourages consumer borrowing and ultimately leads to an increase in consumer spending while rates are low. Although a reduction in the discount rate positively affects interest rates for consumers wishing to borrow from banks, consumers experience a reduction to interest rates on savings vehicles as well. When the economy is growing at a rate that may lead to hyperinflation, the central bank may increase the discount rate. When member banks cannot borrow from the central bank at an interest rate that is cost-effective, lending to the consuming public may be tightened until interest rates are reduced again.

- The *reserve requirement* refers to the money that banks must keep on hand overnight. They can keep the reserve either in their vaults or at the central bank. A low reserve requirement allows banks to lend more of their deposits. A high reserve requirement is contractionary. It gives banks less money to loan. It's especially hard for small banks since they don't have as much to lend in the first place. That's why most central banks don't impose a reserve requirement on small banks. Central banks rarely change the reserve requirement because it's expensive and disruptive for member banks to modify their procedures, they are more likely to adjust the targeted lending rate, it achieves the same result as changing the reserve requirement with less disruption.

2. HISTORY - ECONOMIC AND MONETARY UNION

Economic and monetary union (EMU) is the result of progressive economic integration in the EU. It is an expansion of the EU single market, with common product regulations and free movement of goods, capital, labour and services (Majcen and Trunk Širca. 2015). At the summit in The Hague in 1969, the Heads of State or Government defined a new objective of European integration: economic and monetary union (EMU). In 1972 (at the Paris Summit) the EU attempted to impart fresh momentum to monetary integration by creating the 'snake in the tunnel': a mechanism for the managed floating of currencies (the 'snake') within narrow margins of fluctuation against the dollar (the 'tunnel'). Efforts to establish an area of monetary stability were renewed in 1978 in Brussels with the creation of the European Monetary System (EMS), based on the concept of fixed but adjustable exchange rates. In December 1989, the Strasbourg European Council called for an intergovernmental conference that would identify what amendments needed to be made to the Treaty in order to achieve EMU. The work of this intergovernmental conference led to the Treaty on European Union, which was formally adopted by the Heads of State or Government at the Maastricht European Council in December 1991 and signed on 7th February 1992 (Verbeken and Rakić, 2018).

In 1988, the Hanover European Council set up a committee to study EMU under the chairmanship of Jacques Delors, the then Commission President. The committee's report (the Delors report), submitted in 1989, proposed to strengthen a three-stage introduction of EMU. In particular, it stressed the need for better coordination of economic policies, rules covering national budget deficits, and a new, completely independent

institution which would be responsible for the Union's monetary policy: the European Central Bank (ECB). On the basis of the Delors report, the Madrid European Council decided in 1989 to launch the first stage of EMU: full liberalisation of capital movements by 1st July 1990. The Treaty provides for EMU to be introduced in three stages (European Central Bank, 2018a):

- Stage 1 (from 1st July 1990 to 31st December 1993): the free movement of capital between Member States;
- Stage 2 (from 1st January 1994 to 31st December 1998): convergence of Member States' economic policies and strengthening of cooperation between Member States' national central banks.
- Stage 3 (under way since 1st January 1999): the gradual introduction of the Euro as the single currency of the Member States and the implementation of a common monetary policy under the aegis of the ECB.

The first two stages of EMU have been completed. The third stage is still under way. In principle, all EU Member States must join this final stage and therefore adopt the euro (Article 119 TFEU). However, some Member States have not yet fulfilled the convergence criteria. These Member States consequently benefit from a provisional derogation until they are able to join the third stage of EMU. As things now stand, 19 of the 28 Member States have joined the third stage of EMU and thus have the euro as a single currency, and they together form the area known as the Eurozone.

3. OBJECTIVES AND INSTRUMENTS

3.1. European Central Bank and price stability

The European monetary policy is described by the European Commission as 'an advanced stage of economic integration based on a single market'. The idea is that Member States sit together at the same table and coordinate their economic and fiscal policies.

The main institution that has the duty to manage the Euro, frame and implement EU economic & monetary policy is the European Central Bank (ECB). The ECB has the 3 following decision-making bodies (European Central Bank, 2018a):

- Governing Council, that is the main decision-making body and consists of the Executive Board (see below) plus the governors of the national central banks from Eurozone countries;
- Executive Board, that handles the day-to-day running of the ECB and consists of the ECB President and Vice-President and 4 other members appointed for 8-year terms by the leaders of the Eurozone countries.
- General Council, that has more of an advisory & coordination role and consists of the ECB President and Vice-President and the governors of the central banks from all EU countries.

The primary objective of the ECB's monetary policy is to maintain *price stability*, which benefits are substantial: maintaining stable prices on a sustained basis is a crucial pre-condition for increasing economic welfare and the growth potential of an economy. The ECB aims at inflation rates of below, but close to, 2% over the medium term. Inflation refers to a general increase in consumer prices and is measured by an index which has been harmonised across all EU Member States: Harmonised Index of Consumer Prices (HICP). The HICP is the measure of inflation which the Governing Council uses to define and assess price stability in the euro area as a whole in quantitative terms. Inflation rates of below, but close to, 2% are low enough for the economy to fully reap the benefits of price stability. It underlines the ECB's commitment to provide an adequate margin to avoid the risks of deflation. In a deflationary environment monetary policy may thus not be able to sufficiently stimulate aggregate demand by using its interest rate instrument. This makes it more difficult for monetary policy to fight deflation than to fight inflation.

3.2. Money supply

ECB also manages EU money supply and provides liquidity to the system when needed. Money supply is the entire stock of currency and other liquid instruments circulating in a country's economy as of a particular time. The ECB meets on a monthly basis to determine the quantity of money in circulation and authorises production of euro banknotes by Eurozone countries. This is achieved through open market operations and requires analysis and forecasting of the liquidity situation in the euro area.

The analysis of the liquidity conditions in the euro area starts with the Eurosystem balance sheet: Weekly financial statement. Public and private sector analysis is performed because of the money

supply's possible impacts on price level, inflation and the business cycle. The liquidity needs of the banking system result from the minimum reserve requirements imposed on euro area credit institutions and from autonomous factors, which are normally beyond the direct control of the ECB. Such factors can be banknotes in circulation and government deposits with some national central banks. The ECB normally aims to satisfy the liquidity needs of the banking system via its open market operations. Economists analyze the money supply and develop policies revolving around it through controlling interest rates and increasing or decreasing the amount of money flowing in the economy. An increase in the supply of money typically lowers interest rates, which in turn generates more investment and puts more money in the hands of consumers, thereby stimulating spending. Businesses respond by ordering more raw materials and increasing production. The increased business activity raises the demand for labor. The opposite can occur if the money supply falls or when its growth rate declines.

3.3. European Central Bank's instruments

The operational framework of the Eurosystem consists of the following set of instruments (European Central Bank, 2018b):

- *Open market operations*, which play an important role in steering interest rates, managing the liquidity situation in the market and signalling the monetary policy stance. Five types of financial instrument are available to the Eurosystem for its open market operations. The most important instrument is the reverse transaction, which may be conducted in the form of a repurchase agreement or as a collateralised loan. Open market operations are initiated by the ECB, which decides on the instrument and the terms and conditions. It is possible to execute open market operations on the basis of standard tenders, quick tenders or bilateral procedures.
- *Standing facilities*, which aim to provide and absorb overnight liquidity, signal the general monetary policy stance and bound overnight market interest rates.
- *Minimum reserve requirements for credit institutions*, which intent is to pursue the aims of stabilising money market interest rates and creating (or enlarging) a structural liquidity shortage. The reserve requirement of each institution is determined in relation to elements of its balance sheet. In order to pursue the aim of stabilising interest rates, the Eurosystem's minimum reserve system enables institutions to make use of averaging provisions. This implies that compliance with the reserve requirement is determined on the basis of the institutions' average daily reserve holdings over a maintenance period of about one month.

3.4. Risks and uncertainties

The central bank constantly faces a high level of uncertainty regarding the nature and size of economic shocks. An economy is permanently subject to largely unforeseeable economic shocks that can affect the economy in different ways. The appropriate monetary policy for maintaining price stability depends on the circumstances. Furthermore, the ECB has to consider the existence and strength of the relationships that link macroeconomic variables and the transmission mechanism of its policy impulses to the economy (Bech and Malkhozov, 2016).

To deal with this uncertainty, the ECB's strategy aims to preserve the functioning of the transmission mechanism. The proper functioning of the money market is central to the transmission of the ECB's policy rates. In order to keep the transmission mechanism operational and to ensure the maintenance of price stability over the medium term, a central bank may need to introduce non-standard policy measures. It also needs to be forward-looking, to focus on the medium term in order to avoid the introduction of unnecessary volatility into the real economy, to firmly anchor inflation expectations (it is crucial that the central bank specifies its goal, sticks to a consistent and systematic method for conducting monetary policy, and communicates its decisions and actions clearly and openly), and finally to be broadly based, taking into account all relevant information and using several approaches and models in order to understand the factors driving economic developments.

4. PRESENT AND FUTURE OF EU MONETARY POLICY

4.1. Past year of European Monetary Policy

Mersch (2017), a Member of the Executive Board of the ECB, delivered a speech in which he talked about the challenges for euro area monetary policy in early 2018. Here are some highlights of his speech:

"The Governing Council of the ECB at its October meeting decided to reduce the rate of monthly asset purchases. In my remarks today, I would like to explain the rationale behind that decision, and how it remains

consistent with our mandate for price stability. In short, as our asset holdings rise and the growth outlook improves, unchanged policy parameters actually imply greater monetary stimulus. Furthermore, I am confident that the apparent disconnect between growth and inflation is a temporary phenomenon and that inflation dynamics will increase. It is therefore possible for us to scale back our net asset purchases, while keeping our policy sufficiently accommodative to support those inflation dynamics. If one extrapolates from the current brighter economic outlook, one cannot imagine that we would need to extend further our present purchases. A symmetric approach to our inflation mission would therefore be more appropriate than a one-dimensional promise to do more in case of deflation. While ending the purchase programme quickly could provoke undue market reactions, we should not overlook the fact that the longer our asset purchase programme continues, the less effective the programme and the greater the risks attached to it become. Having a credible view of the exit is important to keep any such risks contained.”

4.2. Future of European Monetary Policy

Mersch (2017) argues that in the last year European monetary policy has successfully stimulated demand and returned slack resources into productive use, but talking about the future and the implementation of monetary policy, he focused his attention on the growing risks that European Union will face. The first risk relates to the subsiding deflationary headwinds, about this he said that:

“because of the uncertainties and imprecisions involved in measuring slack and inflationary pressures in the economy, we might find ourselves behind the curve without realising it. Hence, through the long and variable lags of monetary policy, we will end up with inflation above the rate consistent with our price stability mandate. This would require a sharp correction of the monetary policy settings in years to come. Yet such a correction of interest rates would pose risks to the financial sector. Banks could be hit hard as funding costs rise faster than interest income on outstanding loans.”

The other risk is related to the first one and regards the fact that inflation could turn out much higher than expectations in 2018. But about this we can be confident, he said, that the optimal monetary policy response would involve the ECB having to adjust its forward guidance. And even though “the financial crisis showed how such risks can interfere with the smooth operation of monetary policy through their effects on banks, which remain a key part of the monetary transmission mechanism in the euro area” and that “we should therefore bear in mind that these risks could potentially complicate our ability to meet our price stability mandate in the future [...] and we have to be mindful not to exert an undue influence on price formation”, the recovery in the euro area continues at a robust pace and employment has risen strongly. He concludes his speech by saying that:

“We will continue to monitor developments in the economy and set policy in a way that is consistent with our price stability mandate. In doing so, we must also take into account the balance of risks when setting policy. If we withdraw our monetary policy stimulus too early and too fast, asset prices could drop and yields rise sharply, with negative spill-over effects to the economy. At the same time, we have to be mindful, as our asset purchase programme continues, that the risks attached to it may increase the longer it lasts. Nourishing a market belief that the exit might be permanently postponed could exacerbate the potential cliff effects. A credible perspective on exit is needed to keep these risks contained.”

5. CONCLUSION

Monetary policy is influencing markets and economies has increased sharply over the past years, mainly driven by the recommendations of economic theory and the efforts of policymakers to improve central banking institutions. There is increasing evidence of the growing importance of the links between monetary policy decisions and communication in influencing the overall effectiveness of monetary actions in modern economies. In very general terms, it could be said that monetary policy is what keeps the economy stable and prosperous. That's why we deem that for an European citizen, and, in general, for everyone around the world, it's very important to understand how monetary policy works and how it can influence our everyday life. Everyone has to make this effort, because if we understand how the trend of economic variables like commodity prices, inflation, wages, interest rates, quantities of employment work, and how they can change after a monetary plan, we will be able to make more clever and thoughtful decision about how we want to spend, invest or save our money.

The study of monetary economics enables us to understand, not just how an economy functions efficiently, but also how monetary policy can help the economy adjust from one state to another and how it can find balance and grow. We can't forget that the main objective of the monetary policy is to maintain price stability,

that is very significant for consumers and companies. Price stability supports higher living standards by reducing uncertainty about general price developments, thereby improving the transparency of the price mechanism. It makes it easier for consumers and companies to recognise price changes, which are not common to all goods. To do this the central banks often influence short-term interest rates; the changes in market interest rates affect spending decisions by households and companies and, therefore, economic activity. These are the main ways by which the monetary policy can influence our lives, and there are a lot more, and that's why is momentous to know and understand them.

Talking about European monetary policy in specific, after the analysis of Yves Mersch's speech, we can say that our monetary policy will try to keep the flexible inflation targeting regime, coupled with some form of macro prudential policy. However, in my opinion, we should not try to predict what the more distant future may bring because the changes in the contemporary environment are extremely dynamic, turbulent and unpredictable, but we have to be prepared and active in order to react and overcome this presumable events, especially the ones that can occur in the short-term.

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