

THE MONETARY POLICY INSTRUMENTS IN EUROPEAN UNION

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Abstract: The monetary policy is a fundamental characteristic of modern economic life, having its own mark upon price stability, exchange rate, economic growth rhythm and EU economy's health. This is the result of the capability of certain factors responsible for the monetary policies, to detect the main tendencies of internal and international evolution and capture the evolutionary directions of global and EU economy. We have started our conception of the present article from the role of the Europe Central Bank in developing and applying the strategies of monetary policy by using its specific instruments. We have analyzed how much the strategic objectives of the monetary policy have reflected the international economic realities and if they met the impartial requests of European economy development. Thus, we have suggested identifying the role that ECB has when using its monetary policy instruments for stimulating the economic growth and building a stable socio-economic environment.

JEL classification: E31 E42, E52

Key words: the monetary policy; the monetary policy instruments; the open market operations; standing facilities for credit institutions; minimum reserve requirements.

1. INTRODUCTION

Concerning the Eur Area, the monetary policy is conceived and applied by the European Central Bank (ECB), a banking institution that has similar responsibilities as the national banks outside the Euro Area.

The content of the monetary policy, as it is also the case of ECB, is due both to the economic situation of EU and especially that of the countries that joined the Euro Area, as well as to the economic situation of the countries outside the European area, ECB setting its monetary policy objectives according to the macroeconomic ones, to the main trends registered within the European and global economic evolution.

2. OBJECTIVES

The present article considers the analysis of monetary policy instruments used within the Euro area, from the point of view of the role played by this policy in achieving the macroeconomic objectives, and the analysis of those which especially assure the stability of the financial system.

3. METHODOLOGY

In order to analyze the impact of the usage of monetary policy instruments of ECB, the scientific study required the use of descriptive research methods that led to formulating a series of pertinent conclusion upon the economic-financial climate of the European Union. The instruments of monetary policy analyzed in this study are:

a)the open market operations: ECB manages the requirements of constituting the needed reserves and influences the interest rates on this market; the open market operations play an important role in market liquidity management, being carried out in the following four options: **the main refinancing operations** (MRO) are regular liquidity-providing reverse transactions with a frequency and maturity of one week. They are executed by the Central Bank on the basis of standard tenders and according to a pre-specified calendar; **longer-term refinancing operations** (LTRO) are regularly conducted with a monthly frequency and a maturity of three months (there are also LTRO executed at irregular intervals or with other maturities, e.g. the length of one maintenance period, six months or twelve months). They are executed by the Central Bank in the same circumstances as well as the main financing operations; **fine-tuning operations** can be executed on an ad hoc basis to manage the liquidity situation in the market and to steer interest rates and have the role to smooth the effects on interest rates caused by unexpected liquidity fluctuations. The Eurosystem may select a limited number of counterparties to participate in fine-tuning operations; **structural operations** executed whenever the Eurosystem wishes to adjust its structural position vis-a-vis the financial sector, carried out by the Central Banks by standard tenders.

b)standing facilities for credit institutions: marginal lending facilities (covered with eligible collaterals) and deposit facilities, that provide overnight credit or overnight deposit for exceptional situations;

c)minimum reserve requirements, that lead to the increase of the liquidity needs and, being calculated as monthly average, are able to smooth the temporary liquidity gaps, reducing the volatility of short-term interest rates.

4. ANALYSES

In its essence, the ECB monetary policy aims achieving the balance between the real economy (meaning the goods and services flow) and the nominal economy (meaning the monetary flows). Actions are taken towards these two, both at *strategic level* (at this level the general objectives of the monetary policy are converted into final objectives of the macroeconomic policy), as well as at *tactic level*, where the operational procedures of the Central Bank, submitted to achieving the targeted variables, are applied. Thus, if the *strategic plan* operates with fundamental objectives that are in relation to the whole economic system and have the purpose of assuring a sustainable economic growth, the *tactic level* acts upon intermediary objectives. Such objectives have an operational character, expressing the ECB's way of intervention in the financial-economic life by using the previously mentioned specific instruments.

Along with these instruments, ECB monitors and carefully studies a key-indicator – *the monetary aggregates*. This fact is due to the strong relationship between the monetary expansion and the inflation, relationship that assures to monetary policy a strong and reliable nominal anchor. The important role given by ECB to the monetary aggregates

derives from ECB's announcement of a reference value for the dynamics of the wide monetary aggregate M3, settled at 4.5% (the annual growth rhythm of M3).¹

Table no. 1 The evolution of the annual growth rhythm of M3 aggregate, of inflation rate and of economic growth in Euro area between 2003-2006

Year	2003	2004	2005	2006
Yearly average rate of M3 growth	8,1	5,8	7,4	8,4
Inflation average rate	2,10	2,15	2,19	2,18
Economic growth average rhythm	0,48	1,99	1,78	3,33
Year	2007	2008	2009	2010
Yearly average rate of M3 growth	11,2	9,5	3,25	0,57
Inflation average rate	2,13	3,28	0,3	1,6
Economic growth average rhythm	3,02	0,3	-4,15	1,76

Source: www.ecb.com

The fundamental objective aimed by the ECB monetary policy is maintaining the price stability, as it is defined by the Governor's Council in 1998 as "a yearly growth of the harmonized index of consumer prices (HICP) in Euro area less than 2%"². In other words, the inflation rate must be maintained below, yet close to 2%. Considering ECB's staff vision, achieving this objective directly influences the optimal conditions for a good functioning of the European economy, which means higher employment rate and a balanced economic growth, and a security margin for deflation as well. Thus, ECB Governors Council takes decisions concerning the short-term interest rates, in order to assure the counteract of both inflationary tensions as well as deflationary ones and the price stability on a medium term.³

The ECB monetary policy officials consider that it can influence the economic situation only on a short or medium term, the effects of this policy being reflected on a higher level of revaluation of the economic growth potential, favoured by the price stability. The proper reaction of ECB to the global financial crisis challenges is relevant for the manner in which ECB sized its objectives of monetary policy and promoted them by using the specific instruments.

If during the period of time following the crisis, worried by the generous existing offer on the financial market, which represented a visible risk for price stability, ECB acted towards loan price rising, increasing the interest rate, after the crisis started, ECB promptly initiated measures of loan price decrease. Thus, if for the lending facility the interest rate increased from 2,50% in 2006 up to 4,25% in 2008, after the US financial crisis begun, which threatened to endanger the whole global financial system, ECB decreased the lending facility interest rate, starting with October 15th 2008 (3,75%), reaching on May 13th 2009 a historical minimum of 1%. This can be seen within the next table:

Table no. 2 The evolution of ECB's standing facilities interest rates for credit institutions

Year	Deposit facility interest rate	Refinancing operations interest rate	Marginal lending facility interest rate
1999	2.00	3.00	4.50
1999	2.75	3.00	3.25
1999	2.00	3.00	4.50

¹ ECB, *The quantitative reference value for monetary growth*, ECB press release, December 1st 1998

² Ibidem

³ Gerdesmeier Dieter, *Price Stability: Why is it important?* Frankfurt am Main, January 2011, pg. 9

1999	1.50	2.50	3.50
1999	2.00	3.00	4.00
2000	2.25	3.25	4.25
2000	2.50	3.50	4.50
2000	2.75	3.75	4.75
2000	3.25	4.25	5.25
2000	3.25	4.25	5.25
2000	3.50	4.50	5.50
2000	3.75	4.75	5.75
2001	3.50	4.50	5.50
2001	3.25	4.25	5.25
2001	2.75	3.75	4.75
2001	2.25	3.25	4.25
2002	1.75	2.75	3.75
2003	1.50	2.50	3.50
2003	1.00	2.00	3.00
2005	1.25	2.25	3.25
2006	1.50	2.50	3.50
2006	1.75	2.75	3.75
2006	2.00	3.00	4.00
2006	2.25	3.25	4.25
2006	2.50	3.50	4.50
2007	2.75	3.75	4.75
2007	3.00	4.00	5.00
2008	3.25	4.25	5.25
2008	2.75	4.25	4.75
2008	3.25	4.25	4.25
2008	3.25	3.75	4.25
2008	2.75	3.25	3.75
2008	2.00	2.50	3.00
2009	1.00	2.00	3.00
2009	0.50	1.50	2.50
2009	0.25	1.25	2.25
2009	0.25	1.00	1.75
2011	0.50	1.25	2.00
2011	0.75	1.50	2.25

Source: www.ecb.com

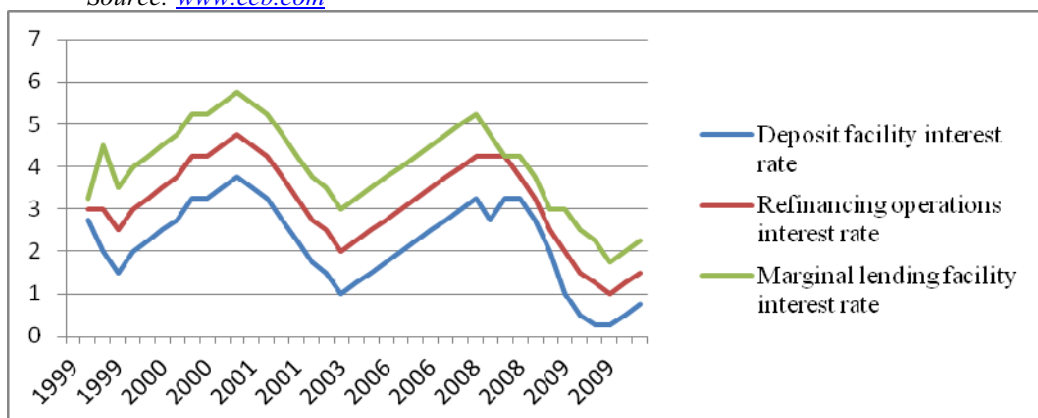


Figure no. 1 The evolution of ECB's standing facilities interest rates for credit institutions

On January 31st there were 6 334 credit institutions active within the Euro area. Among these, 2 267 met the criteria for open market operations; 2 395 met the criteria for marginal lending facility and 2 789 for deposit facility. Although the number of eligible institutions is significant, the real number of those who are active on this market is much lower. E.g., during the second half of year 2010, there were only 145.

The speculative operations that triggered the north-american financial crisis will also be found within the European financial market. Like the USA case, in Europe also, many banks have engaged in risky lending of real-estate, taking mortgage bonds and other toxic assets as collateral in an unacceptably high percentage. After the crisis begun, all these shares have considerably diminished their initial value, thus the losses due to this fact have led them to collapse. As the American economists Nouriel Roubini and Atefhen Mihn mentioned, “until the end of 2009, ECB raised the forecast of accounting devaluations up to 550 billion euro, much higher above the initial forecasts”⁴.

Another risky phenomenon was the easily, but considerably high amount lending from western European banks – from countries such as Austria, Italy, Belgium, Sweden, Germany – of eastern European countries whose economies had a high degree of instability such as Hungary, Ukraine and Bulgaria. As the crisis begun, the national currency of those countries have strongly depreciated, thus the debtors from those countries faced the situation of not being able to meet their contracted obligations, thus creating huge difficulties to the lending banks.

Therefore, ECB also faced similar problems as in the case of FED, except that, as those American economists have noted, the solving means available to Euro area were considerably outnumbered by the American economy’s ones and that due to many reasons:

- an index of economic growth lower than the one registered in USA (e.g., during the 4th quarter of 2010, Euro area has registered an economic growth of 1,90%, in comparison to the 3,10% increase registered in United States);

- the lack of an unitary fiscal policy for the Euro area, this being the main contradiction of the Euro area economic system, the unique monetary policy not being linked to an unique fiscal policy.

- a labour productivity lower than in USA

- an increasingly percentage of elder population, at the expense of the active population.⁵

From all these phenomena, the most dangerous one proved to be the one of the lack of a unique fiscal policy, each country from the Euro area applying its own fiscal policy, that, in relation to political concerns, have generated serious malfunctions to certain countries’ economies such as Spain, Portugal, Greece, Italy, with consequences for the entire Euro area economy. Such phenomena have highlighted the fact that EU is now facing a situation that is relatively similar to the one during 1991-1993, named by the theorists the incompatibility triangle and explained by the fact that a country cannot simultaneously have an autonomous monetary policy, a fixed currency and a free flow of capital. Now, the incompatibility triangle consists in unique monetary policy, national fiscal policies and autonomous national policies. But, “no monetary union have ever survived without having a fiscal and political union”⁶.

⁴ Nouriel Roubini and Stephen Mihn, *Economia crizelor*, Editura Publica, București, 2010, p.220

⁵ Ibidem, p.469

⁶ Ibidem, p.472

Thus, one could estimate that, if persistent actions towards the wholeness of the monetary union with fiscal and political union will not be taken, there could be the risk of Euro area apart, this fact having a strong negative impact on European Union. That due to the fact, as Greece's experience is now showing, that its fiscal policies combined with an incorrect political conduct, have brought it to default. The Greek default could also mean a strong threat to euro currency.

5. CONCLUSIONS

The comparative analysis of the situations the two central banks of USA and EU have faced during the crisis, leads to the conclusion that both have mainly used the same instruments and actions in order to overcome the crisis stage and to salvage the financial-banking system. It also must be highlighted the fact that similar failures of the two banks' activity have favoured the speculative phenomena responsible for the crisis. During the pre-crisis period of time, ECB also had a relatively permissive attitude towards the speculative trends of the financial market and the risky actions of a significant number of Euro area banks. The relatively low interest rate used until 2006 have influenced the lending price decrease and thus the increase of the market liquidity. The subsequent interventions of ECB have diminished the risk, but not totally eliminated it.

During the crisis, the initiated measures and the used instruments have proved their efficiency, but with considerable costs. On the other hand, in order to salvage the financial-banking system of Euro area, ECB was obliged, during the crisis, to make decisions in contradiction to the classic principles of the monetary policy. Thus, it extended the list of eligible assets, from 140 to 2000, in order to avoid those failures of the banks that had portfolios with a high percentage of toxic assets, it increased the refinancing period first up to 3-6 months and afterwards up to one year, it provided foreign currency liquidity.

A large portion of the costs required to exit the crisis situation and the salvage of the financial-banking system will be beard by the contributors, this situation being similar to the one in USA. Thus, the fact that, unlike FED, the ECB monetary policy was much more cautious and the fact that not always the set targets were totally achieved due to the previously mentioned situation must not be ignored.

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