



## EUROPEAN MONETARY POLICY

The European System of Central Banks (ESCB) comprises the ECB and the national central banks of all the EU Member States. The primary objective of the ESCB is to maintain price stability. In order to achieve its primary objective, the Governing Council of the ECB bases its decisions on a two-pillar monetary policy strategy and implements them using both standard and non-standard monetary policy measures. The main instruments of ECB standard monetary policy are open market operations, standing facilities and the holding of minimum reserves. As a response to the financial crisis, the ECB has also changed its communication strategy by providing forward guidance on the future path of the ECB's interest rate policy conditional on the outlook for price stability and has taken a number of non-standard monetary policy measures. These include the purchases of assets and sovereign bonds on the secondary market, with the aim of safeguarding price stability and the effectiveness of the monetary policy transmission mechanism.

### LEGAL BASIS

- Articles 119-144, 219 and 282-284 of the Treaty on the Functioning of the European Union (TFEU);
- Protocol (No 4) to the Lisbon Treaty on the Statute of the European System of Central Banks (ESCB) and the European Central Bank (ECB).

### OBJECTIVES

The primary objective of the ESCB under Article 127(1) TFEU is to guarantee price stability. Without prejudice to this objective, the ESCB supports general economic policy in the Union, with a view to contributing to the achievement of the Union's objectives. The ESCB acts in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources (Article 127(1) TFEU).

### ACHIEVEMENTS

- A.** The guiding principles of ECB action
  - 1.** The independence of the ECB

The essential principle of the ECB's independence is set out in Article 130 TFEU ('When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall



seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body'). The ECB's independence is also maintained by the prohibitions referred to in Article 123 TFEU, which also apply to the national central banks: overdraft facilities or any other type of credit facility in favour of Union institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of Member States are prohibited. The independence of the ECB centres around the free choice of monetary policy instruments. The Treaty provides for the use of traditional instruments (Articles 18 and 19 of the Statute) and allows the Governing Council to decide on the use of other methods (Article 20 of the Statute).

## **2. The principles of accountability and transparency of the ECB**

In order to ensure the credibility of the ECB, the Treaty (Article 284 TFEU) and the Statute (Article 15) impose reporting commitments. The ECB draws up and publishes reports on the activities of the ESCB at least quarterly. A consolidated financial statement of the ESCB is published each week. From the outset, the ECB Monthly Bulletin has provided in-depth analyses of the economic situation and the outlook for price developments. The Monthly Bulletin was replaced in January 2015 with a new Economic Bulletin, which, in view of the switch in January 2015 to a six-weekly interval for Governing Council monetary policy meetings, will be published two weeks after each monetary policy meeting. On 19 February 2015 the ECB published, for the first time, an account of a Governing Council monetary policy meeting and, in so doing, aligned itself with the communication policy of other leading central banks. The ECB addresses an annual report on ESCB activities and monetary policy of both the previous and the current year to the European Parliament. The ECB is accountable to the European Parliament and ECB Executive Board members regularly appear before it.

## **3. Voting rules in the ECB Governing Council (Article 10(2) of the Statute)**

Voting in the Governing Council used to work according to the 'one member, one vote' principle. Under the EU Treaties, a rotation system was to be implemented in the ECB Governing Council's voting system as soon as the number of euro-area countries exceeded 18, which has been the case since 1 January 2015, when Lithuania joined the euro area. The idea behind the rotation is to ensure the effectiveness of the ECB's decision-making system even with an increased number of participants. The Governors from the euro-area countries ranked first to fifth according to the size of their economies and their financial sectors (currently Germany, France, Italy, Spain and the Netherlands) share four voting rights. All others (currently 14) share 11 voting rights. The Governors take turns using the rights on a monthly rotation. ECB Executive Board members hold permanent voting rights.

## **B. The ECB's monetary policy strategy**

### **1. Overview**

On 13 October 1998, the ECB Governing Council agreed on the main elements of its monetary policy strategy, namely (i) a quantitative definition of price stability, (ii) an important role for the monitoring of the money growth identified by a monetary aggregate and (iii) a broadly based assessment of the outlook for price developments. The ECB has opted for a monetary strategy based on two pillars (Pillar 1: economic



analysis; Pillar 2: monetary analysis), whose respective roles were clearly defined once again during the review of the monetary strategy on 8 May 2003.

## **2. Price stability**

Price stability is defined as an inflation rate (year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area) below but close to 2% over the medium term.

## **3. The first pillar of the monetary policy strategy: economic analysis**

The economic analysis assesses the short- to medium-term determinants of price developments. The focus is on real activity and financial conditions in the economy. The economic analysis takes account of the fact that price developments over those horizons are influenced largely by the interplay of supply and demand in the goods, services and factor markets. To do so, the ECB regularly reviews, inter alia, developments in overall output, demand and labour market conditions, a broad range of price and cost indicators, fiscal policy, the balance of payments for the euro area and asset prices<sup>[1]</sup>.

## **4. The second pillar of the monetary policy strategy: monetary analysis**

The monetary analysis exploits the long-run link between money and prices and mainly serves as a means of cross-checking the short- to medium-term indications for monetary policy coming from the economic analysis. Monetary analysis consists of a detailed analysis of monetary and credit developments with a view to assessing their implications for future inflation and economic growth.

## **C. Implementation of the monetary policy: instruments and procedures**

By establishing interest rates at which the commercial banks can obtain money from the central bank, ECB monetary policy indirectly influences the interest rates throughout the euro area economy, and in particular the rates for loans granted by commercial banks and for saving deposits. The ECB uses a range of instruments to implement its monetary policy.

### **1. Open market operations**

Open market operations play an important role in steering interest rates, managing the liquidity situation in the market and signalling the monetary policy stance. The Eurosystem's regular open market operations consist of one-week liquidity-providing operations in euro (main refinancing operations, or MROs) and three-month liquidity-providing operations in euro (longer-term refinancing operations, or LTROs). MROs serve to steer short-term interest rates, to manage the liquidity situation and to signal the monetary policy stance in the euro area, while LTROs provide additional, longer-term refinancing to the financial sector.

Less regular open market operations are fine-tuning operations and structural operations. The aim of the former is to deal with unexpected liquidity fluctuations in the market, in particular with a view to smoothing the effects on interest rates, while the

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[1]The descriptions of the two pillars are taken from: The Monetary Policy of the ECB (2011), <http://www.ecb.int/pub/pdf/other/monetarypolicy2011en.pdf>



latter are mainly aimed at adjusting the structural position of the Eurosystem vis-à-vis the financial sector on a permanent basis.

## 2. Standing facilities

Standing facilities provide or absorb liquidity with an overnight maturity and EONIA (Euro Overnight Index Average) measures the effective interest rate prevailing in the euro interbank overnight market. The Eurosystem offers credit institutions two standing facilities: the marginal lending facility in order to obtain overnight liquidity from the central bank, against the presentation of sufficient eligible assets, and the deposit facility in order to make overnight deposits with the central bank.

## 3. Holding of minimum reserves

In accordance with Article 19(1) of the Statute, the ECB may require credit institutions established in Member States to hold minimum reserves with the ECB and national central banks. The aim of the minimum reserves is to stabilise the short-term interest rates on the market and to create (or enlarge) a structural liquidity shortage in the banking system vis-à-vis the Eurosystem, making it easier to control money market rates through regular allocations of liquidity. The calculation methods and determination of the amount required are set by the Governing Council.

## 4. Non-standard monetary policy measures and crisis response as of 2007: forward guidance and asset purchase programmes

Since July 2013, the ECB has been providing forward guidance on the future path of interest rate policy. Providing forward guidance has been a material shift in the ECB's communication strategy as it has involved communicating not only how the ECB assesses current economic conditions and the risks to price stability over the medium term, but also what this assessment implies for its future monetary policy orientation.

In addition and since 2009, several asset purchase programmes have been implemented with the objective of sustaining growth across the euro area and consistent with the aim of achieving inflation rates below, but close to, 2% over the medium term. In 2009 and 2011, the ECB launched two covered bond purchase programmes (CBPP and CBPP2). From 10 May 2010 to February 2012 the ECB conducted interventions in debt markets under the securities markets programme (SMP). In August 2012 the ECB announced the possibility of conducting outright open market operations (OMTs) in secondary sovereign bond markets to safeguard an appropriate monetary policy transmission and preserve the singleness of its monetary policy. In June 2014, it announced a series of targeted longer-term refinancing operations (TLTROs) aimed at improving bank lending to the euro area non-financial private sector, excluding loans to households for house purchase, over a window of two years. In September 2014, the ECB announced two new purchase programmes, namely the asset-backed securities purchase programme (ABSPP) and the third covered bond purchase programme (CBPP3), aimed at enhancing the transmission of monetary policy, supporting provision of credit to the euro area economy and, as a result, providing further monetary policy accommodation. On 9 March 2015 the ECB started the purchase, on the secondary market, of bonds issued by euro area central governments and certain agencies and international or supranational institutions located in the euro area under the public sector purchase programme (PSPP).



Combined, the ABSPP, the CBPP3 and the PSPP constitute the expanded asset purchase programme (EAPP), whose monthly purchases amount to EUR 60 billion. On 10 March 2016, the ECB decided to expand the present monthly asset purchases to EUR 80 billion, to increase the issuer and issue share limits for the purchases of securities from 33% to 50%, to include investment-grade euro-denominated bonds issued by non-bank corporations established in the euro area in the list of eligible assets and to launch a new series of four TLTROs, starting in June 2016, each with a maturity of four years. These new operations are intended to reinforce the ECB's accommodative monetary policy stance and strengthen the transmission of monetary policy by further incentivising bank lending. They are to be carried out until the ECB detects a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term. On 8 December 2016, the ECB Governing Council decided to maintain the monthly asset purchases at EUR 80 billion until March 2017. From April 2017 until December 2017, and beyond if necessary, the monthly purchases will continue at a level of EUR 60 billion. The ECB also decided to adjust some of the parameters of its asset purchase programme, effective from January 2017: the minimum remaining maturity of eligible assets under the PSPP was reduced from two years to one year and the purchase of securities with a yield to maturity below the ECB's deposit facility rate will be allowed under the EAPP, to the extent necessary.

## **ROLE OF THE EUROPEAN PARLIAMENT**

By virtue of Article 284(3) of the TFEU and Article 15(3) of the ESCB Statute, the President of the ECB is required to present an annual report to Parliament. In its resolution of 25 February 2016 on the European Central Bank Annual Report for 2014, Parliament stressed the need to improve the financial conditions for both public and private investment, warned about the financial risks stemming from protracted low interest rates in certain Member States and high and divergent levels of public and private indebtedness, welcomed the ECB decision to publish the summary minutes of its meetings and stressed the need for democratic accountability in view of the new responsibilities conferred on the ECB regarding supervisory tasks. The ECB President, as a standing practice, appears four times a year before Parliament's Committee on Economic and Monetary Affairs (ECON) to explain the ECB's policy decisions and answer questions from committee members (Monetary Dialogue). The meetings are open to the general public and the transcripts are published on both the Parliament and ECB websites.

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