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Policy decentralization at the ECB
- Sciences Po, OFCE -

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Policy decentralization at the ECB MONETARY DIALOGUE September 2017

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Policy decentralization at the ECB

IN-DEPTH ANALYSIS

Abstract

The decentralized implementation of ECB policy to national central banks has raised concerns about the transparency of policy operations. We argue that these concerns are misplaced: first, the sharp monetary easing under the assets purchase programme is actually allocated according to the capital key of the ECB; second, this allocation may feed divergences between the different Eurozone member states. Though the latter point is not part of the ECB mandate, we argue that another policy may well be possible.

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EXECUTIVE SUMMARY

- Despite a rather "conservative" mandate, ECB's actions reflect broader concerns: the ECB has followed inflation and growth; and it has contributed to financial stability as should do a lender of last resort.
- The implementation of monetary policy in the Eurozone is decentralized since decisions taken by the Governing council – the main decision-body of the ECB – are followed by transactions which are carried out by NCBs. It leads to an operational delegation.
- Regarding the implementation of monetary policy in the Eurozone, credit institutions are treated equally irrespective of their size and location in the euro area.
- Imbalances highlighted by TARGET positions only mirror heterogeneous liquidity needs of countries that are subjected to the same rules and procedures.
- The implementation of the PSPP (Public Sector Purchase Programme) should "achieve market neutrality in order to avoid interfering with the market price formation mechanism". To that end, the ECB has stated that purchases of national sovereign assets would be determined by the ECB's capital key.
- In practice, the criteria have been nearly fulfilled and cumulative monthly purchases of national sovereigns are very close to countries' respective capital keys.
- Within the PSPP, each NCB keeps the profits or bears the losses it makes on its own purchases of sovereign bonds implying that each national central bank is exposed to distinct risk for decisions it has not taken on its own but that was decided at a supranational level.
- The capital key is only one among other criteria to fix the rules for asset purchases. However, it is not neutral and may have led to more distortions on the sovereign bond market than if the ECB had decided to resort to an allocation based on the share of national public debt on the total public debt of the Eurozone.
- We suggest departing from the capital key if it becomes a constraint for the implementation of the programme and limits the ability to pursue assets purchases.
- The ECB could take advantage of decentralization to implement a differentiated stimulus if it wants to address economic heterogeneities in the Eurozone and contribute to convergence of business cycles.

1. INTRODUCTION

The decentralized implementation of European Central Bank (ECB) policy by national central banks (NCBs) is most importantly a procedural question. Briefly stated, decisions taken by the Governing Council are followed by transactions which are carried out by NCBs. It leads to an operational delegation, which should not be mingled with delegation of decisions.

More than 30 years ago, Kenneth Rogoff did show in a very influential paper (Rogoff, 1985) that in contrast with the conclusion that monetary policy ought to be implemented under strict rules – a result obtained by Robert Barro and David Gordon a couple of years before (Barro and Gordon, 1983) -, discretion may improve welfare. This statement was contingent to the implementation of monetary policy by delegation to an independent central bank that would be more “conservative” than the government. The conservative central banker imagined by Rogoff was finally born in 1999, when the ECB started implementing the Eurozone monetary policy under a strict mandate: achieving price stability.

After the advent of the global economic crisis in 2007, the ECB has reached an effective lower bound for its policy rate and endorsed non-standard policy measures. New economic contingencies have turned the conservative independent central banker in the Eurozone into a seemingly less conservative one. The possible change in the very nature of the European central banker has raised fears that the ECB no longer fits its mandate: first, it creates too much cash and generates the risk of rapidly rising inflation and, second, it finances debts and generates further inflation risks and risk-sharing across the Eurozone member states. In this latter case, it would jeopardize the situation of low-risk high-sustainability countries to help the high-risk low-sustainability countries to recover from the crisis. Finally the decentralised implementation of monetary policy in the Eurozone to NCBs may trigger inflation risk and risk-sharing if the coordinated decisions taken at the ECB are not carried out transparently by NCBs. This would occur if, say, NCB of Country A uses the opportunity of non-standard measures to buy more domestic public and private debts than initially planned at the top-level. Country A’s long term rates would decrease relatively to other countries’ in the Eurozone, giving undue benefit to the former, and country A’s inflation might increase relatively to other countries’, moving up the Eurozone average. Beyond a purely technical dimension, the decentralization of monetary policy raises an important issue: the heterogeneity of economic situation in the monetary union. In principle, monetary policy stance should be identical across Eurozone countries. However the financial and sovereign debt crisis has put forward that the transmission of monetary policy through decisions on the short-term policy rate may be transmitted differently at the national level.

Assessing the decentralized model for the implementation of single monetary policy in the Eurozone requires to answer three different questions. First, has the mandate of the ECB changed since the onset of the global financial crisis or later and, if yes, what has been its rationale? Second, has decentralization actually led to higher inflation risk and higher risk-sharing? Third, might there be a better operational framework?

2. THE ECB'S MANDATE

The original mandate of the ECB – achieving price stability – has not changed since it has been laid down in the Treaty on the Functioning of the European Union, Article 127 (1). There is a real objective related to economic growth which is yet relegated to second rank. The Treaty actually states that: "without prejudice to the primary objective of price stability, the ESCB [European System of Central Banks] shall support the general policies in the Union", including "full employment" and "balanced economic growth".[1]

Over the years though and drawing on empirical estimates, the single mandate has moved to a dual one and to some extent to a triple mandate since the Banking Union has been adopted.[2] Actually, the so-called monetary rule of the Taylor-type has long nicely fitted the behaviour of the ECB. Castro (2011) estimated Taylor rules over the period 1999:1 to 2007:12 and found that the ECB had significantly reacted to the inflation rate *and* to the output gap. Blot et al. (2015) showed that the EONIA rate reacted almost similarly to inflation and real GDP deviations from targets before the global financial crisis. A counterfactual experiment ran since 2008 showed however that the Taylor rule no longer fitted the ECB policy.

As a matter of fact, the onset of the global financial crisis and the subsequent European crisis provoked a sharp move in the ECB's policy and led to concerns about banking and financial stability.

The sharp decisions taken by the ECB during the crisis have illustrated its pragmatism. It has notably met the liquidity needs of European banks, changing the operational framework when it was deemed necessary. The fixed-rate full-allotment procedure for main refinancing operations is a good example. The ECB has also played a role as lender of last resort for banks, although this task is not included in its mandate. Larger defaults resulting from the liquidity crisis could then be avoided. The ECB created very long term refinancing operation (VLTROs) by which it provided funds to credit institutions for a 3-year period, and then targeted long-term refinancing operations (TLTROs) to finally improve the transmission of its policies to the *real* economy. It was not only important to cover liquidity needs but it also allowed banks to support sovereign debt market and credit demand. Under the SMP (Securities Market Program), the ECB proceeded to purchases of public securities in the secondary market. This program and the OMT announcement (Outright Monetary Transactions) illustrated the will of the ECB to tackle the sovereign debt crisis, finally leading to the implementation on a larger scale of the public sector purchase programme (PSPP) coupled with corporate sector purchase programme (CSPP). Last, the ECB managed financial distress with emergency liquidity assistance (ELA).

These decisions show that the ECB has endorsed a wider interpretation of its mandate and missions than what the "conservative" central banker à la Rogoff meant. Justifications for this related to the need of restoring the transmission channels of monetary policy that had been impaired by the financial turmoil on sovereign debt markets (Cour-Thimann and Winkler, 2012). The adoption of a forward guidance strategy, by which the central bank announces its MRO (Main Refinancing Operations)rate for an extended period has a similar objective. It drives expectations of interest rates, and thus enhances the transmission of monetary policy.

In summary, despite a rather "conservative" mandate, ECB's actions reflect broader concerns: the ECB has followed inflation *and* growth; and it has contributed to financial stability as should do a lender of last resort.

[1] ESCB is now called Eurosystem.

[2] See Blot, Creel, Hubert and Labondance (2014).

In addition, recent regulatory provisions have increased its powers through the on-going banking union. Under the single resolution mechanism, the ECB embraces micro-prudential supervision powers in case of a failing bank, whereas under the single supervision mechanism, the ECB has *some* macro-prudential supervision powers over the most “significant” banks of the Eurozone. Macro-prudential tools in the hands of the ECB remain incomplete though (Couppey-Soubeyran and Dehmej, 2016). The ECB will be able to manage on a counter cyclically basis, bank by bank and country by country capital, liquidity and leverage ratios, but it will not as regards loan-to-value and debt-to-income ratios which remain in the hands of domestic authorities. The possible lack of coordination that will persist between monetary policy and macro-prudential policy may be welfare-deteriorating (Brunnermeier and Sannikov, 2016).

3. DECENTRALIZATION OF MONETARY POLICY IN THE EURO: DOES IT MATTER?

3.1. Decentralization of monetary policy in the Eurosystem: a technical issue

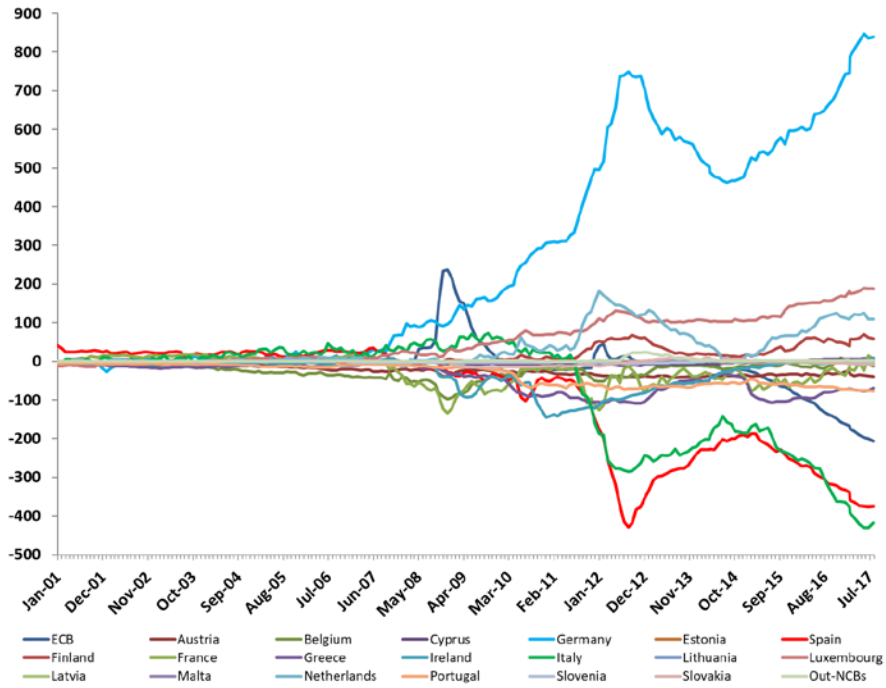
Since 1999, the Eurosystem – comprising the ECB and the national central banks (NCBs) of those countries that have adopted the euro – is responsible for conducting monetary policy for the euro area. The objectives are fixed by the Treaty[3] and the strategy, which consists in setting the instrument and the operational framework for the implementation of the single monetary policy, is defined by the Eurosystem. Henceforth, the monetary unification has not led to the disappearance of NCBs. They have kept a role since one principle specific to the Eurosystem is the decentralized implementation of monetary policy. The ECB coordinates the decisions and the operations and the national central banks (NCBs) carry out the transactions. Decisions regarding the stance of monetary policy – setting the target for the policy rate or deciding to implement assets purchases – and the management of liquidity are taken by the ECB – the Governing Council and the Executive board – but implementation is decentralized.

For liquidity management (main refinancing and long-term refinancing operations), the total amount of allotments is fixed by the ECB while funding's requests are collected by NCB and then liquidity is also provided at the national level. As far as liquidity management operations are concerned, the decentralized framework is in line with an important principle of monetary implementation in a monetary union since credit institutions are treated equally irrespective of their size and location in the euro area. With the fixed-rate tender procedure that was conducted until the end of 2008, the allocation of liquidity was realized according to the price – the interest rate – that credit institutions were ready to pay to get refinancing.4 Since October 2008, the ECB has conducted a fixed-rate / full-allotment strategy for all liquidity providing operations meaning that all credit institutions in the euro area have a full access at a fixed rate to the liquidity operations provided by the ECB. It concerns the MRO (main-refinancing operations), the LTRO (long-term refinancing operations), the VLTRO (very long-term refinancing operations) that had been implemented in two steps in December 2011 and February 2012 and the more recent TLTRO (targeted long-term refinancing operations) launched in 2014. Even though cross-country differences have emerged, as measured by the imbalances of the TARGET positions (figure 1), credit institutions have remained equally treated since they are still subjected to the same rules and procedures. Consequently, existing imbalances only mirror different liquidity needs.

[3] However, it is worth remembering that the quantification of the inflation target is not set in the Treaty but has been decided by the Eurosystem providing some room of manoeuvre in the interpretation of the objective of price stability.

[4] Provided that the proposed rate is above the minimum rate (MRO rate) fixed by the ECB.

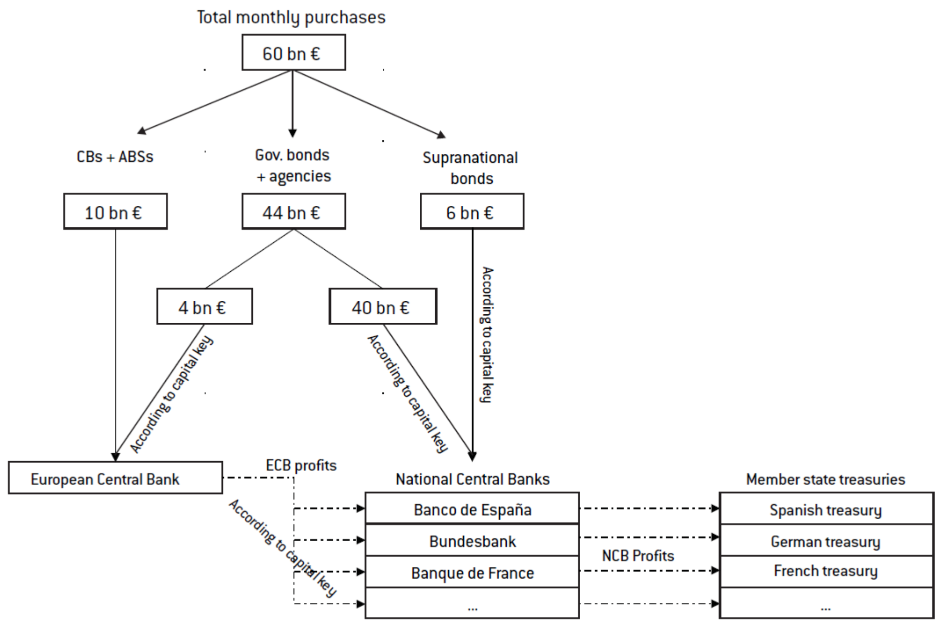
Figure 1: Target balances (in bn.€)



Source: Euro Crisis Monitor Institute of Empirical Economic Research, Osnabrück University, with ECB data

The implementation of the assets purchase policy also entails a decentralized operational framework since the decisions to implement such a policy has been made by the ECB. The policy mainly consists in setting ceilings for the monthly net purchases in the expanded asset purchase programme (APP) – including CBPP (covered bond purchase programme), ABSPP (asset-backed securities purchase programme), PSPP (public sector purchase programme) and CSPP (corporate sector purchase programme) – and defining the list of eligible assets. Purchases are then realized by the ECB and the NCBs. There is yet a major difference with the operations of liquidity provisions. The latter are realized upon banks' requests whereas the assets purchases are on the initiative of the ECB. As the PSPP entails purchases of sovereign assets issued by euro area countries, it has led the ECB to adopt the rule according to which the share of each country in the Eurosystem's monthly purchases is determined by the ECB's capital key (figure 2). Besides, it has been decided that NCBs focus exclusively on their home market, while the ECB may focus on supranationals assets and assets of other programmes. Although the weightings applied on a monthly basis can be a bit different to ensure smooth implementation, the policy is meant "to achieve market neutrality in order to avoid interfering with the market price formation mechanism".

Figure 2: Allocation of monthly assets purchases by the Eurosystem



Source: Claeys, Leandro and Mandra (2015)

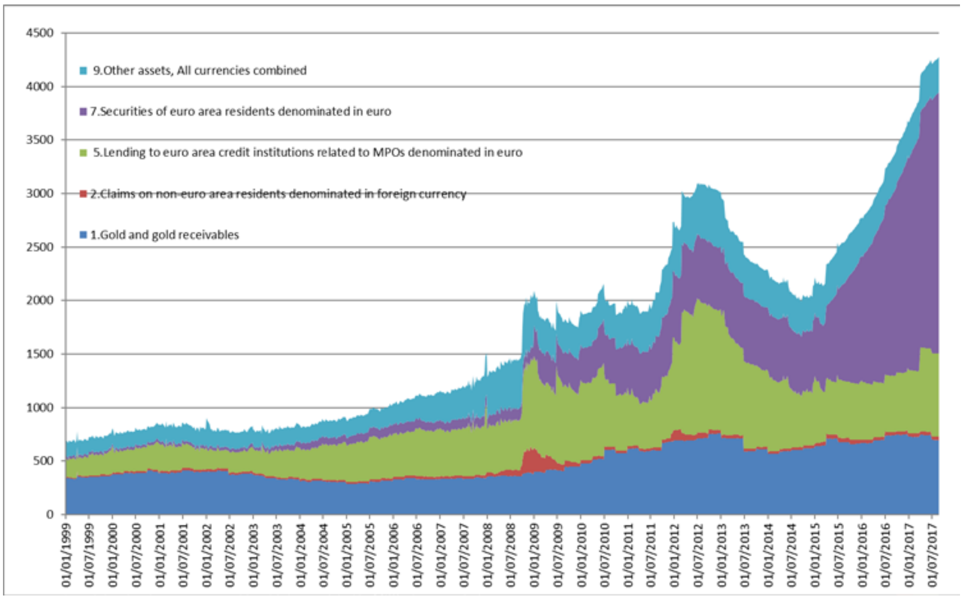
3.2. Decentralization and risk-sharing

The implementation of monetary policy is inherently risky for the Eurosystem. The operations of liquidity provisions involve lending money to private credit institutions that may default. In practice, the risk is managed by the ECB by requesting collateral from credit institutions against refinancing. Thus, the counterparty risk is minimized and becomes a market risk as the Eurosystem may still suffer from losses if it needs to sell the collateral to recover from the default of credit institutions. If losses are realized, they are supposed to be shared among the shareholders – that is among NCBs – according to their capital key.

Besides, the central banks' balance sheet also includes other assets not related to refinancing operations such as foreign exchange reserves on which the Eurosystem may realize profit or losses according to the exchange rate fluctuations. With the implementation of unconventional measures and notably the outright purchases, securities held for monetary policy purpose now represent the bulk of the Eurosystem's balance sheet (figure 3). Consequently, the ECB is exposed to a counterparty risk – if the assets issuer defaults – but also to market risk if the market value of its assets decreases. However, the arrangement guiding risk-sharing may differ from the one that applies to refinancing operations. Within the SMP (Securities market programme) launched in 2010, it was decided that profits and losses would be shared across national central banks according to the ECB's shareholdings rather than borne by the national central bank of the issuing governments. The ECB has signalled that it would intend to adopt the same principle for the OMT, not activated yet.

Within the PSPP, it is also the case for profits and losses realised with the supranational assets and for a small fraction of national debt securities held by the Eurosystem. However, it has been decided by the ECB not to share profits and losses on the portion of assets held for monetary purpose but purchased by NCBs. Consequently, each NCB will keep the profits or bear the losses it makes on its own sovereign bonds, which might interfere with the implementation of the PSPP if a national central bank is constrained by its loss absorption capacity (Blot, Creel & Hubert, 2016), a risk that would materialize if a country is hit by a sovereign crisis. In such a case, the price of sovereign bonds would fall inducing losses for the national central bank while the sovereign yield would increase impairing the transmission of monetary policy in this country. Even if the ECB might then certainly reinitiate assets purchases within the SMP or use the OMT (Outright Monetary Transaction) in order to enable assets purchases of the sovereign country hit by the crisis and share the potential losses, each NCB remains exposed to distinct risks for decisions it has not taken on its own but that was decided at a supranational level. For instance, imagine that country A is expected to default on debt. According to the rules decided at the ECB level, the central bank of country A would still be expected to keep on implementing the PSPP, although the national central bank might be reluctant to purchase ever-riskier domestic public debt.

Figure 3. Assets of the Eurosystem (in bn.€)



Source: ECB.

3.3. Decentralization and the effectiveness of monetary policy

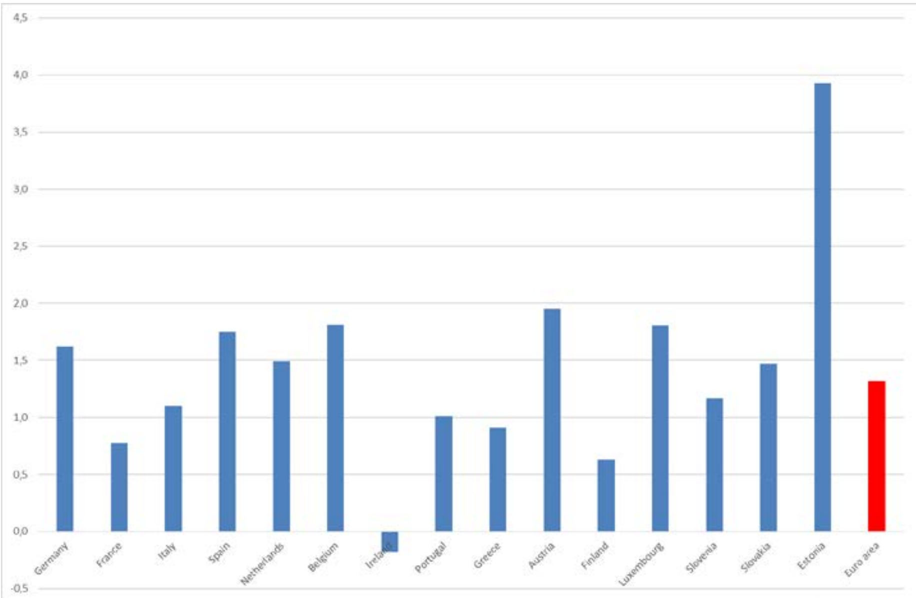
The decisions to resort to outright transactions since the beginning of the crisis have pursued different objectives.5 CBPP aimed to sustain the covered-bond market which is an important source of funding for the banking system. The SMP and the announcement of the OMT in September 2012 were designed to repair the monetary policy transmission mechanism impaired by drying up of some secondary markets for government bonds. Transactions were then targeted on stressed sovereign markets with the aim to mitigate the distortions resulting from mispricing and market sentiment. Finally, the PSPP aimed at amplifying the monetary stimulus beyond the ZLB (zero lower bound) for the euro area to address the risks of a too prolonged period of low inflation. Has it worked? Inflation has long been subdued and the recent rise in the consumer price index is no exception: inflation is still below its target of 2% per year on average (figure 4). In recent communication, the ECB President has recalled that underlying inflation and domestic labour costs also remained subdued. Consequently, core inflation stands close to 1% and does not show signs of sharp increase. As for domestic data, all countries but Estonia have an inflation rate below target. Some like Ireland, Finland and France have even very low inflation rates (figure 5) justifying the need to maintain a very accommodative monetary policy stance. The inflation risk stemming from ECB's policies has not materialized.

[5] See Cour-Thimann and Winkler (2012).

Figure 4: Inflation in the Euro area (in %)

Source: Eurostat.

Figure 5: Inflation in euro area countries (in %), August 2017

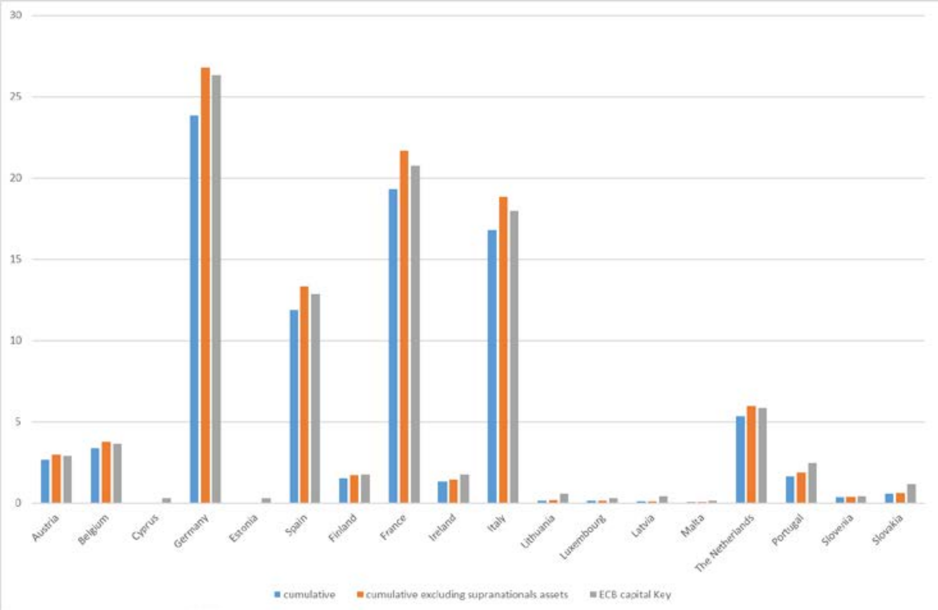


Source: Eurostat.

Now regarding risk-sharing, it remains to be stressed that the allocation of purchases on a homogeneous basis has avoided a situation in which the monetary stimulus would have been higher for one group of countries. With the capital key closely related to the share of each country in the Euro area GDP, such a rule enables to reduce the distortions created by purchases of sovereign assets and to implement the "same" monetary stimulus across euro area countries. In practice, these guidelines have been nearly fulfilled as can be show from cumulative monthly purchases of national sovereigns. They are actually very close to countries' respective capital keys (figure 6). Small differences result from the fact that some countries – Greece and Cyprus – do not participate in the QE programme. Besides, short term deviations may also result from liquidity conditions on some markets. As stated by Mario Draghi at the ECB Press conference held on September 08 2017:

“Our programme is a programme that has been designed in order to pursue, in order to implement our mandate. Our mandate is the pursuing of price stability for the whole of the eurozone. In this sense, that's what determines the size, the design, the composition of our programme, not specific national interest. One can naturally explain very clearly that whenever one has sort of appeared, when people seem to say, “Oh, you bought more bonds of one country and less of another” it's happened because of temporary technical factors that have been corrected in the subsequent months and weeks, weeks, and months. So it's due mostly to liquidity considerations, the rhythm of the reinvestment programme.”

Figure 6: Cumulative monthly purchases in % of total asset purchases and capital key (in %)



Source: ECB.

However, the rules adopted for the implementation of the PSPP has some shortcomings that may limit the effectiveness of monetary policy. The availability of some eligible assets, notably of German assets, may indeed hinder the ability for the ECB to meet the objectives for the monthly purchases. Blot et al. (2016) suggested that the ECB could remove the 25% purchasing limit and the deposit floor constraint on purchases in order to amplify the effect on sovereign rates. Here, we may also suggest departing from the capital key if it becomes a constraint for the implementation of the programme and limit the ability to pursue assets purchases.

4. SOME OPTIONS TO TAKE ADVANTAGE OF THE DECENTRALIZATION OF MONETARY POLICY

Beyond the constraints on the availability of eligible assets, the ECB might also consider other options to take advantage of the decentralization of monetary policy. Two arguments may notably be raised to justify that sovereign asset purchase within the PSPP could depart from the capital key.

i) The capital key is only one among other criteria that can be used to implement a homogenous monetary stimulus across countries

ii) The ECB could also take advantage of decentralization to implement a differentiated stimulus.

The capital key is one weighting scheme among others that can be used to determine the national asset purchases of the Eurosystem. It can be noticed that this weighting scheme modifies the relative availability of sovereign assets in the Euro area bond market. For instance, whereas the Netherlands have a higher share in the capital key of the ECB than Belgium, their public debt represents a lower share of the total sovereign debt in the Euro area (table 1). With relatively more purchases of sovereign debt issued by the Netherlands, the implementation of the PSPP brings the Eurosystem to be relatively more active on this market than on the market of Belgian sovereign bonds. If the geographical breakdown of asset purchases had been set according to the respective shares of government debt it would have notably resulted in additional purchases of French, Italian and Belgium bonds and smaller purchases of German, Spanish and Netherlandish bonds. It may then have mitigated the constraint on the availability of eligible assets since the Eurosystem would have purchased assets for which the supply would have relatively higher. The choice of basing the purchases on the capital key is consequently not neutral. Considering the way it has been applied so far, the PSPP may well have produced distortions on the sovereign bond market by creating scarcity, hence contributing to push down some sovereign yields.

Table 1: Country weights with alternative measures (%)

	Capital Key	GDP weights	Public debt weight
Belgium	3.5	3.9	4.6
Germany	25.6	29.2	21.8
Estonia	0.3	0.2	0.0
Ireland	1.6	2.6	2.0
Greece	2.9	1.6	3.2
Spain	12.6	10.3	11.3
France	20.1	20.7	21.9
Italy	17.5	15.5	22.6
Cyprus	0.2	0.2	0.2
Latvia	0.4	0.2	0.1
Lithuania	0.6	0.4	0.2
Luxembourg	0.3	0.5	0.1
Malta	0.1	0.1	0.1
Netherlands	5.7	6.5	4.4
Austria	2.8	3.2	3.0
Portugal	2.5	1.7	2.5
Slovenia	0.5	0.4	0.3
Slovakia	1.1	0.8	0.4
Finland	1.8	2.0	1.4

Sources: ECB and Eurostat

The argument for a breakdown by debt shares is reinforced by the fact that the purchases of sovereign bonds do not account for the business cycle position of countries. The recovery has been buoyant in Germany but sluggish in France and Italy. In Spain, despite a better economic performance since 2014, unemployment rate is still above its pre-crisis level. Consequently, it is not straightforward to decide on a rule which would give similar stimulus to heterogeneous countries. Theoretically, monetary policy must consider the situation of the Euro area as a whole and should not account for cross-country heterogeneities that should be addressed by appropriate decentralized fiscal policies. However, the ability to mitigate idiosyncratic shocks in the Eurozone is limited by fiscal rules and by the limited role for fiscal transfers. Under the APP, the Eurosystem could manage to implement differentiated stimuli to stabilize the Eurozone as a whole and help Eurozone economies to converge, provided it does not jeopardize the inflation objective. It was notably the aim of the SMP since only some countries, where market distortions were supposed to be significant, were concerned by the asset purchases. It is certain that using the PSPP to address economic heterogeneities would neither be a simple task nor a first-best policy. Such a change would modify the purpose and the implementation of monetary policy and would have to be made transparent by explicitly stating that the ECB is concerned with heterogeneity and adapts marginally its monetary policy to address this issue. Heterogeneities have remained pervasive in the Eurozone and have reinforced since the global financial crisis. A “one size fits all” approach is not necessarily optimal and may even contribute to imbalances as was already emphasized before the crisis. By adopting an outright transactions policy, the Eurosystem has the ability to carry some fine-tuning. Macroprudential policy might be another way to implement differentiated policy to account for heterogeneity of domestic financial risks but it does not depend on the ECB’s decisions.

5. CONCLUSION

Decentralization should not be a crucial issue as long as it boils down to delegation of decisions taken by a single authority internalizing externalities. In the Eurosystem, the implementation is delegated to NCBs but decisions are still taken by the decision-making bodies of the ECB. NCBs are the hands but the brain always lies in Francfort. However, the limitation of risk-sharing through the PSPP may not only limit the effectiveness of monetary policy – countries urging for debt relief are not those that earn the biggest share of the programme – but it also reduces the solidarity inside the Eurosystem. If decisions are set by a single authority, the NCBs in charge of the implementation of those decisions should all act similarly. However, if a NCB were exposed to more risks than another, its willingness to apply the common decision would vanish.

Actually, another issue arises with decentralization. How to deal with heterogeneity? Should this be a concern for the implementation of monetary policy? It seems that the use of unconventional measures – through the SMP and the (planned) OMT – has set a precedent. Why not then imagine that the ECB takes the opportunity of monetary tapering to amply a differentiated policy? The phasing out of quantitative measures could be adapted to the business cycle position of Eurozone countries. The monetary stimulus would diminish more (resp. less) rapidly in countries where the output gap is closed (resp. open). It would not only allow for maintaining some stimulus in countries where it is needed but it would also avoid financial imbalances to rise in countries where monetary stance is too much loose according to the macroeconomic situation.

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