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The ECB's monetary policy stance in perspective

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When the ECB started to reduce policy rates - the first cut dates back to June 2024 -, there were rising concerns that the monetary stance might still weigh down on economic activity, at least in the short-term. But how far had that restrictive monetary stance been? Are the shifts in the interest rates sufficient to assess the monetary policy stance or should we also account for the economic context and also for measures taken by the ECB beyond the policy rate?

When the ECB started to reduce policy rates - the first cut dates back to June 2024 -, there were rising concerns that the monetary stance might still weigh down on economic activity, at least in the short-term. But how far had that restrictive monetary stance been? Are the shifts in the interest rates sufficient to assess the monetary policy stance or should we also account for the economic context and also for measures taken by the ECB beyond the policy rate? We endeavor to answer to these questions in the Monetary Dialogue paper released in September 2024[1].

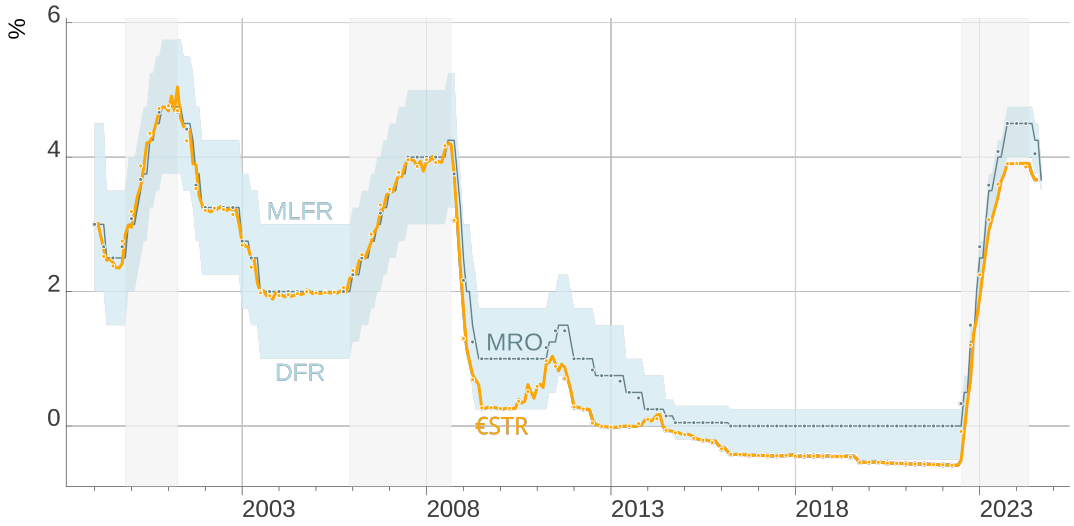
The return of inflation in 2021 far above the 2% inflation target drove a substantial shift in the conduct of the ECB monetary policy. After 7 years of zero or negative policy rates, the ECB decided in July 2022 to increase its so-called *"three key interest rates"*[2]. This rise has been in sharp contrast with the former tightening cycles[3] (graphique 1). The policy rates increased substantially at an unprecedented pace (tableau 1).

[1]This paper is requested by the ECON committee of the European Parliament for preparing the Monetary Dialogue with President Lagarde from the European Central Bank (ECB).

[2]The three key interest rates set by the ECB are the Deposit facility rate (DFR), the rate on the Main refinancing Operations (MRO) and the Marginal lending facility rate (MLFR).

[3]The main refinancing operations (MRO) rate has been the key policy rate steering the monetary stance between 1999 and 2016 while the deposit facility rate (DFR) has been steering the monetary stance since 2016.

Graphique 1: The 2022-2024 tightening cycle compared to previous ones



Note: The grey bars identify the tightening cycles.
Sources: ECB, OFCE's computations.
Last known data point: September 2024.

The change in policy rates has long been the primary measure for defining the monetary policy stance of the ECB. At first glance, an increase indicates a more restrictive stance whereas a decrease suggests a more accommodative stance. The sharp increase in the interest rates, from July 2022, was a response to the unprecedented rise of inflation and was used to achieve price stability, an objective which remains predominant for the ECB in accordance with the Treaty on the Functioning of the EU (TFEU). Accounting for the level of inflation, the real policy rate has reached its highest level since 2009. Given that the euro area inflation rate has returned to a level close to the target, it is tempting to attribute this achievement to the stance of monetary policy. But what stance?

Tableau 1: ECB monetary tightening cycles in retrospect

		Length (Months)	Total Increase (points)	Average Monthly increase (points)
Nov-1999	to	18	2.25	0.125
April-2001				
Dec-2005	to	34	2.25	0.07
Sept-2008				
July-2022	to	23	4.5	0.2
May-2024				

According to the ECB, the monetary policy stance refers to the overall approach and set of measures adopted by the central bank to achieve its primary objective of maintaining price stability over the medium term. In its 2021 review strategy, the ECB made clear

that “each monetary policy decision by the Governing Council is based on an assessment of the monetary policy stance and the choice, design (and calibration) of instruments (…), both individually and in combination.” Actually, and since the global financial crisis, the ECB’s toolkit has widened to account for the balance sheet instruments, such as quantitative easing (QE) measures. Beyond the rise of interest rates, the ECB has now also reduced the size of its balance sheet (QT) since November 2022. Such a reduction of the assets held by the ECB may also influence the financing conditions and thus impact the monetary policy stance.

The definition of the monetary policy stance requires to clearly identify the combination of shifts in different sets of instruments then. In this respect, and since the inception of so-called (at the time) unconventional monetary tools like QE, there have been attempts to produce synthetic indicators of the monetary policy stance encompassing the use of conventional and less conventional instruments. The resulting so-called proxy (or shadow) rates have been used to assess the monetary policy stance when the economy has hit the zero-lower bound (ZLB). Once non-standard measures are withdrawn, proxy rates may also be a useful indicator for assessing the intensity of the monetary policy tightening as they may incorporate the extra effect of monetary policy on long-term interest rates.

For the United States, (Doh and Choi, 2016) proposed a simple approach to assess a so-called proxy funds rate. They updated their model to account for the effect of QT and showed that the proxy funds rate for the US was higher than the target rate announced by the FED from the end of 2021 until August 2024.[4] The intuition is simply that the effect of monetary policy decisions on the monetary policy stance may be captured by some factors encompassing several market interest rates and interest rate spreads.

Using the same approach, we compute two measures of a proxy policy rate for the ECB (See Box 1 in Blot & Creel 2024).[5] While in the US, the proxy funds rate has been above the target set by the FED, the proxy rate in the euro area is below the DFR rate (graphique 2) The reduction in the size of the balance sheet does not seem to entail an amplification in the ECB monetary policy tightening. Total assets of the ECB have been reduced by EUR 2,375 billion since peaking in June 2022, hence by 27%. However, the bulk of the reduction stems from the liquidity operations that have come to an end: EUR −2,100 billion (-96%) since June 2022, contributing for 24 percentage points to the 27% reduction in total in the size of the balance sheet. The liquidity needs of the banking system have weakened so that this reduction has less impact on financing conditions and on the variables included in the computation of the proxy rate (mainly based on sovereign yields and spreads, corporate rate and spread, mortgage rate and spread and retail banking interest rates). By comparison, assets held for monetary policy purpose have only decreased by 11% (EUR 525 billion) and contributed for only 6 percentage points to the reduction in the total assets held by the Eurosystem. There has been less QT in the euro than in the US, which may explain the difference between the proxy rate estimated for the FED and the proxy rate for the ECB.[6]

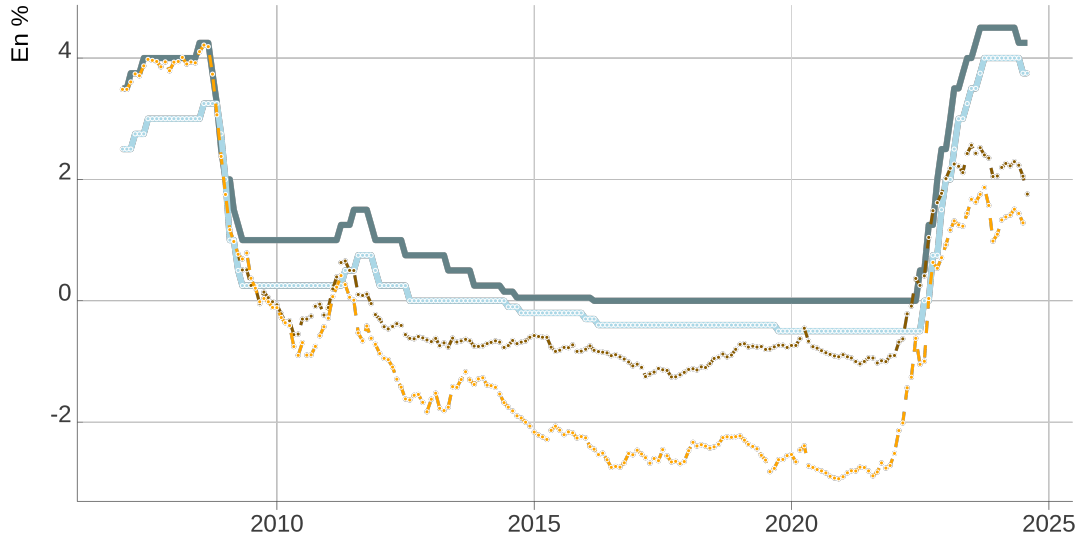
[4] See https://www.frbsf.org/research-and-insights/data-and-indicators/proxy-funds-rate/ for regular updates of the US proxy funds rate.

[5] To account for the importance of banks in the euro area, the second proxy rate also includes retail banking interest rates.

[6] Securities held by the Federal Reserve have decreased by $ 1800 bn, thus explaining the reduction in the size of the balance sheet, which has been shrunk by 21% since April 2022.

While the proxy rate in the euro area remains below the policy rate, it is noteworthy that its increase – and notably the increase of the Proxy2 rate – is of the same order of magnitude as the increase in the policy rate: 4.2 points between December 2020 – its COVID-19 pandemic trough – and July 2024.[7] It may also imply that the bulk of QT is yet to come, as securities held for monetary policy purpose will continue to decrease, so that the ongoing loosening cycle of monetary policy may not be as expansionary if only assessed through the policy rate.

Graphique 2: A proxy policy rate for the euro area



Sources: BCE, Refinitiv Eikon Datastream, authors' computation.
Last known data point: September 2024.

The computation of a proxy policy rate for the ECB shows that the monetary policy stance in the euro area has not been more restrictive than what the increase in the policy rate would suggest. This is in contrast with the US monetary policy stance where the proxy funds rate has surpassed the Federal funds rate. As a side conclusion, attributing the decline of inflation to ECB monetary policy stance would assume a very strong effectiveness of monetary policy. (Romer and Romer, 2023) argue that it takes two years before a monetary contraction actually has an impact on the US inflation rate; it reduces it by 1.5 percentage point in comparison with a no-policy baseline. Two years have now passed since the peak of inflation in October 2022 and the euro area inflation rate has declined by almost 8 percentage points. It is difficult to conceive that such a large impact on inflation could have stemmed from this monetary contraction.

Doh T., Choi J. (2016). “Measuring the stance of monetary policy on and off the zero lower bound,” *Federal Reserve Bank Kansas City Economic Review*, n° Third Quarter, pp. 5–24.

[7]The Proxy1 rate increase is yet a bit smaller : 3.1 points.

Romer C.D., Romer D.H. (2023). “Presidential address: Does monetary policy matter? The narrative approach after 35 years,” *American Economic Review*, *113*, n° 6, pp. 1395–1423.

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