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ECB Objectives and Tasks: Price Stability vs. Lender of Last Resort

Jean-Paul Fitoussi

Executive Summary

Both the action and the communication strategy of the ECB rely on the assumption, explicitly stated, that inflation is always a monetary phenomenon, and that the interest rate instrument should be devoted exclusively to dealing with inflation pressures. According to this prior, the ECB structured its intervention in the interbank market around short term liquidity injections, leaving the interest rates unchanged. This strategy is different from the one pursued by the Fed, that instead used (especially in a first phase) interest rate cuts to reduce the interbank rates. Both strategies were efficient in reducing short term interest rates to their 'normal' level. But they proved different in what concerns their effect on longer term rates. The rate reduction of the Fed also had effects on long run rates, while the spread in the euro zone remained quite high. Thus, from a macroeconomic perspective the two strategies are different, the one followed by the ECB being more restrictive. We may think that this was not an unintended consequence, as the ECB had explicitly asserted its will to tighten its monetary stance. The Briefing paper concludes highlighting the risk, for the ECB credibility, of such an indirect strategy.

During the last audition in front of the Committee for Economic and Monetary Affairs President Trichet defended the ECB stance in the midst of the subprime crisis, advancing a revised and sophisticated version of the neutrality argument.

President Trichet's argument can be summarized as follows:

- *First*, in line with monetarist thinking, inflation is an essentially monetary phenomenon, at least in the medium-to-long run. As I noted in a previous Briefing Paper, this essential and somewhat radical assumption explains the particular importance that money aggregates growth takes in the actions and communication of the ECB; it also explains the refusal to consider differences between headline and core inflation when assessing monetary conditions in the Euro area.
- *Second*, in accordance with the treaties, any other policy objective of the ECB has to be subordinated to the inflation objective.
- *Third*, the main instrument to affect the intermediate objective of money growth remains the interest rate, in spite of the increasing difficulties posed by the development of financial markets. As a consequence, interest rates only have to be used to keep inflation near the objective level of around 2%.
- *Fourth*, other problems, as for example ensuring liquidity needs of the banking sector in order to avoid a systemic crisis, need to be addressed without hampering the main objective of price stability; thus, on one side interest rates cannot be used for other objectives, and on the other any other operation by the ECB should not affect the medium run target growth rate of money supply.

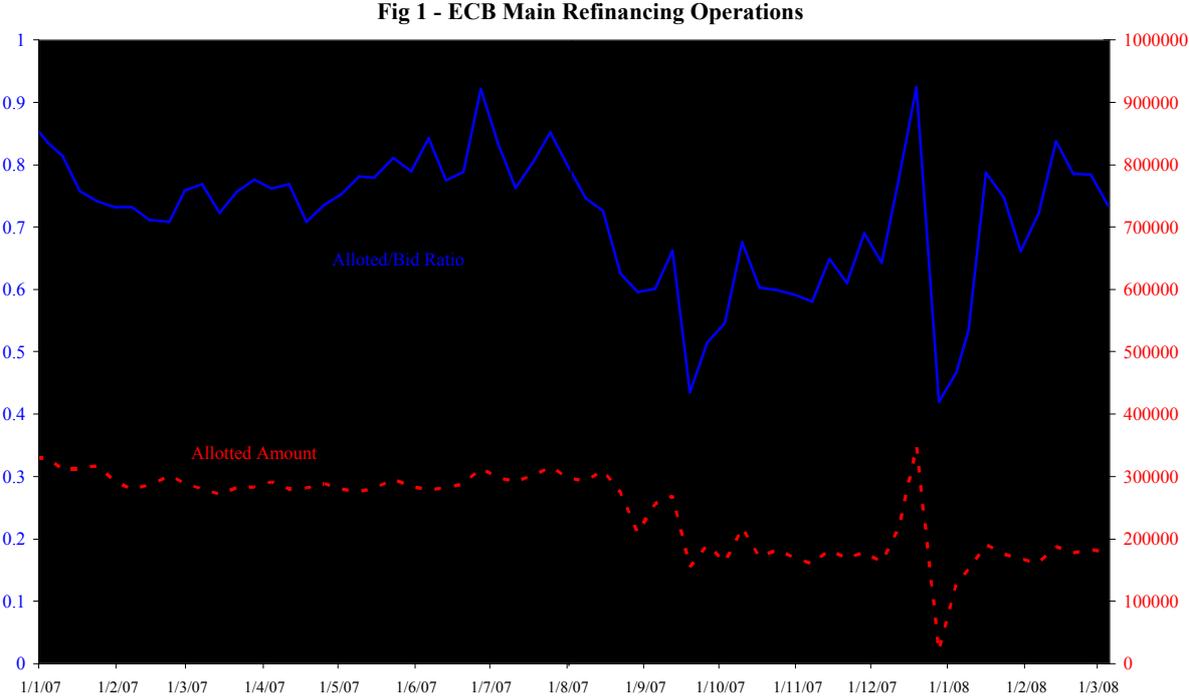
Consistently with these arguments, the ECB has followed in the past months a straightforward and predictable strategy, both in its actions and in its communication strategy.

The Crisis and the Need for a Lender of Last Resort

The subprime crisis represents a typical case in which solvency and liquidity problems are difficult to disentangle. Nevertheless, it is almost a unanimous opinion that in late August and in September the crisis was hitting the credit sector without regard to the actual solvability of the individual institutions, thus creating an important systemic risk. Thus, in spite of the difficulties for central banks to act as Lenders of last resort (LLR) in a context of increasing sophistication of the financial system, the praise for the early intervention of the Fed and the ECB was unanimous. Nevertheless, this intervention took a very different form across the ocean.

The ECB and the Fed in Action, Fall 2007.

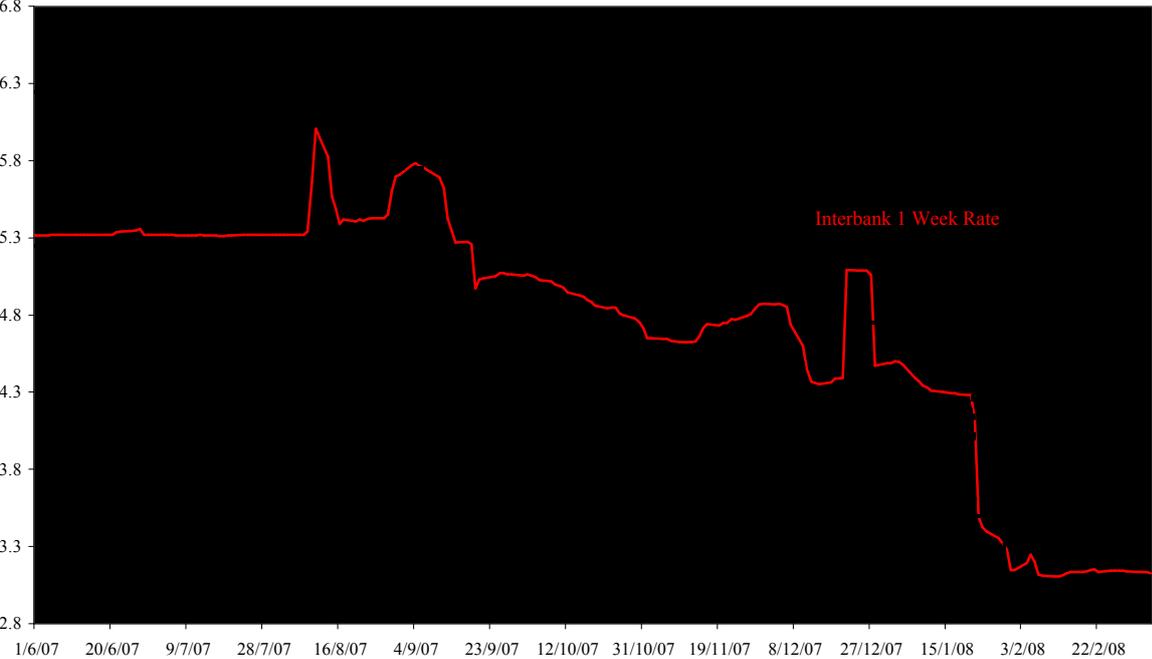
The ECB remained faithful to its credo and to its priorities. The key Euro area interest rates stayed unchanged since the latest rise, in June 2007 that brought the marginal lending facility rate at 5% and the Main Refinancing Rate (REPO) at 4%. At the time the ECB had hinted about further raises in the fall that it did not carry on. On the other hand, the grimmer growth outlook, and the significant rate cuts of the Fed, that triggered a troublesome appreciation of the Euro, did not induce the ECB to revise downwards its rates, nor to foresee possible cuts in the future.



The subprime crisis was primarily dealt with through short term refinancing operations that provided the very short term liquidity that the system needed, without nevertheless increasing the long term amount of money. If we look at figure 1, where I plotted the allotted funds in the weekly auctions for REPO markets (7 or 14 days), and the ratio of the allotted value over the bid value (a broad indicator of demand rationing), we can observe that no major trend appears between the January-July and the August-January periods. In fact, the average allotted funds even slightly decreased in the second half of the year. Thus, overall, liquidity injections in the system stayed constant. What changed, on the other hand, are the variability of both the allotted funds and the ratio of satisfied bids. These two facts, taken together with the lack of intervention on interest rates, prove that the ECB was eager to provide the required liquidity to the system, but only on a very short term, to avoid fuelling inflation.

The strategy pursued by the Fed was rather different. At least in an initial phase, the US central bank used the interest rate instrument to curb the interbank rates (LIBOR), and to inject liquidity into the system. The first reaction of the Fed was a reduction of the Primary Discount Rate, in order to narrow the band for short rates (figure 2). Subsequently, the Fed cut all rates in five different occasions, keeping the window constant. Overall, Fed Funds target

Fig 2 - Federal Reserve Target Rates and Interbank Short Rate.



rates went down 225 points in 4 months.

Late in the Fall, the Fed also turned more massively to open market operations, most notably through the creation in December 2007 of the Term Auction Facility (TAF), where banks could borrow using a broader set of assets as collateral, thus transferring part of the risk of bad loans to the Fed. The TAF has been successful in providing the short term liquidity that the system needed. Facing continuing turbulence on credit markets, on March 7, 2008, the Fed announced that it will almost double the amount allotted through the TAF in the auctions due to take place in March¹.

¹ <http://www.federalreserve.gov/newsevents/press/monetary/20080307a.htm>

Fig 3 - ECB Target Rates and Interbank Short Rate.

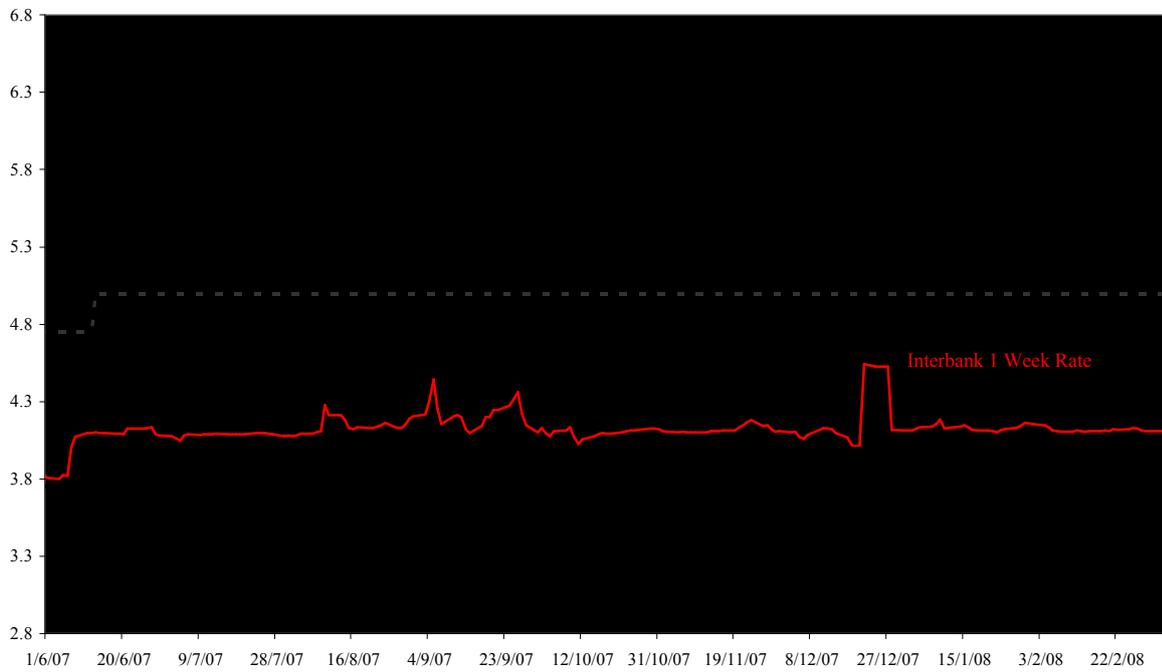
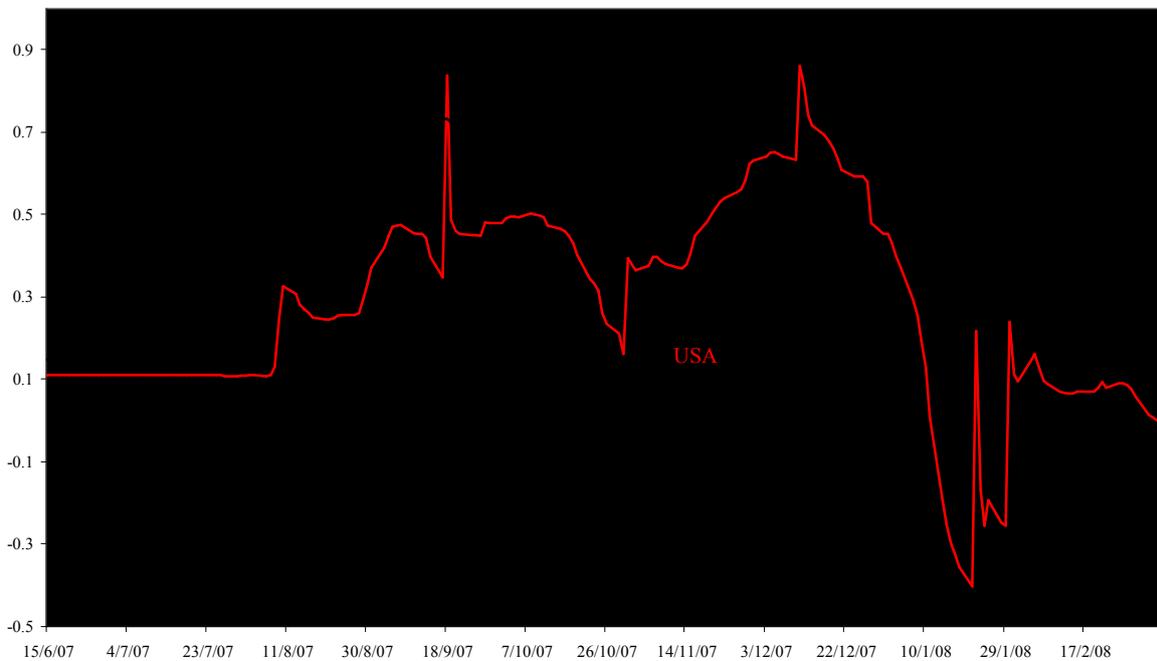


Figure 3 shows the reference interest rates for the ECB and the 1 week Euribor. By comparing it with figure 2, it may easily be verified that while very different, both strategies succeeded so far in bringing down to acceptable levels the spread between short term rates in the interbank market and the target rates. It may actually be said that the ECB was more successful in stabilizing short rates, even if this is explained to a large extent by the different severity of the crisis in the two zones.

Fig 4 - Spread between 3 Months Interbank Rates and Target Rates



Nevertheless, broadening the perspective we realize that the two strategies yielded very different outcomes in the credit markets, with potentially important macroeconomic consequences.

The choice of neglecting interest rates and focussing on short term liquidity injections, while successful to compensate the short term rate hikes, was not neutral with respect to the yield curve. Figure 4 shows the spread between the long term (3 months; higher maturities yield very similar graphs) interbank rates and the target rates for the two areas. It can be seen that this spread was comparable in June 2007, while today it is much higher in the Euro zone than in the US. Access to long term credit is today more expensive in Europe. The strategy followed by the Fed, as of today, seems to have been more neutral with respect to the yield curve, and to have worked in providing liquidity to the system while not tightening the monetary stance.

What the recent events seem to have proven, furthermore, is that it is impossible to cut the link between interest rates and liquidity. Using both instruments (and even mainly interest rates, as seems to have been the case with the Fed) is less disruptive and more effective. After all, the existence of such a link should not come as a surprise. We have known for a long time from standard textbook analysis that the link between interest rates and liquidity may be broken either because interest rates are abnormally low, or because money is perfectly neutral. The first case, known as the “liquidity trap”, is a pathological situation in which monetary policy is notoriously ineffective (Japan is the most famous and recent example of such a case). For what concerns money neutrality on the other hand, it may be argued convincingly that it holds in the long run; but today only the ECB seems ready to behave as if money was neutral also in the short run.

Unintended Consequences or Strategic Choice?

We may attempt at a different explanation for the behaviour of the ECB. Maybe, instead of being excessively dogmatic, it may have simply acted strategically. The ECB could have been aware of the consequences on long term rates of its decision to keep rates unchanged; then, it could have willingly let the markets carry on the restriction of the monetary stance that it had planned and announced before the summer.

Nevertheless, if this explanation were true, the consequences for the macroeconomic environment would not be unintended; but we could have even more serious unintended consequences on the credibility of the institution. Markets would rightly feel that the ECB uses external shocks to implement its policies without clearly stating the objectives. For an institution that has often been accused in its short history to be insufficiently transparent in its decision process and in its policy choices, this could become an even harder problem to resolve than excessive inflation or a recession.

We have to admit though that the period is characterised by a growing uncertainty about the level of the “natural rate of interest”. It may well be that the crisis did have an effect on the latter, may be increasing it, and that we would be in a position to judge what was the best strategy only in retrospect. But our imperfect knowledge about the level of the natural rate of interest itself should lead us to prefer the strategy aimed at combating the gravest danger: depression and debt deflation.