

**Macroeconomics and Monetary Economics****Issues Regarding the Conducting of the Euro Area Monetary Policy during the European Debt Crisis**Adina Criste<sup>1</sup>

**Abstract:** This article provides for the identification of the present challenges faced by the monetary policy of the European Central Bank, given that the sovereign debt crisis has complicated the pursuing of its primary objective of the maintaining the price stability. This research is a part of a larger framework, being a continuation of some previous works related to the issue of the sustainable functioning of a currency area. Based on the research of the international monetary institutions documents, we have presented "the route" of the financial shock and also the challenges facing the European Central Bank monetary policy in the current period and in the short-term perspective. The results reveal that the current crisis has been maintained and enhanced by the conflict occurrence between the "no bail out" clause provided in the Maastricht Treaty, and the "too big to fail" principle applied to the sovereign debt of the European countries. This discrepancy has undermined the confidence in the euro project at a level where the conventional channels of the monetary transmission mechanism do not work efficiently. This topical subject could be a reference for the academic research regarding the European monetary integration process and its new challenges.

**Keywords:** financial shock; interbank market; unconventional measures; European Central Bank policy

**JEL Classification:** E44; E52; H63

**1. Introduction**

The route of the initial shock that triggered the financial crisis of 2007 has been steered and amplified by both the financial factors (the increasing of the funding cost for the financial sector, and hence for the households and non-financial corporations; the general decrease of the asset prices with an impact on the net wealth), and non-financial factors (the pervasive decline of the economic activity which has affected the consumers' confidence and has given rise to a prudential behaviour).

In this time of crisis, the European Central Bank (ECB) monetary policy is facing with a number of challenges related to the maintaining the price stability and to the fostering the lending activity of the economy, given the uncertain environment with

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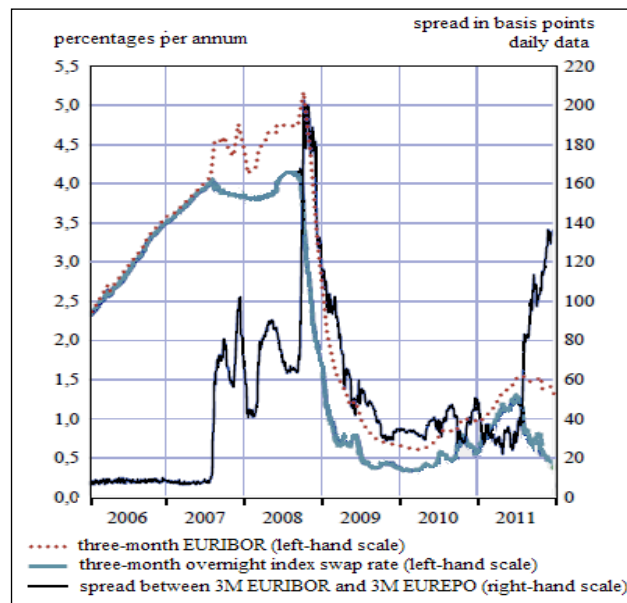
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prudent investors and given the profoundly damaged fiscal sustainability for some Eurozone Member States.

## 2. The Interbank Market: The Spreading Stage of the Financial Shocks

In the Euro Area, the global financial shock has been most visibly reflected in the rising the gap between the different types of the interbank interest rates. Thus, in autumn 2008, the interbank market has quickly shown the engender of the Lehman Brothers bankruptcy shock<sup>1</sup> by rising sharply the spreads between the monetary policy interest rates and the short-term interbank interest rates: EURIBOR and OIS (overnight index swap rates). Those latter have sharply increased at the historic levels (see Figure 1).

During this period, the demand for liquidity to banks became very volatile, increasing the preference for ensuring long-term liquidity and severely affecting the redistribution of funds in the interbank market (Cecioni, Ferrero & Secchi, 2011).

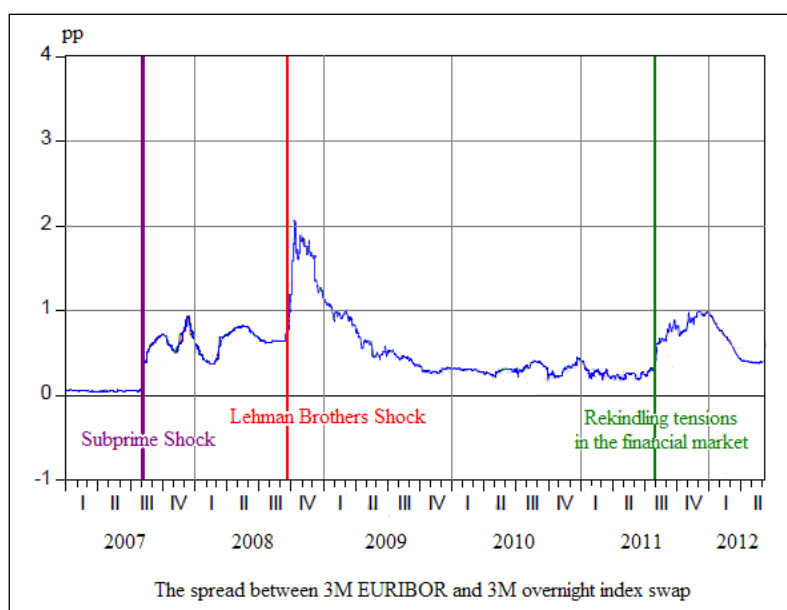


**Figure 1. The financial shocks in the interbank market**

*Source: European Central Bank, Annual Report 2011*

<sup>1</sup> The disruptions exhibited in the interbank market are generally an accurate signal for the evaluation of the financial shock intensity. The initial shock, in August 2007, a specific and a local one (the “subprime” shock), has also been strongly reflected in the interbank market.

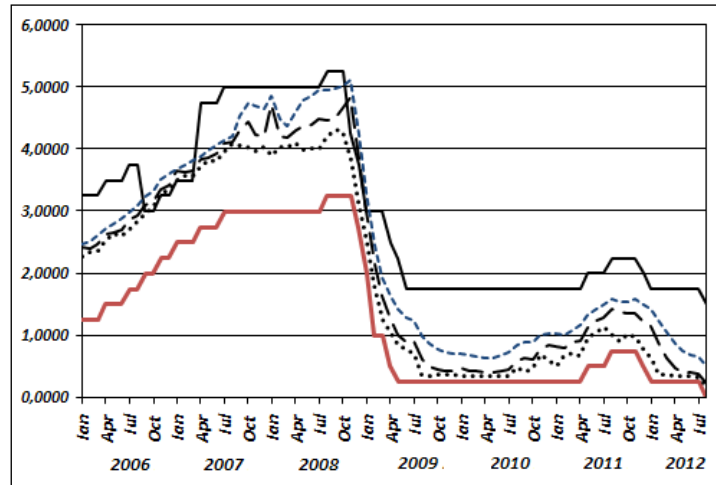
The increasing of spread between the secured interest rate (the three-month overnight index swap rate) and the unsecured interest rate (the three-month EURIBOR rate) signals the propagation of the shock in the interbank market. Generally, the disturbances developed in the interbank market represent a fairly accurate indicator for assessing the financial shock intensity. Hence, the initial shock of august 2007, the “subprime” shock, has been also strongly reflected in the interbank market (see Figure 2).



**Figure 2. The signalling of the financial shock propagation in the interbank market**

*Source: Collignon, Esposito, Cui (2012)*

The transmission of the Lehman Brothers shock has deepened the financial crisis already started in 2007 and in response to this shock, the ECB has intervened extensively in the money market by reducing the monetary policy key interest rates and by expanding the area of application for the unconventional measures. As it is shown in the Figure 3, the ECB has significantly decreased the official interest rates between October 2008 and May 2009.



**Figure 3. The development of the interbank interest rate(%)**  
*Source: Statistical Data, ECB*

In normal times, when the interbank market operate in a functional manner, the signal of change in short term interest rates cause changes in expectations and portfolio balance, which further influence other interest rates, longer term and thus eventually send in the real economy (through the two channels - the credit channel and the borrowing channel). In times of financial market turbulence and uncertainty, the interbank market is “locked” by the arising of liquidity problems so that solvent banks may have difficulties to borrow. In this case, signals using conventional tools of monetary policy are no longer effective.

The asymmetric information, specific to the financial market, underlies of the problems in the interbank market. There are three sources that can cause problems in the interbank market (Freixas et al., 2000): the uncertainty related to the banks’ solvency (the interbank market has access to only the incomplete information); the cautious behaviour of the interbank market players in times of crisis; the liquidity on the interbank market could evaporate because of the prudential behaviour of banks (a bank refuses to lend the other bank when it cannot be reliable that it will be able to cover its own liquidity shortage by borrowing from other banks). These expectations could become self-fulfilling and to prevent such a circumstance, the interbank market must be controlled by a credible institution, as a lender of last resort – features that a central bank should have.

### 3. Current Challenges for the Monetary Policy

The “freezing” of the interbank market in eurozone has subsequently influenced the developments of the longer-term interest rates, including those of the sovereign bonds issued by the eurozone’s countries. The distrust manifested by investors regarding the ability of some European countries to pay their debts, has fuelled the risk aversion, entailing a fragmentation of the Euro Area financial markets, highlighted by the increasing interest rate differentials. During the periods when the government bonds are considered “risk-free” securities and liquid instruments, the yields on the government bonds influence significantly the conduct of monetary policy transmission to the real economy. The changes of monetary policy interest rates (both current interest rate and expected interest rate) are conveyed on the interest rates for sovereign bonds.

Since the end of 2008, the relation between the monetary policy impulse through the interest rate channel and the yield for sovereign bonds has been altered by the effects of the Lehman Brothers shock, given that the financial market behaves in a procyclic manner. Therefore, some sovereign bonds (those issued by the governments of “vulnerable” economies) have begun to be affected by high and volatile risk premium. In these circumstances, the monetary policy has no longer the main responsibility for “establishing” the developments of government bonds yields, thus disturbing the signal conveyed to the real economy.

Since 2009, it has been observed a close relationship between the evolution of the bank credit risk and the evolution of the sovereign risk, and this feature represents a major impediment in eliminating the crisis effects in the Euro Area. On the one side, the rising of sovereign risk harms the bank credit risk through the banks’ exposure to the government debt. This generates the deleveraging pressure, with massive sales which could bring financial “disorders”. On the other side, the “weak” banks increase the government burden. These two effects reinforce each other and create a vicious circle. For banks, increasing their own credit risk makes more difficult their refunding. In short, the unsecured funding is affected by the increased of the bank risk perception, while the secured funding is undermined by the deterioration of collaterals. Such a perception represents a significant barrier in guaranteeing loans to the real economy. Since in the Euro Area, the credit institutions are the main funding source, the credit flow towards the private sector might be jeopardized. With no room for reducing short-term interest rate (which is near zero), and in order to address and to mitigate these distortions created in the different segments of the financial markets, with repercussion on the real economy, many central banks have appealed to different unconventional measures.

### 3.1. The Unconventional Monetary Policy Channels

Cecioni, Ferrero, Secchi (2011) display the way the unconventional monetary policy measures work, showing that they are transmitted through two channels to the economy: the signalling channel and the portfolio-balance channel. Below, we present shortly both channels described by these authors.

**The signalling channel** is activated through the communications made by the central bank aiming at informing the public about its intentions concerning the future developments of short-term interest rates, the purchase of financial assets, or the implementation of other measures in order to eliminate market dysfunctions. An effective functioning of this channel is based on a high credibility of the central bank, allowing to rebuild the confidence in financial markets and to influence the public expectations about the policy decisions, and the development of long-term interest rates. These communications are considered unconventional monetary policy tools when they communicate information that go beyond the central bank usual practice.

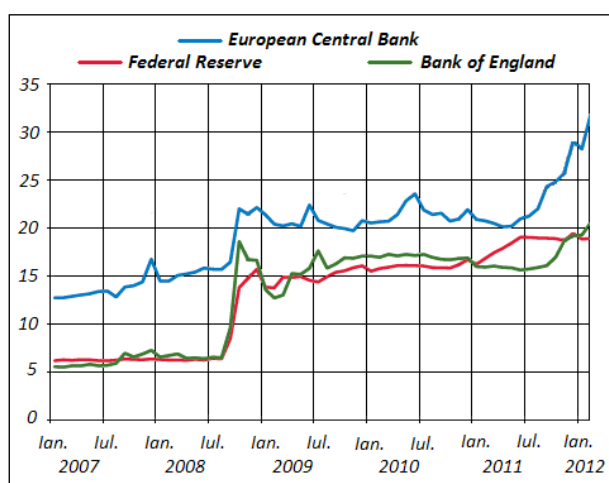
**The portfolio-balance channel** is enabled through the specific operations of a central bank: securities purchase, liquidity injections, asset swaps. Such operations modify the size and the structure of the balance sheet of both the central bank and the private sector. The central bank is the only economic agent that can lead to large scale such specific operations, because it has the power regarding the provision of monetary base. An effective functioning of this channel is based on the imperfect substitutability among private sector's balance sheet items. The specific operations held through this channel aimed at influencing prices in some "dysfunctional" segments of financial market, or alleviating the financial frictions exerted on the funding conditions. During a financial crisis, the creditors might prefer to provide funds only for short- time periods, increasing the risk for a collapse of credit availability. In this case, the central bank can enhance the liquidity provisions to credit institutions in order to accommodate the increased demand for precautionary reasons. When there are tensions generated by the liquidity mismatch between the asset and the liability side of private banks, the central bank can decide to provide liquidity for longer terms, thus sustaining the amount of credit offered to the economy and reducing term spreads.

Cecioni, Ferrero, Secchi (2011) remark that a too prolonged exploit of these unconventional measures might generate market distortions.

Bernanke and Reinhart (2004) have shown that there are three strategies of monetary policy to stimulate the economy when the monetary policy interest rate has reached or is close to its minimum level (0), namely:

- ensuring investors that short-term interest rates will be kept at low levels in the future;

- changing the relative supply of securities market by changing the composition of the central bank balance sheet;
- increasing the size of the central bank balance sheet beyond the level corresponding to zero interest rate monetary policy. This strategy is one of the *quantitative easing* (QE). The manner of its implementation is different from country to country, depending on the specific interactions between the banking system and the monetary authority and the primary targets of monetary policy. Such measures have been reflected in the balance sheet of these central banks, which have substantially increased (see Figure 4).



**Figure 4. The evolution of the central bank's balance-sheet (% of GDP)**

Source: IMF, 2012

In USA and UK, the central banks (Federal Reserve and Bank of England) have applied the QE strategy by purchasing financial assets in order to influence the long-term interest rates, especially those of government bonds. At the European level, such a policy has meant an extended refinancing operations conducted by central banks of the Eurosystem which provides liquidity lending in large quantities loans at fixed interest rates.

The difference between the policy of Bank of England, or Fed, and the policy of the European Central Bank is primarily an institutional one: while for the Bank of England or Fed, the decision of purchasing government bonds is a directly one, because there is a single monetary policy, but also a single fiscal policy (the government's policy), for the ECB such a decision is more difficult, because it should take into account more governments.

### 3.2. Unconventional Measures applied by the European Central Bank

During the crisis, the ECB has implemented measures that have not distorted the overall monetary policy strategy, but they were completed it. It was noticed a complementary relationship between the unconventional measures and the interest rate policy in times of financial crisis.

In October 2008, because the financial turmoil has triggered significant disruption and liquidity shortages in different financial market segments, the ECB decided to conduct its refinancing operations with fixed rates and full allotment (ECB, 2009). The purpose of these operations was to support the availability of credit to the private sector and to eliminate tensions and disruptions in the interbank market.

In spring 2010, the Governing Council decided to implement a program to purchase the government and private debt securities issued by euro area countries (*Securities Markets Programme*). This decision was taken, besides others, in the context of the increasing uncertainty of investors with respect to the sustainability of public finances in some euro area countries, in order to address the disturbances manifested in the government bond markets of such countries and to eliminate the risk of contagion to other bond issuers. Through this program, it has been pursued the restoring of an adequate functioning of the monetary policy transmission mechanism, addressing the malfunctioning of some financial market segments (the government and private debt securities markets). The purchasing operation of such assets has not injected the extra-liquidity in the financial markets, because it has been sterilised through the weekly collection of fixed-term deposits from the banking sector (ECB, 2011). The purchase of these securities has been significant until the beginning of the 2011. Between February and July 2011, these interventions have been very limited.

In the second half of 2011, the tensions in financial markets have increased significantly. In order to counter the risk of impairing the monetary transmission mechanism, the ECB decided to apply unconventional monetary policy measures during August-December 2011<sup>1</sup>. Thus, in August 2011 the Governing Council announced that it would start again actively to implement the SMP in order to eliminate both the increased risk for a malfunctioning of government debt markets and the tensions running on other markets. The ECB also decided to expand the field of assets accepted as eligible collateral for its refinancing operations, through the *Covered Bond Purchase Programme*. The covered bonds are an important category of assets for financing the banks and the economies of the Euro Area. The application of unconventional measures aimed at: reducing the maturity in the money market; easing funding conditions for credit institutions and companies; encouraging the credit institutions to maintain or to expand lending activity to

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<sup>1</sup> For a more detailed presentation, see *ECB Annual Report 2011*, pp. 14-16.



firms and households; and improving the liquidity in the important segments of private debt securities market.

The study conducted by Cecioni, Ferrero and Secchi (2011) argues that the unconventional monetary policy measures have supported financial intermediation by providing liquidity to the solvent banks and by restoring the confidence among the market players, helping to maintain the viability of the banking system and of the important financial market segments. However, the authors underline there is considerable uncertainty concerning the quantification of the unconventional monetary policy effectiveness.

The significant increase in the ECB's balance sheet due to its interventions made to absorb the shocks from the financial markets (in the context of the reducing space for maneuver the interest rates and applying unconventional measures) involves certain risks related to the monetary policy conducting in the next stage. Caruana (2011) states out the inflationary pressure risk, the financial instability risk, the risk of potential financial market distortions and the risk of the conflicts created with the authorities managing the government debt. Therefore, the risks related to the price and financial stability for the next period should be closely monitored, and the best way through which monetary policy can support this process is the formation of low inflationary expectations of the private sector. But this is only a necessary condition, and not a sufficient one, since the monetary policy must be supported in this direction by the other macroeconomic policies.

#### **4. Conclusions**

The transmission of the Lehman Brothers shock has deepened the financial crisis already started in 2007 and it was firstly reflected in the interbank market. The European Central Bank has entered in a new phase for conducting its monetary policy. It has intervened extensively in the money market by reducing the monetary policy key interest rates at the lowest levels and by expanding the area of application for the unconventional measures.

The challenges of the European Central Bank have emerged in the context of the increasing uncertainty in the financial regarding the ability of some European countries to pay their debts. This situation has fuelled the risk aversion, and the increasing of interest rates on the sovereign debt, affecting the public and the private sector. The sovereign debt crisis effects denote a strong relationship occurrence between the public sector debt and the private debt, between the bank credit risk and the sovereign credit risk, encumbering the monetary policy tasks.

Another challenge for the monetary policy emerged from the fragmentation of the Euro Area financial markets, highlighted by the increasing interest rate differentials. Such a case demonstrates that the membership of a currency area does

not automatically guarantee a smoothly distribution of risk. Investors will always make the difference between countries depending on the economic and political position of each one. Even if the currency area is a well defined institutional entity, the economies of that system are also well defined entities. This situation creates a conflict between the local and the global (the monetary union) management – another challenge for the common monetary policy and generally, for the governance of the eurozone.

The crisis of sovereign debt in the Euro Area was maintained and amplified by the existence of the conflict between two principles of macroeconomic policies: the "no bail out" clause and the "too big to fail" principle applied to sovereign debt of the European countries. This conflict has actually undermined the confidence in the euro project at a level where the conventional channels of the monetary policy do not work effectively.

The conduct of monetary policy in the current crisis is a difficult task, also because its primary objective, the price stability, cannot be considered a sufficient condition for the financial stability.

The European Central Bank can best contribute to the financial stability by a firmly anchoring of the inflation expectations at low levels and by providing liquidity needs of the financial system, but the monetary policy must be supported in this direction by the other macroeconomic policies. Besides the central bank, each sector of the economy, the government, the financial institutions, and the private sector should assume their responsibilities for this general objective.

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