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Monetary Policy in the Eurozone: A Stability-Oriented Policy

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Abstract The article presents the interventions put into effect by the ECB to eliminate the banking system's instability and implement a process to strengthen the Economic and Monetary Union

Keywords Monetary Policy, Bonds, Yield Curve, Spread

1. Introduction

This article highlights the evolution of monetary policy and budget policies following the sovereign debt crisis in the Economic and Monetary Union (EMU). The 2008 financial crisis clearly underscored the limits of the EMU to confront macroeconomic imbalances, guarantee financial stability and avoid contagion of markets.

Within the EMU there is nonetheless the awareness of defending the single currency. To pursue this objective, the EMU has revised its economic governance, better coordinating monetary policy and budget policy. In this new context it has therefore tried not to upset the institutional structure of the Monetary Union, maintaining a single monetary policy focused on price stability and national fiscal policies oriented at reducing excessive public debt.

When the work was finished the econometric analysis.

2. The Single Monetary Policy

In the Eurozone there is a single monetary policy and it is based on a strongly independent Central Bank whose principle objective is to preserve price stability[1] and therefore at the same time to keep inflation in the Eurozone close to but below two per cent[2]. Up until the eve of the financial crisis, the Eurozone showed a low inflation rate and low macroeconomic volatility. The global financial crisis then destabilised the good order. The Central Bank, for its part, responded to the crisis by applying conventional measures to reduce interest rates[3]; and to non-conventional measures to support the financial sector[4], or rather, to allow financial institutions to access more financing against abundant guarantees.

These actions, however, have done little to slow the widening of spreads on Eurozone government bonds. All this has had a negative impact not only on the financial markets but also in the real economy and public finances of the area's countries. A contagion effect was subsequently seen in the Member Countries, that is to say, one country's bond yields have influenced the trends of other countries, not reflecting the market conditions. These countries, therefore, encountered an elevated level of debt[5]. Faced with the growing distortions present in the financial markets that put the functioning of the transmission mechanism of monetary policy at risk, the ECB decided to intervene, presenting the Outright Monetary Transactions plan on September 6.

3. The Outright Monetary Transactions Plan

The OMT plan foresees purchasing Eurozone countries' public debt securities on the secondary market. This means an unlimited purchase bonds[6], that is, there is no *ex ante* quantitative limit in the OMT[7]. To guarantee greater transparency, the ECB will publish weekly the quantity and the value of the securities under the OMT plan, while it will publish monthly the average maturity of the quantities, and giving information as well on the countries affected. The purchase of securities is conditioned by the adherence to a

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1 See articles 127, 130 of the Treaty.
2 Between 1999 and 2007 inflation equalled 2.04 percent (ECB, 2012).

3 Between 2008 and 2009 interest rates were considerably reduced.
4 The non-conventional measures consist of: offer of unlimited liquidity at a fixed rate to the Eurozone banks; extension to twelve months of the refinancing operations; increase of the assets used as a guarantee; purchase of guaranteed obligations, that is, covered bonds.
5 This means that because of the contagion effect the Member countries encounter a negative externality. This points out a market failure.
6 The ECB's purchases regard sovereign bonds with maturity of between one and three years.
7 With the new plan, the Securities markets programme has been officially dropped. Since 2010 it purchased bonds worth 211.5 billion euros (ECB, *Sole 24 Ore*).

macroeconomic plan of the European Financial Stability Facility (EFSF/ESM) 8 or of preventative financial assistance, that is, the Enhanced Conditions Credit Line (ECCL)9. This means dealing with a conditioned assistance, and that the ECB can suspend purchases if the country doesn't respect its commitments. The ECB will not be a privileged creditor in these purchases (seniority), but will have the same treatment as other private creditors. This implies that in case of default by the debtor it will encounter the same treatment as the other holders. An exit strategy is foreseen for exiting from the OMT plan. The exit strategy is put into effect when the country that has requested assistance does not comply with the adjustment programme of the European Stability Fund. In this case the ECB blocks the purchase of public securities so avoiding moral hazard by Member Countries 10 . In the setting of the OMT the sterilisation of purchases is also provided for, a measure needed to guarantee price stability. The ECB also involves the International Monetary Fund in the Outright Monetary Transactions; it will cooperate in preparing adjustment programmes for the countries that request help and performs a monitoring role. While this repeats the scheme tried in already-operational rescue plans 11 , the mechanism does however introduce sanctions for countries that request help but do not put the recovery programme into action.

4. Why Review the Governance

The need to amend the governance has matured since the financial crisis, to improve the functioning of the euro area. The economic policies have to too independent excessive macroeconomic imbalances, endangering functioning of EMU. And 'necessary to give a correct interpretation of the TFEU and in particular Article 120 stipulates that the Member States "Shall conduct their economic policies in order contribute the objectives of the Union", and Article 121 States that they "regard their economic policies as a matter of common concern and coordinate them within Council".

It' obvious, therefore, the need to transfer to the supranational levels the governance. However, it is also appropriate to reflect of the opportunity to give a different interpretation of Article 123 of the TFUE, which prohibits any form of credit facility with the ECB in EMU institutions or birdies in difficulty

8 The Economic Adjustment Programme referred to has already been signed by Greece, Ireland and Portugal.

9 ECCL is based on the IMF's Precautionary Credit Line (PCL) benchmark and was instituted by EU member states in July 2011 in order to guarantee a greater capacity for actions by the EFSF. This is a precautionary assistance programme for countries having problems relative to liquidity, the spread and high borrowing costs. The programme foresees the Stability Fund buying securities at auction, lasts one year and can be extended twice for six months.

10 The aid provided to date by the EU, the IMF and the ECB is also subject to periodic exam by the Troika (EU Commission, IMF, ECB) .

11 The Troika scheme is thus proposed again.

5. Empirical Analysis

The analytical expression used is as follows:

	Belgiun	Germany	Ireland	Greece	France	Italy
Belgiun	10000					
Germany	-0.1910	10000				
Ireland	0.6965	0.0608	10000			
Greece	-0.0336	0.2515	-0.1178	10000		
France	-0.8165	0.1520	-0.8531	0.0522	10000	
Itay	0.5000	0.4631	0.5970	0.1321	0.4082	10000

Person's Correlation. Government Stock Long Last 2 Years. Data of Each Month from 06/06/2010 to 18/09/2012.

Data of the Analisys Show the Instability of the Financial Markets.

6. Conclusions

The crisis gave the Economic and Monetary Union cause to reflect on the weak points of the monetary policy and on the need to introduce protective barriers (firewalls) able to contain financial instability in the Eurozone, attempting to avoid the link between bank-risk and country-risk.

With the OMT plan, the ECB has clearly showed its independence and desire to improve the mechanisms of transmitting monetary policy.

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