



Standard monetary policy in the euro area

KEY FACTS

Monetary policy is the primary mission of central banks; it consists in acting on the price of money. By influencing lending rates, monetary policy plays an important role in the economy and has practical consequences for our daily lives.

The European Central Bank (ECB) and the national central banks of the euro area countries (NCBs) together formulate monetary policy and draw up a common strategy. Each NCB is then responsible for implementing it. The primary objective is **price stability, which helps to maintain the currency's purchasing power** and to support growth. "Price stability" does not mean 0% inflation but corresponds to "inflation rates below, but close to, 2% over the medium term".

We speak about "standard" monetary policy as since the 2008 financial crisis the traditional tools have been complemented by a series of "non-standard" measures.

The main instruments of "standard" monetary policy are "**key interest rates**", the rates on the loans the central bank makes to commercial banks. When one of the latter needs liquidity for its cash flow, it can borrow money from the central bank. Changes in the interest rates applied to commercial banks' borrowing have a major impact on those in the rates on the loans granted by banks to the economy (firms, individuals). In the euro area, **monetary policy relies on the banking system to finance the economy; it does not act directly by adjusting the quantity of money, but indirectly through its action on the price of money, i.e. interest rates.** A rise or fall in interest rates, especially if it is rapid, slows or accelerates loan applications and therefore investment and job creation (see "Understanding Standard Monetary Policy – Steering short-term interest rates").

In exchange for their loans from the central bank, banks have to pledge collateral in the form of securities. These financial assets must meet minimum eligibility criteria, for example a satisfactory rating assigned by the rating agencies.

A BRIEF HISTORY

- 13 March 1979: entry into force of the **European Monetary System (EMS)**; first steps towards European monetary integration and the single monetary policy
- 1979: **second oil shock**; the US policy interest rate reaches the exceptional level of 20% in June 1981
- The 1980s: following the two oil shocks and under the influence of the monetarist school of thought and US monetary policy, central banks in developing countries make combating **inflation** their priority
- 1992: signature of the **Maastricht Treaty**
- 1992-1993: **EMS crisis**; speculative attacks force several European currencies to leave the EMS
- 1993: **independence** of the Banque de France
- 1998: the Bank of England Act is passed giving the **Bank of England independence**. Creation of the **European Central Bank (ECB)** and the **Eurosystem**
- 1 January 1999: creation of the **euro**
- 10 March 2016: policy rate lowered to 0% in the euro area

KEY FIGURES

247

billion euro
Average amount of commercial banks' refinancing from euro area NCBs between 1999 and 2007

2.34%

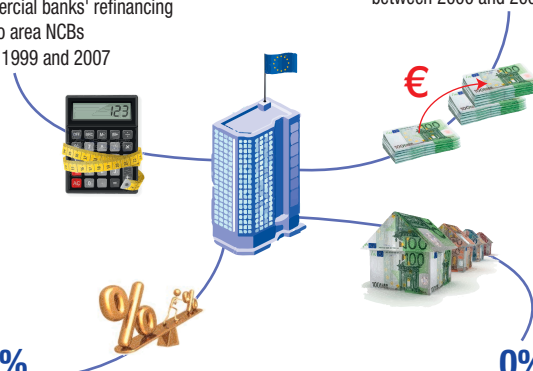
Average inflation rate in the euro area between 2000 and 2004

4.75%

Interest rate on the main refinancing operations in the euro area between October 2000 and May 2001

0%

The lowest deposit facility rate under standard monetary policy, reached on 5 July 2012



UNDERSTANDING STANDARD MONETARY POLICY

Steering short-term rates: the interest rate corridor and minimum reserve system

In order to manage their liquidity, commercial banks have two options:

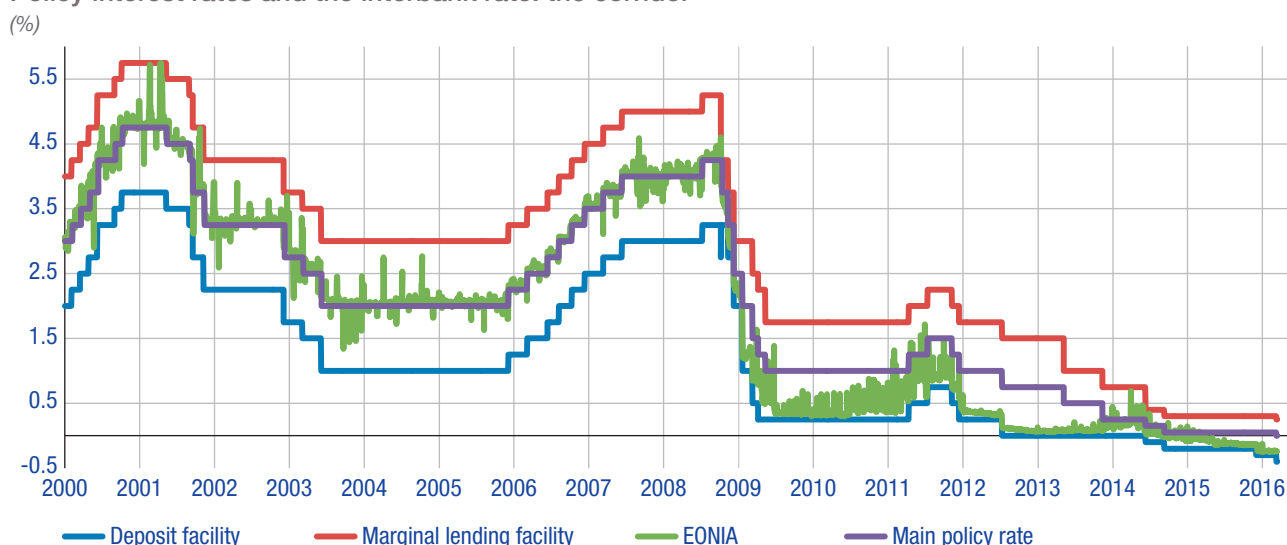
- borrowing from or depositing funds with the **central bank**. Every Tuesday, banks can borrow liquidity for a period of one week. The interest rate is determined by a system of tenders based on the ECB's main policy rate, the **rate on its main refinancing operations**. Banks can raise their bids to be sure of obtaining the amounts they need. By means of this key rate, the central bank steers short-term interest rates, which influence the rates on long-term lending to the economy and thereby economic activity, growth and employment across the board. Banks can also borrow from the central bank for 24 hours, but at a higher rate, the **marginal lending facility rate**. If, on the other hand, they have a temporary liquidity surplus, they can deposit this with the central bank, which remunerates it at the lowest rate of interest – the **deposit facility rate** – which can even be negative (see Non-standard monetary policies);
- borrowing or lending on the **interbank market**. Banks lend liquidity to one another over the very short term. An overnight rate is determined by the interplay of supply and demand: in the case of the euro area this is the **EONIA** rate (euro overnight index average). The interbank rate is set between the central bank's deposit facility rate, which acts

as the “floor”, and the central bank's marginal lending facility rate, which constitutes the “ceiling”. Banks indeed have no interest in lending at a lower rate than the deposit facility rate nor in borrowing at a higher rate than the marginal lending facility rate. This is known as the **interest rate corridor**.

In order to increase its effectiveness, standard monetary policy is also underpinned by a **system of remunerated minimum reserves**: commercial banks **have to deposit with the central bank a proportion of their customer deposits**. The **reserve requirement** of each institution **is calculated as an average over a period of around six weeks**, which helps to:

- **stabilise the interbank market rate**. Provided they fulfil their requirements on average over the period, banks can vary each day the amount deposited in their account with the central bank in accordance with changes in the EONIA. On a given day, a bank can for example take advantage of a high EONIA to lend all of its reserves on the interbank market, which will exert a downward pressure on the EONIA;
- increase the **effectiveness of the pass-through** of key interest rates to the rest of the economy: the reduction of market liquidity increases commercial banks' borrowing needs, which gives key interest rates greater impact.

Policy interest rates and the interbank rate: the corridor



Source: Banque de France.

UNDERSTANDING STANDARD MONETARY POLICY

The fundamental role played by expectations for the credibility of monetary policy

Before the 1980s, monetary authorities regularly implemented “stop-go” policies in close cooperation with the government: these policies aimed to limit temporary disruption to the economy and therefore to accelerate and then slow down growth.

Monetary policy now aims to **promote an environment that is conducive to economic growth, independently** of the public authorities and the electoral cycle, notably by virtue of the **credibility of central banks’ decisions**. When economic agents (individuals, firms and public administrations) can count on the monetary authorities’ ability to curb inflation over the medium to long term, **it is easier**

for them to make **investment decisions**, which are an engine of growth.

This credibility acquired over time is primarily founded on two pillars: **independence** and the **transparency of the objectives and instruments** of monetary policy.

When a central bank’s actions are sufficiently clear and credible, simply announcing future measures has an effect on the economy, as changes to key interest rates are anticipated and passed on by economic agents. This is what is known as the **expectations channel**.



ECB President Mario Draghi’s monthly press conference following the meeting of the Governing Council



As proof of the ECB’s transparency, the minutes of the Governing Council’s monetary policy meetings are now made public ([available on the Banque de France website](#))

TO LEARN MORE

Suggested viewing

- [ECB and the Eurosystem explained in 3 min](#)
- [The Transmission of Monetary Policy – Whiteboard](#)
- [Conventional monetary policy](#)
- [The ECB’s helping hand - monetary policies explained - real economy](#)

Useful links

- [Monetary policy](#) (Banque de France website)
- [Main euro area interbank market rates](#)
- [The history of economics and money](#)
- [The ECB’s Governing Council](#) (European Central Bank)
- [European monetary policy](#) (European Parliament)