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ABSTRACT:

Bernhard Herz

A Taylor rule for the ECB's unconventional monetary policy - a critical link perspective

During the last decade the European Central Bank's conventional monetary policy reached its limits when interest rates approached their effective lower bound. Like other central banks worldwide the ECB then moved to an unconventional policy of quantitative easing and introduced its Asset Purchase Programme (APP) with massive purchases of particularly public but also private bonds. We modify the well-known Taylor approach, a very valuable tools to examine conventional interest rate policies, to analyze unconventional asset purchases with the focus on two questions. (i) What are the drivers of ECB's unconventional monetary policy? Was the change in monetary instruments also accompanied by a change in monetary targets, in particular a greater emphasis on financial stability? (ii) Did the ECB also move from a policy orientated at the euro area average to a policy focused on the developments of specific (crisis) countries, the so-called critical link approach. In our empirical analysis we find that price stability, the exclusive legal target of the ECB, was not a determinant of asset purchases. Instead financial stability considerations seem to have dominated unconventional monetary policy. In particular we find evidence in line with the critical link hypothesis that financial stability concerns with respect to Greece and Italy did matter. More specifically Greek fiscal conditions as measured by the spread of Greek bonds vers bunds as well as the conditions of the Italian banking sector as indicated by the ratio of non-performing loans had a significant effect on the ECB's monthly asset purchases. Obviously, these fiscal and financial conditions are highly interconnected due to the well-known banking sovereign nexus.