cash management INTEREST RATES

IS THE CENTRAL BANK A PILLAR OF STRENGTH?

JONATHAN CURRY LOOKS AT THE EUROPEAN CENTRAL BANK – SET UP TO TAKE CHARGE OF MONETARY POLICY FOR COUNTRIES USING THE EURO – AND THE CHALLENGES ITS POLICIES CREATE FOR EUROPEAN CORPORATE TREASURERS AND MONEY MARKET FUND MANAGERS.

The European Central Bank's (ECB) objectives with regards to monetary policy can present challenges for treasurers and money market fund (MMF) managers when they are trying to predict the future direction of euro zone interest rates.

The primary objective of the ECB is to maintain price stability, which is defined as maintaining price increases below 2% over the medium-term.

In pursuit of this goal the ECB adopted a 'two-pillar' strategy. The first pillar assigns a 'prominent role to money' whereby the ECB monitors the three-month moving average growth rate of M3 relative to a reference value of 4.5%. The prominence given to tracking M3 reflects the strong influence of Germany's Bundesbank in setting the strategic goal of the ECB in the run up to the launch of the euro in the late 1990s.

The second pillar encompasses all of the "economic and financial indicators which affect price developments." Unlike the US Federal Reserve (USFR), which has a broader remit, the ECB focuses solely on price stability on the assumption that only monetary policy can influence price levels in the economy.

For this reason, the ECB does not have an objective for real income levels or for, for example, the rate of unemployment. The ECB clearly has a defined objective for its monetary policy decisions and two specific targets to guide it.

However, there has been an ongoing debate about the relevance and importance of the first pillar. It has been argued that there is evidence to suggest that, for economies with a low inflation record, there is no clear link between monetary growth and inflation, even in the long run, which brings into question the relevance of using a monetary target. Despite all the attention given by the ECB to the first pillar, M3 growth – in relation to the reference value set by the ECB – has failed to be a good guide to interest rate decisions. Indeed, the correlation between the ECB's repurchase rate and M3 growth has been negative since the start of European Monetary Union (EMU).

This lack of clarity between the ECB's stated objectives and actual decisions produces challenges for MMF managers and corporate treasurers who are trying to predict the direction of the official repurchase rate, which is a key driver of interest rates across the money market curve. Downgrading the importance of the first pillar would help to align policy, with ECB actions increasing transparency to the market.

Debates have also taken place over the appropriateness of the price stability point target of 2% over the medium-term. Most other central banks that have adopted inflation targets have set a point target with a tolerance range either side, such as that set for the Monetary Policy Committee (MPC) of the Bank of England, or they have set a target range which is usually 2% wide. This gives a degree of flexibility to deal with temporary movements in inflation that are not deemed to be a threat in the long-term.

It is also sometimes argued that this issue is exacerbated for the ECB as it uses the headline inflation level in its target as opposed to a measure of core inflation – this is used, for example by the USFR. Core measures of inflation filter out the more volatile components and temporary factors, which occur in the headline inflation figures, but which are unrelated to price trends.

There is evidence to suggest that the ECB has become increasingly tolerant of inflation in a range of 2-3%. Since the beginning of 2001, inflation has been below 2% in only seven out of 42 months, yet interest rates have fallen from 4.75% to 2.0% during this period. In explaining its policies the ECB has stressed the medium-term nature of its price stability objective.

A number of suggestions have been made to help improve transparency, such as, over what time horizon the definition of price stability should apply? Gaps between stated objectives and actual policy can produce challenges to managers of MMFs and corporate treasurers in predicting the direction of the ECB's repurchase rate.

It has also been argued that other major central banks have a greater degree of transparency around their monetary policy decision-making. For example, the USFR and the UK's MPC release formal minutes from their policy decision meetings. The release of these minutes gives the Federal Reserve and the MPC an opportunity to explain any changes in policy and tell the markets the key issues they are focusing on when considering interest rate decisions.

Both institutions also use speeches or testimonies from members to highlight current issues affecting their deliberations on monetary policy. They sometimes try and point market participants in the right direction if they think that markets are pricing in interest rate levels that are out of line with the policymaker's central case for rates.

However, the ECB does score highly in terms of adding clarity around its thoughts on monetary policy in two areas. One is the detailed monthly bulletin it releases which gives information and comment around economic and monetary developments affecting the euro zone. The other is the detailed statement the ECB Governor makes after every alternate fortnightly rate-setting meeting, together with the question-and-answer sessions held after the release of the statement.

When managing MMFs, one of the key objectives is to maintain the fund performance in line with its benchmark on a consistent basis. Uncertainty around the direction of short-term interest rates generates volatility in the money market curve which creates problems for the MMF manager.

A central bank which aims to have a transparent monetary policy process will enhance its credibility with market participants and help to reduce volatility at the shorter end of the yield curve. Avoiding any confusion by explaining deviations from the established monetary policy framework will also help. The ECB goes some way to meeting this requirement but, compared with other leading central banks, there is still room for improvement.

European Central Bank/Frankfurt. Photo: Christoph Lison and Claudio Hills

Jonathan Curry is Head of Global Cash Management at Barclays Global Investors.
jonathan.curry@barclaysglobal.com
www.barclaysglobal.com