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Spillover of the ECB's monetary policy outside the euro area: How different is conventional from unconventional policy?☆

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Abstract

This paper compares the macroeconomic impact of conventional and unconventional ECB policy actions on the euro area and its spillover to six EU countries outside the euro area (the Czech Republic, Denmark, Hungary, Poland, Sweden and the UK). The comparison is based on a synthetic index of overall euro area monetary conditions (MCI) obtained by factor analysis, and specifically on two sub-components of the MCI, one tracking the conventional and the other the unconventional policy of the ECB. A standard monetary VAR shows that the transmission of unconventional monetary policy in the euro area is quite different: prices react more quickly, but the response of output is delayed and weaker. A block-restricted VAR is then used to measure the spillover of ECB policy abroad. The importance of euro area monetary policy for macroeconomic developments is confirmed for all six countries. A conventional monetary shock affects inflation and output in largely the same way as within the euro area. Unconventional measures have generated a variety of responses. Overall, exchange rates respond rather quickly, the effect on the real economy is slow and limited (like in the euro area) and, in particular, inflation often remains unaffected.

Keywords: Monetary policy; ECB; Unconventional measures; VAR; Synthetic indicator

JEL classification: E58; F42

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1. Introduction

Since the onset of the global financial crisis, the ECB, like other major central banks, has drastically cut interest rates in response to the unravelling of the financial system and resorted to a number of unconventional monetary policies (UMPs) that make extensive use of the its balance sheet[1]. The importance and effectiveness of the newly developed instruments have been evolving constantly over time. The ECB's policies were originally aimed at tackling liquidity shortages in the banking sector and keeping the money market working with enhanced credit support. As the debt crisis escalated, additional stimulus measures were introduced to support specific financial market segments, most notably sovereign bond markets (Eichengreen, 2012). The role of unconventional instruments has further increased since the ECB policy rate hit the zero lower bound (ZLB), given that the economic recovery has been frail and inflation subdued. The Public Sector Purchase Programme (PSPP), i.e. de facto fully fledged quantitative easing adopted in 2015 to tackle disinflationary trends in the euro area, represents the latest chapter in this story.

Monetary policy adjustments by a major central bank spill over to other countries. The size and discretionary nature of unconventional instruments modify the transmission of conventional policy effects. The spillover works in this case through a variety of channels, including the traditional interest rate channel (Chen, Filardo, He, & Zhu, 2012; Fratzscher, Lo Duca, & Straub, 2014). Easing policy by lowering the interest rate may lead to portfolio rebalancing and push investors towards foreign assets promising higher yields. This move might in turn lower foreign long-term interest rates and ease monetary conditions abroad, but could be offset by appreciation of the foreign currency. As the banking system becomes ever more internationally integrated, unconventional operations targeted at propping up the collateral of banks can have a direct impact through the bank lending channel. Finally, the signalling or expectations channel of the future stance of policy might affect the unwinding of positions. The behaviour of the foreign central bank may be affected, too. The impact on foreign macroeconomic developments is therefore rather ambiguous, as it depends on the relative strength of the different channels in place. The response of financial variables and the longer-term effects on macroeconomic variables can be quite different. The effect on financial variables can be rather quick given the international integration of financial markets, but also very transitory, with little impact on the real economy. The effect on foreign macroeconomic developments can take longer to materialise, as it needs to be intermediated by the impact on domestic macroeconomic variables. This difference matters for the central bank's responses when coping with the spillover.

The goal of this paper is to provide evidence on the transmission of conventional and unconventional monetary policy shocks from the euro area to EU countries that do not participate in the EMU. Specifically, we focus on three Central European countries (the Czech Republic, Hungary and Poland), two euro opt-out countries (Sweden and the UK) and Denmark (a participant in ERM II). Nevertheless, their degree of dependence on the euro area differs due to their choice of domestic monetary policy—although with the notable exception of the UK none them has resorted to unconventional measures of its own.

In the first step, we create a synthetic indicator of the euro area monetary conditions that incorporates both conventional and unconventional instruments, following Lombardi and Zhu

[1] Borio and Disyatat (2010) and Woodford (2012) provide a classification of different unconventional monetary policy measures. Pattipeilohy, Van den End, Tabbae, Frost, and de Haan (2013) and Boeckx, Dossche, and Peersman (2014) list the UMP measures taken by the ECB.