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## PRESS RELEASE

**Interest rate policy versus monetary base policy: implications for the central bank balance sheet**

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The priority aim of the euro area's monetary policy is price stability. That is why the Eurosystem bases its monetary policy strategy primarily on a quantitative definition of price stability. The ECB Governing Council defined price stability as a year-on-year increase in the HICP for the euro area of less than – but close to – 2 p.c. in the medium term. There can therefore be no doubt about the ultimate objective of monetary policy. To permit an accurate estimate of the risks to price stability, the monetary policy strategy is based on an analytical framework comprising two pillars. The economic analysis assesses the economic and financial developments and the inherent risks to price stability. The monetary analysis examines developments in the money supply, lending and their components, and looks for signals of relevance for longer-term inflationary trends.

In the very short term, the Eurosystem uses its open market operations to steer the money market interest rate. This implies that, in practice, the Eurosystem conducts an interest rate policy. The underlying idea is to steer the short-term interest rate in order to influence the term structure of interest rates and hence also real activity, the money supply and inflation. At the beginning of each month the Governing Council therefore determines the key rates which indicate the monetary policy stance. The minimum bid rate of the main refinancing operations is particularly important here. The operational framework for conducting monetary policy is designed to stabilise the overnight interest rate at the level set by the Governing Council for the minimum bid rate. In theory, however, other options are also possible. For instance, the central bank could actively steer the monetary base or central bank money instead of the money market interest rate, which in principle should make it possible to influence money creation on the part of credit institutions, and hence the real economy and inflation. Since the monetary base is closely linked in conceptual terms to the money supply, and given the primary role of money in the monetary policy strategy, one might even think that the monetary base is perhaps a better target.

However, if the advantages and disadvantages of the two options are weighed up, it is evident that the conditions are more favourable for conducting an interest rate policy than for a monetary base policy. The reason is that the uncertainty generated by money demand shocks and the instability of the monetary multipliers is greater than that generated by global demand shocks, certainly for the very short term which is relevant for the conduct of operational policy. That explains why central banks of countries with well-developed financial markets nowadays conduct an interest rate policy.

The choice of an interest rate policy is not at odds with the leading role of money in the monetary policy strategy of the Eurosystem, because the horizon applicable to the attainment of the ultimate aim– according to the definition of price stability: the medium term – is different from that for the conduct of operational policy, where the very short term is relevant. It is mainly in the medium to long term that monetary analysis has a comparative advantage as an indicator of the risks to price stability.

Conducting an interest rate policy implies an endogenous central bank balance sheet. The central bank meets the demand for liquidity in order to stabilise the interest rate around the target level. Fluctuations in demand for base money are thus reflected in the balance sheet items. It is therefore not base money but the interest rate that signals the monetary policy stance. This implies that the sometimes abundant provision of liquidity during the period of financial turbulence that began in the summer of 2007 performs no function in signalling the monetary policy stance.