Monetary Policy in Times of Crises
An Analytic View of the Era Trichet

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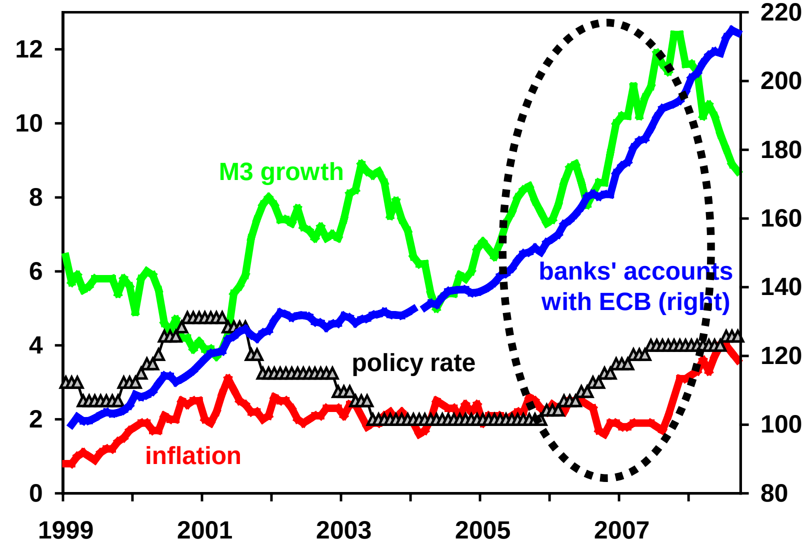
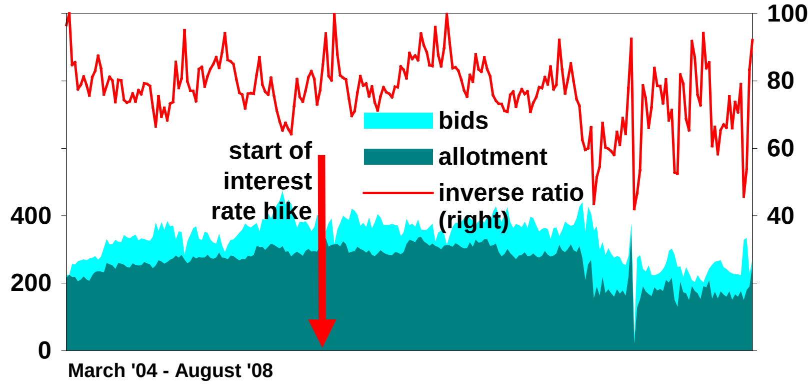
I 2003-08: Trichet and the QTM
II 2008-11: Trichet as Europe's LLR

European Monetary Policy from Trichet to Draghi
Friedrich Ebert Foundation, Berlin, 24 October 2011

Rising interest rates - but increasing money growth



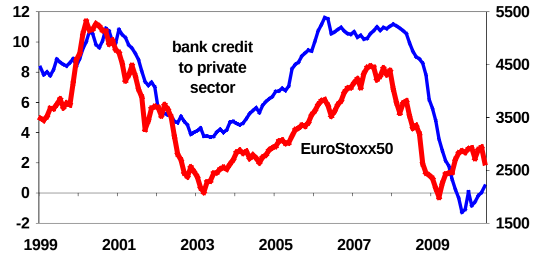
Money auctions before and during interest rate restriction



- Liquidity shortage no lever for higher rates
- ECB's Separation Principle: base money supply decoupled from interest rate policy

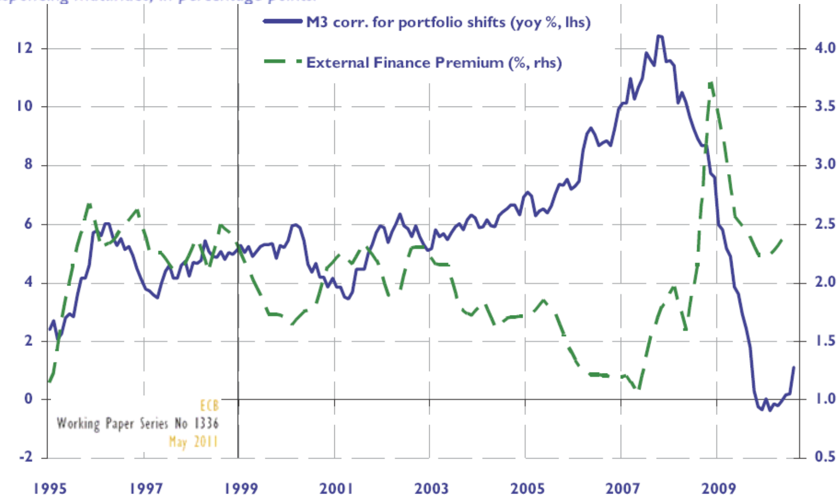
Asset price inflation and QTM

- Long waves of relative-price movements of asset and goods prices
- Bank credit expansion financing the bubble in Europe
- No spill-over to goods prices due to unemployment and free trade

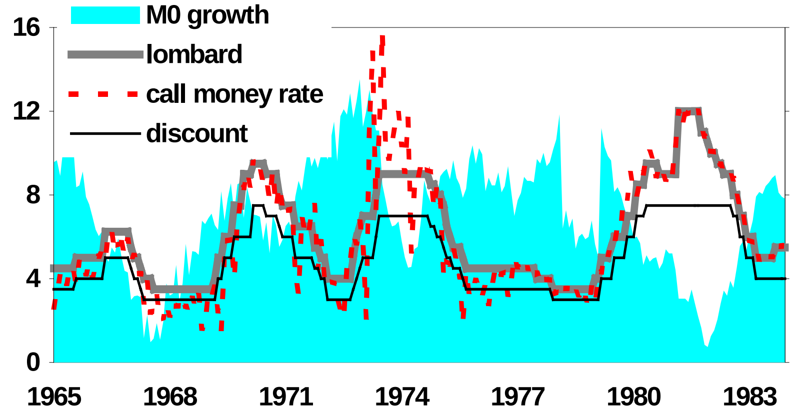


High money growth lowers external finance premium

Notes: M3 refers to annual growth rates of M3, corrected for portfolio shifts; The external finance premium is measured as an average of spreads between lending rates, including corporate bond yields, and measures of risk-free rates of corresponding maturities, in percentage points.

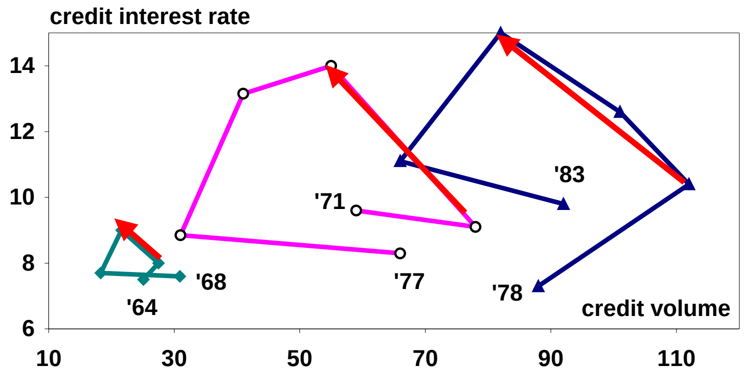


The Bundesbank's way of policy making



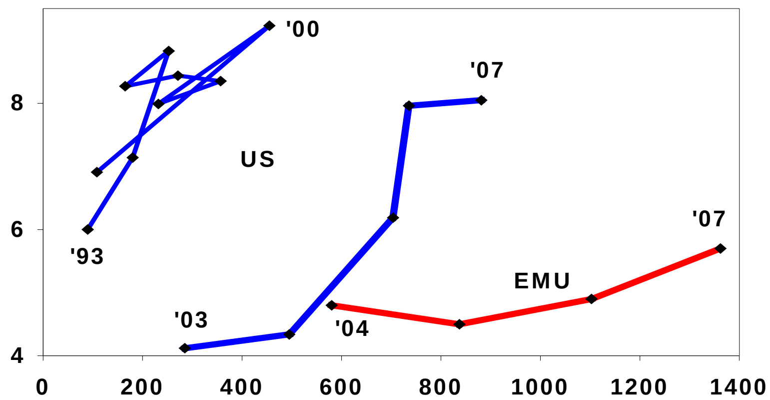
- **Base money growth inverse to interest rates**
- **Credible threat and effective shortening of quantitative refinancing**

Credit market cycles in Germany



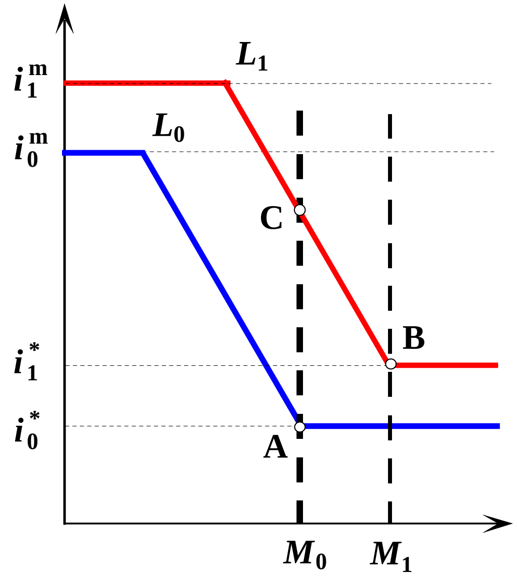
- **Banks reduce new loans when Bundesbank starts monetary contraction**
- **Left shift of credit supply curve with rising credit-market interest rates**

Credit markets in US and EMU



- **Credit business moving along supply curve**
- **Volume of new credit shrinks not before outbreak of financial crisis**

Proposal: money supply as additional instrument



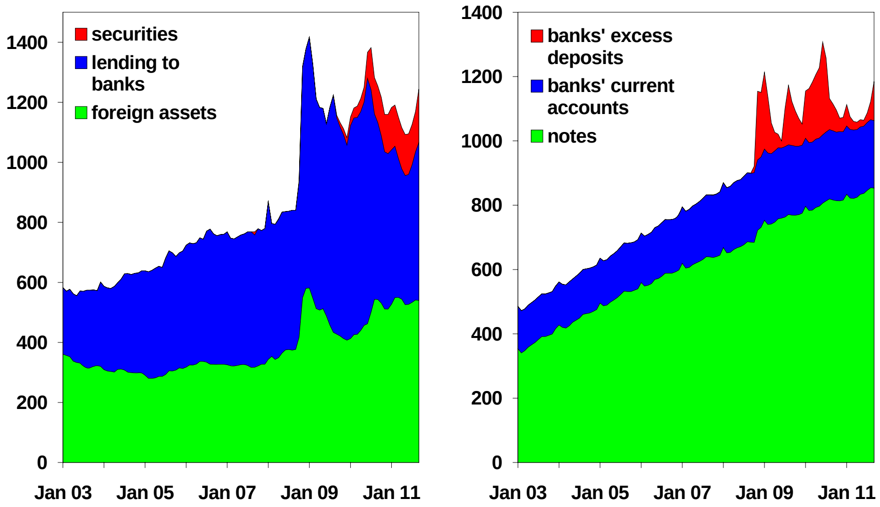
- **Money-market floor system with ceiling**
- **Rising money demand in boom**
- **Higher interest rates following Taylor Rule**
- **Accommodation in case of "normal" anti-inflation (B)**
- **Monetary squeeze in case of asset inflation (C)**

Constraining excessive financial round-about services

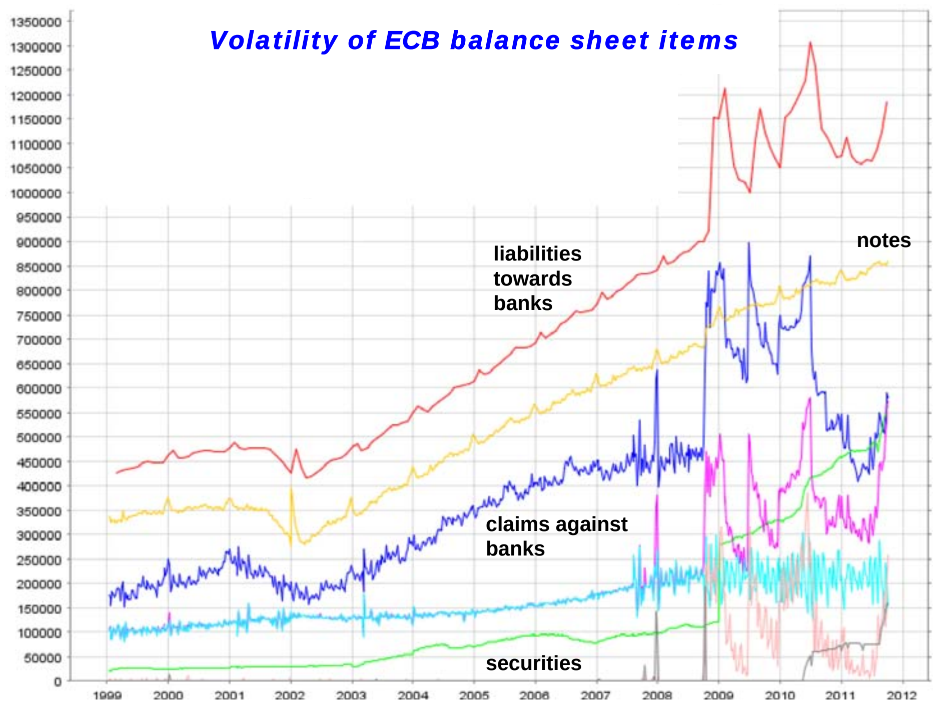
> **"After quantity controls [of base money] were dismantled, the major central banks were left with a single policy tool: the ability to change the short-term policy rate. They lost control over the supply of bank credit and their influence over the demand for credit also weakened. The build-up in banks' leverage was a direct result of the removal of quantity controls."**
>
> *D'Arista / Griffith-Jones* (2010)

- **Financial-intermediation chains depend on belief of unlimited access to CB refinancing**
- **Quantity controls -> Drawing liquidity from markets, banks hold more liquid assets, less risky investments**
- **Spread between money-market and target interest rates signals CB's concern about asset prices**

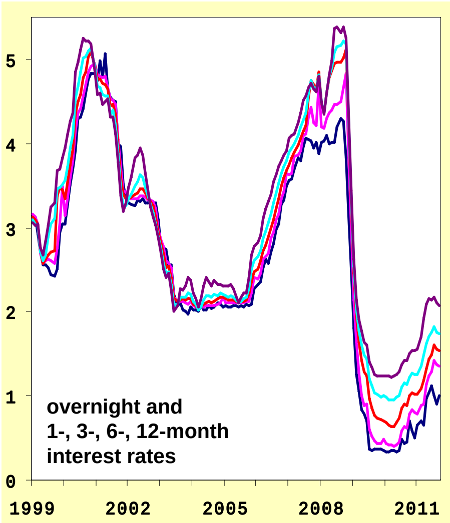
Structure of ECB's main assets and liabilities

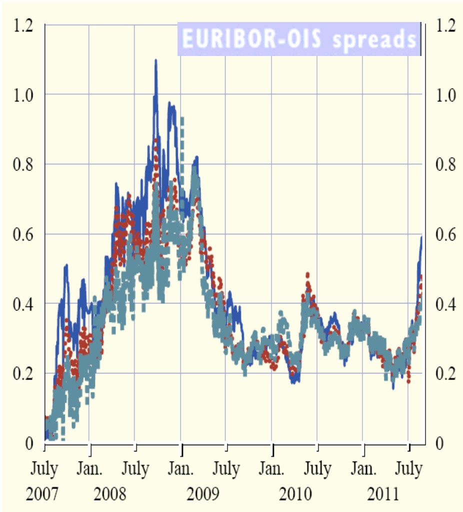


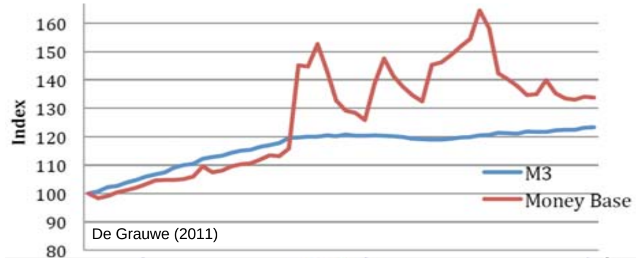
Volatility of ECB balance sheet items

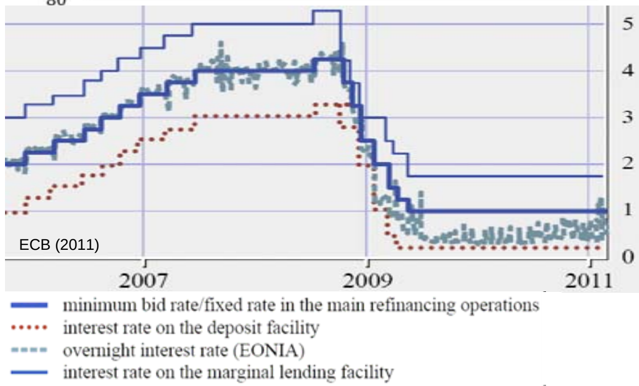


Money market rates: low, but high term and risk spreads





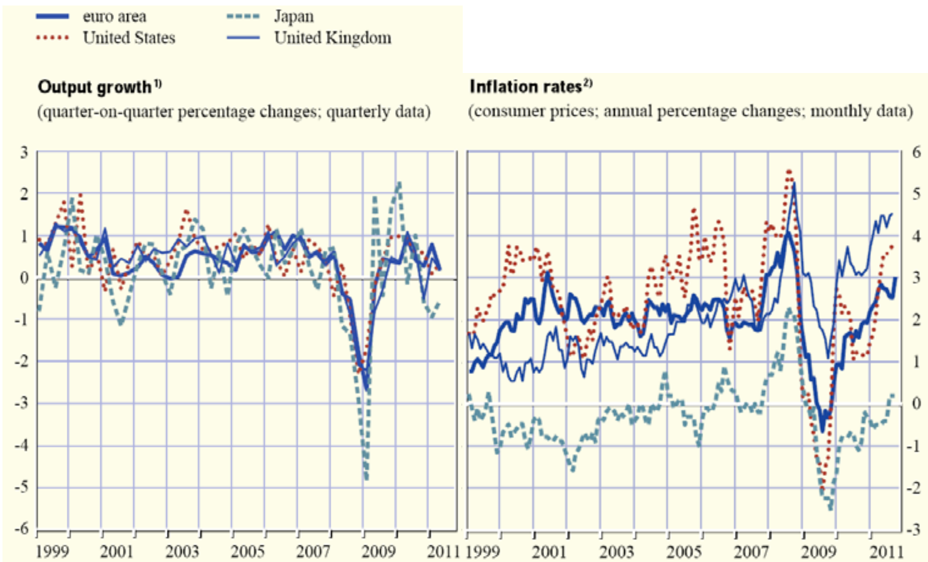




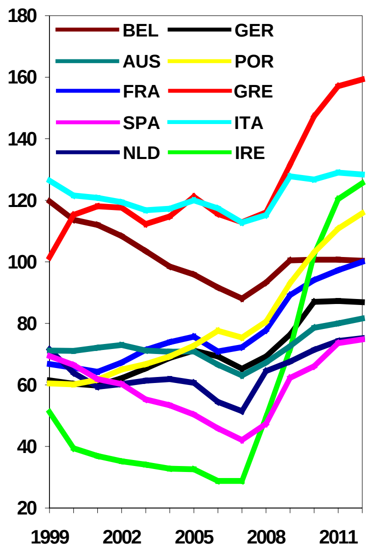
Quantitative Easing?

- **M3 growing only weakly**
- **Why maintaining positive rate on deposit facility?**
- **Balance sheet reversal and hyperinflation risk: dominance of velocity over money supply**

EMU macroeconomics: tolerable after all?



Explosion of public debt after US financial crisis



- **The big mistake: Keynesian deficit spending instead of Friedman's money rain**
- **The big myth: debt crisis resulting from bank crisis**
- **The basic EMU problem: national public debt denominated in "foreign currency"**
- **The big omission: no LLR in EMU for national public debt**
- **The predictable result: instability in bond markets, freezing of interbank markets**

Eroding the limits between monetary and fiscal policy

- **ECB forced to act in place of missing / weak EMU fiscal rescue institutions**
- **Fed and BoE hold more public debt than ECB - but for different reasons**
- **Why not restrict ECB's LLR role to banks?**
  - **Replacing non-performing government loans implies rescuing insolvent banks**
  - **Accepting national bankruptcy not tolerable for political reasons: ECB deciding on EMU membership**
  - **But: ECB losing political independence**

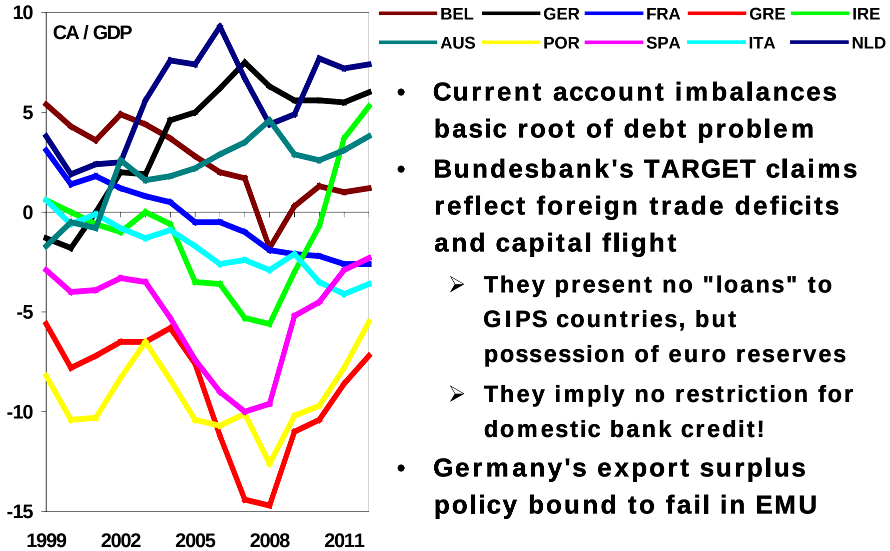
> **"We will urge the ECB to continue its wise policy of supporting the efforts of Italy and Spain."**
>
> *Franco Frattini, Foreign Minister of Italy* (2011)

Bond purchases necessary for policy transmission?

> **"The interest rates that financial and non-financial corporations have to pay when issuing bonds are usually based on the interest rate on the relevant government bonds ('price channel'). Dysfunctional bond markets would create a situation in which the ECB's official interest rates were no longer appropriately reflected in the longer-term interest rates that are relevant to the decisions taken by households and firms, and thus particularly important for price stability."**
>
> *ECB* (2011)

- **Market agents do not follow distorted bond rates**
- **Preserving bond prices indispensable for monetary policy conduct?**
  -> ECB should declare Maastricht Treaty not feasible

One size fits all? Addressing intra-EMU divergence



- **Current account imbalances basic root of debt problem**
- **Bundesbank's TARGET claims reflect foreign trade deficits and capital flight**
  - **They present no "loans" to GIPS countries, but possession of euro reserves**
  - **They imply no restriction for domestic bank credit!**
- **Germany's export surplus policy bound to fail in EMU**

Looking backwards ...

- **Loss of base money control before and after the crisis**
- **Benefit from price stability bias via unemployment and globalisation**
- **Ironing out political failures in EMU**

Looking forward ...

- **Devoting the Monetary Pillar to asset markets control**
- **Controlling intra-EMU divergences via country-specific haircuts on national-bond collateral**
- **Private wealth cut in insolvent countries? Unlimited ECB lending to a European Monetary Fund?**