ECB vs Fed

Comparing Approaches to the Crisis

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Observatory of the ECB 10th Anniversary Workshop

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Paper 1

Jürgen von Hagen (Bonn)

"The Monetary Face of the Crisis"

Paper 2

Charles Wyplosz (Geneva)

"A Tale of Two Central Banks in the Eye of a Storm"

Discussion on von Hagen

Purpose of paper

- Analyze crisis in terms of money supply process

  → Comparison with Great Depression

Main conclusions

- Central banks have prevented contraction in money supply
- Massive liquidity injections may produce future inflation
- Euro area was less affected by crisis

  → ECB was right in being less expansionary than the Fed

Discussion on von Hagen

Strategy for analysis

- Look at evolution of money supply and money multiplier

$$M = \frac{1+k}{r+k} B$$

→ M is the money supply (e.g., M1)

→ B is the monetary base (cash + bank reserves)

→ k is the ratio of cash to bank deposits

→ r is the ratio of bank reserves to bank deposits

- Money supply M determined by B, k, and r

Discussion on von Hagen

Possible effects of crisis

- Increase in ratio cash/deposits k

  → Proxy for non-banks' confidence in banking sector

- Increase is ratio reserves/deposits r

  → Proxy for banks' confidence in other banks

- Increases in k or r reduce the multiplier

Appropriate policy response

- Increase in monetary base B → expansionary policy

Discussion on von Hagen

What has happened in the US?

- Significant reduction in ratio cash/deposits k

  → No flight to cash (deposit insurance)

- Huge increase is ratio reserves/deposits r

  → Breakdown of interbank market

  → Huge reduction in multiplier

- Huge increase in monetary base B

- Small increase in money supply M

Discussion on von Hagen

What has happened in the euro area?

- No change in ratio cash/deposits k

  → No flight to cash (deposit insurance)

- Very significant increase is ratio reserves/deposits r

  → Breakdown of interbank market

  → Significant reduction in multiplier

- Significant increase in monetary base B
- Small increase in money supply M

Discussion on von Hagen

Main comment

- Monetarism still survives!
- Is it useful to look at crisis using monetarist approach?

  → I do not think so

Discussion on von Hagen

Main comment

- Approach based on looking at ratios k and r

  → Effect on multiplier

  → Reaction of central bank (monetary base)

- But k and r are <u>not</u> structural parameters

Discussion on von Hagen

Main comment

- In particular, consider ratio reserves/deposits r

→ Aggregate reserves are determined by central bank

→ Ratio r is not directly related to a "lack of confidence"

→ Monetary base B does not react to increase in r

→ Monetary base B causes increase in r

Discussion on von Hagen

Main comment

- This does not mean that quantities are unimportant

  → Central banks as market-makers of last resort

- But the analysis should be completely different

  → M as collection of heterogeneous liquid assets

  → May have some long-run correlation with prices

  → But no role as driver of short-run developments

Discussion on von Hagen

Comment 2

- Monetarist approach is especially unsuitable for US

  → Huge market-based ("shadow") banking system

  → No direct link with monetary base B

Discussion on von Hagen

Comment 3

- Increase in monetary base should <u>not</u> lead to future inflation
- Central banks will raise interest rates

  → Straightforward in euro area

  → More tricky in US (paying interest on reserves)

  → Fed may end up incurring some losses

  → Not a problem

Discussion on von Hagen

Comment 4

- Covered bonds purchased by ECB

  → Issued by euro area banks

  → Do <u>not</u> involve lending to EU governments

Discussion on Wyplosz

Purpose of paper

- Examine actions taken by ECB and Fed during crisis

Main facts

- Similar but far from identical actions
  - → Different initial conditions (mortgage markets)
  - → Different institutional arrangements
- Slow realization of seriousness of crisis → GDP forecasts
- Fed moved considerably faster on rates
- Impact of crisis more severe in euro area than in US

Discussion on Wyplosz

Main conclusions

- Why was the Fed more aggressive on rates?

  → Different forecasts (ECB more optimistic on growth)

  → Different mandates (ECB focus on price stability)

- Why was the Fed more innovative in its operations?

  → Very different operational procedures before crisis

  → Fed had to travel far to respond to crisis

Discussion on Wyplosz

Main comment

- ECB "separation principle" between

  → Provision of liquidity

  → Setting the policy rate

- "Separation principle can only operate in a liquidity trap"
- "Separation principle predicates use of the monetary base"

  → I disagree with these statements

Discussion on Wyplosz

Main comment

- What is the separation principle?

  → Governing Council chooses policy rate

  → Executive Board decides on liquidity provision

  (to keep very short-term rates close to policy rate)

- Separation principle

  → Should operate at all times (not just at liquidity trap)

  → Nothing to do with use of base money as “instrument”

Discussion on Wyplosz

Main comment

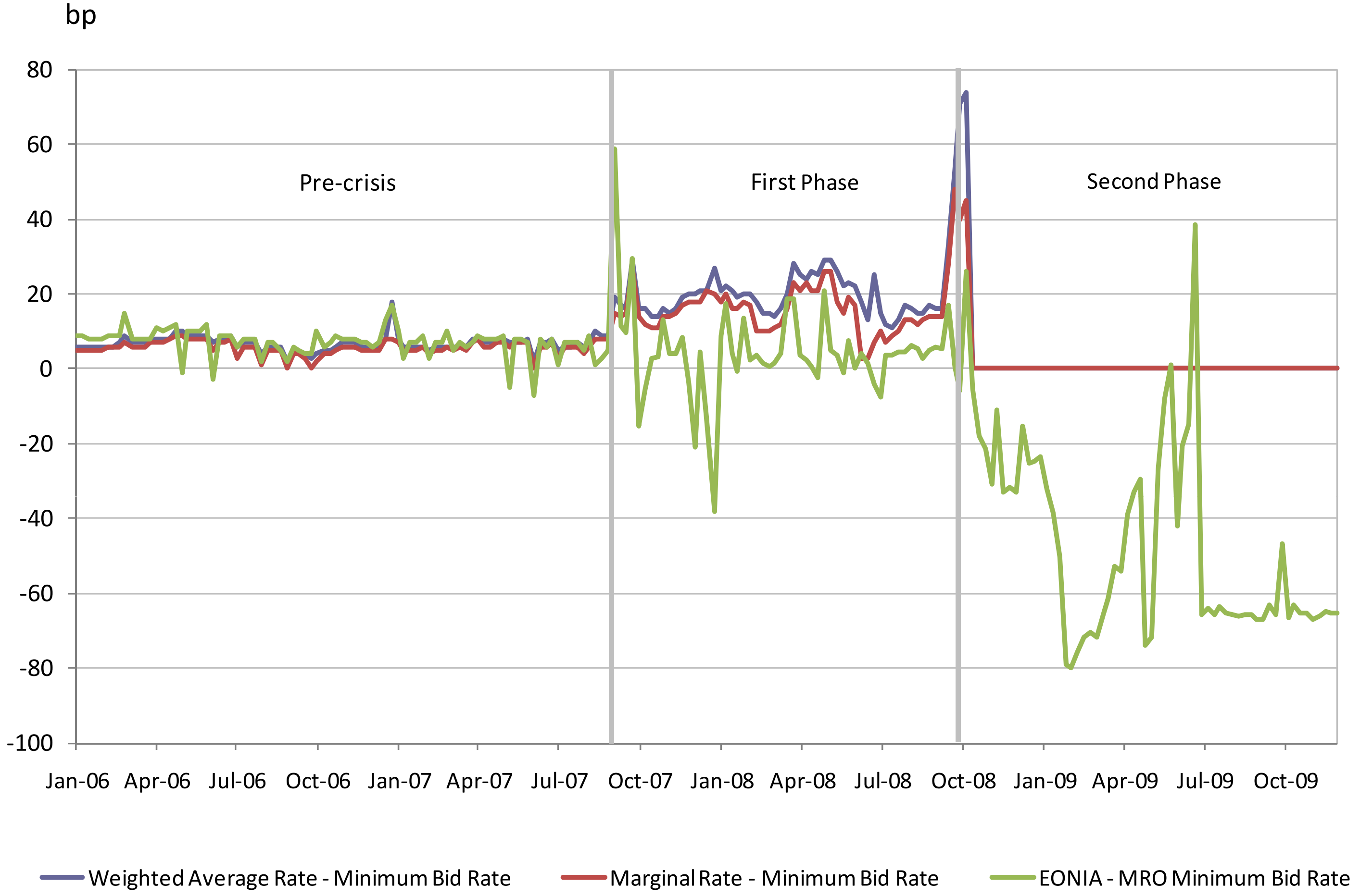
- ECB abandoned separation principle in October 2008

  → EONIA rates have been close to deposit facility rate

  → ECB has kept interbank rates far from policy rate

Discussion on Wyplosz

EONIA spreads



Discussion on Wyplosz

Main comment

- ECB should not have abandoned separation principle
  - → Either drain excess liquidity
  - → Or lower policy rate
- Why did it do it?
  - → Maybe fear of "liquidity trap" (losing control of M)

Final comments

On monetary policy strategy

- ECB’s two pillar approach did not seem to be an advantage

  → Monetary pillar needs to be redefined

On operational procedures

- ECB had a better set of operational procedures

  → Fed should make permanent move in this direction