

ECB vs Fed

Comparing Approaches to the Crisis

Comments by Rafael Repullo

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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 in 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 in 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 not 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 not 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 not 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”

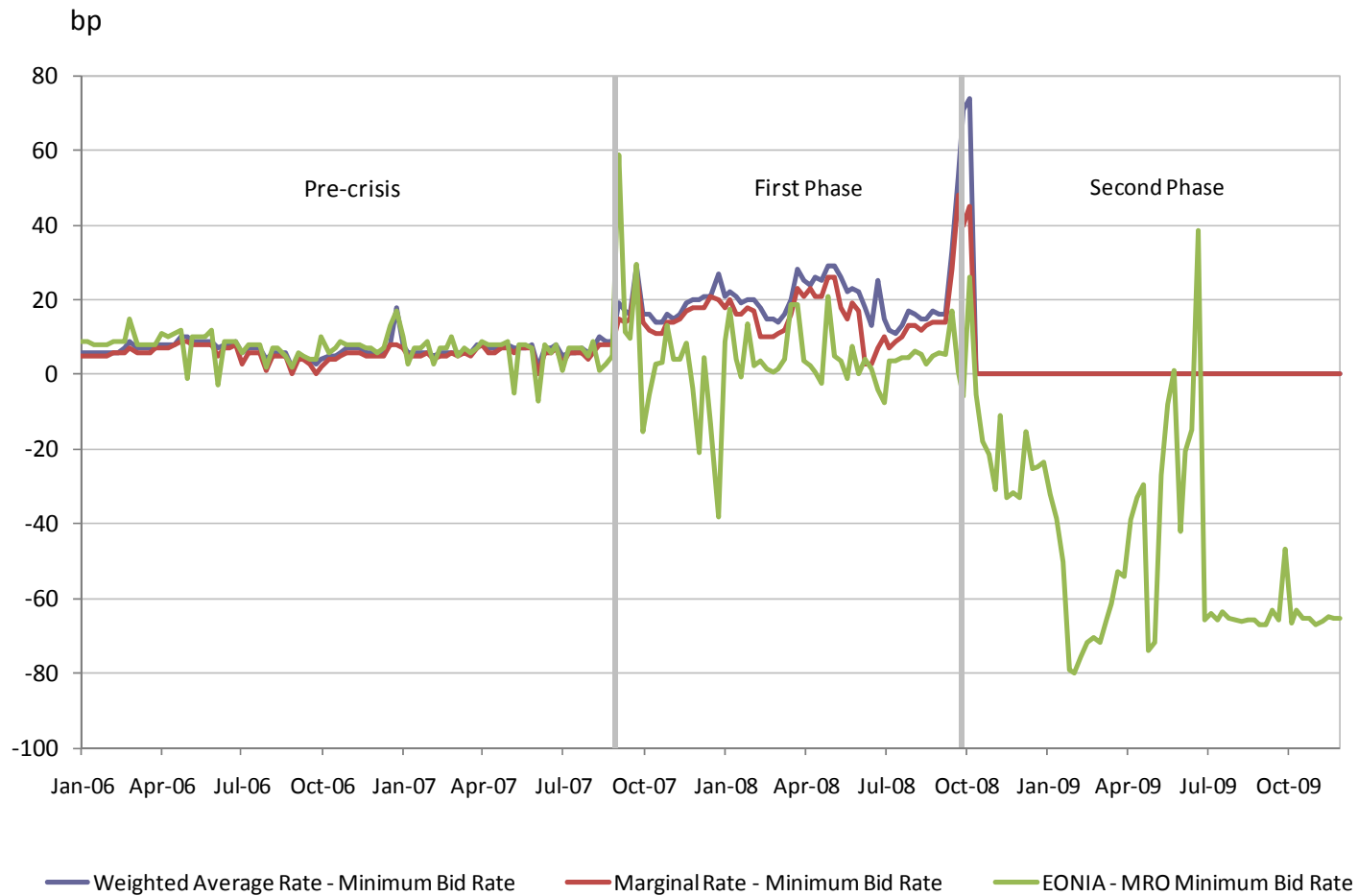
Discussion on Wyplosz

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