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Some Issues for Monetary Policy in the Euro Area in 2009

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Objective

Discuss

… some conceptual issues regarding credit crunch recession, deflation scare and monetary policy

… ECB monetary policy responses, communication and upcoming challenges

1. Credit crunch recession: A definition

Bernanke & Lown (1991):

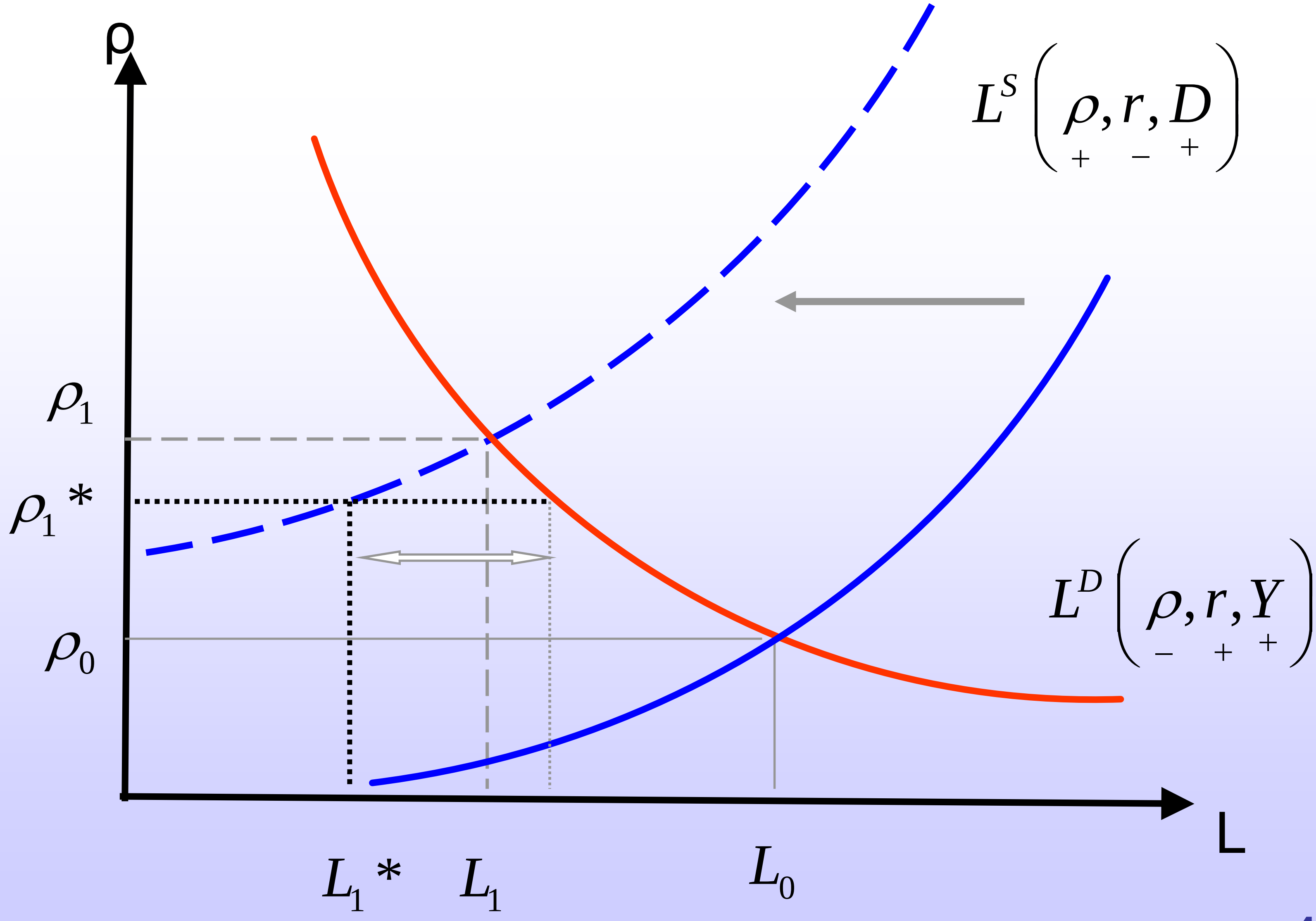
We define a bank credit crunch as a significant leftward shift in the supply curve of bank loans, holding constant both the safe real interest rate and the quality of potential borrowers.

On 90/91 recession:

... probably demand factors, including the weakened state of borrowers balance sheets, caused much of the slowdown,

... also a shortage of equity capital has limited bank‘s ability to make loans.

Loan Market



ρ
$L^S\left(\underset{+}{\rho}, \underset{-}{r}, \underset{+}{D}\right)$
ρ_1
$\rho_1 *$
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$L^D\left(\underset{-}{\rho}, \underset{+}{r}, \underset{+}{Y}\right)$
L
$L_1 *$
L_1
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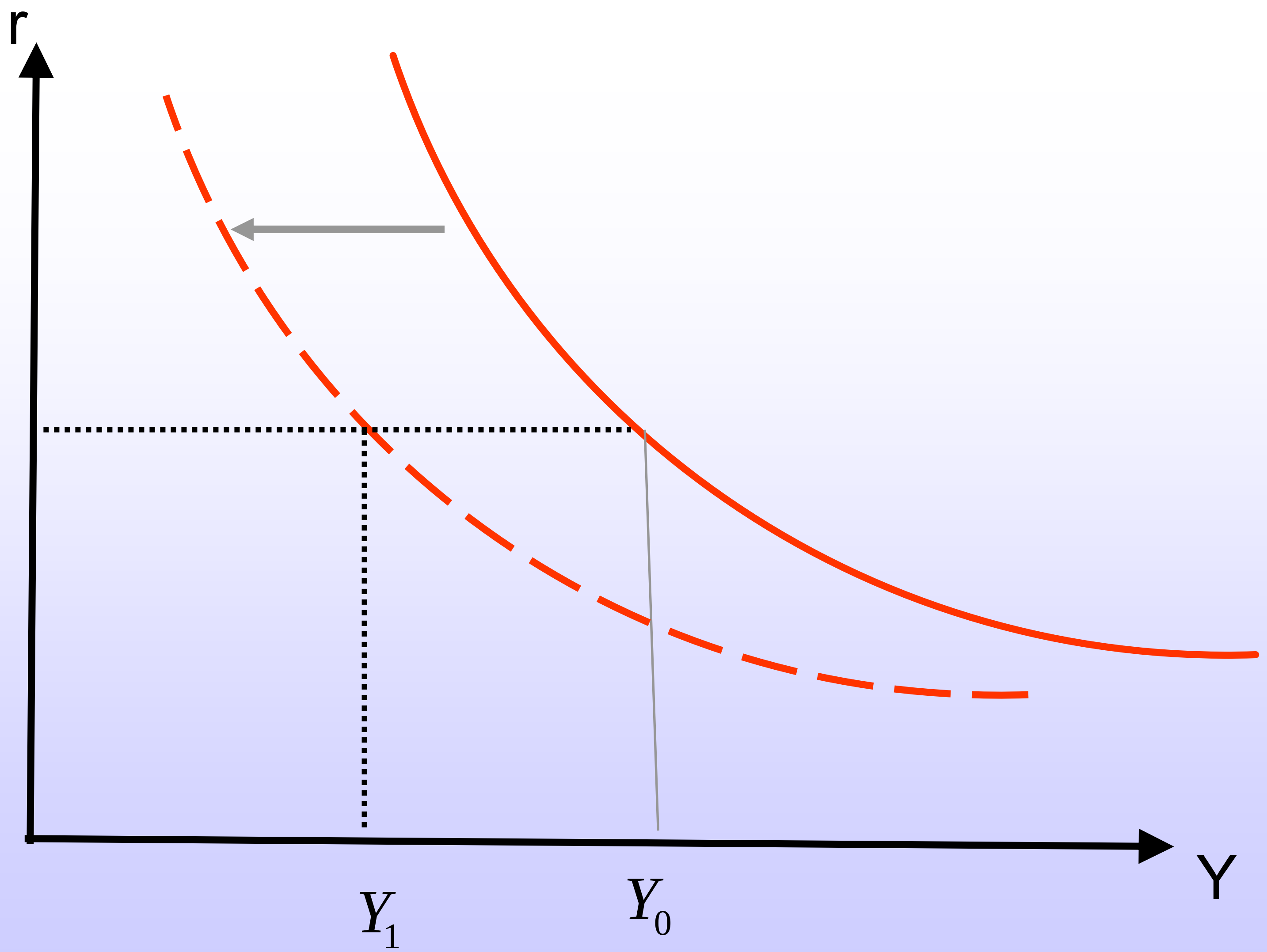
2. Macro effects and recession

- **Bernanke &Lown 91:**

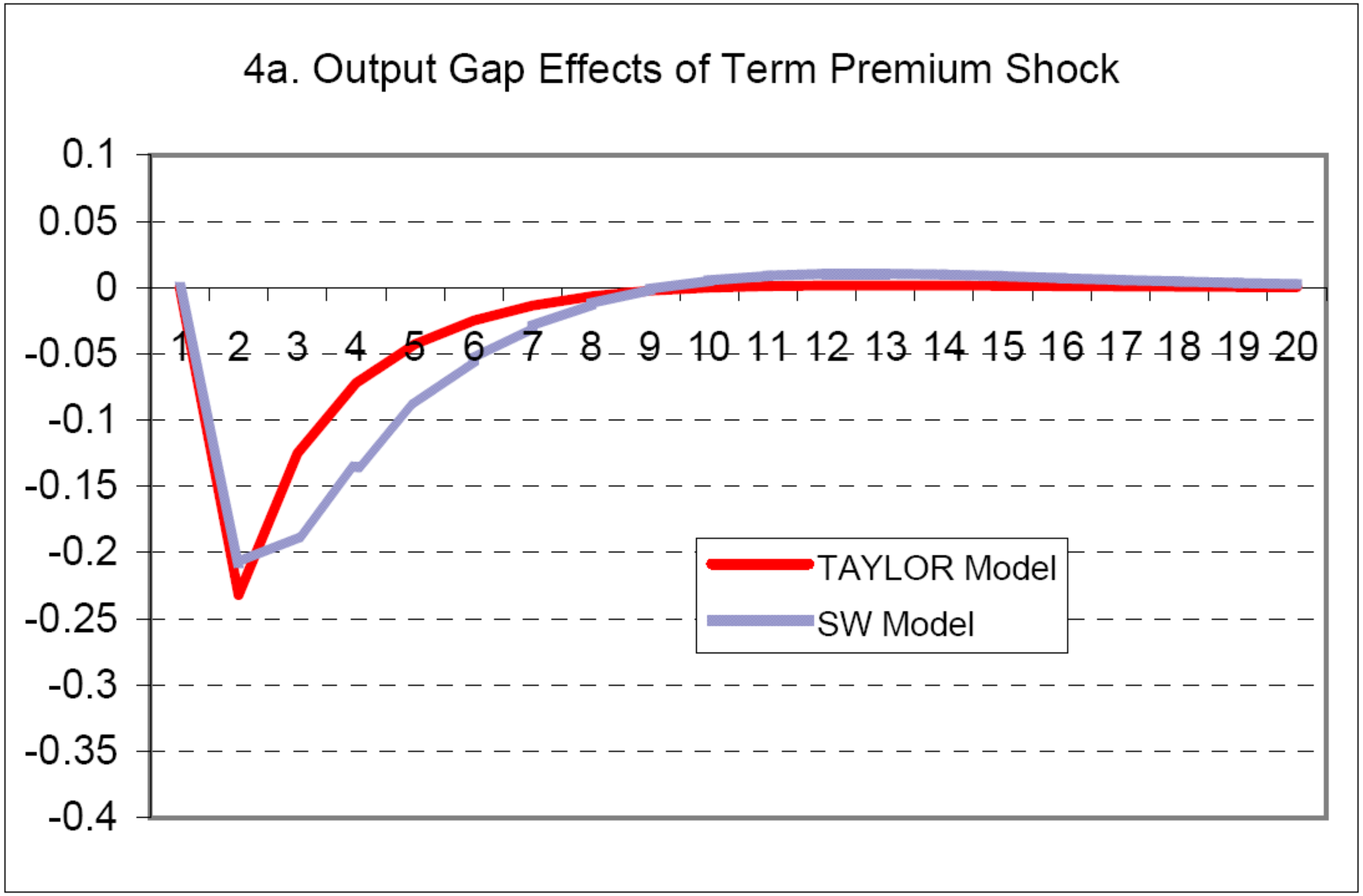
  in IS-LM diagram an exogenous decline in bank lending due to shortage of capital is a negative IS shock.

  This requires only that bank loans are imperfect substitutes for other assets, no credit rationing.

Credit shock implies IS curve shift

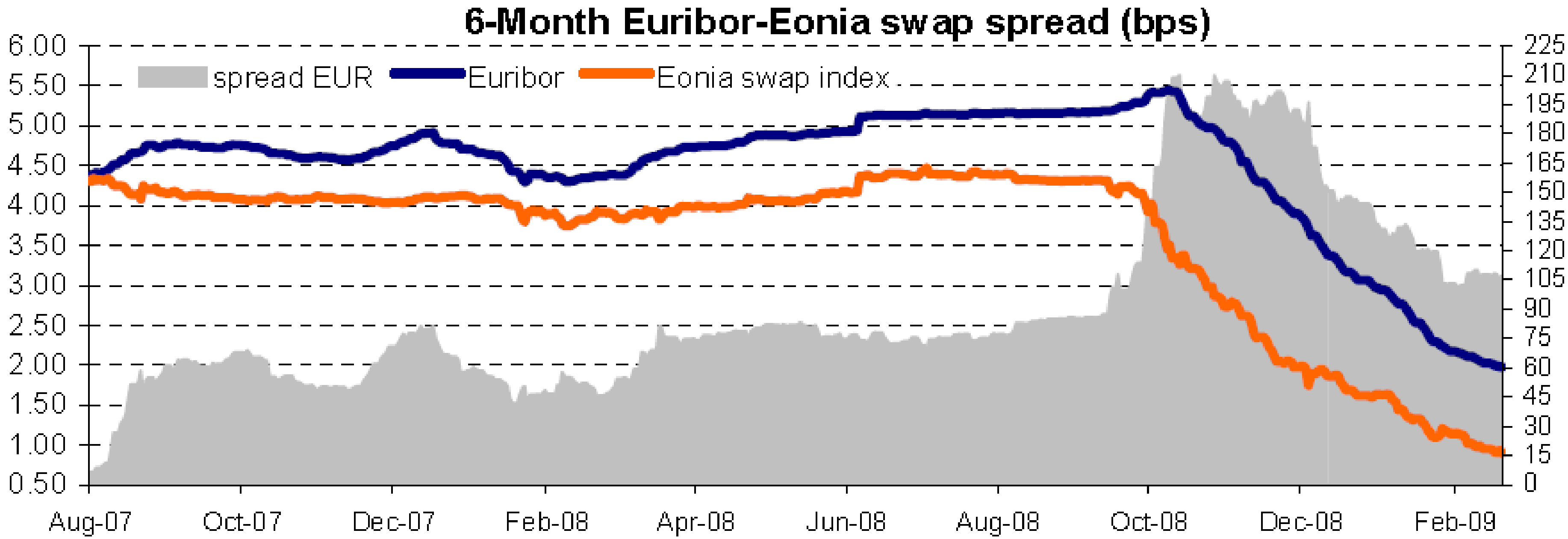


Quantitative assessment: Risk premium shocks in 2 macro models

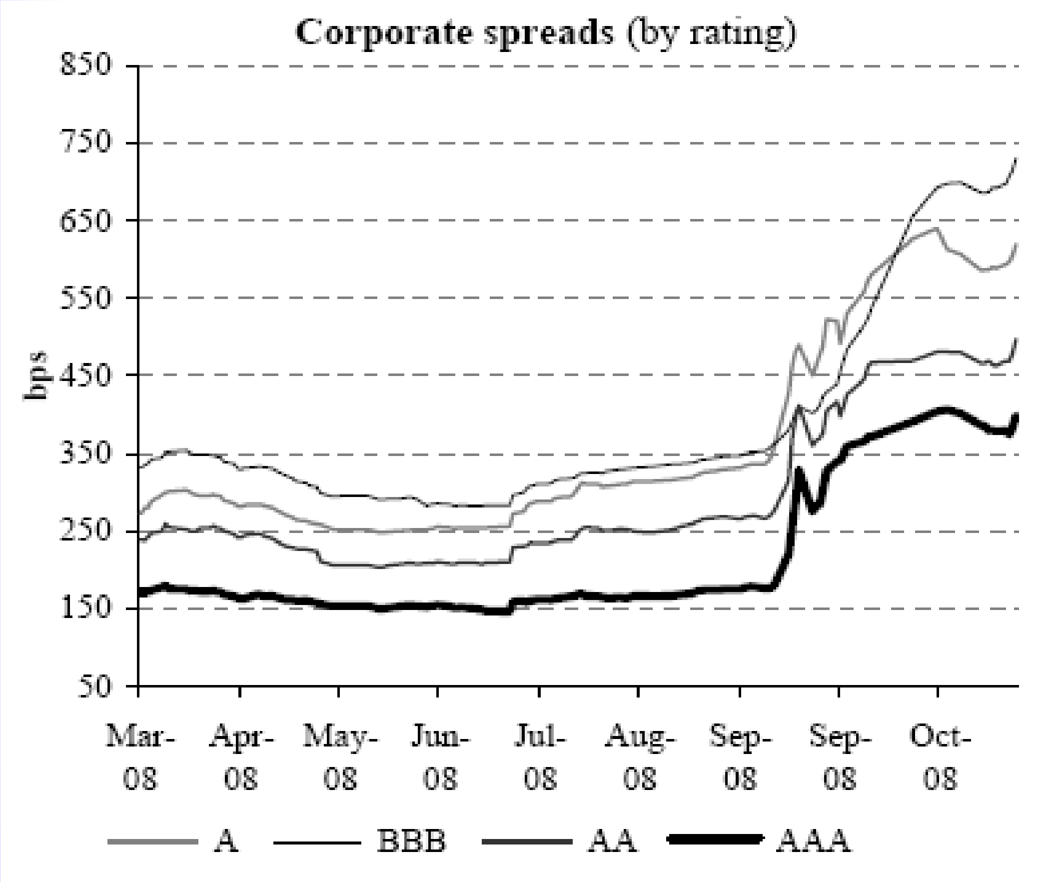


Increase in risk premium by 1 percentage point. Taylor (1993) and Smets and Wouters (2007). Source: Taylor-Wieland (2009).

Euro area money market spreads



Corporate spreads and loan growth



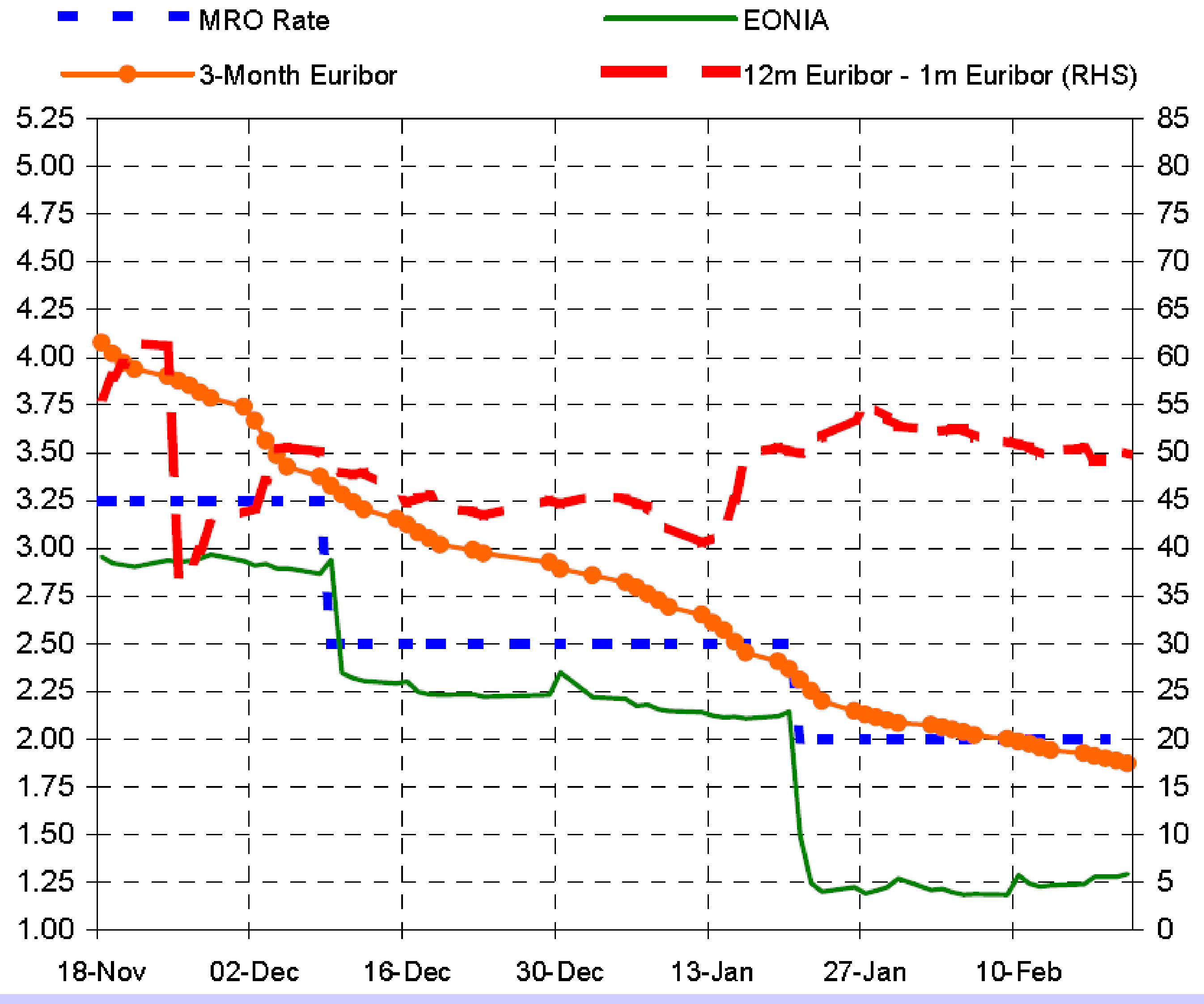
Loans to private sector

Oct 08	7.8
Nov 08	7.1
Dez 08	5.8

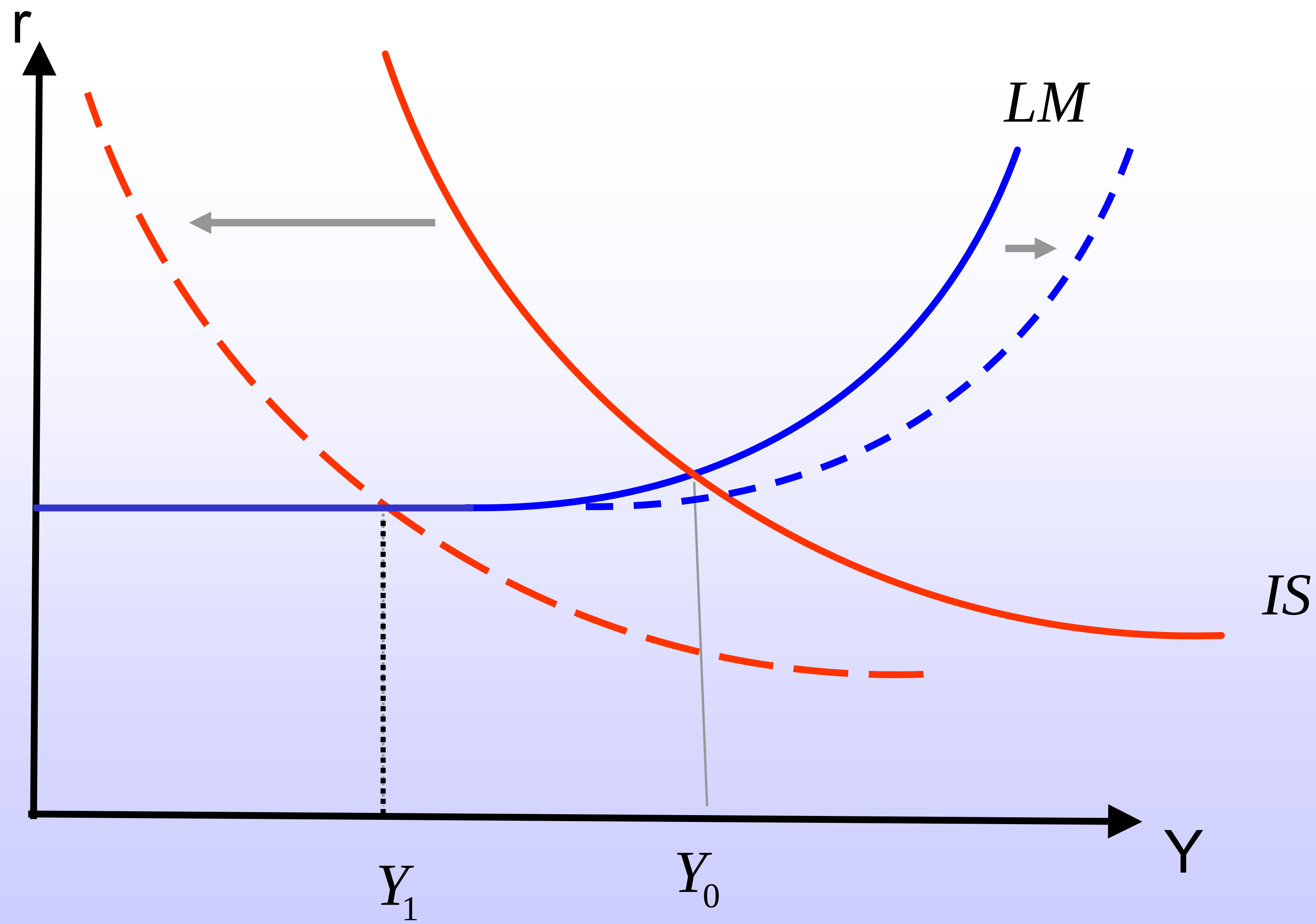
3. Monetary policy options and zero bound on nominal interest rates

- Bernanke&Lown 91:
  - ➔Some have worried that an unwillingness by banks to lend can render monetary policy impotent, this concern is misplaced unless a traditional liquidity trap also exists.

ECB Policy so far



Zero bound and policy effectiveness

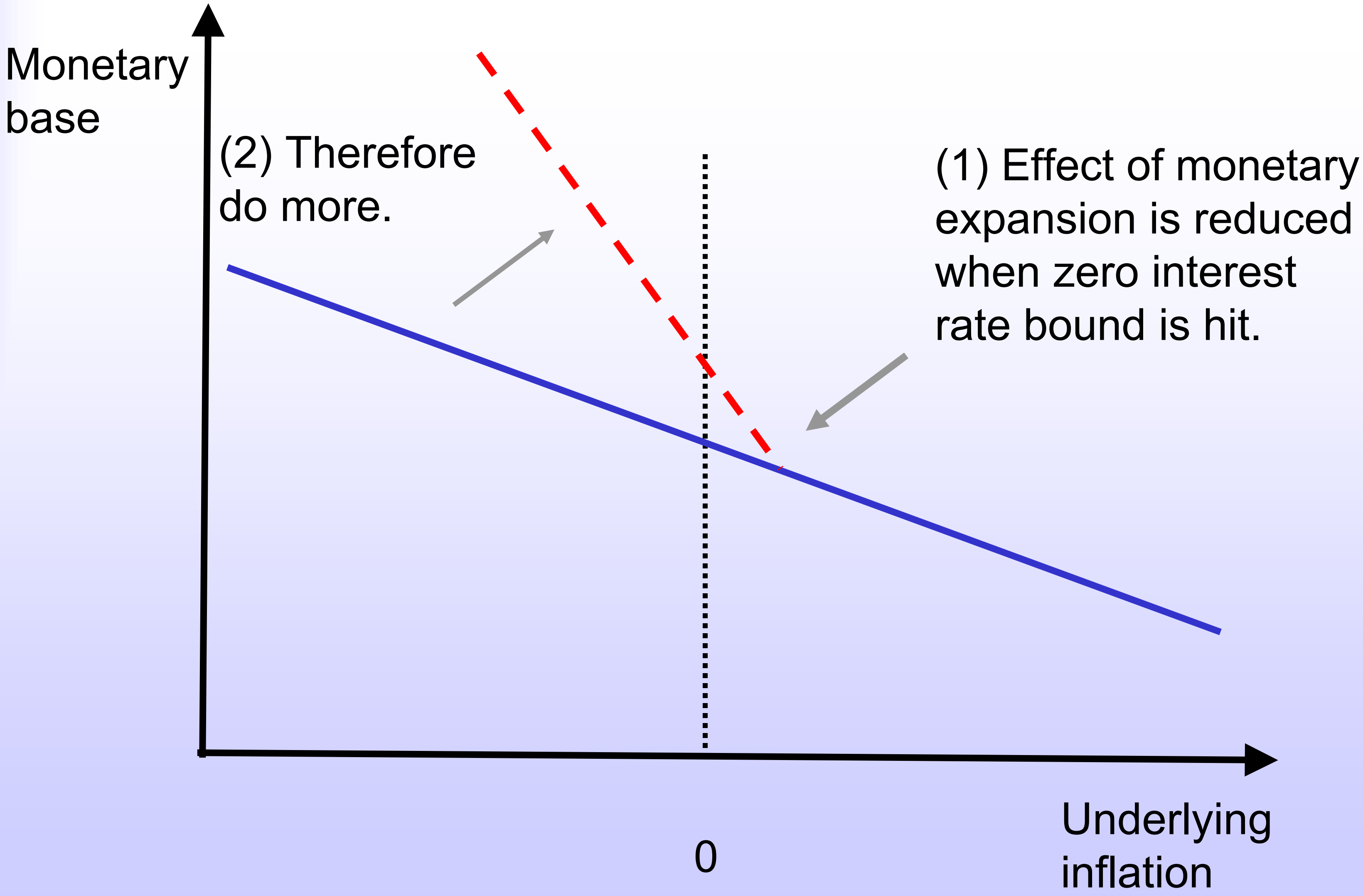


4. Quantitative easing

- Orphanides and Wieland (JJIE 2000)
- Real balance and portfolio-balance effects still active when interest rate channel disappears.
- Monetary policy is expanding monetary base

$$mb = -k(\text{underlying inflation})$$

Zero bound and quantitative easing

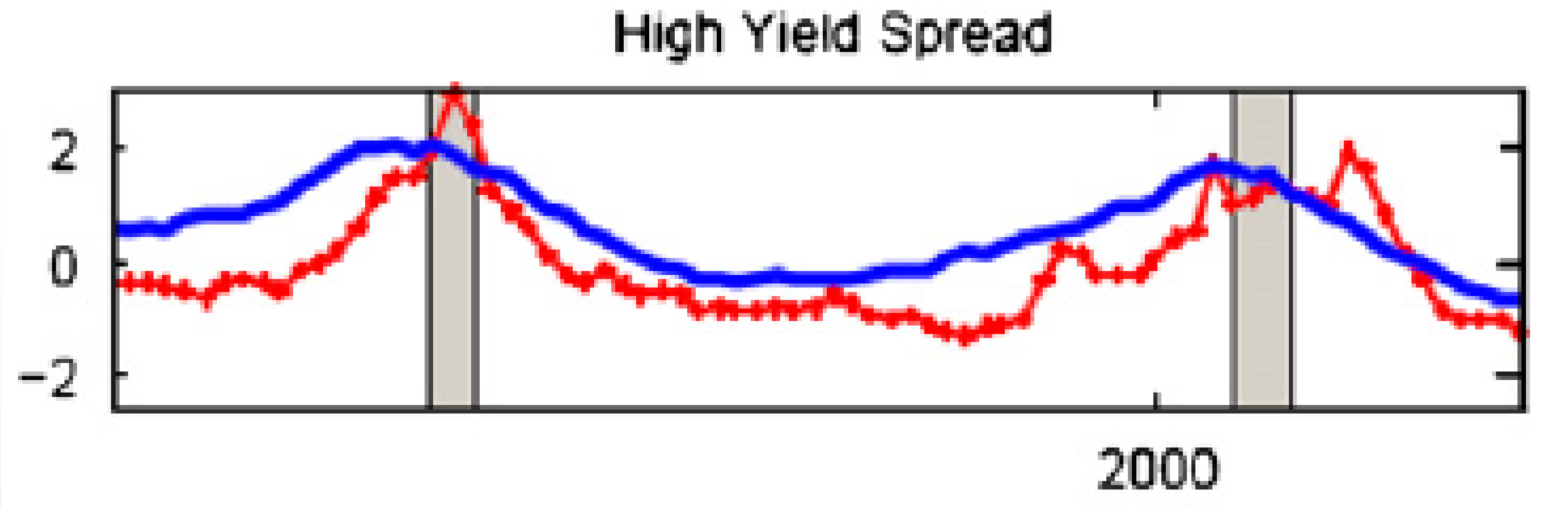


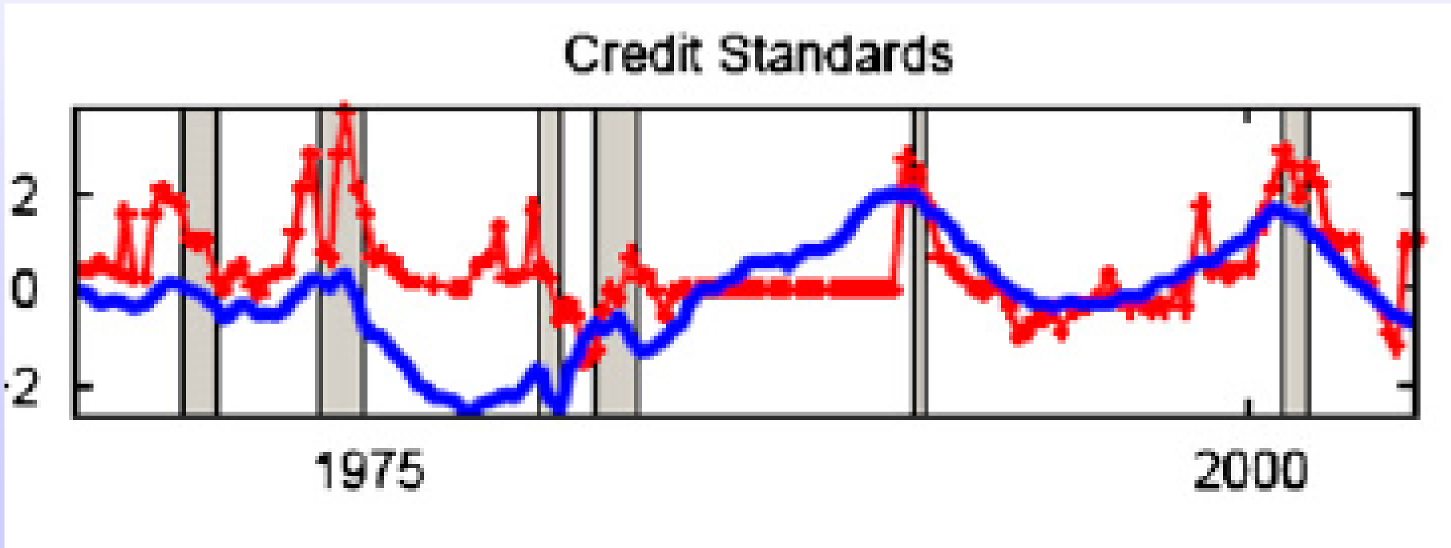
Questions regarding ECB communication on interest rate floor and quantitative easing

- Is there a perceived floor for the real interest rate?
- Is there an aversion against zero nominal interest rates per se, or does it only depend on perceived need for re-inflation?
- MRO versus EONIA?
- How would quantitative easing be implemented?

Additional Slide

Data and models: U.S. Spreads, credit standards and external finance premia





Source: De Graeve (JEDC 2008)