Lecture 4

The Monetary Policy Strategy of EMU

In this lecture, we analyse how the European monetary policy works. First, we briefly look at theory to understand how monetary impulses are transmitted and how they affect the economy. Second, we discuss different monetary policy concepts that are derived from theory and that provide indicators for orientation. Finally, against this background, we try to evaluate the monetary policy strategy of the Eurosystem.

4.1 How monetary policy affects expenditures and prices (transmission process)

- Money creation by contracts
- The simple quantity theory of money: Quantity of money, expenditures and the price level
- The portfolio theory of money: Liquidity preference and the demand for money
- The reputation theory: Direct effects on inflationary expectations

A central bank can only fulfil its task of preserving the value of money if it has control over the money stock. Money is created by private contracts, however. There are two channels of creating
money. First, commercial banks buy bonds, which are issued by the government or by private firms. Second, commercial banks make credit contracts either with private business, private households or the government. So, the central bank can only indirectly affect the stock of money. The leverage for the central bank becomes effective whenever non-banks withdraw money from their bank accounts so that a bank has to pay in legal tender or, plainly, in cash (bank notes). In this case the commercial bank needs central bank money (base money). The individual bank can lend this liquidity from another bank in the so called money market. But the financial sector as a whole can only increase its liquidity by contracting with the central bank. The central bank regulates the liquidity of the financial sector by short-term contracts. Its main monetary policy instrument is variation of the short-term interest rate at which private banks can lend base money. This interest rate is called the main refinancing rate.

Actually, the business of 'lending' central bank money is a little more complicated. The central bank provides its money only against securities. So, a bank in need of liquidity has to offer financial assets (usually bonds) to the central bank in exchange for central bank money. That exchange can take various forms. The usual case is that the bank sells securities to the central bank and repurchases these securities at a pre-fixed later date. The interest rate is in this case defined as a discount rate or repurchase rate (‘repo’). Another case is that the central bank lends base money against collateral (against bonds). By regulating the liquidity status of the financial sector the central bank controls, albeit indirectly, the stock of money in the economy (the ‘quantity of money’). Variations in the money stock can be observed and provide an indicator of the effects of monetary policy. If the central bank offers liquidity to the banks at more favourable conditions (by reducing the repo rate) this monetary impulse will probably stimulate the expansion of the money stock. At least we can suppose that commercial banks take more liquidity at the favourable terms in order to increase their credit volumes and money supply. On the other hand, if the central bank increases its main refinancing rate this will have a dampening effect on the expansion of the volumes of money and credit. Presumably, the restrictive effects of monetary policy are more certain than its expansionary effects.