THE CHANGE IN MONETARY POLICY – ADAPTING MONETARY POLICY INSTRUMENTS TO CURRENT CHALLENGES[1]

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The monetary policy and their use of instruments has changed in the last few decades. These adjustments of the instruments in due courses are important for the effective enactment of monetary policy and its enforcement. They serve to cover an indispensable need for central bank money from credit institutions. For the first time, in 1948, the first rule for minimum reserve with the founding of the 'Bank deutscher Länder' was applied, without setting a specific percentage. More precise requirements for the minimum reserve followed by the Bundesbank in section 16 to the Bundesbank Act. For this purpose, certain liabilities were given maximum rates; for example: sight liabilities up to a maximum of thirty percent and savings deposits up to a maximum of ten percent. The ECB can set its maximum reserve rates from zero to ten percent. Until 1999, the Bundesbank provided central bank money to limit the demand for discount bills and Lombard loans. For both instruments the Bundesbank established quotas, which were set separately for each individual credit institution and needed a complicated procedure. For this connection, the liability and structure of the credit business were crucial. The credit institutions were not allowed to exceed these quotas at any time. The direct influence on the refinancing conditions was the special feature of the discount credit and this instrument had relatively low interest rates. The discount bills were discounted by the lending customers themselves, passing such bills on to the credit institutions who, in turn, gave the bills to the Bundesbank. Due to the remaining endorsement of the respective credit institution, they remain as debtors, even if they are passed on to the central bank. These bills had emerged as a result of goods delivered or services rendered between enterprises or self-employed persons; their origin validating their status as 'fine trade bills' (section 19 (1) no. 1 of the Bundesbank Act, valid until 31.12.1998). This definition was mentioned in section 21 (2) of the Reichsbank Act of 1924 for the first time. These considerations went back to the real bills doctrine, in which a strong linkage between the real-economy banking business and the refinancing takes place at the central bank. With this, inflationary effects could be limited. Therefore, the credit institutions should get the opportunity to finance real bills more easily. The discount bills were backed by three parties, who had to be solvent and their financial circumstances had to be sufficiently assessed by the Bundesbank (for example, with the help of annual accounts). In this way, the quality of the bills is guaranteed; therefore, excluding a credit risk for the central bank. The detailed concept of the discount credit is shown in Chart 1.

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[1] The full article “Der Wandel in der Geldpolitik – Anpassung der geldpolitischen Instrumente an die aktuellen Herausforderungen” is available on the CD enclosed with this publication.

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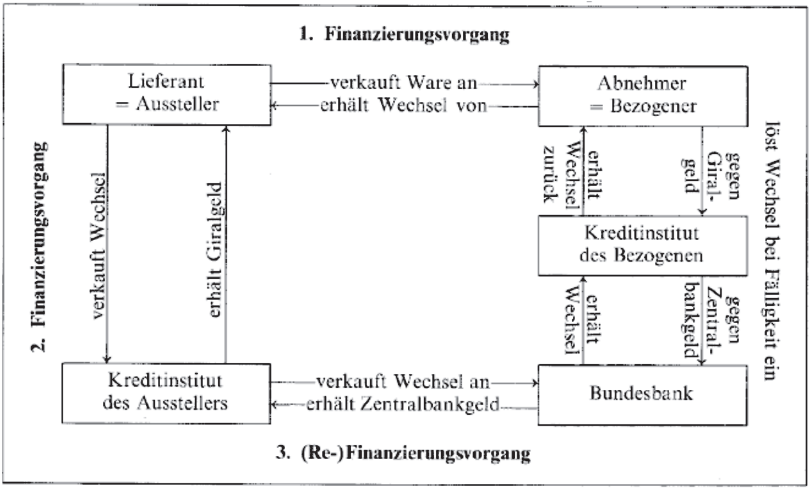

Chart 1. Path of discount credit as a financial instrument
Source: Dickertmann et al. (1984), p. 83.

Since 1973, the Bundesbank has additionally used changing repurchase transactions to provide central bank money. The running time had been ten days. To expand the period up to 65 days, they used another instrument called *repurchase agreements*. From that time until now, the Bundesbank has taken the political view that temporary transactions have the advantage of short term reversibility, in contrast to outright transactions. Outright transactions were also established by the Bundesbank in 1967 and 1975 by the purchase of public bonds, but the liquidity was already reduced one year later. As a result of the mergers within the European Union, the instruments of monetary policy must be adapted to new circumstances and some instruments have to be changed.

The Financial crisis started in 2007 with financial market turbulences in the US subprime market. 2008 was the peak of this crisis, due to the bankruptcy of the US investment bank, Lehman Brothers Inc. In the following years, the crisis expanded to several EU member states. As a result, different central banks extended the terms of financial operations, lowered the terms of deposit and introduced new instruments with an uncertain future for the economy. In the context of high tensions observed in certain market segments, the ECB began to purchase government bonds through the SMPs in 2010. Its program was not to have any effects on the monetary policy stance of the ECB. In order to ensure liquidity, specific operations (especially offering time deposits) were conducted each week to readjust the excess liquidity. The successor is the OMTs, which was announced in 2012, but has not been applied until now. If it is necessary from a monetary policy perspective, the ECB will consider such purchases. This program should only be applied selectively to individual financially-troubled countries, thereby reducing adding on interest by the purchases. The purchases are linked to an auxiliary request to the ESM crisis fund and saving restrictions combined with reform requirements. Any excess liquidity, provided by OMTs, will be fully reabsorbed by targeted operations. As a successor of the SMPs and OMTs the ECB started the program

'Quantitative Easing' in 2015. The QE-program is different from the OMTs, because bonds are bought from all European states. From 2014 until now, the ECB has launched two series of targeted longer-term refinancing operations (TLTRO), which is another non-standard measure. These operations draw more directly from the business policy of a credit institution, because these instruments are at least partly linked to the past and new lending of banks to the private sector. Therefore, it provides incentives for banks to avoid negative net lending or granting additional loans to the real economy. This parallels the former discount credits of the Bundesbank, because quotas are also applied to TLTROs; although these quotas aren`t enforced as strictly as they used to be for the discount credit. The following Chart 2 shows the development of the refinancing operations in the Euro area. From 2015 until today, most of the central bank money is allocated by the purchase program, which is nearly 75 percent of all liquidity. The main refinancing operations make up only a fraction and that shows the shift towards the permanent provision of central bank money.

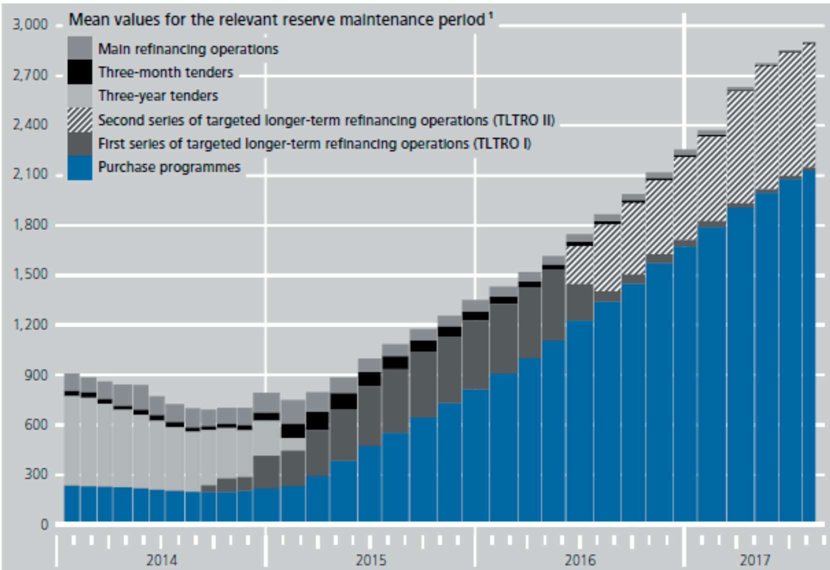

Chart 2. Outstanding liquidity broken down by market operations in the Euro area
Source: Deutsche Bundesbank, Monthly Report August 2017, p. 26.

The purchase continues until today; ten years after the start of the financial crises and seven years after the debt crises. On the basis of the circumstances of that crisis an unlimited and almost unconditional provision of central bank money has developed. The need for this is to be questioned.