Frankfurter Allgemeine Zeitung

**The normalization of monetary policy**

Dr. Michael Heise, 16.11.2009

A policy of historically low interest rates and unbridled liquidity was called for in the months gone by to avert a collapse of the financial system. Now the time for an exit seems to be gradually approaching. For months now the economy has been showing signs of improvement. Central bank growth projections for 2009 and 2010 are being nudged up and the ECB will probably move them up a further notch in December. Super-low interest rates and abundant liquidity are fueling the financial markets and treating the banks to juicy profits. All of this has helped the economy to get back on its feet. But if the medicine is administered for too long, new excesses and financial market bubbles will form. We have experienced this repeatedly in recent years as low interest rates deployed to tackle the Asian crisis, the dotcom crash or the housing crisis sowed the seeds for fresh excesses on the financial markets.

So far, so good. But wouldn't a less expansionary policy undermine economic activity? First off: monetary policy only affects the real economy with a time lag of one to two years. If interest rates are raised today, that would have little impact next year when government demand programs are still providing a boost anyway. Could an about-face in monetary policy prompt a new banking crisis? That is also unlikely. The banks are not short of liquidity but rather capital, despite the considerable progress already made. The European Central Bank no longer needs to inject unlimited liquidity, particularly as it could counter any renewed bottlenecks swiftly. Nor would a higher interest rate than the current 1% on 12-month funds derail the banks. At most this would curtail their profits somewhat, while at the same time pushing up those of the ECB, that is, indirectly, of the tax payer.

The biggest risk inherent in a gradual exit is not a renewed flare-up of the banking crisis but a steep rise in the euro which could jeopardize the nascent upswing in the euro area. Whether we see such sustained strength of the euro hinges crucially on whether the ECB and the Fed move more or less in step or act very differently. If the Fed puts off the about-face for longer, it will be imperative for the euro that the Asian central banks do not also stick to their expansionary stance and continue hoovering up dollars to prevent their currencies from appreciating. This would render an "isolated" euro appreciation almost inevitable. International coordination of the gradual crisis policy exit plan is highly desirable.

In sum, therefore, there are good reasons to initiate the normalization of monetary policy now. But there is no cause to over-dramatize the situation. It borders on the absurd when the ECB comes under fire for acting irresponsibly from those very quarters who bemoaned its hesitancy in the crisis. The expansionary policy was appropriate and there is still time to avoid exuberance and aberrations down the road. However, the change of tack must come soon.