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For a timely U-turn
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The ECB says the time is not yet ripe for a monetary policy U-turn, for an “exit” from its anti-crisis policy. The economy is running in low gear, with idle capacities and enormous pressure on prices. Credit demand is declining and the banking crisis is not yet definitively over. In such a situation, disconnecting the monetary drip prematurely could cause a relapse, as happened in the Great Depression eight decades ago.

Does that make a clear case for retaining bargain-basement interest rates and the central banks’ unconventional lending policy? Not necessarily. For one thing, the present economic situation should not be the central focus of monetary policy, but the developments in one or two years – the time it takes for decisions made now to work through to prices. There are signs of change here. The ECB will have to factor unexpectedly strong growth in the second half of the year into its projections and will presumably have to revise these sharply upward for 2009 and 2010. So far the dreaded meltdown on the labor market has not materialized either, and at the end of the year inflation will be well into positive territory again owing to the development in raw materials prices alone. Given this outlook, slowly skimming off the surplus liquidity injected into the banking system during the crisis would be justifiable. The ECB’s cleverly constructed toolkit would permit this without any major market upheavals. For example, the full allotment tender procedure that in principle gives the banks unlimited access to liquidity could be abandoned. The ECB could phase out extraordinary refinancing operations or soak up liquidity through repo transactions. Alternatively, if the huge liquidity buffer is still deemed necessary for the banking system, its price could be raised a little (e.g. to more than 1% for one-year liquidity).

Moves of this kind would have nothing to do with inflation mania – an accusation popularly leveled at the ECB. Rather, monetary policy should have greater regard for developments on the financial markets. Extremely low interest rates encourage greater risk-taking, triggering exaggerated price swings on the markets. That the price of gold and commodities has been heading sharply north for months, that banks are generating high revenues on securities trading for their own account and the markets are booming in the emerging countries stems not least from virtually cost-free central bank credit.

It was good that the central banks acted rigorously during the crisis. And it is true that a premature U-turn must be avoided. But adhering to a massive stimulus stance for too long comes at a cost, as recent history amply and vividly demonstrates. Alan Greenspan combated the LTCM financial market crisis with low interest rates ten years ago. This supported the irrational exuberance on stock markets, whose collapse, especially in the tech sector, again led to expansionary monetary policy at the beginning of the present decade. That in turn contributed to the overshooting on the property and credit markets that we are now working to redress – with low interest rates. Dramatic as the crisis may be, this is an aspect we overlook at our peril.