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The “Great Crisis” and Monetary Policy: Lessons and Challenges

1 Introduction

Almost two years have passed since the eruption of the financial market turbulence which progressively evolved into the deepest and broadest financial and economic crisis since the 1930s. There is no doubt that the global and European economies are going through a “great crisis”, one of exceptional proportions, in terms of its impact, scope and duration. Moreover, the current crisis appears to be “beyond compare” because although it does share important features with previous crises, it is also characterised by some unique ones relating to both its causes and its dynamics. I want to thank you for inviting me to address this prestigious conference and speak about the lessons from this crisis for monetary policy and the challenges that lie ahead in the new macroeconomic environment that is likely to emerge.

The events of the past two years have raised a number of important issues concerning the prevention and management of crises and allowed relevant lessons for market participants and policy-makers to be drawn. The underlying causes of, and the contributing factors to, this crisis, as well as the events and processes that determined its evolving nature and intensity over time, point to several conclusions about the role of the public authorities – central banks, supervisors and governments – in safeguarding financial stability and about the effectiveness of the existing institutional framework and the available policy instruments in achieving this objective. They also raise questions about the functioning of financial markets and institutions, in particular their capacity to price, allocate and manage risk efficiently.

In my remarks, I will focus on the contribution of monetary policy to preventing a financial crisis and – if one occurs – to mitigating its impact on the financial system and the broader economy. More specifically, drawing lessons from the current crisis, I will address the following questions:

- What is the role of monetary policy in dealing with a financial crisis and in helping to safeguard the stability of the financial system, while at the same time ensuring the preservation of price stability?
- How effective have monetary policy instruments and the “non-standard” measures taken by central banks, notably the ECB, been in mitigating the impact of the crisis on the economy, by promoting the orderly functioning of money markets and fostering the provision of credit to the private sector?
- As conditions normalise and we need to look beyond the crisis, a crucial issue is: what is the appropriate exit strategy that can ensure the preservation of price stability and the gradual return of markets to conditions of normality where financial institutions do not need to rely on the extraordinary measures of central bank financing and government support?
- Finally, in the post-crisis macroeconomic environment, what can monetary policy do to reduce the likelihood of a financial crisis, like the current one, occurring again and thus help to prevent its potential adverse effects on economic activity and price stability?

2 Dealing with the Financial Crisis: the Role and Effectiveness of Monetary Policy and Liquidity Management

Let me first concentrate on the role of monetary policy – and more generally central bank policies – in dealing with a financial crisis and how this role can be performed in a manner that is compatible with the preservation of price stability. In doing so, I will highlight the actions taken by the ECB during the current crisis and I will assess their effectiveness.

The ECB and the Eurosystem have as primary objective the maintenance of price stability. At the same time, the Eurosystem aims to safeguard financial stability.¹ The two policy goals are, in general, positively related. Price stability is a necessary condition for financial stability, which in turn is essential for the effective transmission of monetary policy. Disturbances that result in severe financial market turbulence, which disrupts the intermediation process and threatens the stability of the financial system, are likely to have adverse consequences for economic activity and price stability. But this is not always the case, as other factors or processes can counteract the impact of financial market stresses on price developments. There are occasions when the constellation of disturbances affecting the economy can lead to situations that may pose policy trade-offs.

When assessing the role of central bank policy in supporting financial stability, it is important to distinguish between a change in the monetary policy stance – that is, a change in the policy rate and/or in the supply of central bank money – and the management of liquidity that aims to mitigate the impact of shocks on the interbank

money market so as to ensure its orderly functioning and the efficient transmission of monetary policy to the economy. This distinction is crucial both for substantive reasons and in order to better understand the rationale of the policies pursued by the ECB – the various standard or non-standard measures taken – that have aimed at counteracting the effects of the crisis on the financial system, economic activity and price stability.

Since the financial turbulence erupted in summer 2007, financial and economic developments as well as central bank policy responses can be usefully examined and assessed over two time periods. During the first period, from early August 2007 until early October 2008, the ECB did not ease the stance of monetary policy – as defined by its key policy rates – to address financial market tensions. On the contrary, in July 2008, it raised its key policy rates by 25 basis points to counter increasing inflationary pressures and medium-term inflation risks. Nevertheless, from the onset of the crisis in August 2007, the ECB took swift and decisive action to provide liquidity in the interbank money market in order to alleviate market pressures and ensure, to the maximum extent possible, that liquidity problems would not turn into solvency problems, and that systemic risk would be effectively contained.

During this first period, the Eurosystem engaged in active liquidity management, adjusting the intertemporal distribution of liquidity provision within the reserve maintenance period, but without changing the total supply of bank reserves over the entire maintenance period (of, in most cases, 28 days). At the same time, the maturity profile of the refinancing operations

¹ See the *Mission Statement of the Eurosystem* (www.ecb.europa.eu).

was altered, with more central bank liquidity being provided to banks for periods up to three months (and as of March 2008, also up to six months), and correspondingly less in the weekly main refinancing operations, so that the overall supply of bank reserves was kept broadly unchanged. As a result, between the end of June 2007 and the end of September 2008, the balance sheet of the Eurosystem increased only moderately by about EUR 100 billion.²

To sum up, for more than a year after the eruption of the financial market turmoil, the unfavourable combination of, on the one hand, persisting and increasing inflation risks and, on the other, substantial stresses in the financial system and risks to its stability required a “separation” of the monetary policy stance from the management of liquidity. The former was defined so as to achieve the primary objective of preserving medium-term price stability. The latter aimed at, and was effective in, mitigating pressures in the money market and tensions in other financial markets, as measured, for example, by CDS spreads and corporate bond risk premia, which gradually eased.

With the collapse of Lehman Brothers in September 2008, the crisis entered a new phase: it intensified greatly and abruptly, spread across economic sectors, and broadened globally, affecting advanced, emerging and developing economies. Risk aversion rose dramatically and confidence plummeted as shown by several indicators, stresses in the banking system increased, the money market became dysfunctional, and world economic activity weakened substantially accompanied by a sharp

drop in world trade and a marked decline in commodity prices.

The sudden and dramatic deterioration in financial market conditions and the macroeconomic environment changed the outlook for price stability and inflation risks diminished significantly in the euro area and globally. At the same time, the risks to financial stability increased. In response, the ECB and other major central banks eased monetary policy and injected large amounts of liquidity, also employing non-standard policy measures. Over the seven months since the financial crisis deepened and broadened, the ECB reduced its key policy interest rate by 325 basis points, to 1%. The magnitude of the monetary policy easing over such a short period of time was unprecedented and highlighted the exceptional policy response to the crisis. Equally unprecedented has been the expansion of liquidity provided by the ECB in the interbank money market.

Indeed, the provision of liquidity by the ECB to the euro area banking system has been extraordinary in size and scope, and has involved implementation of non-standard measures. Following the Lehman Brothers bankruptcy, banks became ever more reluctant to lend to each other as a result of a sharp increase in the perceived risks of counterparty default and a continued lack of transparency about the health of banks' balance sheets.³ To ease banks' severe funding problems, the ECB took unprecedented steps and increased its intermediation activity. Since October 2008, the ECB has provided unlimited funding in euro at fixed interest rates over periods up to six months against

² At the end of September 2008, the size of the balance sheet of the Eurosystem was EUR 1,013 billion, an increase of 11% compared with its size at the end of June 2007, before the turmoil erupted.

³ The effects of asymmetric information and counterparty credit risk on the interbank market and the various policy responses are analysed in Heider et al. (2009).

an expanded list of assets eligible for use as collateral in Eurosystem refinancing operations. In addition, the ECB has supplied liquidity in other currencies, notably US dollars, on the basis of a swap agreement with the Federal Reserve. This extraordinary expansion



of liquidity provided to euro area banks is reflected in the growth of the Eurosystem's balance sheet. Between the end of September 2008 and the end of April 2009, the (simplified) balance sheet of the Eurosystem increased by EUR 456 billion, reaching EUR 1.51 trillion on 24 April 2009, which is equivalent to about 16% of the 2008 euro area nominal GDP. By comparison, over the same period, the size of the Federal Reserve System's (simplified) balance sheet increased by USD 966 billion to USD 2.18 trillion, equivalent to about 15% of the 2008 US nominal GDP.

Have the policy actions taken by the ECB been effective? They have resulted in a significant improvement in money market conditions. They have also reduced the cost of financing of the economy, contained the impact of the crisis on economic activity and minimised the risk of deflation. The spread

between the three-month EURIBOR (Euro Interbank Offered Rate) and the three-month EONIA (Euro Overnight Index Average) swap rate, a widely used measure of interbank market tensions, declined by almost 130 basis points over the past seven months, from the highs of above 180 basis points recorded in October 2008 to just below 60 basis points in mid-May 2009. Moreover, money market rates have declined even more from the peaks reached in October 2008. For example, the three-month EURIBOR stood at 1.27% in mid May 2009, more than 400 basis points lower than its peak value of 5.39% in October 2008. These are favourable developments also relative to those observed in other major money markets, where interest rate spreads and levels have been falling sharply as well.⁴

The transmission of the policy rates to money market interest rates is an important, but intermediate, step towards bank lending rates. The structure of the euro area financial system, with the dominant role played by the banking system in the financing of the economy, implies that the transmission of the ECB's policy rates to the euro area bank lending rates is of utmost relevance for economic activity. Until October 2008, the borrowing costs of households and firms seemed to have increased compared with the policy rate, as bank lending standards tightened and bank interest rates followed the path of the EURIBOR. But the substantial reduction in policy rates and the unlimited provision of liquidity to the banking system over the past seven months have resulted in a decline in bank lending rates, particularly as regards short-term credit.

⁴ For example, the corresponding US money market spread, the three-month LIBOR (London Interbank Offered Rate) minus the OIS (Overnight Indexed Swap) rate, had declined to just under the 100 basis points mark in April 2009.

Nevertheless, financing conditions have remained tight and growth in credit to the private sector has decelerated, partly as a consequence of the deleveraging of banks' balance sheets and persisting stresses in the bank wholesale funding markets. After a prolonged period of "search for yield" by investors and the accompanying excessive growth of credit and leverage, the large write-downs on bank assets, the reduced bank profitability and the low confidence in the health of the banking system have forced banks to embark on a process of deleveraging. Needless to say, the ongoing structural adjustment in the banking sector and the low market confidence cannot be counteracted by monetary policy. To address these developments and help strengthen banks' balance sheets, governments have provided a significant amount of support to banks in Europe and elsewhere, through capital injections, the provision of government guarantees on new bank debt as well as asset relief schemes aiming at removing troubled assets from banks' balance sheets.⁵ The common goals of these government measures are to safeguard financial stability, help restore the provision of credit to the economy and bolster confidence in the soundness of the financial system and in the prospects of the economy.

At the current juncture, a key feature of the crisis is a mutually reinforcing interaction between, on the one hand, the weakening of economic activity and rising unemployment, and, on the other hand, the process of deleveraging of banks' balance sheets and the persisting stresses in some bank funding markets. The weakening of

economic activity could lead to a further deterioration in bank balance sheets and prolong the deleveraging process. This could limit the willingness of banks to supply credit, which would adversely affect economic activity and increase the likelihood that banks will suffer further credit losses and tighten their lending standards. The deleveraging process and the emergence of a strong adverse feedback loop between the real economy and the financial sector will undoubtedly affect the impact of monetary policy on the economy and will make it harder to assess its effectiveness. This also underscores the importance of effective implementation of the government measures to strengthen bank balance sheets and of other policy actions that can improve the functioning of funding markets.

At its meeting on 7 May 2009, the Governing Council of the ECB decided to lower the interest rate on the main refinancing operations by 25 basis points to 1% and to keep the interest rate on the deposit facility unchanged at 0.25%. We also agreed on important measures of "enhanced credit support", aimed at encouraging banks to expand credit to the private sector, improving market liquidity and funding conditions for banks and enterprises and, more generally, enhancing the transmission of monetary policy actions to the real economy. These measures include the purchase of euro-denominated covered bonds issued in the euro area, the provision of central bank liquidity with a maturity of 12 months to the banking system, and making the European Investment Bank an eligible counterparty in the Eurosystem's monetary policy operations.

⁵ *In the euro area, banks had received just over EUR 113 billion of capital injections from governments and around EUR 300 billion of government guarantees by early May 2009.*

3 The Exit Strategy from the Extraordinary Policy Measures Taken During the Financial Crisis

To sum up, the monetary policy responses of the ECB and the other major central banks to the current crisis, especially since its deepening and broadening in September 2008, have been extraordinary – indeed, they can be labelled “unprecedented”. But they have been appropriate in the light of the severity and scope of the crisis, and its potential effects on financial stability and price stability. Unprecedented has been the extent of the monetary policy easing since last autumn; unprecedented has been the amount of liquidity provided by the Eurosystem to the banking system at different maturities and in different currencies and the related expansion of its balance sheet; and unprecedented has been the use of “non-standard” measures to provide central bank liquidity and support the provision of credit to the private sector. These facts underscore the importance of adopting an appropriate exit strategy from the extraordinary macroeconomic stimulus, the government bank support schemes and the non-standard monetary policy measures.

The features of the appropriate exit strategy and the pace of its implementation will depend on several considerations, but let me emphasise two. The first is the overriding goal to effectively counter any risks to price stability over the medium to longer term and ensure that medium-term inflation expectations remain firmly anchored to price stability. The second is the need to progressively reduce the reliance of the banking system, and more generally of the financial sector and the economy, on government support schemes and central bank non-standard measures, which are of an exceptional and tempo-

rary nature, and to restore the normal functioning of markets. To this end, once financial conditions and the macroeconomic environment improve, the non-standard monetary policy measures taken should be quickly unwound and the liquidity provided should be absorbed in a timely manner.

The effective implementation of the exit strategy will have to address a number of issues. The ease and speed with which the central bank can revert from the non-standard to normal operating procedures in a smooth manner will depend on the resolution of the underlying problems causing the dysfunctioning of the money market. In particular, transparency and confidence in the reporting of market participants' exposures to toxic assets and highly risky loans must be such that adverse selection, which has been a cause of dysfunction of the money market, ceases to be a problem. Moreover, any changes in the operational framework should be clearly communicated by the central bank with a sufficient lead time to allow market participants to prepare and adjust their liquidity management. The ECB and the Eurosystem are committed to pursuing such a timely and transparent communication policy.

Another issue of relevance for the implementation of the appropriate monetary policy stance in the context of an exit strategy is the careful assessment of the extent to which parts of the monetary policy transmission mechanism have been affected by the financial market turbulence, and the implications of this for the conduct of monetary policy. For example, during the crisis the ratio of the broad monetary aggregate M3 to the monetary base M0 has dropped rapidly and substantially because the provision of liquidity by the central bank is being only partly transmitted – and to a much lesser extent

than in normal times – to the bank credit market and the real economy. Once the economy recovers and the deleveraging of banks' balance sheets is complete, the value of this “money multiplier” will start reverting to normal. Vigilance and appropriate policy responses are therefore needed to avoid an excessive expansion of credit to the economy. These concerns may seem premature at the present juncture of tight financing conditions, but it is important to be prepared so that the exit strategy is implemented effectively and we avoid sowing the seeds of credit and asset market excesses in the future that could constitute a risk to price stability.

One attractive feature of most non-standard measures used by the ECB is that they can be easily unwound and that the liquidity provided can be withdrawn automatically at the maturity of the refinancing operations. Of course, the relative advantages of different non-standard measures with regard to their unwinding should be judged against their effectiveness in providing the necessary credit support during the crisis. And the effectiveness of different measures depends on the economy's financial structure, for instance the extent to which the financing of the economy relies on the banking system, as is the case in the euro area, or it is market-based, as is the case in certain other advanced economies.

Finally, the timing of the implementation of an exit strategy will clearly depend, first and foremost, on the outlook for price stability, which is partly related to the pace of economic recovery and the return to normality in financial markets. Recently, we have observed an increasing number of posi-

tive signs suggesting that the economy is stabilising and that the recovery may start sooner than previously envisaged, despite the further strong deterioration of economic activity in the first quarter of this year. However, the available economic data and survey indicators point to a stabilisation at low levels and economic activity in the euro area is likely to gradually recover in the second half of 2009 and in the course of 2010. The monetary policy stance and the non-standard measures taken so far will ensure the preservation of price stability over the medium term and will progressively provide further support to economic activity.

4 Financial Crisis Prevention and Monetary Policy

The high uncertainty associated with the transmission of monetary policy when the financial system is under stress and the implementation challenges of the exit strategy that I previously mentioned are only two reasons that underscore the need to prevent the build-up of financial imbalances in the first place. One of the lessons from the current crisis, which is also supported by recent research findings⁶, is that monetary policy tools should be among the instruments to be employed to prevent asset market excesses and the systemic and deflation risks they entail. The events of the past two years have revived the debate on whether, and to what extent, monetary policy can be used to “lean against the wind” of emerging asset price bubbles; or whether monetary policy can indeed be conducted in what could be called a “symmetric” manner over the financial cycle, that is, being accommodative in

⁶ E.g. Diamond and Rajan (2008); Adrian and Shin (2008); Maddaloni et al. (2008); Alessi and Detken (2009); De Fiore and Tristani (2009); Cecchetti et al. (2000); see also Taylor (2009).

an environment of falling asset prices, while being commensurately restrictive during a financial market boom.⁷

Let me elaborate on these issues by first looking at periods when financial markets are declining sharply. In general, market participants will expect public authorities, including the central bank, to take measures to mitigate the impact of a major crisis once it occurs. From the perspective of the central bank, a monetary policy easing, in all likelihood, would not only be supportive of financial stability, but it would also be appropriate for achieving the price stability objective, as inflationary pressures could be expected to diminish during a severe financial market downturn and an associated weakening of economic activity. For financial institutions, however, the expectation of being “bailed out” in a crisis is likely to encourage excessive risk-taking during boom times, or even fuel an asset price



boom. The available evidence and recent research show that a higher, possibly excessive, level of risk-taking has been observed in the past during periods of persistently low interest rates.⁸ In order to reduce such potentially dangerous

side-effects of non-standard measures of liquidity provision and of the very low policy rates during a crisis, monetary policy would have to be sufficiently tightened during the financial boom phase. Such a policy would dampen financial market excesses through two channels. It would tend to reduce asset prices by increasing the rate at which an asset’s future income stream is discounted. Most importantly, the anticipation of such a policy response would reduce the likelihood of a speculative bubble emerging in the first place, by affecting investment behaviour and reducing the level of risk incurred by financial intermediaries in their lending.⁹

Can such a “symmetric” monetary policy response to financial market cycles be effectively implemented? The ECB’s monetary policy strategy offers an appropriate framework, and one that seems better suited than the traditional inflation targeting framework, for two main reasons. First, the ECB defines quantitatively its price stability objective – an inflation rate below, but close to, 2% – in a manner that would allow the conduct of a more restrictive monetary policy during a period of buoyant financial markets, even in an environment of relatively subdued inflationary pressures. In other words, leaning against the wind of booming asset prices by raising the policy interest rates would, even in the short to medium term, be compatible with the ECB’s monetary policy strategy aiming at consumer price (HICP) stability. Leaning against the wind would likely result in lower consumer price inflation over the short to medium term, but would be expected to be more

⁷ See pertinent discussion in Kohn (2006 and 2008).

⁸ See Jiménez et al. (2007).

⁹ See Diamond and Rajan (2008); Cao and Illing (2008).

effective in maintaining price stability over the longer term, by helping to prevent the materialisation of deflation risks when the asset bubble bursts.

The second reason is that the emphasis placed by the ECB on the analysis of monetary and credit developments in order to identify longer-term inflation risks can also provide signals of growing financial imbalances, which in principle could be used to contain financial market excesses.¹⁰ Even if leaning against the wind would not be an explicit policy aim, a greater reliance on the analysis of monetary and credit developments when defining the appropriate monetary policy stance would likely result in a tighter policy during times of booming financial markets and a more accommodative one in less favourable conditions. This is because asset price booms are often fuelled by strong money and credit expansion. Recent research, also by ECB colleagues, has shown that financial imbalances – especially the more “costly” ones – are usually related to a large build-up of leverage in the economy, which is associated with strong money and credit growth.¹¹

In practice, however, the implementation of a policy of leaning against the wind may not be straightforward. And, certainly, it cannot be based on a mechanical response of the central bank policy rate to developments in monetary and credit aggregates, not least because the recent experience has shown that rising asset prices are not necessarily closely associated with a significant increase in inflationary pressure and medium-term inflation

risks that would call for a tightening of monetary policy. Structural factors, such as increases in trend productivity growth, technological innovation or the inflation-dampening effects of global competition, can contribute to keeping consumer price inflation low for a considerable period of time while asset prices are rising rapidly. In such situations, the use of the single monetary policy instrument, the interest rate, to pursue the objective of price stability might require a change in one direction, but financial stability considerations might point in another direction.

Moreover, it has been argued that monetary policy is “too blunt a tool” to be effective in preventing the build-up of imbalances, because interest rate increases might need to be very large in order to significantly influence asset price dynamics and risk-taking in periods of “irrational exuberance” in financial markets. A number of counter-arguments supported by empirical evidence can be advanced to address this traditional concern. *First*, the experience during the current crisis with off-balance-sheet structured investment vehicles (SIVs) suggests that the profitability of such entities, whose balance sheets are characterised by high leverage and a maturity mismatch, is very sensitive even to small changes in the spread between long and short-term interest rates. To the extent that the central bank is able to affect the slope of the yield curve, such a maturity mismatch and leverage would be curtailed.¹² *Second*, while central bank warnings about observed excessive

¹⁰ See Alessi and Detken (2009) and Gerdesmeier et al. (2009).

¹¹ See Detken and Smets (2004); Adalid and Detken (2007); Goodhart and Hofmann (2008); Christiano et al. (2008); Baumeister et al. (2008).

¹² See Adrian and Shin (2008).

risk-taking might not always have triggered immediate corrective action, their explicit communication in conjunction with relatively small changes in the key policy rate could have the desired effect. This is because a change in the policy rate would serve as a signalling device and increase the credibility of the central bank's risk assessment.¹³

Third, by slightly increasing the price of leverage at an early stage of an asset price boom, the central bank could break herding behaviour when the development of a bubble depends on investors observing other investors purchasing the bubble-prone asset.¹⁴ Thus the view that monetary policy may not be an effective tool to lean against the wind of asset price booms can be challenged. But no consensus on this issue has yet emerged. The effectiveness of conducting monetary policy in a "symmetric" manner over the financial cycle will have to be assessed in practice.

My remarks have focused on lessons and challenges for monetary policy in the light of the "great crisis". However, other policies should certainly also be at the centre of attention when drawing lessons from the experience of the past two years, not least because other policies can complement and support the efforts of central banks to prevent and manage a crisis. The events of the past two years have revealed several weaknesses in the financial system and highlighted important inadequacies in the regulatory and supervisory frameworks. Strengthening and broadening the regulatory framework as well as conducting macro-prudential supervision are important priorities in Europe and globally.¹⁵ In particular, the establishment of an effective framework for

macro-prudential oversight and the further development of the relevant analytical underpinnings, such as financial stability indicators as well as early risk warning and stress-testing models, would greatly contribute to financial crisis prevention.

5 Conclusion

I have characterised the current crisis as "great" and one "beyond compare". The crisis has also been a learning experience beyond compare, for market participants and policy-makers, including central bankers. What is essential now is to make sure that the lessons that have been drawn from this experience are actually learnt, and that public policy and market behaviour adapt accordingly. For monetary policy, this implies that financial stability considerations should be taken into account when formulating policy aimed at preserving price stability over the medium and longer term. In particular, close monitoring and deeper analysis of asset price movements, monetary and credit developments, and the build-up of financial imbalances can provide valuable information for the conduct of monetary policy. The ECB's monetary policy strategy provides an appropriate framework for such an analysis and for effective policy formulation. The more immediate challenge for monetary policy over the medium term is to strike a balance between, on the one hand, responding in a timely and effective manner to incipient risks to price stability as the economy recovers and market conditions normalise, and, on the other hand, winding down in a proportionate manner the non-standard measures that have been implemented

¹³ See Hoerova et al. (2008).

¹⁴ See Loisel et al. (2009).

¹⁵ See, for example, Papademos (2009a and 2009b).

to mitigate the adverse effects of the crisis on the banking system, financial market segments and the broader economy. Finally, I would like to stress that, just as a crisis is a multi-faceted phenomenon, the public policy response cannot rely only on one policy instru-

ment or the actions of one authority. The joint efforts and cooperation of central banks, supervisors and regulators are necessary for effective crisis prevention and management. In this manner, we will better address the challenges that lie ahead.

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