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Central bank collateral frameworks

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A B S T R A C T

This paper seeks to inform about a feature of monetary policy that is largely overlooked, yet occupies a central role in modern monetary and financial systems, namely central bank collateral frameworks. Their importance can be understood by the observation that the money at the core of these systems, central bank money, is injected into the economy on terms, not defined in a market, but by the collateral frameworks and interest rate policies of central banks. Using the collateral framework of the Eurosystem as a basis of illustration and case study, the paper brings to light the functioning, reach, and impact of collateral frameworks. A theme that emerges is that collateral frameworks may have distortive effects on financial markets and the wider economy. They can, for example, bias the private provision of *real* liquidity and thereby also the allocation of resources in the economy as well as contribute to financial instability. Evidence is presented that the collateral framework in the euro area promotes risky and illiquid collateral and, more generally, impairs market forces and discipline. The paper also emphasizes the important role of ratings and government guarantees in the Eurosystem's collateral framework.

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Money is economical power.
– Walter Bagehot (1873)

1. Introduction

If money is economic power and money is issued against collateral, it stands to reason that it is important to understand the nature of the collateral and the terms of the exchange. The money at the core of modern economies is central bank money, what bankers call liquidity. This is injected into the economy, through banks as intermediaries, on terms not defined in a market, but by the collateral frameworks and interest rate policies of central banks. In some jurisdictions, or currency areas, central bank independence means that collateral frameworks are not subject to formal supervision, review, or even much by way of discussion.

☆ This paper has been written in parallel with a book, cited as Nyborg (2016), and provides a summary of some of the ideas and findings in that larger manuscript. Thus, the majority of the text in this paper is shared verbatim with that of the larger manuscript, though the order of passages may be different. The research sampled here has been a large undertaking and I would like to thank Lilia Mukhlynina, Cornelia Rösler, and Jiri Woschitz for research assistance. The responsibility for any errors is mine. I have also benefited from comments from participants at the ECB Workshop on "Structural changes in money markets: Implications for monetary policy implementation" (September 2013), seminars at the Central Bank of Ireland (April 2014), the Universities of Chicago and Wisconsin (March 2015) and Zurich (June 2015), the Swiss National Bank (April 2015), Norges Bank (September 2015), the Yale Program on Financial Stability Annual Conference (August 2015), and UC San Diego (November 2015). I would also like to thank Ulrich Bindseil for comments and the ECB's legal department, outreach division, and collateral team for clarifying some issues.

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