Central bank collateral frameworks

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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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1. Introduction

Money is economical power.
- Walter Bagehot (1873)

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.
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