

Monetary policy responses to the crisis and implications for future monetary policy

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Introduction

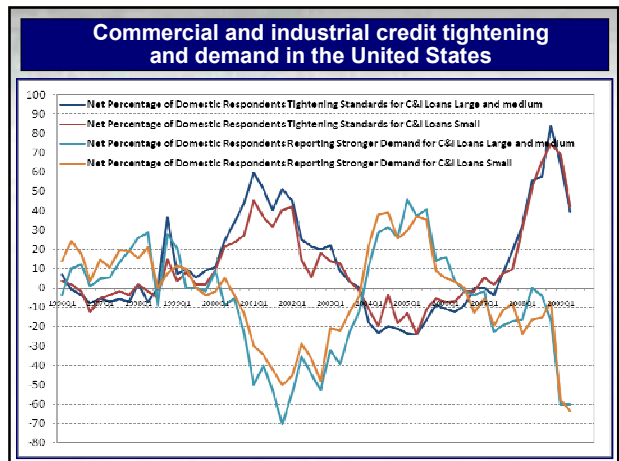
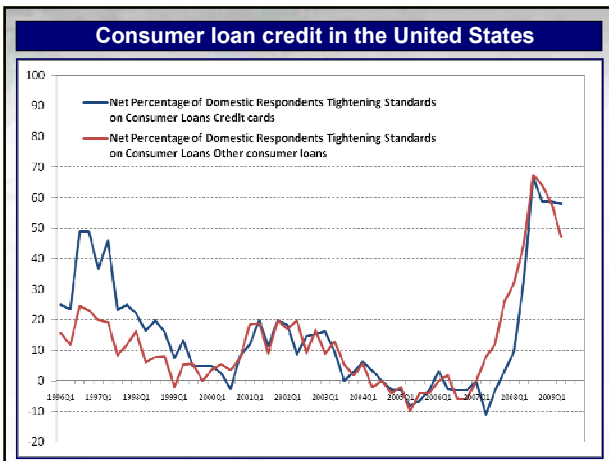
- The recent financial crisis has created challenges for monetary policy:
 - Credit spreads widened significantly
 - Output declined
 - Interest rates declined to zero bounds
- Raised questions about
 - the efficacy of monetary policy at these low rates
 - the ability of monetary policy to be effective in the face of impaired transmission mechanisms

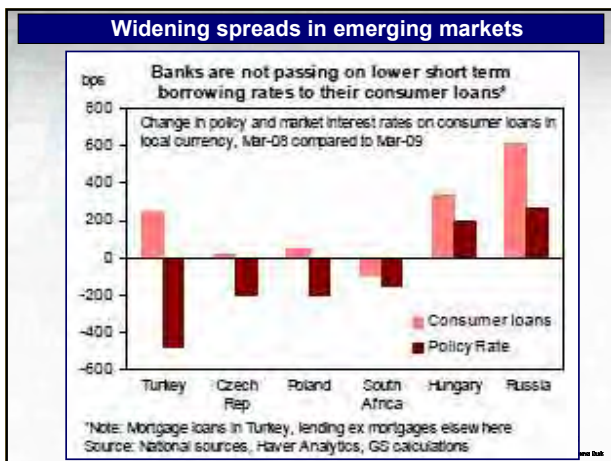
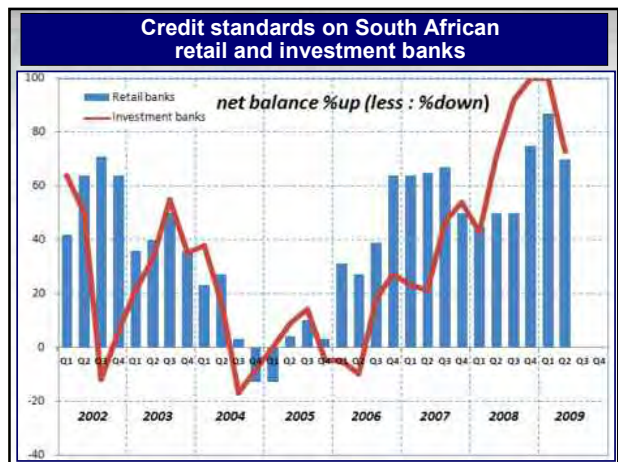
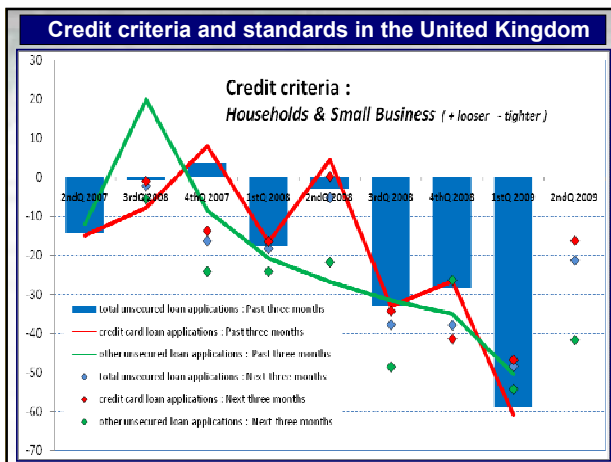
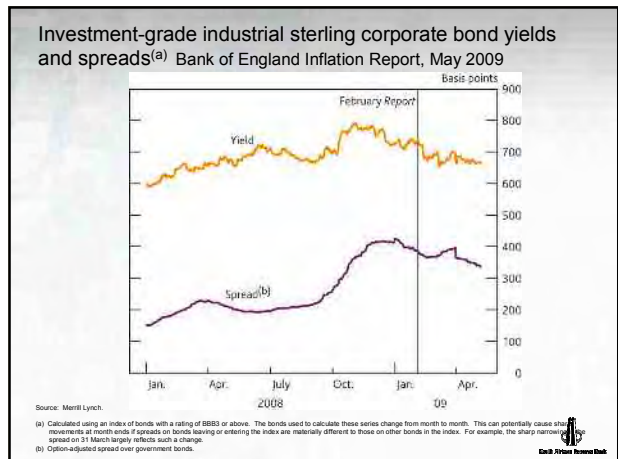
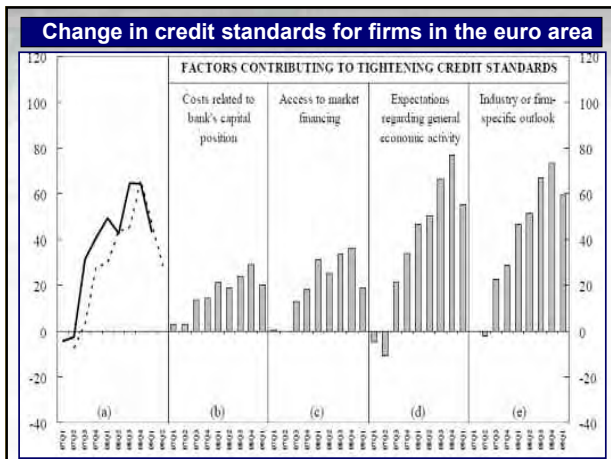
Introduction (cont...)

- implementation of unconventional measures and their exit strategies
- and longer run concerns about
 - the relationship between monetary policy and:
 - financial stability: the relationship between monetary policy and asset prices/credit bubbles (should monetary policy lean or clean?)
 - bank regulation

How were transmission mechanisms impaired?

- High risk premia on loan rates of banks and higher credit criteria, impairing the transmission mechanism from policy rates to retail policy rates (widening credit spreads and restrictive lending standards are part of the deleveraging process). Often offsetting impact of lower policy rates
- Cost of credit to households and firms increased
- Baa corporate bond rates increased by over 200bp
- Interest rates on junk bonds by over 1000 bp





How were transmission mechanisms impaired?

- Many money markets that had been key sources of funding effectively closed
- Disruption to international trade and capital movements due to high risk aversion affects the usual open economy impact of monetary policy changes.
- Policy rates falling to the zero bound particularly in advanced economies

Does this impairment mean that monetary policy is no longer effective?

How should monetary policy respond?

- Despite higher spreads and lending rates, monetary policy is still effective in the sense that without the reduction in policy rates, the output contraction would have been even more severe.
- Mishkin: "If the Fed had not aggressively cut rates, the result would have been both higher interest rates on default-free bonds like Treasury securities, and a substantial increase in macroeconomic risk with much higher credit spreads. Interest rates relevant to household and business spending decisions would then have been *much higher than what we see currently*".
- Concludes that not only has monetary policy been effective, it has been even more potent than during normal times because not only has it lowered interest rates on default free securities, it helped lower credit spreads.



How should monetary policy respond? (cont...)

- This does not imply that monetary policy on its own can solve the problem, but it can reduce the likelihood of a financial crisis generating an adverse feedback loop (financial accelerator).



How have central banks responded?

- Aggressive interest rate reductions in many cases.
- Some explicitly in order to try and avoid or mitigate recessions.
- Others that were explicit inflation targeters framed the response in terms of the impact of the output gap on the outlook for inflation.
- King: "...try to slow the pace of adjustment to domestic demand in order to limit the impact on output and employment".
- Fischer: "...to avoid the threat of deflation"

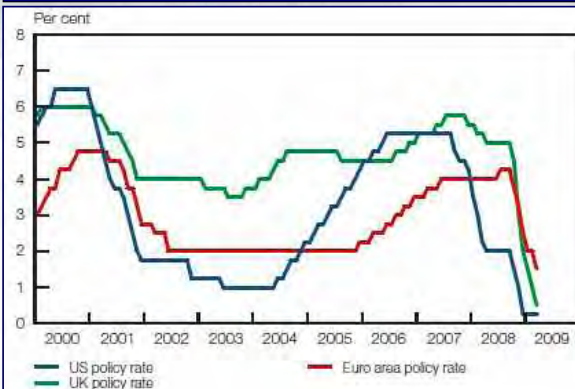


How have central banks responded?

- Raises the question whether central banks should move gradually or quickly?
- Behaviour appears to have been asymmetric- slow on the upside, quick on the downside.
- Contrast Fed's 'measured' moves and 'aggressive' moves.
- Risk-management approach to avoid deflation?



Central banks' policy rate responses to the global crisis



How have central banks responded? (cont...)

Other broad responses included:

- Active liquidity management
- Enhanced and emergency liquidity provision
- Support to market trading activity
- Bank recapitalisations

In general, many of these interventions were a result of impaired banking systems.



Interest rates at the zero bound

- Use of quantitative easing (QE). But considerable uncertainty remains about the size and reliability of these effects under the circumstances prevailing near the zero bound.
- Quantitative easing may have expansionary effects through various channels. This is particularly the case if it has a direct effect on inflation expectations and asset prices, and leads to increased expenditure.



Interest rates at the zero bound (cont...)

- Conventional unconventional approach (classical QE) is to buy assets (e.g. government securities) which are traded in liquid markets. This can increase credit supplies if not hoarded by banks- **but this is a problem if banks are not lending** or if demand is weak.
- QE failed in Japan in 90s and early 2000s: not strong demand for credit (deleveraging taking place); and on supply side banks were reluctant to extend credit because of impaired balance sheets.



Interest rates at the zero bound (cont...)

- Unconventional unconventional methods: when credit markets are dysfunctional, targeted purchases by CBs of assets may improve the liquidity in markets for those instruments. Helps reduce the illiquidity premium, and may reduce reliance on bank lending.



Interest rates at the zero bound (cont...)

- Referred to as "credit easing". Lending is also intended to prevent disorderly and disruptive sales of illiquid assets which would drive asset prices even lower.
- High quality corporate bonds spreads had increased to an average of over 5 percentage points- represented an illiquidity premium which could be reduced by increasing activity and liquidity in the market.
- Usually only against good collateral.



US Quantitative easing

- Fed initially chose the route of credit easing- buying distressed assets from the banks. Concentrated on buying up the type of loans that would bring down the spread between Federal borrowing, bank borrowing and company borrowing.
- Initial plan was to spend US\$500bn on MBSs and another US\$100bn on debt from Fannie Mae & Freddie Mac.



US Quantitative easing

- 19 March: In addition to another \$750bn in MBS the Fed will buy US\$300bn of long term government debt. Balance sheet will have increased by US\$1.75 trillion - double the amount committed to the fiscal stimulus.
- TALF- Term asset backed lending facility- relatively limited use by can expand to US\$ 1 trillion (up to 5 years maturity).
- Outstanding amounts of short term liquidity provision has been shrinking as liquidity concerns have declined



UK Quantitative easing

- BoE announced Asset Purchase Facility (APF) in January- allowed to purchase up to £150 billion of assets. Later changed to £175 billion
- Up to £50 billion can be used to purchase private sector assets.
- The timing and scale of asset purchases are for the MPC to decide.
- "Purchases of assets by the APF should also provide confidence to investors that they can sell assets, reducing concerns about liquidity and stimulating trading activity. That should make it easier for companies to borrow directly from capital markets....." (Bank of England)

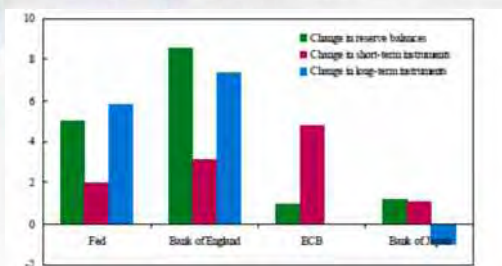


Euro area quantitative easing

- Previously focused on supplying unlimited liquidity
- In May, announced it had agreed to buy €60bn in 'covered bonds'- issued by banks and backed by public sector loans or mortgages.
- (According to FT, the original plan was for a €125bn programme which would have included other private sector assets).



Changes in major components of central bank balance sheets (% of GDP in 2008)



Sources: Bank of England, Bank of Japan, ECB, and Federal Reserve Board.
 Note: Changes between end-June 2007 and end-June 2009. Short-term instruments - less than one year; long-term instruments - one year or longer (at the time of intervention).



Interest rates at the zero bound (cont...)

But there are dangers:

- King: Fine dividing line between helping to oil the wheels in markets which are temporarily impaired, and artificially supporting markets in which there is no underlying demand.
- Taylor: argues that simply having quantitative easing can be problematic if it does not deal with the root cause of the problem.



Interest rates at the zero bound

- Argues that it was not a liquidity problem, but a problem of counterparty risk. Therefore there is little role for liquidity provision. Rather policy should have focused on requiring more transparency etc.



Are the current developments inflationary?

- Dangers that current unconventional moves are inflationary.
- Political opposition, (eg Merkel)
- Currently should not be, given the low levels of demand.
- General agreement that these developments will have to reverse as things normalise.
- May be a fine balancing act to prevent the reversal from bringing the recovery to a halt. Key is to reduce balance sheets in a timely fashion.



Are the current developments inflationary?

- Kohn: size of balance sheet will not preclude raising interest rates when appropriate for macro stability
- Programmes will be terminated when necessary
- But many assets are long term. Loans to back securitisation market are for 3 years:
 - Can sell debt on an outright basis or temporarily through reverse repos;
 - Developing capability to do the same with MBS;



Are the current developments inflationary?

- Paying interest on excess reserves can provide a floor to the fed funds rate even if declines in lending are not sufficient to bring reserves down to their desired level;
- Working with Treasury to promote legislation to enhance the absorption of reserves.



Are the current developments inflationary?

- Bill White: Do central banks have the skills to reverse the expansion as quickly as they would like?
- "The exit problem is not inconsequential."

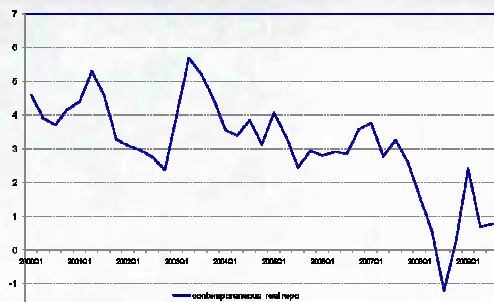


South African monetary policy in the crisis

- Impacted on the economy with a lag (as with most emerging economies)
- Interest rates reduced between December 2008 and August 2009 by 500 basis points.
- This despite inflation significantly above the target range- implies a flexible inflation targeting framework.
- In conjunction with a fiscal policy stimulus.
- Real interest rates at low levels.



South African real repurchase rate



EM real interest rates (DB)

Real interest rates have only declined in a few EMs*



* Real interest rate change (Sep 2008 to March 2009) %
 ** Policy interest rate March 2009, %
 ** Real interest rate calculated as the difference between the policy interest rate and the actual inflation rate.



Selected EM monetary policy reactions

	change i	Current i	inflation	real i	GDP
Brazil	-4.25	8.75	5.2	3.55	-0.4
Chile	-7.75	0.5	3.1	-2.6	-1.5
Mexico	-3.75	4.5	6	-1.5	-6.5
Hungary	0	8.5	3.6	4.9	-6
Poland	-2.5	3.5	3.7	-0.2	1
Russia	1.75	6	11	-5	-8.5
SA	-5	7	6.7	0.3	-2
Turkey	-8.5	7.75	5	2.75	-4.7



South African monetary policy in the crisis

- No extraordinary liquidity provision was required, as banks and financial markets were not impaired in the same way that they were in advanced economies.
- Not at the zero bound, as with other EMs with higher inflation). EMs generally have not had to engage in QE; or bank recapitalisation.
- But banks have been behaving procyclically in South Africa.



Monetary Policy and Financial Stability

- Raises the question of the interaction between monetary policy and financial stability.
- In a crisis situation monetary policy clearly has to take responsibility for financial stability issues because of the broader implications for the economy.
- But can monetary policy solve problems of the banking system or financial system with interest rates alone?



Monetary Policy and Financial Stability (cont...)

- There is also an important coordinating role with fiscal policy if a financial stability focus is adopted. Monetary policy can for example provide liquidity to prevent a run on banks, but if banks need recapitalisation, some coordination with fiscal authorities is inevitable.
- White argues that financial stability and price stability are not separate objectives, but intimately related: monetary policy can have financial stability implications, particularly if the achievement of price stability over short time horizons blinds policy makers to build-ups of imbalances.



To "lean" or "clean"?

- Raises the issue of whether monetary policy should respond to asset price or credit bubbles.
- Important for when 'normality' is restored – do we go back to business as usual, or should monetary policy frameworks be amended to account for asset price build-ups (asset prices added to a Taylor rule?)
- Should monetary policy try and 'lean' against the wind, or should it 'clean' up afterwards?
- Pre-crisis emerging consensus that interest rates are a poor tool to resist asset price booms. For example, dominant view was that asset prices are taken into consideration to the extent that developments impact on current and future inflation.



To "lean" or "clean"? (cont...)

- Which assets should be targeted and why?
- Can monetary authorities recognise asset price bubbles? Difficulties in estimating deviations from fundamental value in order to lean against it.
- Size of increases required would be very large- remedy could be more costly than the disease. Monetary easing can effectively 'clean' up afterwards and restore economic growth.



Case of moderating credit/asset booms (White, Borio)

- Exclusive focus on inflation induces booms and bust cycles particularly when inflation is under control over relatively short time horizons.
- Liberalised financial systems are inherently procyclical – endogenous cycles where good news leads to increased demand for and supply of credit. Sets in motion a cycle of optimism, higher asset prices, more collateral and more loans.
- Overshooting of fundamentals and the bubble bursts.
- Often not accompanied by inflation.



Case of moderating credit/asset booms (White, Borio)

- Problem is one of excessive credit creation, and monetary policy should lean against these excesses. Relying only on regulatory mechanisms to moderate a boom is insufficient.
- Don't focus on particular assets, rather on developments which seem significantly out of line with what the fundamentals would seem to suggest.
- Higher rates at the peak of the cycle implies less chance of hitting the zero bound at the bottom of the cycle.



A new macrofinancial framework?

- Emerging consensus (?) that there is a need for a new macro financial framework to combat procyclicality in a market friendly way.
- Disagreements on the role of interest rate policy in this.
- White: Central banks should be given ultimate responsibility for resisting procyclicality and systemic distress.
- Lean against the wind, and pre-emptive tightening should replace pre-emptive easing
- Interest rates in the expansion phase would be tighter than inflation control alone would warrant.



A new macrofinancial framework? (cont...)

King:

- Could use the policy rate to meet the inflation target and credit bubbles (2 goals with one instrument) by accepting a trade-off between the two objectives.
- Instead of accepting unemployment or high inflation to reduce financial imbalances, create a new instrument to limit the debt build-up.
- Focus on policies to reduce the growth in financial sector balance sheets which must provide incentives for banks to reduce the volatility of their balance sheets.



A new macrofinancial framework? (cont...)

Emphasis on regulations that reduce the procyclicality of bank lending:

- General elements would include countercyclical provisioning as in Spain. Bank of Spain adopted statistical provisioning to supplement specific provisioning with the intent of capturing expected losses earlier in the cycle. The countercyclical provisioning offers several advantages. It provides banks with incentives for better risk management, and its anti-cyclical nature mitigates the tendency to reinforce cycles.



A new macrofinancial framework? (cont...)

- Procyclical capital ratios: Goodhart and Persaud have proposed contra-cyclical charges - capital charges that rise as the market price of risk falls as measured by financial market prices.
- Emphasis on decreased leverage. Regulators will have to monitor risk to react to increases in systemic risk.
- How do you measure systemic risk appropriately?



Conclusion

- Changing bank regulations are not easy and enthusiasm wanes as crises fade
- Incentives for banks to keep ahead of the regulators
- Monetary policy cannot be totally independent of financial stability considerations.
- "Monetary policy works best when the banking system is working normally".

