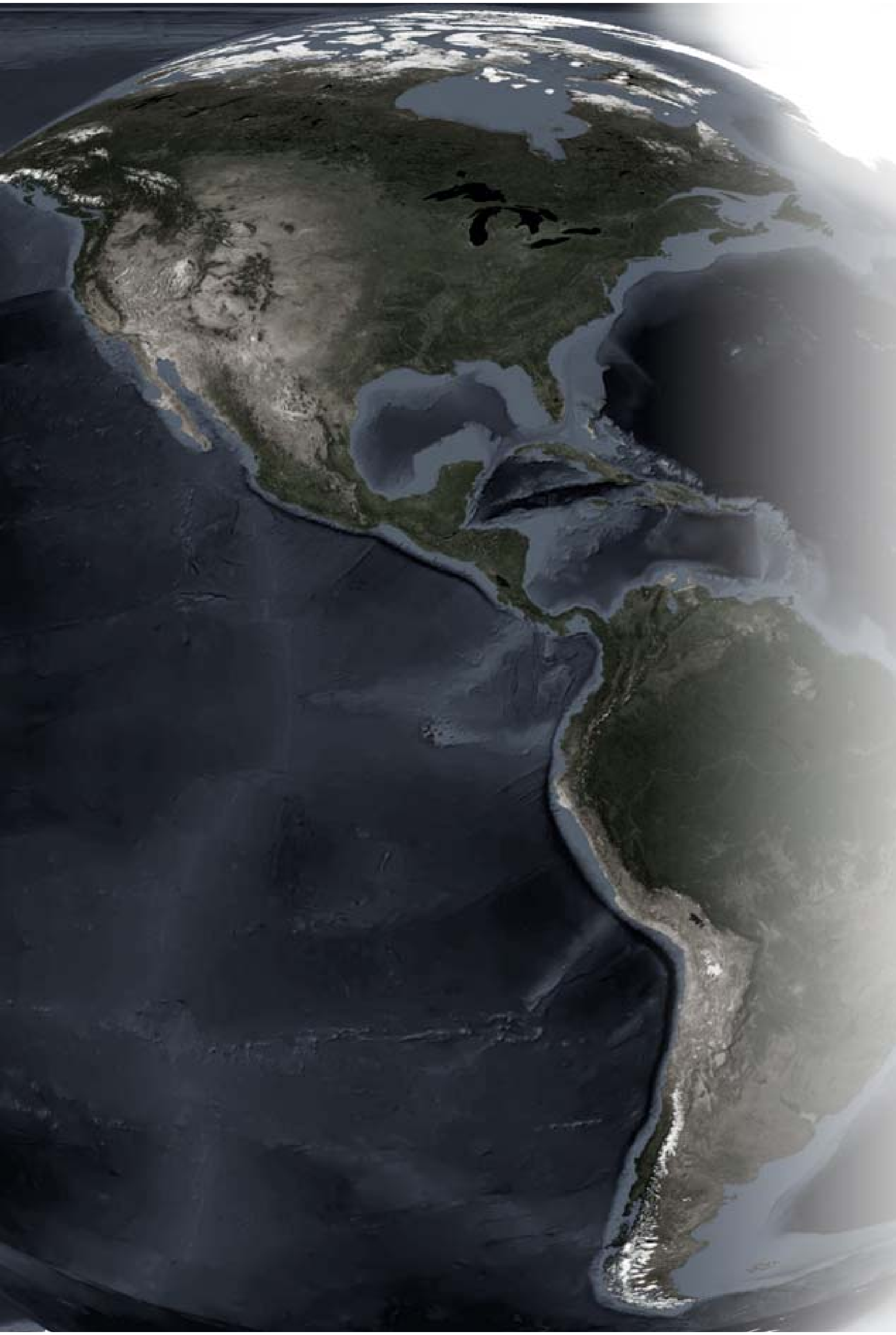


Monetary Policy: Lessons from Financial Crisis?

Vittorio Corbo

Centro de Estudios Públicos

Santiago, Chile

Presented at the Central Bank of Uruguay/IEA Meetings in Montevideo, Uruguay, December, 7-8, 2013

Monetary Policy before the Crisis

- In the last 20 years, most countries discovered the benefits of price stability and did the homework to achieve the objective of price stability.
- To achieve its objective, they invested in building up strong fiscal fundamentals and created autonomous central bank with a mandate to achieve and preserve price stability.
- Central banks (CBs) have been aware that Monetary Policy (MP) has effects on output:
  - Short run: there is a Phillips curve and therefore MP affects the output gap and inflation;
  - Long run: by reducing inflation uncertainty MP sets the basis for a higher potential output growth; macroeconomic instability lowers long-run growth.

Monetary Policy before the Crisis

- The most common monetary policy framework used by CBs has been Flexible Inflation Targeting (FIT) with a flexible exchange rate.
- In a FIT framework the policy rate is set to bring the projected inflation rate close to its target.
- The monetary policy transmission mechanism results from a neo-Keynesian sticky-price adjustment model (Woodford, 2003).
- In this model, a policy rate change results in an adjustment of real rates, assets prices and expectations of future inflation.
- In this framework, expectations of future policy rates play a key role and Central Bank's communication and transparency policies have a central role on shaping inflation expectations.
- The use of a FIT monetary policy framework becoming the norm up to the eve of the Great Financial Crisis.

Monetary Policy before the Crisis

- It was understood that achieving the separate objective of Financial Stability was facilitated by price stability and appropriate (micro) regulation and supervision of the financial system.
- It was thought that assets price bubbles could emerge but should not be tamed by monetary policy as it was too blunt an instrument.
  - Studies showed that a 100 pips increase in the policy rate would reduce housing prices 1% and reduce GDP in 0,3%.
- Monetary policy could be used to address the aftermath of a bubble burst.

Monetary Policy During a Financial Crises

- From previous crisis and from the recent one it has been learned that during a financial crisis central banks have a central role to play to control it or its effects.
- For this purpose, it has to take early on in the crisis actions to cushion its effects on the real economy:
  - Stop financial market panics.
  - Prevent financial institutions from collapsing due to liquidity restrictions, and prevent systemically important institutions from collapsing even if insolvent.
    - Here it is essential to quickly clean up and recapitalize the banks.
  - Ensure that short term credit markets function properly.

Monetary Policy During a Financial Crisis

- Type of policy actions that are called for:
  - First line of action is to offer extensive liquidity support to banks that operate with the central bank and that pledge good collateral.
  - When non-bank intermediaries are also important players in the financial system, then the lending of last resort support should be extended to them.
  - Reduce policy rates aggressively to steer the observed real policy rate towards the new equilibrium value of the natural rate resulting from the forecasted reduction in aggregate demand.
- When the policy rate is close to the zero-lower bound, central banks should also consider non-conventional policies:
  - Commit to keep the rate low for an extended period of time;
  - Use outright purchase of assets to bend the slope of the yield curve through portfolio effects.

Monetary Policy During a Financial Crisis

- The commitment to keep interest rates low for an extended period of time raises inflation expectations and reduces the expected short term real interest rate, boosting aggregate demand.
  - But CBs should be aware that there is much uncertainty about the path of the monetary policy rate consistent with price stability.
  - In particular, there will emerge a problem of time inconsistency if the economic situation improves unexpectedly and calls for a change in policy.
  - Still a central bank should make public its central scenario to help economic agents' expectation formation (transparency).
- When the crisis affects liquidity in foreign currency, liquidity should be provided in foreign currency (lend foreign reserves through swap arrangements).

Monetary Policy During a Financial Crisis

- CBs have to cooperate with fiscal authorities when a crisis requires the use of government insurance or capital infusion.
- There is a separate question about how emerging markets with an open capital account and a flexible exchange rate should cope with large swings in capital inflows.
  - Here, the best line of defense should be to have a strong macro/regulatory framework and let the exchange rate be an important part of the adjustment.
    - Previous work is required to have low pass-through and low currency mismatches in the balance sheets of households and corporations.

Monetary Policy after the Financial Crises

- Today there is more consensus that central banks (CBs) should have an important role to play in promoting financial stability.
- In particular, the high costs of the current crises suggest that CBs will play a more active role in controlling credit booms and asset price bubbles in the future.
- This will require to build capacity to distinguish when upswings in asset prices are bubbles and when are driven by fundamentals.
- And if there is enough evidence that a bubble is developing CBs should act to stop it.
- A leaning-against-the-wind stance using the instrument of the policy rate faces a trade-off and does not work well:
  - An aggressive reaction to potential bubbles can cause instability and political tension;
  - A weak reaction to potential bubbles may allow a real bubble to grow and unleash a financial crises.

Monetary Policy after the Financial Crises

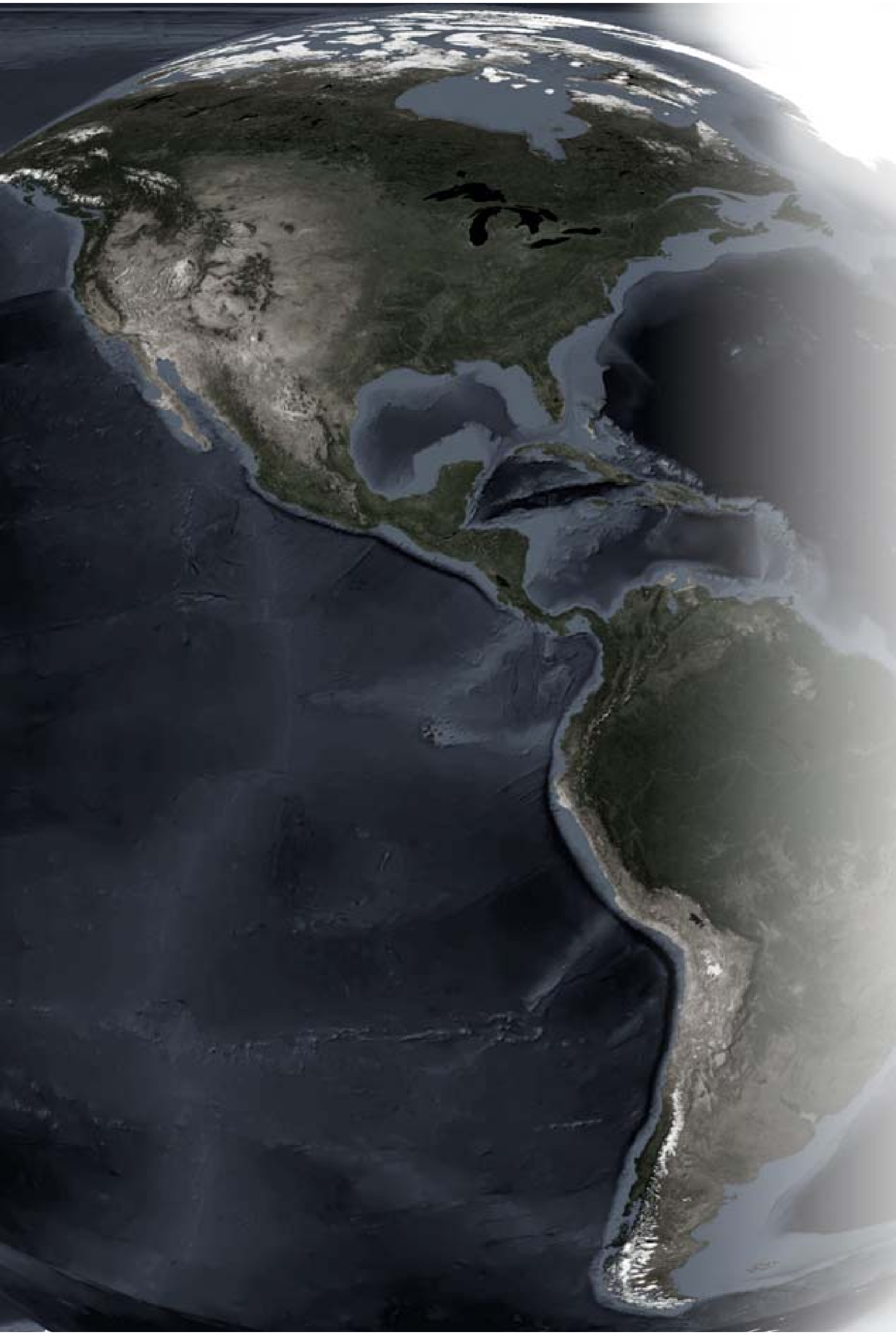
- CBs should have a second instrument to deal with the source of systemic problems: macro prudential regulation and supervision.
  - Macro prudential supervision can deal more effectively with fragilities and distortions in the financial system and can have a countercyclical role. It also complements micro regulation.
    - Pro-cyclical capital buffers, higher capital requirements, liquidity requirements, loan to value and debt service to income ratios for mortgage and adjustment in risk weights when measuring RWA.
    - If there is evidence that the real exchange rate is moving away from fundamentals or that credit growth is excessive, one should also consider the use of Capital Flow Management tools.

Monetary Policy after the Financial Crises

- As CBs play a more active role in macro prudential policy, they will have to collaborate with other regulatory bodies of the financial system, especially in countries where supervision is not in the CB.
  - The importance of Financial Stability Councils.
- CBs also need to develop richer models in which financial sector and the incentives of its players are key building blocks.

Monetary Policy after the Financial Crises

- As many advanced countries reached the zero lower bound for the policy rate, there have been suggestions to raise the inflation target level (Blanchard et. al (2010), Rogoff (2011)).
  - But central bankers should be aware of the potential loss of credibility and that the volatility of inflation rises with the level of inflation and that volatility is costly.
  - Nominal interest rates will rise with the increase of the target level.
- Countries that already have a credible inflation targets around 3% annual should think twice before reducing its target.
- Once the current crises is left behind, countries will adapt the FIT framework.



Monetary Policy: Lessons from Financial Crisis?

Vittorio Corbo

Centro de Estudios Públicos

Santiago, Chile

Presented at the Central Bank of Uruguay/IEA Meetings in Montevideo, Uruguay, December, 7-8, 2013