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Monetary Policy Lessons from the Global Crisis*

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Originally, I had asked the organizers of the conference to present here the book that we have written with some colleagues about the implementation of monetary policy. What they offered, and I am grateful for this, is participation in this distinguished panel. So, what I should do now is to summarize in the 10 minutes or so allocated to me the few hundred pages of which our book consists, stressing in particular the findings relevant for the lessons to be drawn from the crisis. Since I suspect I will not be able to report on all the details which are covered in our book, I suggest you go and buy a copy as soon as it will be in the libraries, at the turn of the year.

Yet, I do not want to subject you to the unbearable suspense implied by waiting until then, so I will give you an abstract.

The encompassing word for our stylized interpretation of what happened to the implementation of monetary policy during the crisis is "widening". The first aspect is a widening of objectives. By 2007, all major central banks had settled on establishing and controlling a short term interest rate by means of a corridor approach, with a lending and a borrowing facility and reserve requirements to be respected on average in a maintenance period, even if significant variants existed of this approach. During the crisis, central banks drastically widened their objective, as they started paying attention, and trying to influence, a plurality of rates. The specific form this took was an emphasis on spreads. The justification and the reason behind this widening was that impaired banking and capital markets were no longer able to keep spreads between the rates on different assets and the short interest rate fixed by the central bank, at an orderly, fundamentally based level and this was seriously affecting the transmission of monetary policy, and hence, eventually, the real economy.

Since a few decades, we have learnt that a plurality of objectives requires a plurality of tools, so a widening of objectives required a widening of tools. Specifically, central banks had to find additional tools to the traditional one of supplying the net liquidity to the market needed to keep the short interest rate at the desired level. These additional tools were found in the manipulation of the balance sheet of the central banks. The most encompassing concept we found for what happened in this respect is that central banks brought onto their balance sheet a good part of the intermediation that impaired banks or impaired financial markets were no longer capable of carrying out, thus attenuating the impact that reduced intermediation would have had on the real economy. This concept is particularly apt at covering what the Federal Reserve and the European Central Bank have done with their credit easing and enhanced credit support, respectively, while quantitative easing, such as practiced by the Bank of

* The views expressed are personal and do not necessarily correspond to those of the European Central Banks.

England, followed a different, more monetarist, logic. In this case, additional reserves should have multiplied into larger money aggregates buoying up, in turn, aggregate demand and thus activity. The end results for the central banks balance sheet were, however, analogous. An additional common theme to what central banks did during the crisis was that this was and had necessarily to be seen as a bridge to more fundamental measures, that would allow again the private sector carrying out fully its intermediation function.

Some frameworks for implementing monetary policy, or technologies as we call them in our book, proved better able to carry out the new, or rather dramatically expanded, intermediation function. Basically, broad technologies with large amounts of central bank reserves, many counterparties and a variegated collateral, like the one of the European Central Bank and the Bank of Japan, performed better during the crisis than the narrow technologies, like that of the Fed, while the performance of narrow and broad technologies in controlling short term rates was the same before the crisis. This is confirmed by the fact that, during the crisis, the Fed broadened its technology, making it, in some respect, even broader than that of the European Central Bank, which changed less drastically.

As I said, central bank intermediation action was, and had to be, a bridge towards more fundamental measures, enabling the private sector to resume in full its intermediation. It was crucially important, in this respect, to recognize that central banks were confronted with a trade-off when complementing the intermediation activity of the private sector. If you think of intermediation as a good, you can visualize what happened during the crisis as a negative shock to the supply of intermediation, which dramatically increased its price (the increase of the spreads I talked about a minute ago). To attenuate the extremely negative consequences on the economy of this reduced supply and increased price of intermediation, central banks supplied intermediation and, so doing, reduced its price. But a reduced price of intermediation is also a reduced incentive for the private sector to supply this good, hence the trade-off between helping the economy by shielding it, at least partially, from the effects of reduced intermediation, while not unduly reducing the incentives for a recovery of private sector intermediation. Hence the choice of central banks to price their facilities as “back-stops”, with a price of intermediation well below that prevailing during the crisis but well above that prevailing in normal times.

The trade-off between helping the economy and maintaining incentives for private intermediation becomes more unfavourable as the situation normalizes. This can also be seen in the fact that the room between the crisis price and the “normal’ price within which to fix a “back stop” price gets much smaller. These developments are of course welcome, but make the choice of the central bank of an optimal point on this trade-off more difficult.

I will not say anything about the difficult exit process, at least in this initial statement, in particular, please, do not read anything in what I will say about the speed with which the European Central Bank will exit from unconventional policies. What I would like to say is something about monetary policy implementation when the crisis will have definitely moved away from the attention of policy makers to that of economists and historians. Basically, my encompassing word here is thinning, meant as the opposite of widening, which I mentioned before as the encompassing word for what happened during the crisis. I think central banks should go back to their primordial business of fixing and controlling, through the provision of the appropriate net amount of liquidity, a short term rate of interest, consistent with their ultimate objective, in the case of the European Central Bank and many other central banks price stability. This statement has no implication about whether the monetary policy implementation technology should be broad or narrow, according to the definition given above, in terms of counterparties, collateral and size of reserves. As far as interest rate control is concerned, these two variants of the monetary implementation technology are, in normal times, equivalent and therefore each central bank can choose the variant better fitting its financial structure. For instance, for the European Central Bank, acting in a financial market which is fairly, but not perfectly, integrated, with the segmenting effects of the crisis on market integration likely to linger a while longer, with a banking system that is still affected by national borders, a broad technology will continue to be more appropriate. Another point I would like to make is that a return to the control of a short rate of interest does not necessary mean that the corridor approach between a lending and a borrowing facility, which prevailed at the turn of the century, will remain the prevailing one. In our book we advance the possibility that a system based on standing facilities rather than reserve requirement would be better able to stabilize rates and we even advance the idea that monetary policy, like much of current financial activity, could be implemented off-balance sheet, by means of derivatives.

Let me also note en passant, that regulation will be an important part of the thinning I think has to come after the widening of monetary policy which we saw during the crisis. This is basically for two reasons. First, the crisis has shown that, among other things, liquidity management by banks was seriously inappropriate, and regulation bears a responsibility for that, which requires change. Second, the crisis has shown that central banks can do things that nobody, either between central bankers or private market participants, thought they could do, and this inevitably creates moral hazard, that has to be corrected by regulation. The recent Basel III regulations are obviously an answer to this need.

So, if you want a summary of the summary, after having drastically widened the scope of monetary policy implementation during the crisis, the task which will prevail when this will be over will be to thin it back. The timing and modalities of this thinning back is the next challenge for monetary policy implementation.