How should the crisis affect our views of monetary policy?

Conference: "Macro and Growth Policies in the Wake of the Crisis"

Session I- Monetary Policy, Remarks by Dr. Guillermo Ortiz

I. Introduction

As Olivier Blanchard has pointed out, the economic crisis has challenged some aspects of the conventional wisdom regarding the conceptual framework and implementation of monetary policy. In my view, it has also reinforced the case for continuing the implementation of others.

Although the epicenter of the crisis was in the developed world, I believe there are relevant lessons from previous emerging market crisis. In the following comments I underscore some of these lessons as well as my own views.

II. Inflation Targeting

First some facts:

During the Great Crisis of 2008-2009, emerging markets showed more resilience than advanced economies. Now, emerging markets are exiting the global crisis at a much faster pace than advanced economies. This reflects sizable policy support, favorable external conditions and solid macroeconomic policy fundamentals that proved helpful before, during and after the global financial turmoil.

Since the crises of the 1990s and early 2000s there has been a much stronger policy framework in most EM. This was of course facilitated by a benign external environment characterized by positive terms of trade effects.

- Fiscal positions were strengthened and international reserves were substantially increased.
- Domestic capital markets were developed.

- A consistent framework of monetary/ exchange rate policy was developed with flexible exchange rates and inflation targeting in many EM.

This framework was fundamental in the achievement of economic stability and sustained growth.

It is well documented in academic research that the impact of the "great moderation", the reduction of fiscal dominance (greatly helped by the reduction of the debt overlay of the 80's after the Brady Plan) and the adoption of inflation targeting was very helpful to reduce inflation in EM, and particularly in Latin America which was an inflation prone region.[1] Average inflation rate in Latin America was 136 percent per year in the 1980s and 240 percent per year in the first half of the 1990s. Brazil's inflation rate exceeded 1,000 percent per year in five of the six years between 1989 and 1994. It was not until the mid 1990s that inflation in the region began to moderate, averaging less than 20 percent per year in 1995-1999 and only 7 percent in 2000-2009.[2]

It may have been the case that some IT central banks paid little attention to monetary aggregates, credit expansion and leverage of households and business. Its operational simplicity may have provided the wrong view to some policymakers, in the sense that implementing monetary policy was almost mechanical. The models developed to guide central banks decisions under IT did not explicitly develop a non-trivial financial sector, therefore the issue of financial shocks to the real economy was not explicitly considered which is obviously a major gap. Thus, the economics profession faces the challenge to develop better analytical tools to understand the interaction between the real sector and the financial system and the interconnection among markets and institutions. This would facilitate our understanding of how monetary policy should interact with macro-prudential tools in a more integrated framework.

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[1] Batini, N., K. Kuttner, and D. Laxton, 2005, "Does Inflation Targeting Work in Emerging Markets? World Economic Outlook, chapter 4. International Monetary Fund.

[2] International Monetary Fund, World Economic Outlook Database October 2010, data for Latin America and the Caribbean.

Having said that, one of the positive lessons of the recent crisis was the effectiveness of the inflation-targeting framework, particularly in EM. Although the crisis prompted large relative price adjustments, inflation remained under control. Recent research shows that, relative to other countries, inflation targeting countries were able to maintain better anchored inflation expectations during the crisis; and with their flexible exchange rate regimes saw sharp real depreciations that helped reduce the output contraction.[3]

In Mexico, for example, early on in the crisis the peso depreciated sharply against USD, and more recently, commodity prices have shoot up. However, inflation has remained under control while expectations remain anchored. The inflation targeting framework, combined with the credibility gained over the years (a solid fiscal stance and a well-capitalized financial system), has ensured that the central bank can adjust its policy stance in response to business cycle fluctuations. Of course, access to the newly created FCL and the swap lines from the Fed was very helpful to strengthen the reserve position during the crisis (thus reducing perceived country risk). This was a radical departure from previous episodes, which resulted in inflation and severe financial dislocations.

Most EM inflation targeters have intervened recurrently in the foreign exchange market before, during and after the crisis. The objectives have varied depending on the different country circumstances. Intervention have generally aimed at reducing exchange rate volatility, smoothing abrupt fx fluctuations and/or at accumulating (or in some cases reducing) international reserves. This issue has been the source of considerable discussion (and confusion) and given rise to the notion of "fear of floating", since x-rate intervention is at odds with the theoretical framework of IT. I would only add that most EM fx interventions have not aimed at targeting a certain level of the exchange rate; it is well understood that it is not possible to achieve two targets with one instrument. However, the most recent episode of the so called "currency wars" has revived this issue. In my opinion, the more frequent and intense interventions observed in the fx market in recent times merely reflect the implications of the different macro

[3] Carvalho Filho, Irineu de, 2010, "Inflation Targeting and the Crisis: An Empirical Assessment" IMF Working Paper 10/45.

condition and speed of recovery between developed and emerging markets. It also reflects the increasing importance of China's exchange rate policy in influencing monetary and exchange rate policy in the rest of the emerging markets, particularly in Asia.

Regarding the zero lower bound, fortunately, in emerging markets we didn't experience this constraint, as the risk of deflation was never a threat as in developed countries. It is admirable that central banks in developed countries have been able to offer a toolkit to fight the zero-bound constraint – QE, targeting a price level, etc... However, I wouldn't minimize the risks of the zero-bound constraint. It is clear that risks of ensuring price stability are asymmetric – central bankers are better equiped to fight inflation than deflation.

It is unclear to me the usefulness of these instruments to overcome the zero-bound constraint. We are fortunate that the toolkit was not fully tested. But it is interesting that no central bank opted for changing the inflation target, or targeting a price level – not even Japan. That these instruments would overcome the zero bound constraint by making real ex-post rate negative is apparent, but the long-term consequences of these policy decisions are less clear. In fact, the strategy to undo QE remains untested and inflation risks persist in the eyes of many observers.

III. Financial Stability and the Role of Central Banks in Banking Supervision

For emerging markets, the Great Crisis was a fundamental stress-test. It was a test on the ability of the domestic financial system to withstand a global financial crisis. It was also a test on the ability of the real economy to absorb a very large shock and to experience a sharp-policy induced rebound.

No EM economy that suffered a financial crisis in the 1990s and early part of this century in Asia or Latin America suffered a domestic financial crisis as a consequence of the global crisis. This is truly remarkable. It shows that EM

learned from their mistakes. EM banks did not load up with toxic assets and were well capitalized heading into the crisis.

Given the nature of EM crisis, macroprudential considerations were very much the focus of attention of policymakers in the aftermath of these episodes. Maybe not in the sense of establishing a formal macroprudential framework as it is being done today in several countries, but in terms of implementing preventive regulation such as avoiding currency mismatches and excessive leverage that led to credit booms and collapses in previous episodes. That is a missing piece in Olivier's graphs regarding the monetary framework in EM.

The great crisis was a massive institutional failure, involving financial institutions, regulators, rating agencies and international organizations. There was clearly a deficient regulatory and supervisory framework for the financial system at an international level. This reflected the widespread belief that market discipline (and its pillars) was sufficient to promote financial stability even in the absence of a strong framework for financial regulation and supervision.

The crisis showed us that price stability alone does not imply financial stability. Lightly regulated financial markets, subject to the forces of market discipline, do not suffice to allocate resources effectively and manage risk. In addition, the global financial crisis demonstrated that the financial system tends to reinforce the economic cycles, a bias that is amplified today by the highly interconnected nature of financial institutions and markets.

Therefore, it is essential to rethink the role of central banks as guardians of financial stability, much as it has been the case in many EM after their financial crises. This has been the subject of much discussion and debate in academic and multilateral forums. In particular, it is important to analyze central banks' involvement in the design of financial regulation and their role in banking supervision. It is apparent that central banks need to have a bank supervisory responsibility that bodes well with their responsibility to ensure the stability in financial systems (like the case of Canada).

Yet, it would be desirable that central bank's supervisory role does not interfere with its independence to conduct monetary policy. While it is justifiable that central banks oversee the payment systems and market positions, as these have a direct effect on the stability of the financial system, allowing them to take a much broader responsibility, such as bank supervisory or capital adequacy of banks, can distort the conduct of monetary policy and eventually blur the role of monetary and fiscal policies.

Moreover, it is desirable that a government institution should undertake the broader role of bank resolution. Since these institutions usually determine when to intervene or re-capitalize banks, they should be part of the government. These institutions should have the means to carry out their mandate. Only fiscal policy can be burdened with these permanent interventions.

IV. Asset Prices Targeting

Another lesson from the crisis is the need to consider asset price targeting. The housing bubble in the US, the UK, Ireland and Spain is the obvious example, and it is clear that the debate will continue. Two questions seem key to this debate:

- First, were monetary authorities too complacent and eased too much for too long?
- Second, can central bankers identify and dis-inflate asset bubbles while avoiding the business cycle side effects?

If we agree that excess looseness was the root of the financial crisis, then it is clear that authorities failed to normalize on time and there is probably no need to introduce explicit asset price targets for central banks. In contrast, if we agree that monetary policy was not the cause and the asset price bubbles were exogenous, then there could be an argument to target asset prices. The answer probably lies somewhere in between, and it varies from case to case.

However, even if central banks are mandated to target asset prices, the operational aspects could complicate monetary policy immensely and may well result in conflict of objectives. The difficulty is twofold: first, to identify *ex ante* asset price bubbles and second, to stabilize asset prices while minimizing its negative effects on the business cycle. Although desirable, it is not clear that asset prices should be targeted explicitly. Clearly, a challenge for central banks and regulators is to develop early warning indicators of bubble's forming in asset prices that could help the authorities to mitigate them.

One alternative is to deal with asset price bubbles in the framework of macroprudential policies in which central banks must play a central role. The appropriate tools to deal with bubbles may require an array of measures such as margins, reserves, credit limits, etc... many of which are being currently applied by several Asian countries experiencing property bubbles. One important lesson on this subject is pragmatism, and the willingness to both prevent and overcome political or special interests that are often behind the formation of bubbles.

V. Monetary and Fiscal Policies

A word about monetary and fiscal policies. The special lending facilities to the financial sector and sovereign debt support, as the ones undertaken by the US Fed and the ECB, have blurred the boundaries between monetary and fiscal policies. However, there are two justifications. First there are political constraints. While it is difficult for me to assess how binding such constraints were, the lack of consensus in US Congress to unleash a quick support for the financial system was evident. Moreover, the lack of the political agreement in the US regarding medium-term fiscal sustainability is not only influencing the current stance of monetary policy (i.e. the second round of QE) but is, in my view, one of the major threats to financial stability for the world economy.

Secondly, and perhaps more relevant for this discussion, the crisis justified a broader policy response that would have been called for by orthodox economic

theory. It is true that monetary and fiscal policies are usually linked in the long term by the budget constraint and should be kept separate in the medium term. However, the crisis challenged this "purist" approach as monetary and fiscal authorities had to assess the trade-off between a full-fledged banking and debt crisis, or to increase its indebtedness and ensure stability in the banking and monetary union. It is difficult to say when to intervene and how much is too much, but we all know that the consequences of no intervention probably would have been much worse. Again, this was relatively new to developed countries, but has been the response of most emerging market economies to financial crises, where the line between monetary and fiscal policies has been often blurred.

In general, despite this departure from the orthodox view, monetary and fiscal policies have been kept separated for the most part. The US, the UK and the ECB justified its intervention on the need to maintain the stability of the financial system and the monetary union that are part of their Charter. Moreover, the expansion in their balance sheet could be perceived as temporary and should not jeopardize the long-term conduct of monetary policy. In other words, they should be able to shrink their balance sheets when conditions normalize. The perception was – and there has been some recent evidence in this direction – that the drop in asset prices was the result of extreme risk aversion and justified the intervention of monetary policy to prevent a confidence crisis.

On the fiscal front, policy focused on providing more permanent support, as was the recapitalization of banks in the US; or the long-term lending to countries in macroeconomic stabilization programs, in the case of Europe. In fact, to support highly indebted countries, Europe developed the Stabilization Fund, which was funded or guaranteed by the Government members. It is true that the ECB intervention in the sovereign bond market attracted some criticisms, but to the extent that these were short-term interventions and backed by Europe's governments, it should not influence the long-term conduct of monetary policy or long-term inflation expectations.

VI. International Coordination

As a final point, I want to mention briefly the issue of international cooperation. This remains a source of tension. During the crisis, international cooperation improved and evidence was the US Fed swap lines, the IMF programs, and the new bank regulation negotiated within the G-20. However, developed and emerging markets monetary cycles moving in opposite directions have resulted in a source of tension. The monetary policy expansion in developed countries has resulted in excess aggregate demand in emerging markets. This, in turn, has distorted local asset prices, such as exchange and interest rates.

Some have argued for more monetary policy coordination, but it is unclear that his would happen. Unfortunately the result has been the built up of imbalances and more interventionist policy by countries such as China. There are no parallels in history when this has happened and it could well pose new challenges when developed central banks start compressing their balance sheets. A greater role for the IMF in this area would be welcomed. If not aiming at greater coordination because at least to make countries aware of the international dimension of domestic policy choices and to minimize their side effects.