2/11/2011

How should the crisis affect our views of monetary policy?

Background Note for Session I – Monetary Policy
Conference on "Macro and Growth Policies in the Wake of the Crisis"
March 7-8, 2011 – Washington, DC

The years before the crisis had seen the emergence of a consensus view of monetary policy. It went roughly like this:

1. Flexible inflation targeting provides a sound framework for monetary policy.

2. The supervisory and macroeconomic aspects of monetary policy can be largely separated.

3. Departures of asset prices from fundamentals are hard to detect in real time, and the contractionary effects of sharp falls in asset prices can be largely offset by monetary easing. As a result, asset prices should affect monetary policy only to the extent they help predict goods-price inflation and the output gap.

4. The zero lower bound is a minor issue: it will be encountered only rarely with consequences that are likely to be modest, and policymakers have powerful tools (targeting long-term rates, adopting a temporarily high inflation target, and more) they can use if it becomes a major constraint.

5. Monetary and fiscal policy are linked in the long run through the government budget constraint, but in the medium run they should and can be kept largely separate.

II. The crisis and the policy responses have raised issues about each of these. Taking them in reverse order:

5. To what extent have policy actions in the crisis, such as the special lending facilities, measures to prevent the disorderly failure of particular financial institutions, and measures to support sovereign debt, blurred the lines between monetary and fiscal policy? Are such actions a mistake? Are they necessary in extreme circumstances? Or should they be a standard part of the monetary policy toolkit?

4. Has the zero lower bound been an important constraint in the crisis? Does the failure of central banks to adopt some of the pre-crisis ideas for dealing with the zero lower bound reflect drawbacks of those ideas that were not understood by their proponents, or excessive caution or lack of concern about unemployment on the part of policymakers? Should any of those ideas be adopted now? Should central banks adopt higher inflation targets once the crisis has passed? Should they target a price level path (or a nominal GDP path)?

3. Should interest rate policy respond to asset prices? If so, what asset prices—and what types

of movements in those prices—should affect policy? Should central banks take instead a more ecumenical view of monetary policy, thinking of not only the policy rate, but also of margin, reserve, down payment, and capital requirements jointly as the tools as macroeconomic and financial stabilization policy (as many of them once were)?

2. Is it important for central banks to play a major role in financial supervision? Should changes in capital requirements and related tools be coordinated with interest rate policy? Can regulation of systematic risk and supervision of idiosyncratic risk be fruitfully separated? If central banks use a larger set of tools beyond the policy rate, can, realistically, full central bank independence be preserved, or does it need to be redefined?

1. Is inflation targeting the right framework going forward? Is the so-called "divine coincidence" assumption that stable inflation implies a stable output gap a reasonable approximation, or should central banks explicitly care about the output gap? And, if so, how? Also, even when they claim to follow an inflation targeting strategy, central banks in many emerging economies clearly care about exchange rate movements beyond their effect on inflation. Many of them use the policy rate and manage their reserves so as to smooth their exchange rate. Are they right to do so?

III. Some other issues concerning monetary policy that are raised by the crisis:

1. Do large expansions of central bank balance sheets pose a significant risk of inflation? If so, through what channel? A largely conventional one of losing sight of the inflation objective and of long and variable lags? A loss of confidence in central banks and a consequent unmooring of inflation expectations? Capital losses on central banks' balance sheets and a resulting loss of independence?

2. Is there any truth to the claim that central banks responded much more aggressively and creatively to disruptions in financial markets than to the prospect of years of high unemployment? If so, was this appropriate? And if it did occur and was not appropriate, why did it occur?

3. Do the increasingly precarious fiscal positions of many countries threaten central bank independence?

4. How has the crisis changed the importance of international coordination in monetary policy? For example, swap lines and other arrangements among central banks were important during the crisis. And at the zero lower bound, a central bank cannot easily offset the aggregate demand effects of other countries' exchange rate or trade policies. Do these observations have important implications going forward?

5. Should central banks change their communication policies substantially as a result of the crisis?