Monetary Policy Strategies – Any Changes after the Crisis?

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Outline

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Introduction

Three remarks

- Poland: No major practical expertise in economic and financial crises issues
- Most of the presentation deals with international experience, mainly of developed countries
- Monetary policy strategy
  - Final goals
  - Methods (techniques) used by central banks to make decisions („narrow” understanding of „strategy”)
  - Operational (implementation) dimension

Monetary policy before and during the crisis

Successful monetary policy before the crisis?

- The two decades before the crisis (until mid-2007) were labelled as:
  - A period of „Great Moderation” (Bernanke 2004)
  - The „Golden Years of Central Banking” (Gerlach et al., 2009)
- Was monetary policy really so successful given further developments (the crisis)?
- Monetary policy consensus
  - Centred around the concept of „one target, one tool” policy
  - Inflation Targeting (IT) „spirit” prevailing (explicit and implicit IT)
  - Theory and practice of IT **increasingly stressing self-regulating properties of the market economy** (2000s)

Monetary policy strategy consensus before the crisis

- Final goal
  - Inflation stabilization in the medium term (monetary stability)
- Methods used
  - Forward looking interest rate changes based on inflation forecasts
  - Pronounced role of expectations’ management
  - Credibility: Central bank independence and transparency
- Operational dimension
  - The short-term inter-bank rate as the operational target
  - Central bank policy rate as the main instrument

What went wrong with the consensus?

- Final goal
  - Not enough prominence was given to financial stability issues
    - Financial instability development due to central banks' concentration on monetary stability (BIS economists)
- Methods used
  - Developments in the money and credit markets not taken into account in the decision-making process and underlying models
- Operational dimension
  - Liquidity management became underappreciated (Kroszner 2010)

During the crisis…

- …IT („one target, one tool” approach) was questioned…
  - …albeit only one country formally suspended IT, i.e. Iceland 2008 (Gudmundsson 2010)

- Final goal: real and financial developments received key attention from central banks
  - Inflation was subdued, deflationary threats

During the crisis cont’d

- Methods used
  - Financial markets’ developments became of crucial importance in the decision making process
    - Expansion of the lender of last resort function
  - Any other major changes in the decision-making framework?
- Operational dimension
  - Most of the crisis-related changes in this area!
    - Non-standard measures (unconventional methods, „balance-sheet” policies) developed
  - Zero-bound problem, liquidity provision of key importance

Monetary policy after the crisis: A short overview of the international discussion

New era in central banking and monetary policy?

- „…following the ongoing financial crisis **central banks are now probably on the verge of a further, fourth, epoch**…(Goodhart 2010)
- "**Central banking will never be quite the same again after the global financial crisis.** (…) The years ahead will be a period of **experimentation** in central banking. (…) …they will need **a new compass to sail in largely unchartered waters**."(Borio 2011)

Some proposals are really far reaching!

- For example Arestis & Sawyer (2010) argue:
  - „…IT cannot deliver low inflation, …fine-tuning through interest rate manipulation should not be attempted, …**a constant real interest rate target based on growth should be adopted instead**.
  - The **key objective of monetary policy should be shifted to financial stability**, the **independence of central banks should be brought to an end**, and **their decision making should be coordinated with other macroeconomic decision making**."

Issues under discussion: Less extreme positions

- Final goals
  - What inflation rate should be targeted?
    - Blanchard et al. (2010): Increase the inflation target!
    - Proposal rejected by the central banking community
  - Financial stability and inflation control relationship
    - How the goal of financial stability should relate to the inflation target?
      - Financial stability a supportive target? Or a dual mandate?
      - On a more technical level: Any quantitative target for financial stability?
        - » Targeting asset prices? Merge with the CPI?

Issues under discussion cont’d

- Methods used
  - The conduct of interest rate policy
    - Growing consensus: „Leaning against the wind”
      - Monetary policy should pre-emptively lean against credit procyclicality
      - Interest rates during credit expansion should be higher than they would have resulted only from forecasted inflation or Taylor-type rules
      - Money and credit as early warning indicators (Papademos, Stark 2010)
  - Identification of potentially dangerous financial bubbles difficult (Posen 2010)
    - An ex ante distinction between „dangerous” and „safe” bubbles is a major problem
    - Not clear when to prick a bubble, nor what are the net costs (or benefits) of a pre-emptive action!

Issues under discussion cont'd

- Operational dimension
  - Available tools
    - Consensus: Traditional monetary policy instruments alone cannot be the only tools used to control the boom-bust cycle. Macroprudential and microprudential instruments are also needed!
  - Coordination of monetary and macroprudential policies with regulatory and supervisory policies
    - Macroprudential analysis at central banks
    - Decisions on microprudential instruments – where should they be housed?

Serious political economy challenges

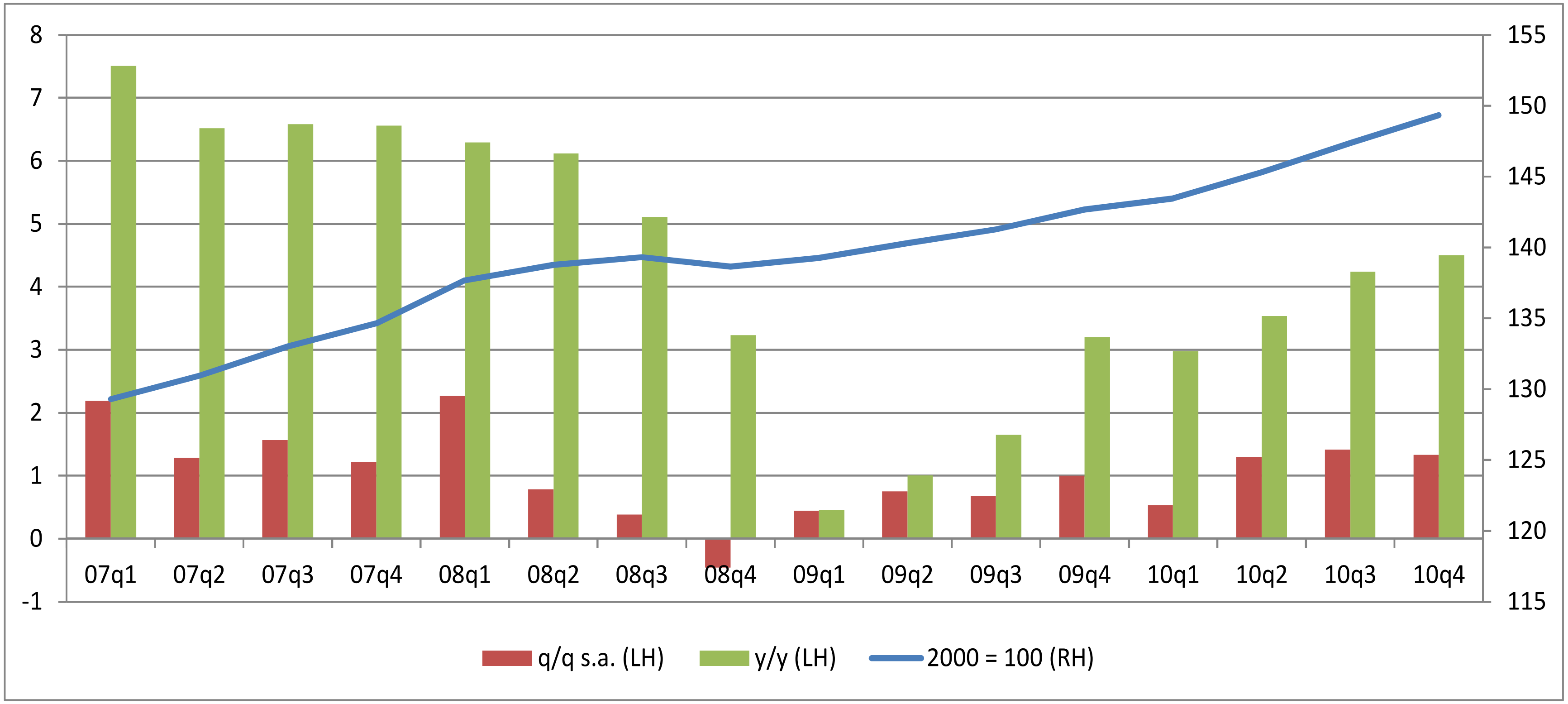
- Central bank independence may be questioned in practice: negative impact on expectations' control!
  - Increasing role of judgement and discretion in decision-making
    - Difficult to estimate the net cost of pre-emptive actions
  - Increased role of public debt
  - Coordination between central banks and other bodies responsible for financial stability

Poland: Monetary policy strategy during and after the crisis

Poland weathered the crisis quite well

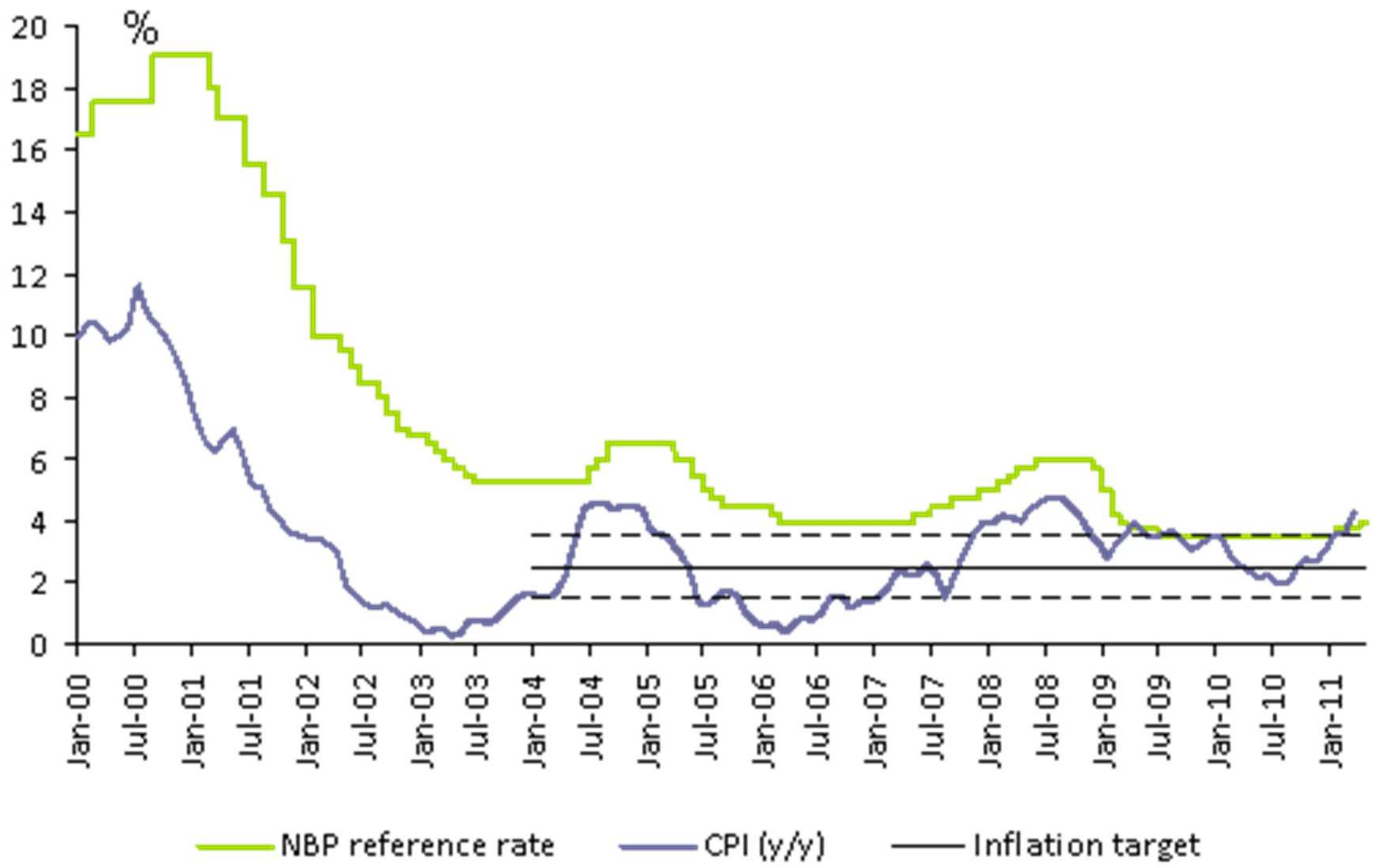
- No recession
  - In 2009 the only EU country with positive GDP growth!
    - Poland: 1.7%
    - EU: -4.2%
    - Euro area: -4.1%
- No financial institution went bankrupt, no bail outs!
- „Inflation targeting served Poland well” (Belka, March 2011)
  - Including the freely floating exchange rate

Poland: GDP growth 2007-2010 (quarterly)



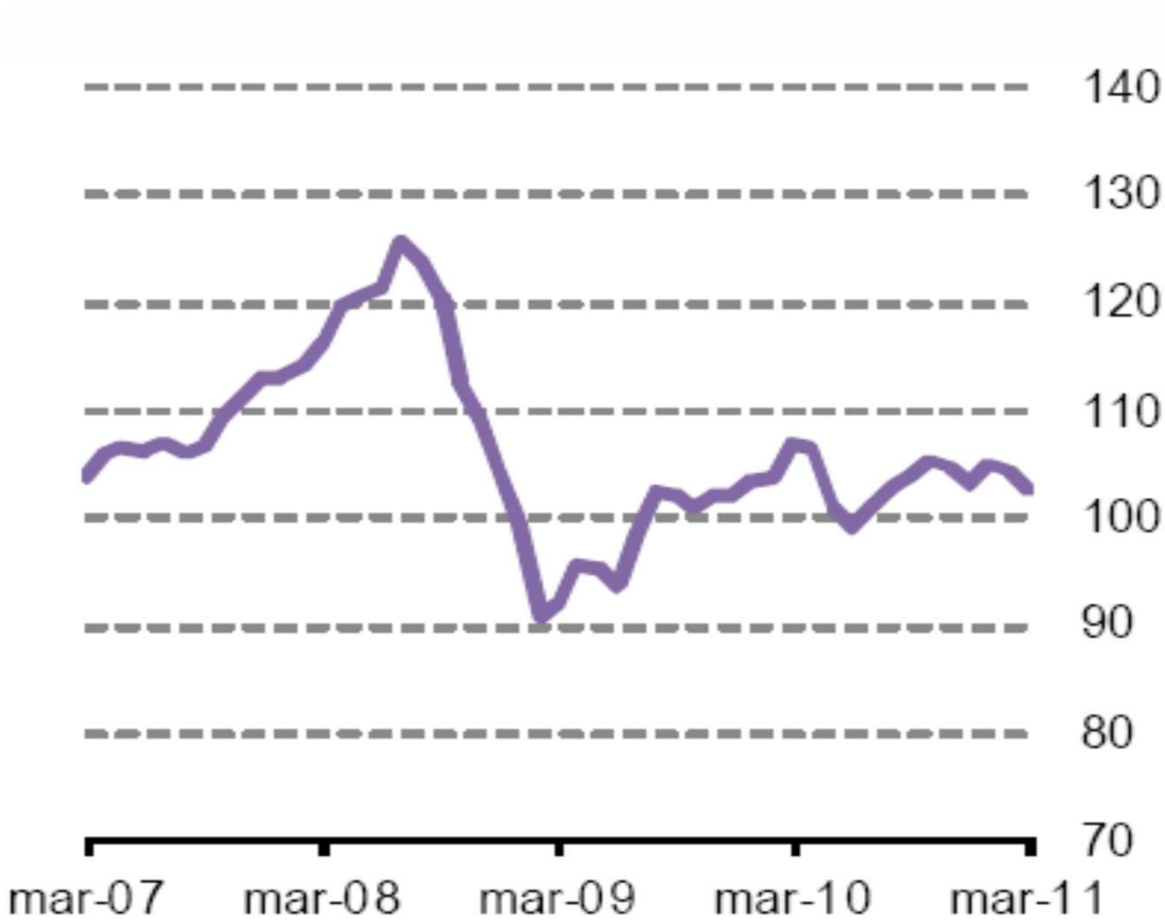
Source: CSO and NBP.

Poland: NBP policy rate, its inflation target and CPI, 2000-2011



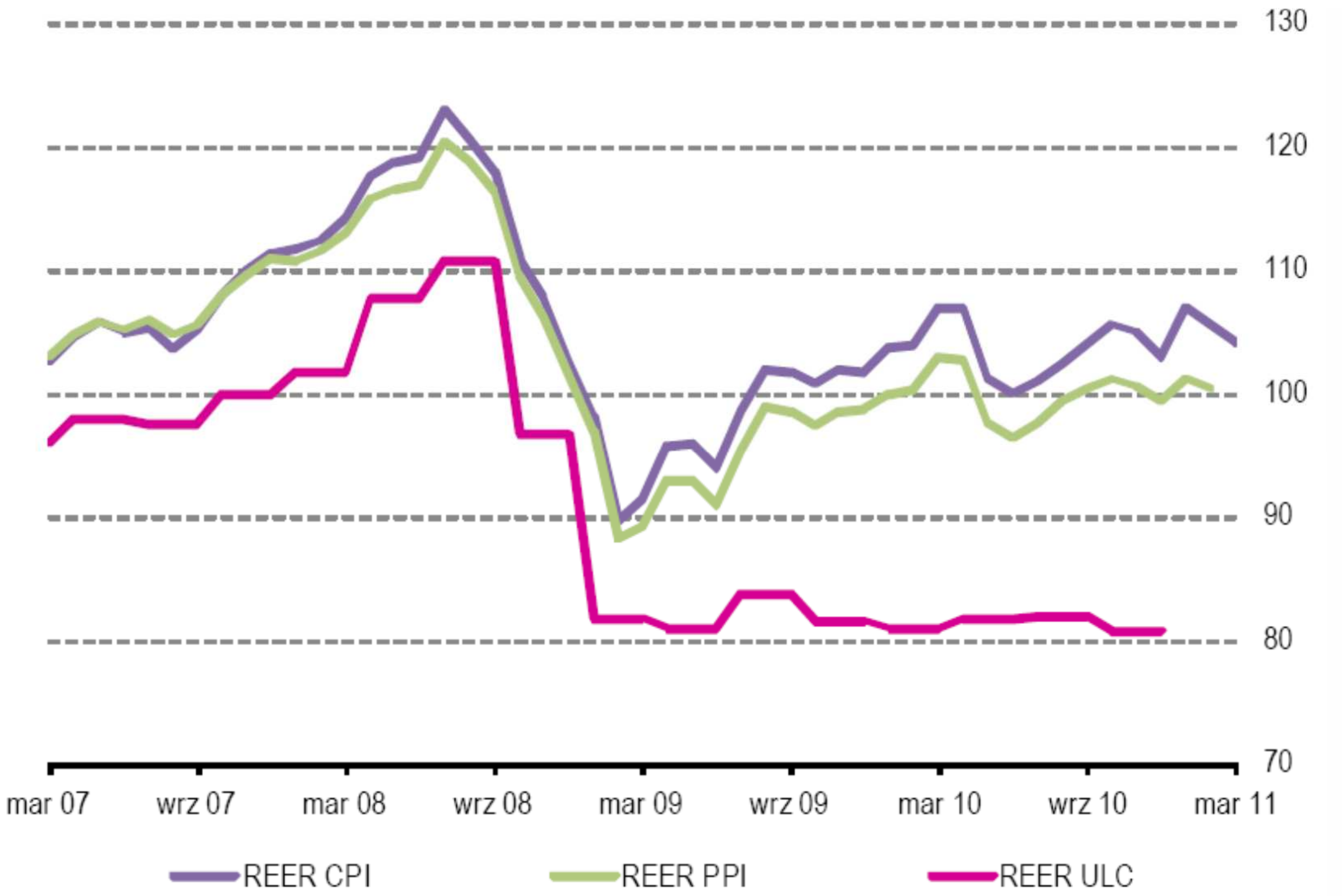
Source: CSO and NBP.

Poland: The freely floating exchange rate worked well (March 2007 – March 2011)



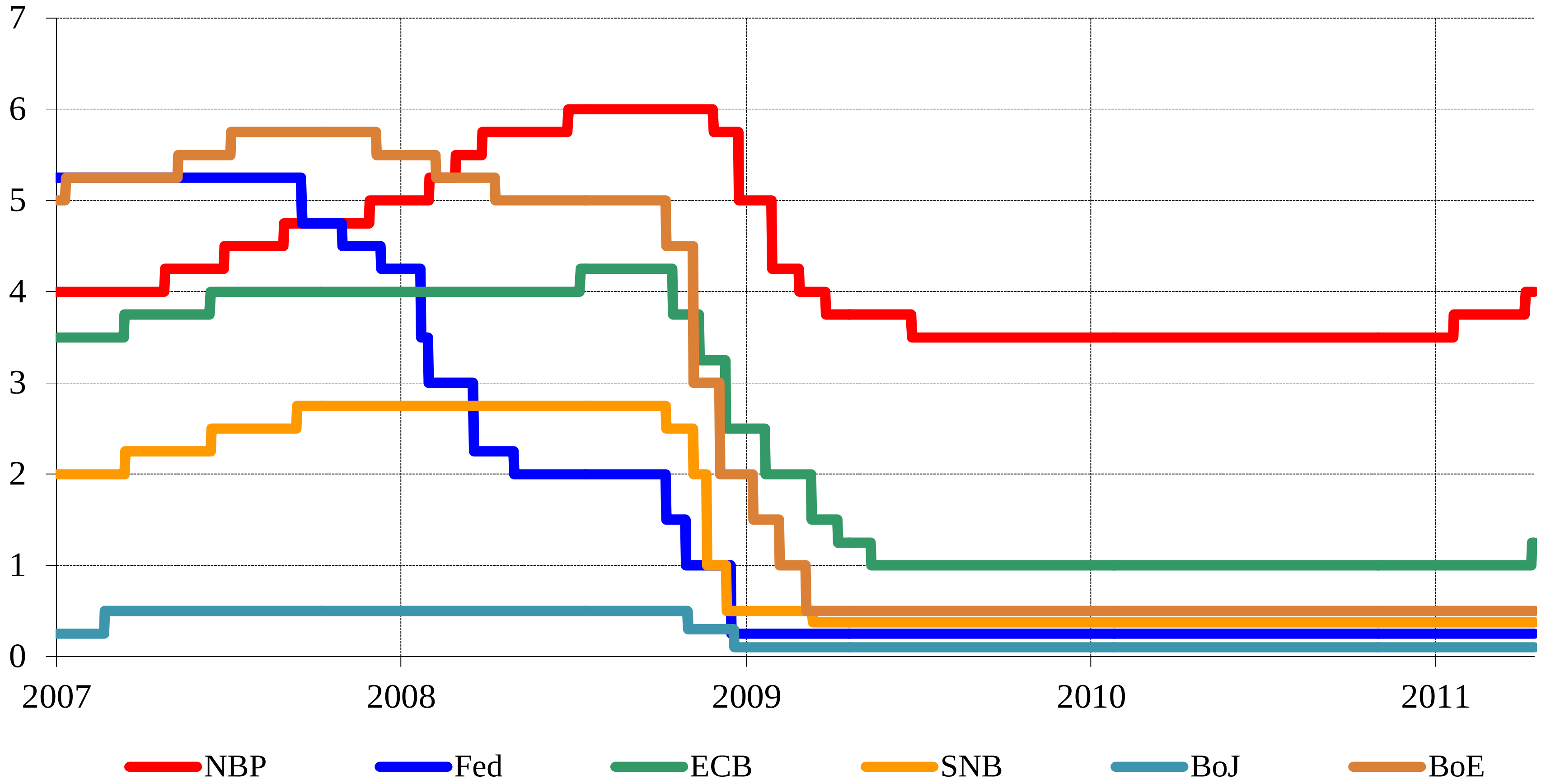
Note: Zloty's nominal effective exchange rate (2005=100, increase=appreciation).
Source: NBP.

Poland: Zloty's real effective exchange rate (March 2007 – March 2011)



Note: 2005=100, increase=appreciation.
Source: NBP.

Selected central banks' policy rates, 2007-2011



Source: Websites of the central banks referred to.

Other measures by the NBP, 2007-2010

- NBP legislation modified
  - December 2007: Agreement with the Ministry of Finance and Polish FSA – Financial Stability Committee created
  - Autumn 2008: NBP mandate broadened
    - NBP Act amended by the Law on the Financial Stability Committee
      - Article 3 stating the NBP goals expanded: The tasks of the NBP shall also include: (…) **acting to sustain stability of Poland’s financial system…**
- „Confidence Package” (October 2008)

„Confidence Package”

- Selected measures
  - Open market operations expanded
    - Operations aiming at providing liquidity (repo) introduced with full allotment of bank bids
    - The list of eligible assets accepted for repo operations was extended
  - Reserve requirement ratio reduced from 3.5% to 3.0% (mid-2009)
  - Foreign exchange swaps offered (2008-2009)
  - Discount credit facility introduced (2010)
- **No considerable modifications in the NBP operating system!**
  - **Growing level of liquidity surplus!**

Selected central banks' balance sheet changes, 2006-2009 (in %)

Central bank	2006	2007	2008	2009	2009/2006
BoE	26.2	26.9	71.1	47.4	217.2
Eurosystem	10.7	31.1	37.6	-8.3	65.5
Fed	3.1	4.7	145.5	-0.5	155.9
BoJ	-22.2	0.6	9.2	-1.7	8.1
NBP	2.9	10.7	23.6	18.9	63.0
SNB	2.6	13.5	68.9	-3.3	85.4

Source: Annual reports of the central banks referred to (as posted on their respective websites).

NBP started its exit strategy in the course of 2010

- All FX swaps stopped (April)
- Repo operations gradually phased out
- Reserve requirement ratio raised to 3.5% (December 2010)
- Discount credit facility abolished (end-2010)
- 2011: Two policy rate increases so far
  - Reference rate:
    - 25.06.2009: 3.5%
    - 20.01.2011: 3.75%
    - 06.04.2011: 4.0%

Searching for a new strategy

- *Monetary Policy Guidelines for the Year 2007* (September 2006): For the first time financial stability as an element of NBP's monetary policy strategy mentioned
  - **„…it is becoming ever more essential for monetary authorities to allow for the financial stability in their decisions.** (…) In assessing the risk of the emergence of disruptions in the asset market and the inflation outlook, **it may be useful in the longer run to account for the paths of monetary aggregates.”** (NBP 2006, p. 4-5)

NBP *Monetary Policy Guidelines for 2011* (September 2010)

“The global financial crisis has shown that in order to ensure long-term price stability **factors related to financial system stability should play a more pronounced role in monetary policy than to date**. **Inflation targeting enables the pursuit of such a policy** while **providing support for the regulatory and supervisory policies** addressed to the financial sector.” (NBP 2010, p. 4)

NBP *Monetary Policy Guidelines for 2011* Cont'd

„…in assessing the risk of turmoil in the financial system and the inflation outlook in the longer run, **it is useful to analyse monetary and credit aggregates**. A fast increase in these aggregates may lead to growing macroeconomic imbalances in the economy, including imbalances in the asset markets. **Monetary policy decisions should take into account the risk connected with excessive increase in these aggregates**. **Regulatory and supervisory policies** in the financial sector that have an impact on credit growth and its structure **are an important factor influencing monetary policy.**" (NBP 2010, p. 6)

Other developments aiming at increasing the role of financial stability at the NBP

- Started long ago
  - 2001: First *Financial Stability Report*
  - 2002: Financial System Department created
- 2008: A setback
  - Banking supervision transferred to the FSA
- 2011 developments
  - Systemic Risk Committee
  - New office at the Economic Institute dealing with macroprudential issues

Final remarks

Any changes in monetary policy strategies after the crisis?

- Nominally not many changes so far
  - Nor in central banks' legislations
    - UK!?
  - „The debate has just started” (Borio 2011)
- The very basic principles of IT are retained
  - IT framework is quite flexible
  - IT appropriate for credit-money economies
  - Gradual evolution of the IT framework to be expected
- Successfully incorporating financial system's considerations into the IT approach is the main challenge in the creation of a new, more robust monetary policy framework

Any changes in monetary policy strategies…? Cont’d

- Monetary policy must continue to be more pragmatic than before the crisis
  - Self-regulating properties of the markets should be treated with caution
  - Final goal: Balancing several targets: Inflation, financial stability, growth
  - Methods: A broader set of information to be taken into account
  - Operations: Not only the O/N interest rate to be considered; other policy tools to be used more flexibly
- However, will such strategy still be called „Inflation Targeting”?

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Thank you!

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