

# **Monetary Policy Strategies – Any Changes after the Crisis?**

Zbigniew Polański  
Economic Institute, National Bank of Poland

Eight Annual NBP-SNB Joint Seminar  
Zurich, May 15-17, 2011

# Outline

- Introduction
- Monetary policy before and during the crisis
- Monetary policy after the crisis: A short overview of the international discussion
- Poland: Monetary policy strategy during and after the crisis
- Final remarks

# 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 uncharted 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

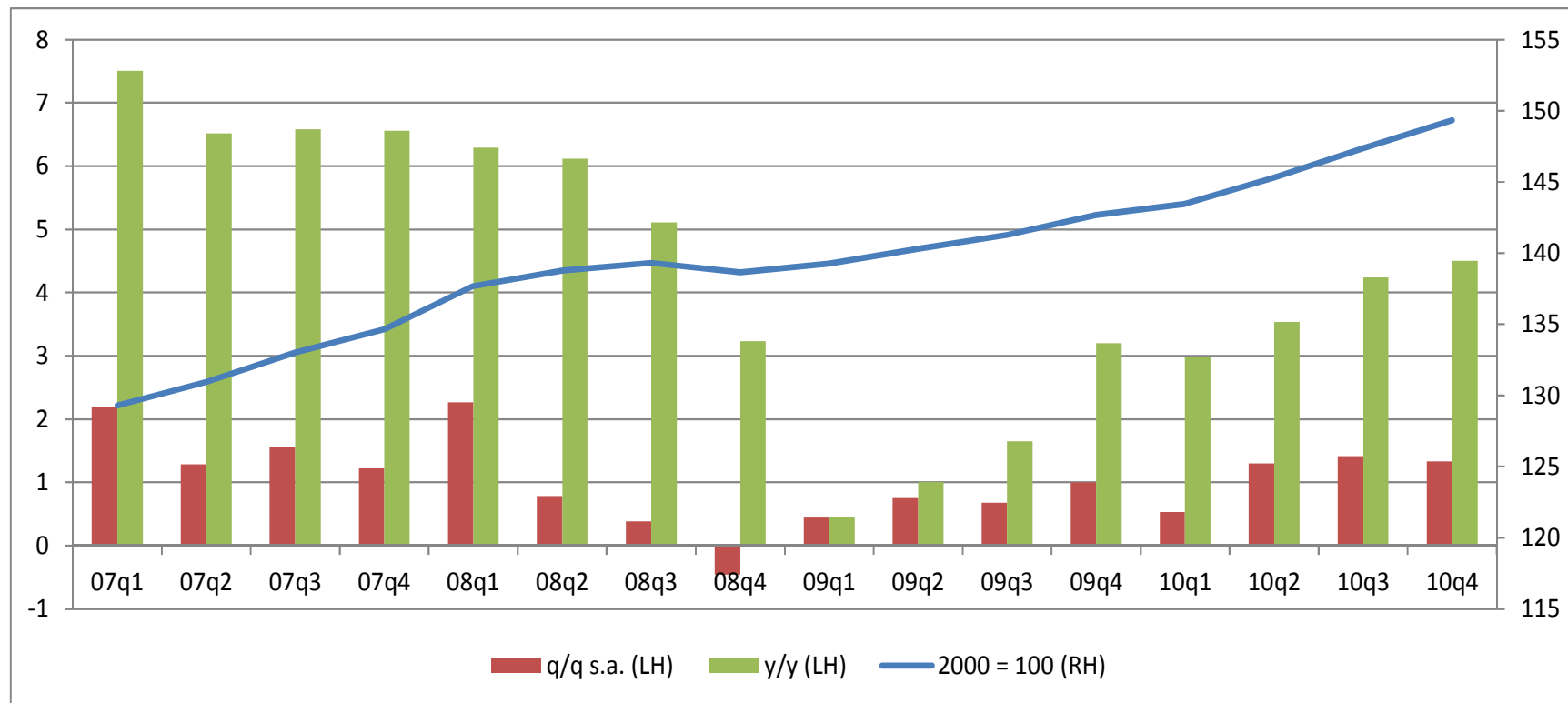
- Central bank independence may be questioned in practice: negative impact on expectations' control!
  - Increasing role of judgement and discretion in decision-making
    - Difficult to estimate the net cost of pre-emptive actions
  - Increased role of public debt
  - Coordination between central banks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

# **Poland: Monetary policy strategy during and after the crisis**

# Poland weathered the crisis quite well

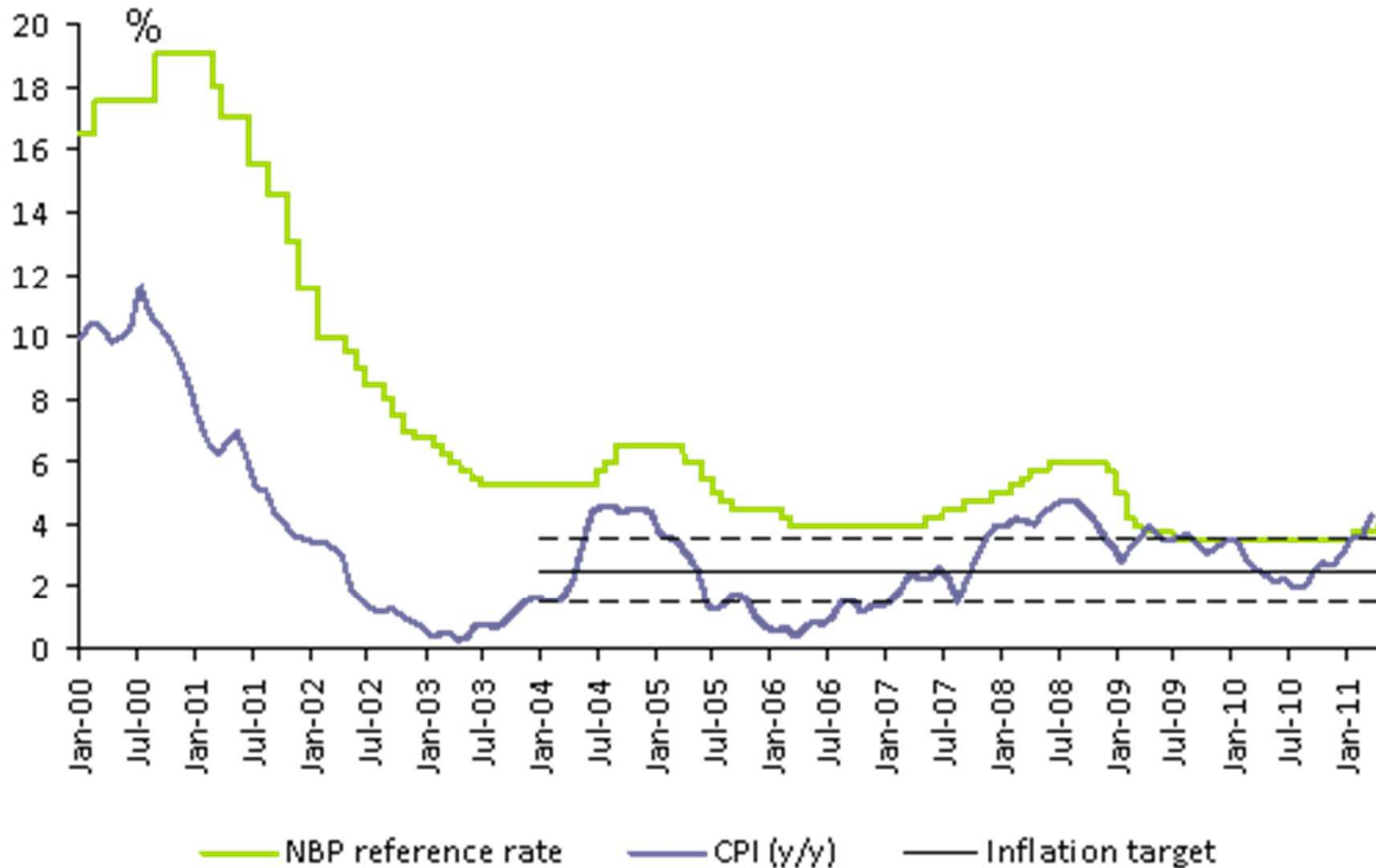
- No recession
  - In 2009 the only EU country with positive GDP growth!
    - Poland: 1.7%
    - EU: -4.2%
    - Euro area: -4.1%
- No financial institution went bankrupt, no bail outs!
- „Inflation targeting served Poland well” (Belka, March 2011)
  - Including the freely floating exchange rate

# Poland: GDP growth 2007-2010 (quarterly)



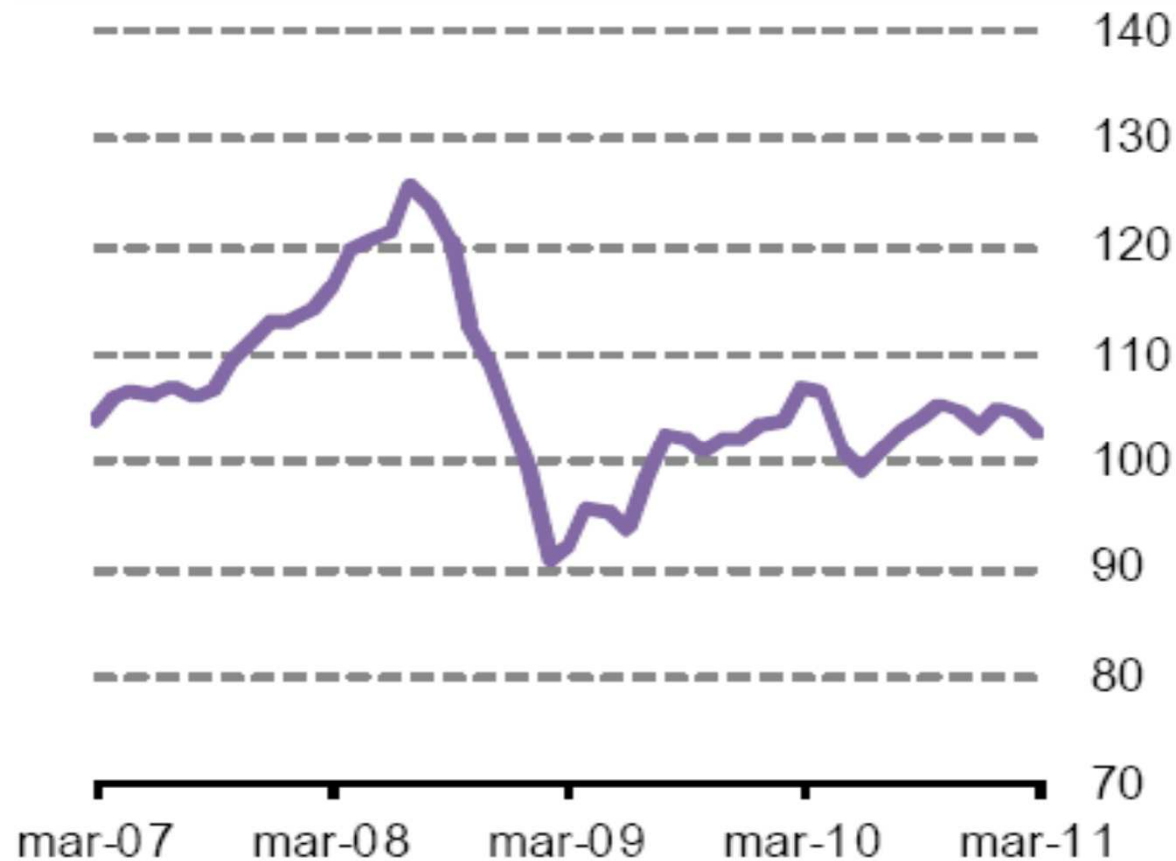
Source: CSO and NBP.

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



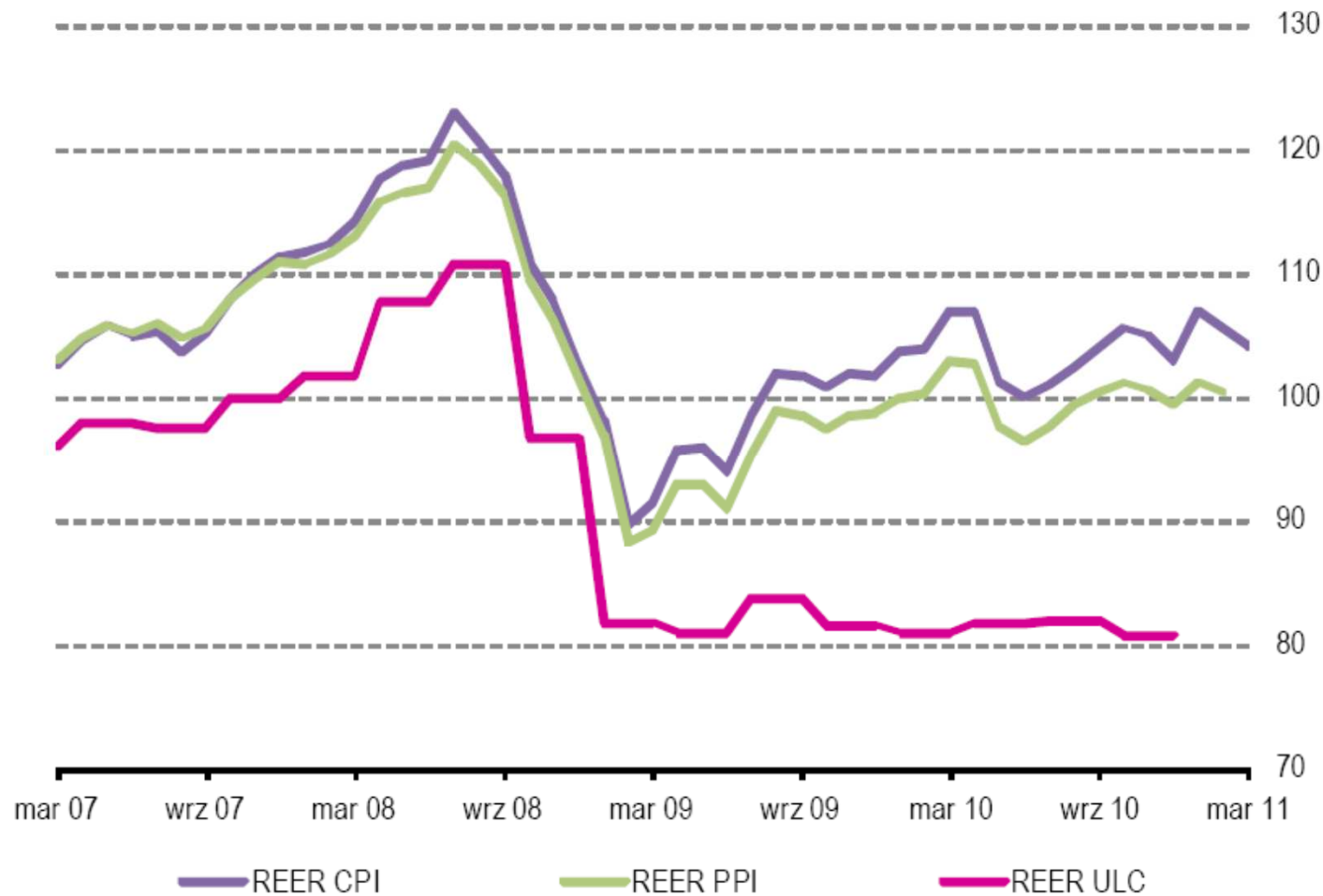
Source: CSO and NBP.

# 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.

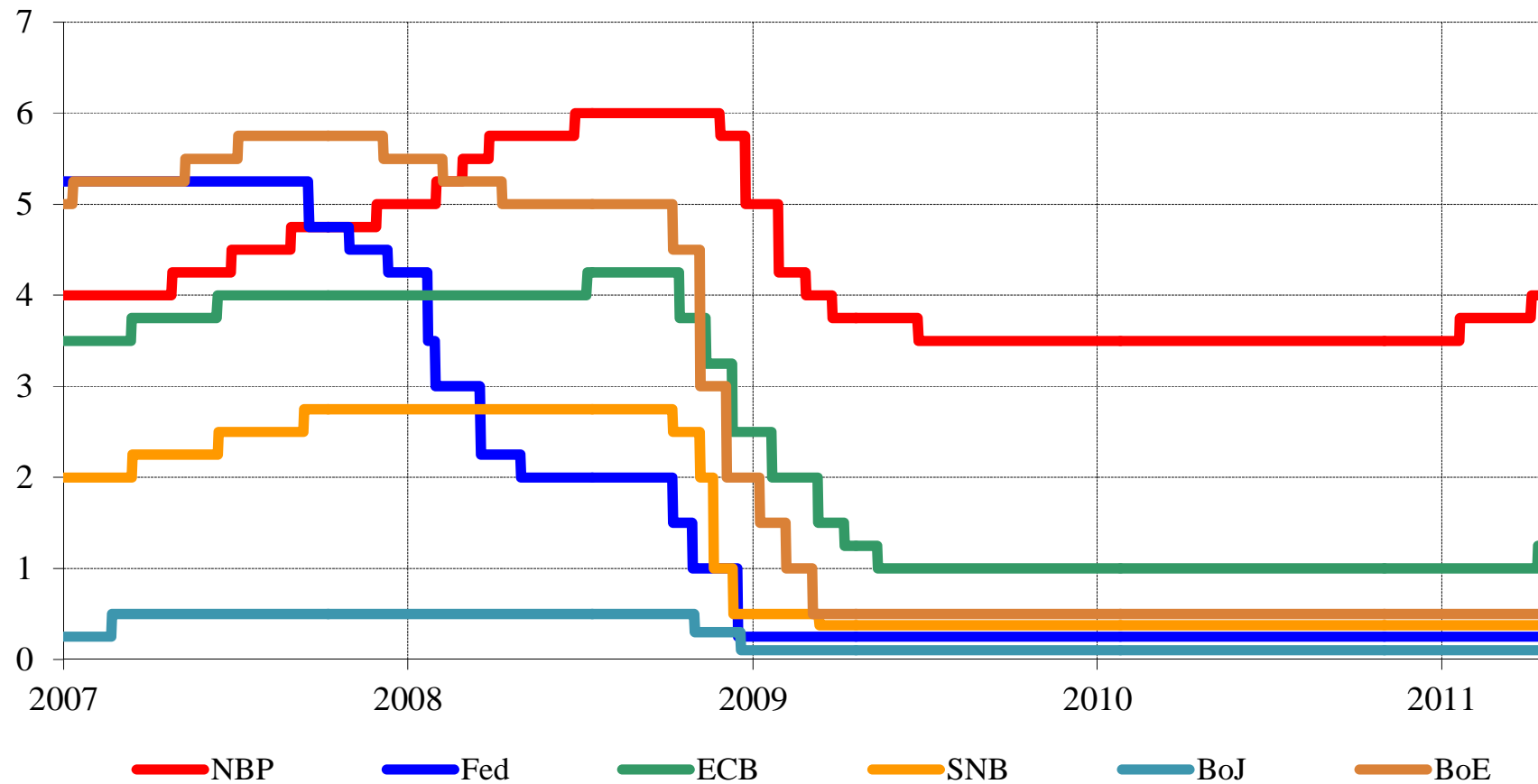
# Poland: Zloty's real effective exchange rate (March 2007 – March 2011)



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“?

# References

- Arestis, P., Sawyer, M. (2010): „What Monetary Policy after the Crisis”, *Review of Political Economy*, vol. 22:4, pp. 499-515 (<http://129.11.89.221/MKB/MalcolmSawyer/monetary.pdf>).
- Bernanke, B. (2004): „The Great Moderation”, Remarks at the meetings of the Eastern Economic Association, Washington, D.C., February 20 (<http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2004/20040220/default.htm>).
- Blanchard, O., Dell’Ariccia, G., Mauro, P. (2010): “Rethinking Macroeconomic Policy”, IMF Staff Position Note, 12 February (SPN/10/03) (<http://www.imf.org/external/pubs/ft/spn/2010/spn1003.pdf>).
- Borio, C. (2011): „Central banking post-crisis: What compass for uncharted waters?” (forthcoming in C. Jones & R. Pringle (eds): *The Future of Central Banking*, Central Banking Publications).
- Gerlach, S., Giovannini, A., Tille, C., Viñals, J. (2009): *Are the Golden Years of Central Banking Over? The Crisis and the Challenges*, Geneva Reports on the World Economy 10, International Center for Monetary and Banking Studies and Centre for Economic Policy Research.
- Goodhart, C.A.E. (2010): “The changing role of central banks”, BIS Working Papers No. 326, Basel, November (<http://www.bis.org/publ/work326.pdf>).
- Gudmundsson, M. (2010): “Challenges to inflation targeting: raising some issues”, in: “Perspectives on inflation targeting, financial stability and the global crisis”, BIS Papers No. 51, Basel, March, p. 7 (<http://www.bis.org/publ/bppdf/bispap51.pdf>).
- Kroszner, R.S. (2010): “Comment on Charles Goodhart’s paper “The changing role of central banks”: what should central banks do?”, in: Goodhart (2010, pp. 21-23).
- NBP (2006): *Monetary Policy Guidelines for 2007*, September, Warsaw ([http://www.nbp.pl/homen.aspx?f=/en/publikacje/o\\_polityce\\_pienieznej/zalozenia.html](http://www.nbp.pl/homen.aspx?f=/en/publikacje/o_polityce_pienieznej/zalozenia.html)).
- NBP (2010): *Monetary Policy Guidelines for 2011*, September, Warsaw ([http://www.nbp.pl/homen.aspx?f=/en/publikacje/o\\_polityce\\_pienieznej/zalozenia.html](http://www.nbp.pl/homen.aspx?f=/en/publikacje/o_polityce_pienieznej/zalozenia.html)).
- Papademos, L.D., Stark, J. (ed.) (2010): *Enhancing Monetary Analysis*, European Central Bank, Frankfurt am Main (<http://www.ecb.eu/pub/pdf/other/enhancingmonetaryanalysis2010en.pdf>).
- Posen, A.S. (2010): “Do we know what we need to know in order to lean against the wind?”, Speech at the Cato Institute 28<sup>th</sup> Annual Monetary Conference, Washington, D.C., 18 November (<http://www.iie.com/publications/papers/posen20101118.pdf>).

Thank you!

Zbigniew Polański  
National Bank of Poland