A Step in the Dark: Unconventional Monetary Policy After the Crisis

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What follows are my personal views.

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Outline of talk

- Before the crisis
  - ⇒ Debt fueled demand as an answer to structural problems
- Market panic and market breakdown
  - Mend the market
- How to revive growth?
  - Low interest rates! What is the theory? Should it change post crisis?
  - But growth fails to revive even at zero policy rates.
  - Unconventional policies to push long rates lower.
- But what effects have they had?

Before the crisis…

- Debt-fueled demand as the answer to slow growth.
  - Increasing financialization?
  - Political response to inequality operating through housing (US)?
  - Opportunities opened up by Euro integration (Euro periphery)
- Crisis

Reactions to Crisis

- Fix the financial sector and markets
  - TALF, TAF, TARP, SMP, LTRO
  - LSAP1, OMT
  - Worked well – central bankers are deservedly heroes.
- Restore growth
  - Ultra-low real interest rates
  - ZLB, UMP
  - Is the theory right?
  - How to make it work?

Theory behind low rates

- Neutral rate is strongly negative
- Interest rate channel post-crisis
  - Corporate investment: But what if banks will not lend, policy uncertainty
  - Consumption: But what if young borrowers heavily indebted?
  - Get older savers to spend. What if they have end-of-life savings goals that are disrupted by crisis?
    - Lower rates => More savings
- Could low rates be less expansionary than we think, even contractionary?

Also is the interest rate channel too blunt a tool?

- Debt-fueled demand localized and therefore post-crisis disruptions local
  - Sectors (Housing, autos), regions (Vegas, Euro periphery), classes (lower middle class)
- Is targeted fiscal policy not better?
  - Debt write-offs
  - Unemployment insurance

How to achieve ultra low real long rates when faced with ZLB?

- Fed: Lowering rates without raising inflationary expectations
- Forward guidance
  - Low for long
  - Commitment?
- Large Scale Asset Purchases
  - Ricardian equivalence
  - Segmented markets and portfolio balance
  - But stock of Fed bond holdings should matter, not flow?
    - Why is news about flow so disruptive?

Raising inflationary expectations -- BOJ

- Little room to reduce nominal long rate.
- Need to raise inflationary expectations so that the long real rate converges to the equilibrium long real rate.
- If inflationary expectations raised too fast or too much, bond prices can fall significantly as nominal yields rise.
- Tough act!

The Unintended Consequences of UMPs

- Risk taking and Investment Distortion
  - Risk taking and low rates – empirical evidence
  - Can financial risk taking increase without increasing real risk taking?
    - Limited bank lending
    - Policy Uncertainty
    - Re-emergence of covenant lite loans

The Unintended Consequences of UMPs

- Spillovers: Cross-border Capital flows and Asset Price Booms
  - Is there a reasonable policy response for the receiving country?
    - Monetary tightening?
    - Fiscal tightening – politically feasible?
    - Prudential norms including capital controls

  The difficulty of countercyclical policy
  - Driving out of multiple ditches when the world has one accelerator
    - Monetary policy coordination (Caruana (2012))

The Unintended Consequences of UMPs

- Postponing reform
  - Political action is endogenous – fear of calamity helps
  - When central banks say they are the only game in town, they become the only game in town.
- Exit
  - Complicated by leverage
  - Careful communication: But exit will be more abrupt than entry

The view from an emerging market

- Excess stimulus post crisis is the root of current problems (as was the U.S. response to the “global savings glut”).
- Pro-cyclicality in most policies is a fact of life across countries.
- Exhortations to put our house in order so that we can ride out volatility are economically right but practically unhelpful.
- What is the lesson for emerging markets? Build reserve buffers and rely on external demand?
- Is the world condemned to slow growth and to increasing indebtedness in industrial countries?

Bottom line: Rethinking global monetary and financial architecture

- Crisis and response is leading to fresh crisis.
- To break the cycle, we need to rethink crisis responses.
- The attempt to restore growth quickly may create problems for the medium term.
- Strong and sustainable global growth may require rethinking global monetary and financial architecture.