Outline of comments on Weber et al.

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Background

. The transmission mechanism in Europe may have changed after EMU.
. The exchange-rate channel may have weakened.
. Financial development suggests changes the policy rate may have a greater impact on long rates and asset prices.
. On the other hand, globalization may have made it harder for central banks to influence the prices of goods and assets (the "conundrum").
. A priori one cannot tell which way it may have gone in recent years.

Weber and co-authors

. Provide us with a superb survey of the theoretical and empirical literature on the transmission mechanism, with special focus on the European case.
. They test for breakpoints in the potency of the transmission mechanism in Europe.
. Conclude that a break may have taken place in 1996-1999.
. More importantly, they conclude that in all likelihood the transmission mechanism in Europe has remained quite strong since EMU.
. My view here is that the strength of the transmission mechanism in Europe was enhanced by the credibility the ECB rapidly acquired, as manifested in very well anchored medium and long-term inflation expectations.

Current Issues

. Global financial markets are in turmoil.
. The transmission mechanism is under stress.
. What are some of the potential issues faced by central banks these days?

The Upswing in Bank Lending Feels Great…

. On the way up in the lending cycle in many countries, especially in the US, we have observed the well know pro-cyclical behavior discussed by Shin in this conference last year and others since Minsky and Kindleberger.
. For example, in this world of asset-backed lending, as the asset values increase, the economic and regulatory capital of financial intermediaries goes up, lending expands further, asset values go up some more, and so on, until a break happens.
. In the so-called parallel banking system this process is reinforced by mark-to-market rules, market-following rating agencies, VaR risk-management systems and so on.
. Everywhere in the financial system a massive amount of short-term funding takes place, supported by lax practices and regulatory rules on maturity mismatches and liquidity risk in general, and by deposit insurance and implicit liquidity guarantees provided by central banks.

… But it is Always Followed by a Crunch

. On the way down, after a break in the upward momentum, the process works in reverse.
. Assets loose value, capital declines, lending contracts, and so on.
. For a while balance sheets may expand not because banks want to lend more, but because they have to honor commitments made to clients and investors.
. Eventually balance sheets start to contract. Europe is not there yet, but may be heading in this direction.
. Liquidity in the system dries out, as exemplified by currently high TED spreads (110 basis points for one month) and high swap spreads (now at 94 basis points for two years).
. The expansion turns into a contraction, driven by risk aversion and a flight to safety.

Policy Options

. At first, central banks have responded with a classic lender-of-last-resort provision of liquidity.
. However, as the pool of collateral started to shrink in value, especially real estate prices, the Fed was led to lower interest rates in order to prevent asset values from melting too fast, with potentially disastrous economic consequences.
. This point is perhaps useful because the complexity of current financial practices often leads to a certain loss of clarity in what is really going on.
. For example, in the real estate world, the cash flows from mortgages are often sliced and sold in a variety of complex forms (CMOs, CMOs-squared, with senior/junior tranches, etc.).
. But it all amounts to ways of slicing the same pie!
. If the size of the pie starts to shrink, the pieces start to loose value, forced liquidation takes place, and the contraction cycle is reinforced.
. For example, the massive amounts of Mortgage Equity Withdrawals by US households have declined form $800 billion a year to close to zero right now.
. All of this sets in motion an increase in the saving rate, and a corresponding reduction in aggregate demand.
. In order to cushion a massive and sudden collapse in asset values, the Fed felt it was necessary to cut the Fed Funds rate, so as to avoid a deep economic slowdown.

Conclusion

. In a credit crunch situation the bank-lending and balance-sheet channels of monetary policy transmission change.
. When this change is taken into account, the policy response often requires cuts in interest in addition to the provision of liquidity.
. We seem to be experiencing such a breakpoint in the transmission mechanism in the US, one that justifies interest rates below Taylor-rule based recommendations, for a period of time.

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