Is Monetary Policy Overburdened?

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Navigating the Great Recession: what role for monetary policy?
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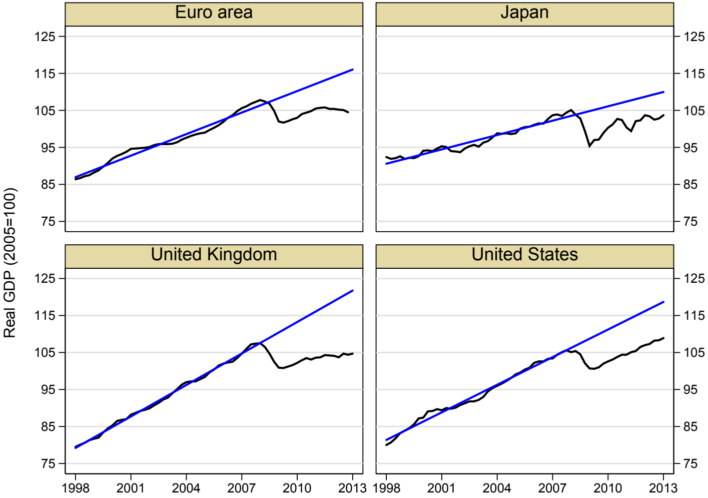
The only game in town?

- Following Great Moderation era, governments and the public have high expectations from central banks.
- Disappointing growth in the aftermath of the Great Recession added to problems that monetary policy is asked to help solve.
- The added burden of broader public policy goals:
  - Restoring high employment
  - Restoring fiscal sustainability
  - Restoring financial stability

The long-term costs

- As more is expected of central banks, the risk of political capture and misuse by governments increases.
- Unprecedented liquidity provision facilitates postponement of needed adjustment by governments and other institutions.
- This is politically attractive in the short run. But long-term adverse consequences could outweigh more visible immediate benefits.
- Diminished central bank independence and compromised credibility reduce monetary policy effectiveness to preserve price stability and to contribute to crisis managements.

Disappointing growth



Real GDP and linear trend fit over decade ending in 2007Q4.

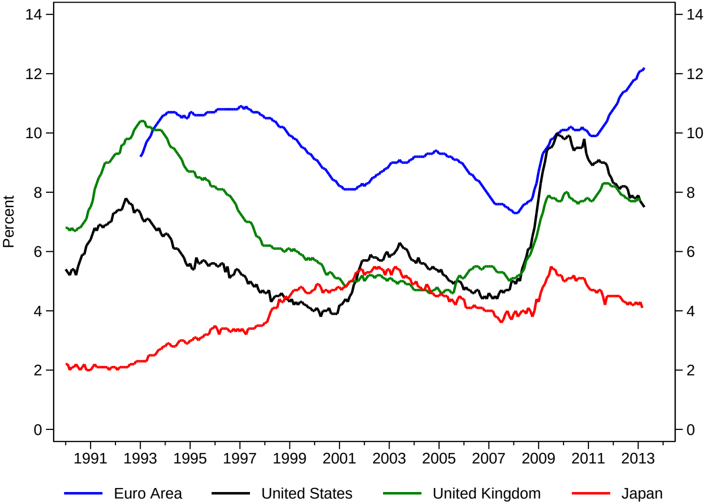
Consequenes of disappointing growth

- Insufficient creation of new jobs—high unemployment.
- Insufficient growth in government revenues—coupled with high pre-crisis debt raises questions of fiscal sustainability.
- Insufficient support for repair of private sector balance sheets and smooth deleveraging.

Full employment

- A desirable public policy objective.
- An appropriate monetary policy target?
- Can monetary policy create jobs and potential GDP?
- Role for structural, labor, fiscal policies.
- Recall rationale for Inflation Targeting and its success.

Unemployment rate



Central bank mandates

Federal Reserve:

"promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

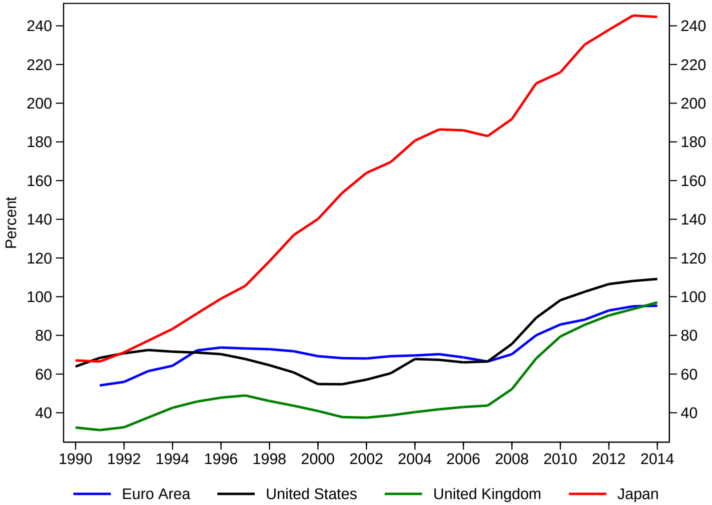
Multiple goals

European Central Bank:

"The primary objective ... shall be to maintain price stability."

Price stability first

The threat of fiscal dominance: Gross debt

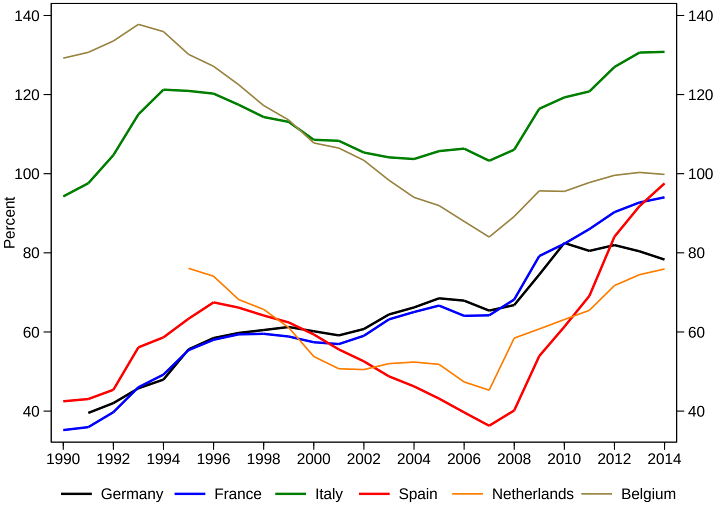


Gross debt as a percent of GDP, IMF Spring 2013 WEO.

The threat of fiscal dominance

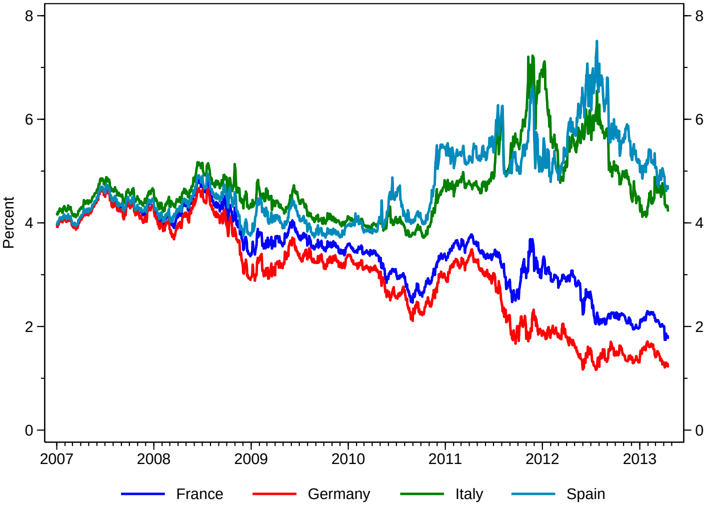
- Zero bound: fiscal and monetary policy become blurred
- Purchases of government debt and near zero financing costs relieve short-term fiscal strains.
- The larger the size of the balance sheet, the larger the temptation/risk for a price level adjustment that reduces the real value of outstanding debt.
- Unpleasant intertemporal political economy implications.

The euro area: A sovereign crisis?



Gross debt as a percent of GDP, IMF Spring 2013 WEO.

The existential threat facing the ECB

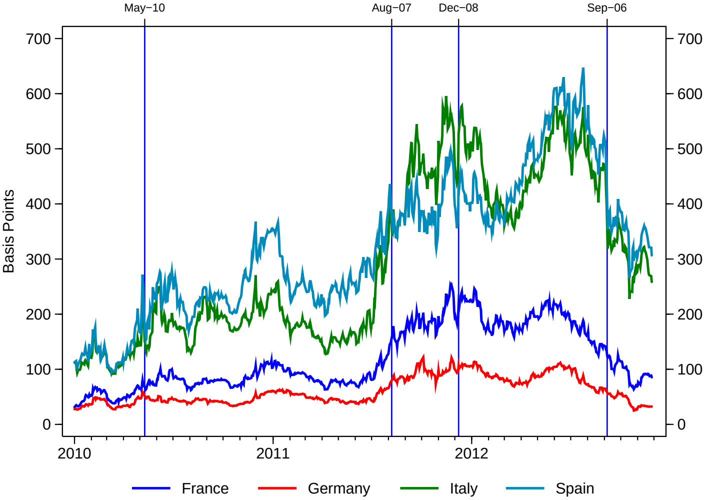


Yields on ten-year sovereign debt.

An impossible dilemma

- The ECB cannot solve what is fundamentally a political problem.
- The ECB has the capacity to "buy more time" for governments by ensuring the threat of immediate collapse is averted for a while.
- ECB interventions give the option to governments to postpone resolution of the crisis.
- By postponing resolution, governments raise the costs for the euro area as a whole.

ECB interventions: Five-year CDS on sovereigns



Vertical lines: SMP (I, II), LTRO and OMT announcements.

Financial stability: Crisis prevention

- Need for stronger capital buffers
- Need for macro-prudential supervision
- Additional role for monetary policy?
- A stronger case for “leaning against the wind.”

Financial stability: Clean up from crisis

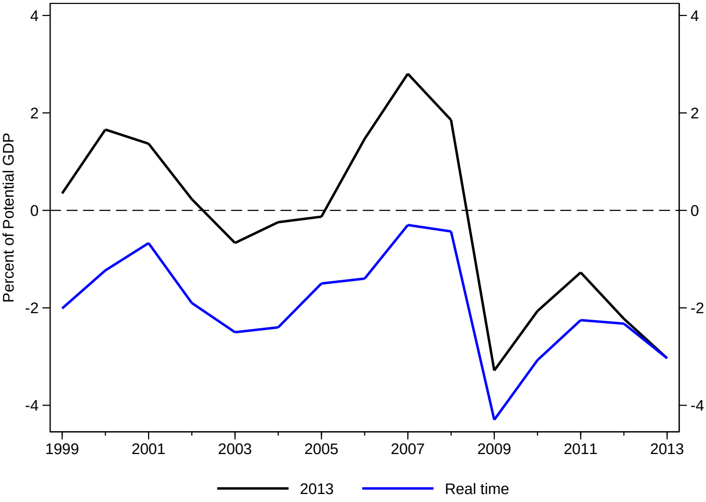
- Massive liquidity provision facilitates cleanup.
- Accommodation postpones balance sheet repair.
- Ultra-cheap liquidity as a recapitalization device.
- Would central banks tighten when needed to preserve price stability if balance sheets remain weak?
- What if governments do not present credible backstop?
- Unpleasant intertemporal tradeoffs.

Overburdened monetary policy

- Monetary policy is not a substitute for structural and labor policies.
- Monetary policy is not a substitute for fiscal reforms.
- Monetary policy is not a substitute for stronger capital buffers and shortcomings in micro- and macro-prudential supervision.
- Overreliance on monetary policy is bound to disappoint.
- Despite the impressive firepower in their balance sheets, magic bullets are not to be found in central bank arsenals.

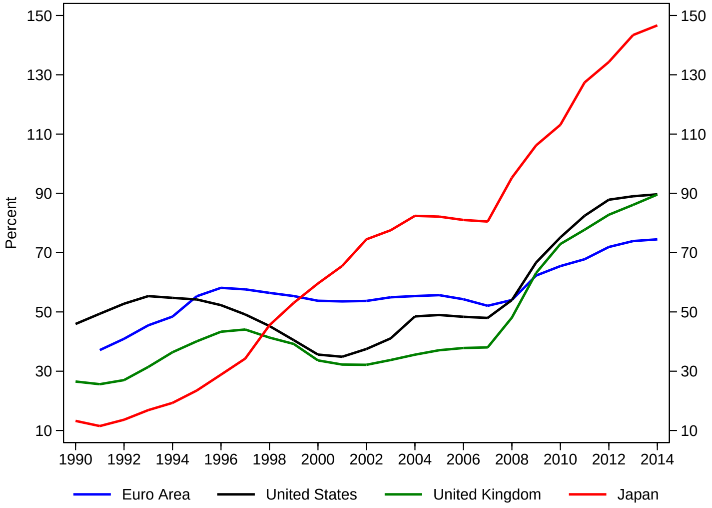
Additional Slides

Real-time and retrospective output gap estimates



IMF estimates from Spring WEO: April 2013 and real-time.

Net debt



Net debt as a percent of GDP, IMF Spring 2013 WEO.

The problem with multiple goals

"The legislation under which we operated required us, in formulating our advice, to have regard for the inflation rate, employment, growth, motherhood, and a range of other good thing." (Don Brash, 1999)

How is Fed's dual mandate interpreted?

"I know that it is fashionable to talk about a 'dual mandate'—that policy should be directed toward the two objectives of price stability and full employment. Fashionable or not, I find that mandate both operationally confusing and ultimately illusory ... Asked to do too much—for instance ... to square continuously the hypothetical circles of stability, growth and full employment—[the Federal Reserve] will inevitably fall short. If in the process of trying it loses sight of its basic responsibility for price stability, a matter which is within its range of influence, then those other goals will be beyond reach."

Paul Volcker (2013)