Zdeněk Tůma: Frontiers of monetary policy

Speech by Mr Zdeněk Tůma, Governor of the Czech National Bank, at the Forecasting Dinner 2009, Czech National Bank, Prague, 12 February 2009.

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Ladies and gentlemen, dear colleagues,

I had the opportunity to speak on the occasion of the Forecasting Dinner several times, but this year is rather special in one respect and that is the global economic crisis, in the midst of which we are right now. Severity of the crisis brings new challenges to central bankers which result in unconventional methods of the monetary policy conduct. Indeed, the policy interest rates in the United States reached effectively zero and the European Central Bank is expected to lower its policy interest rate to historically low level soon. Global economic outlook is worsening and the latest macroeconomic forecast of the Czech National Bank expects the economic growth to be around zero this year and only roughly one percent growth in the year 2010. Accordingly, we expect inflation to hit almost zero in summer this year but return close to the Czech National Bank inflation target of 2% in the first half of the year 2010. Challenges we face as central bankers lead me tonight to talk about frontiers of monetary policy, issues that have been heavily discussed among central bankers recently but are not completely resolved yet.

The first frontier, I would like to mention tonight, is the reaction of monetary policy to observed changes in asset prices, of course, in order to prevent creation of asset bubbles in equity or real estate markets. Many economists and economic journalists argued recently that if the central banks reacted to the sharply rising asset prices between years 2003 – 2007, the bubble in equity and real estate markets would not have developed and we would not be where we are today. It is not that the policy reaction to asset prices was not discussed among the central bankers during those years, but there is one crucial constraint on our side and that is that the reaction is in reality dramatically difficult. Donald Kohn, Vice Chairman of the Federal Reserve pointed out recently that in order to be successful in this respect three tough conditions must be met. First, policymakers must be able to identify bubbles in a timely fashion with reasonable confidence. Second, a somewhat tighter monetary policy must have a high probability that it will help to check at least some of the speculative activity. And third, the expected improvement in future economic performance that would result from the curtailment of the bubble must be sufficiently great.[1] Based on those he expressed a view, which I share, that while the recent experience may have made us a bit more confident about detecting bubbles, it has not resolved the problem of doing so in a timely manner, nor has it shown that small-to-modest policy actions will reliably and materially dampen speculation. An extra policy reaction to changes in asset prices thus still remains questionable.

The second frontier to be mentioned tonight is related to the monetary policy implementation, current situation on the money market and financial stability of the banking sector. For years the monetary policy implementation was not an issue and central banks were able to tighten the short-term money market interest rates such as for instance 3M PRIBOR closely to the key policy rate. Unfortunately, this changed in August 2007 for the US interest rates when the 3M LIBOR for the US dollar denominated funds started to deviate significantly from the Federal Reserve target for funds. A year later following the second round of the financial crises that peaked during the bankruptcy of Lehman Brothers also the Czech short-term money market rates started to elevate well above our policy rate, the two week repo rate.

1 Quoted from speech of Vice Chairman Donald L. Kohn: “Monetary Policy and Asset Prices Revisited” at the Cato’s Institute 26th Annual Monetary Policy Conference, Washington, D.C., on November 19, 2008.

What we know is that all these movements were caused by principal uncertainty among the commercial banks worrying about their solvency and financial stability. The banks were not sure among themselves about to what extent they were hit by the collapse of the market with asset-backed securities and consequently about their counterparts' ability to stay in the business over a longer period than one day. Central banks reacted and extended the money market operations in order to narrow spreads between the market rates and key policy rates. For instance, the Czech National Bank introduced a new liquidity providing repo operation despite the fact that the money market as a whole operates with huge surplus and on average the Czech National Bank has to withdraw roughly 400 billions Czech crowns from the money market to be able to control the market interest rates. While introduction of this new operation made the money market participants less nervous, unusual spread between the market rates and the key policy rate still persists. This is not only the case of the Czech economy or other Central European economies but we observe the same also in the eurozone. Commercial banks operating in the eurozone are willing to borrow around 250 billions Euro from the European Central Bank paying the key policy rate and at the end of the same day to deposit the same money at the European Central Bank being paid the discount rate, which is 1 percentage point less, but the spread between the short-term money market rates and the key policy rate still persists. Magnitude of the commercial banks' position compared with the European Central Bank shows how huge the uncertainty has been. Only restoration of confidence about solvency and financial stability among commercial banks can most probably solve this problem.

The third frontier we are concerned about is connected to the emergency liquidity assistance. Under standard circumstances central banks provide liquidity to commercial banks only. In case of an urgent need a commercial bank may ask the central bank for an emergency credit. What we see in the United States today is an attempt to extend this emergency assistance beyond the banking system and provide liquidity against collateral to non-banking firms. On one hand, one understands the effort of the Federal Reserve to provide funding also to the non-banking sector of the economy when the traditional channels are freezing. On the other hand, the Federal Reserve is effectively printing money against collateral with uncertain value and there are concerns when and how the Federal Reserve will close and null these operations to avoid potential inflationary consequences. It is argued that similar operations should be done rather by the Ministry of Finance against issuance of the public debt. The Federal Reserve is probably aware of the delicacy of current situation and Chairman Ben Bernanke recently tried to assure the economic society that the Federal Reserve is prepared to close the respective funding windows when necessary.[2] However, a question that remains to be answered is how this will work in reality?

Ladies and Gentlemen, instead of a conclusion let me please assure you that in spite of all the frontiers we face today the Czech National Bank does its business as usual and we will do whatever is necessary to meet our ultimate objective of price stability. Finally, I would like to wish to all of us for the year 2009 to be less challenging than the previous one.

[2] See speech of Chairman Ben Bernanke: "Crisis and the Policy Response" at the Stamp Lecture, London School of Economics, London, on January 13, 2009.