Manuel Sánchez: Monetary policy in time of crisis

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the Universidad Autónoma de Nuevo León, Monterrey, NL, Mexico, 26 August 2011.

This is a free translation of the original remarks in Spanish.

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It is an honor for me to close the Banco de México lecture series hosted by the School of Economics of the Universidad Autónoma de Nuevo León. I have a great appreciation for this institution where, during the eighties, I was a professor of many students who today are excellent economists.

The purpose of this series of lectures is to explain to students how our central bank fulfills its responsibilities mandated by law in order to improve Mexicans' well-being. The lectures which today conclude highlighted the implications of our central bank's main goal set by the Constitution, which is to pursue the stability of the domestic currency's purchasing power, and of its other complementary goals of promoting both the sound development of the financial system and the adequate functioning of the payment systems.

This morning I would like to review the role of monetary policy in an international context and, based on this, frame some lessons for Mexico. The central focus of my presentation is that while during the global financial crisis of 2007–2008 monetary policy was effective in re-establishing liquidity in the main advanced economies, current economic conditions in those countries reveal problems whose solutions are far beyond the scope of monetary policy. The best option for all countries, including Mexico, is to identify the underlying factors that might be hindering long-term growth and tackle them without delay. My comments are entirely my own and do not represent those of Banco de México.

The unusual rebound of the world economy

After experiencing a significant contraction, the world economy has been growing since mid-2009. Nevertheless, as compared with other business cycles, it has been recovering at a weaker pace due to the lower dynamism of advanced economies that were severely affected by the global financial meltdown. It comes as a surprise that the United States, the epicenter of the crisis, has not been improving enough to offset the fall in output observed during the past recession and resume its long-term growth path.

Indeed, for more than a century, US GDP has followed a trend of annual growth of approximately three percent, which accounts for nearly two percent in per capita terms. However, since 2009, output has remained around nine percent below the level that would have otherwise prevailed due to its trend, representing the widest and longest negative deviation from this secular reference since the Great Depression.[1] This divergence might not narrow in the near future if current forecasts for the US economy materialize. For example, the main consensus forecasts call for an average annual US GDP growth of 2.2 percent for 2011 and 2012, which further widens the aforementioned deviation.[2]

Explaining this phenomenon has become an issue of intense study and debate, thus confirming that economic problems are often very complex. In particular, some analysts have pointed out that the weak performance of advanced economies must be offset with measures

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1 See Robert E. Lucas, Jr., "The U.S. Recession of 2007–201?", Milliman Lecture, University of Washington, May 19, 2011.

2 Blue Chip Economic Indicators Vol. 36, No. 8, August 10, 2011.

to stimulate aggregate demand, including monetary policy measures, either because the main problem is perceived to be the lack of total spending or because such measures provide time to solve fundamental problems. Next, I would like to analyze this opinion by focusing on the role of central banks in tackling and solving these issues.

Central banks' response to the liquidity crisis

There is a broad consensus among economists that central banks can provide, through an adequate monetary policy, a price stability framework that allows the economy to run smoothly. It is also widely accepted that inflation operates as a tax on society, deteriorating significantly the long-term growth of per capita income. In a similar fashion, it is generally admitted that central banks cannot foster economic growth for a long time through a monetary policy that jeopardizes price stability.

In contrast, there is less agreement as to the role that central banks with a price stability record might play in the short term under weak economic conditions. This issue has turned out to be of particular interest because in recent years the central banks of advanced economies have implemented unconventional monetary measures, frequently known as quantitative easing (QE), to face their extremely adverse economic environment. Due to its importance for Mexico, my comments will focus on the United States, notwithstanding the fact that other countries like the United Kingdom and the European Monetary Union have adopted similar actions.

How effective have central bank policies been and what are their limitations? In the wake of recent experience, two periods must be identified. The first involves the liquidity crisis that emerged in mid-2007 and peaked with the failure of Lehman Brothers during the last months of 2008, when financing in many markets contracted due to the increase in counterparty risk perception, ending in a flight to government-backed assets.

As professor Robert Lucas has clearly pointed out, this financial crisis was very similar to that during the Great Depression, in which credit froze due to the fall in bank deposits originated by the bankruptcy of many financial institutions. However, unlike that episode, this time, the Fed did not allow a contraction of highly demanded liquidity.[3]

In particular, the Fed used conventional monetary policy to reduce the fed funds interest rate from 5.25 percent in July 2007 to levels close to zero at the end of 2008. Since the second half of 2008, as an extraordinary measure, the Fed also bought a significant amount of illiquid (and low-quality) assets from financial intermediaries in exchange for liquid reserves held by them at the central bank.

These operations confirmed that monetary policy tools are not exhausted when the policy interest rate reaches zero. Under such circumstances, conventional monetary policy is ineffective because it involves operations with short-term government securities which, by paying a rate close to zero, become quasi-money and therefore the central bank cannot supply liquidity effectively through open market purchases.

The overall strategy contributed to the dissipation of financial panic by the end of the first quarter of 2009, as reflected by the reduction in the spread between the cost of private financing and that of public financing to levels close to those prevailing prior to the crisis.[4]

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[3] See Robert E. Lucas, Jr., *op. cit*.

[4] For example, the spread between the 3-month Libor rate and the overnight indexed swap, which reflects the banks' funding cost as compared to the central banks' reference rate, began to increase in August 2007, reaching their highest mark of 364.4 basis points during the fourth quarter of 2008, and then decreasing to 36 basis points (pre-crisis levels) by the second quarter of 2009.

The effect in spite of the towering financial turmoil was that GDP fell significantly less than during the Great Depression but, unlike that time, there was no deflation.

Although the central bank's intervention as a lender of last resort was effective, it was not free of costs, as the bail-out of low-quality asset holders created incentives for excessive risk taking in the future, a problem known as "moral hazard". Nevertheless, this cost might have been lower, at least in the short term, than that if financial panic had not been tackled.

Economic stimulus through monetary policy?

A second period of the monetary strategy deals with the continuing and deepening quantitative easing since 2009. In this stage, the Fed has been mainly seeking to boost the economy through lowering long-term interest rates by purchasing long-term government bonds in exchange for liquid bank reserves. This measure was aimed at reducing long-term returns in order to stimulate both credit and investment and, therefore, aggregate demand.

In fact, this operation could have been performed without the intervention of the monetary authority. Since bank reserves are equivalent to short-term debt, the US Treasury could have opted for simply reducing its debt's average term to maturity, limiting long-term securities, and enabling a flattening of the yield curve.

In any case, the impact of the recent monetary easing on the yield curve and, even less so, its influence on the economy, is not clear. Part of the inconclusive evidence is that both yield reductions and increases have been considered by some analysts as a sign of monetary policy effectiveness; the former as a direct impact and the latter as an indirect effect due to higher growth expectations.[5]

As for quantitative easing, which has almost tripled the size of the Fed's balance sheet in three years, the Fed faces the challenge to exit the strategy in time to prevent inflationary pressures and minimize any possible negative impact on the US economy. On different occasions, the Fed has stated how it would apply various measures to normalize monetary policy from its expansionary stance.[6]

However, there are certain actions of a different nature identified by the monetary authority which seem to have similar effects on economic activity. Inflationary pressures would arise when an improvement in economic conditions reduces the demand for bank reserves. With returns on bank reserves nearing zero and higher rates on government securities during the improvement, conventional monetary policy would regain effectiveness. In such a case, fighting inflation would require selling short-term government securities to reduce bank reserves. The alternative measure of increasing interest rates on reserves in order to make them match those on short-term government securities and induce banks to keep reserves has the same effect.[7]

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[5] For a graphic description of monetary policy's ambiguous effect on US interest rates, see John H. Cochrane, "Is QE2 a Savior, Inflator or a Dud?", available at http://www.bloomberg.com/news/2011-06-02/is-qe2-a-savior-inflator-or-a-dud-business-class.html. Some doubts about the monetary stimulus on the economy are mentioned in Frederic S. Mishkin "Monetary Policy Strategy: Lessons from the Crisis", NBER Working Paper No. 16755, February 2011.

[6] See Ben S. Bernanke, "Statement before the Committee on Financial Services", U.S. House of Representatives, July 13, 2011.

[7] This argument is fully described in Robert J. Barro, "Thoughts on QE2", available at http://www.economist.com/blogs/freeexchange/2010/11/qe2.

Other economic policy options

In addition to possibly implementing a new stage of quantitative easing, many analysts have mentioned the need for adopting other measures to offset the weak performance of advanced economies. The first policy consists of new fiscal stimulus programs aimed at raising public expenditure and reducing taxes. In view of the unsustainable path of public-debt-to-GDP ratio projected for the United States and other advanced economies, the supporters of this alternative combine stimulus with a long-term fiscal consolidation program that would begin in a few years.

Although it might seem appealing, this initiative faces a lack of credibility on future fiscal adjustment because today's authorities do not want to deal with the costs associated with any current austerity measures. In fact, the fiscal adjustment needed to begin stabilizing the public debt would probably have a negative impact on such economies in the short term.

A second option is, unfortunately, the return to the old idea that having higher inflation is beneficial either to boost the economy's nominal GDP or to handle the "liquidity trap" or to dilute high public debt levels. This proposal has multiple drawbacks, the most notable being ignoring past lessons. A monetary policy aimed at creating more inflation could enhance nominal GDP but not necessarily real GDP if, for instance, inflation is perfectly anticipated. Also, as I mentioned, QE has ruled out the scenario in which monetary policy ends when the policy interest rate reaches zero. On the other hand, the inflationary dilution of debt, apart from being extremely unfair, deteriorates the credibility of government commitments and raises the financing cost of government debt. In any case, central bank capacity to control inflation may be weakened.

A third and more reasonable option is to identify and correct the fundamental factors that are behind low economic growth. One possibility is that some economic policies might be having the unintended consequences of limiting the necessary adjustments needed to resume a more vigorous economic recovery; for example, the fall in real estate prices towards new equilibrium or the recognition of low-quality mortgage loans by financial institutions. Another possibility is that greater government intervention and uncertainty on future economic policies could be leading to an adverse business environment.

Some lessons for Mexico

The relatively limited effect of the global financial crisis on Mexico – due mainly to the minimum exposure of financial intermediaries to toxic foreign assets – allowed banks to avoid losses, financial markets to avoid interruption of their operations and, thus precluded the need for Banco de México to consider expanding its balance sheet for liquidity purposes. Additionally, the ongoing process of convergence to the inflation target limited the reduction in interest rates implemented, and taking the adoption of unconventional monetary policies in Mexico off the table.

On the other hand, the limited countercyclical fiscal policy that affected only moderately public debt during the crisis gave certainty to the economy. In retrospect, these actions seem to have been adequate as they allowed the economy to absorb the impact of the external shock without compromising the government's future decisions.

The experience from industrialized nations reveals that the emergency measures to supply liquidity were necessary during the crisis although it would certainly have been preferable to have had better financial rules and supervision to prevent such a crisis. Also, the impact that an extraordinarily lax monetary policy could be having on output is still unclear, and the exit strategies will probably be complex. On another front, an expansionary fiscal policy that puts the stability of public debt at risk in the future requires significant correction, which will generate a possible adverse effect on economic activity.

Final comments

During the global crisis, monetary policy expanded to supply the required liquidity and maintain the functioning of markets. In terms of “moral hazard”, the costs generated by central banks’ intervention are probably lower than those that would have emerged with no intervention, at least in the short term. Nevertheless, the favorable impact that quantitative easing has had on those economies is less clear. The costs are unknown because the growth of central bank balance sheets has been unprecedented and their adjustment to prevent future inflationary pressures might be difficult.

The option of higher inflation proposed by some analysts minimizes significant costs, and that of further fiscal stimulus seems limited given the need to consolidate the weak public finances of advanced economies. The alternative that seems more promising is that of identifying the possible fundamental causes of lower economic growth in order to eradicate them and foster a return to the secular growth path.

Finally, Mexico will continue to make progress as long as it focuses on a clear, long-term vision that does not give preference to short-lived benefits which could have excessive costs in the future, and implements policies aimed at promoting long-term economic growth.