Seppo Honkapohja: How did the crisis challenge the central banking as we knew it? What should (not) change?

Remarks by Mr Seppo Honkapohja, Member of the Board of the Bank of Finland, at the Conference on "Financial and macroeconomic stability: challenges ahead", Istanbul, 4–5 June 2012.

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I. Introduction

The on-going financial crisis brought about realizations of "tail risks", which has forced a serious rethink on several dimensions of central banking. The most obvious challenge is the greatly increased importance of financial stability objective that has come about as a result of the banking and financial market problems during the crisis. It is evident that financial stability objectives will also have a bearing on the conduct of monetary policy.

There has been a fair amount of new research on the interrelations between financial stability and monetary policy and significant research effort is ongoing in this area. As the next speaker in the panel is an expert in the financial stability area, I will not focus on these issues in my remarks. Instead I will take up three other consequences of the crisis and their influence on the practices of central banking. In my opinion these areas are important for both macroeconomic policy and research.

1. The Great Recession of 2008–2009 was combated with the use of some strong monetary policy measures, together with fiscal stimulus policies. Some new forms of monetary policy have been used. What do we know about their effects and effectiveness? Is there a need to keep these new policies in the tool kit of central banks in the longer term?
2. The recession has been followed by sluggish recovery in many advanced market economies. The current situation is placing a very large role for monetary policy. This is straining the usual boundaries between monetary and fiscal policy.
3. The fiscal deficits led to rapidly rising levels of public debt, which are now a huge concern. Though the levels of public debt were rising in many advanced market economies before the crisis, the Great Recession accelerated the public debt problems. The high public debts are a concern more generally and not just in the euro area. These debt problems are likely to pose a challenge for defining the proper domains of fiscal and monetary policies in the coming years.

II. Monetary policies to combat the crisis

When the crisis became acute the initial response of most central banks took the form of rapidly executed reduction in the policy interest rate. When the policy rates reached an effective lower bound, central banks had to resort to unconventional policies. Though details of these policies differ, one can classify them in two main types.

The first type of unconventional policies consists of large-scale asset purchases and/or extensive provision of liquidity to banks. Both types of policies have resulted in significant increases in the central bank balance sheet. The Federal Reserve and the Bank of England have both purchased large quantities of government bonds to influence the economy. Liquidity provision to banks has been the primary unconventional policy response by the ECB and also some other central banks, for example, by the Bank of Sweden.

What do we know about the effectiveness of these policies in countering a recession? According to various studies the effects of these policies on the real economy have been

favorable – at least in a qualitative sense. The basic mechanism of central bank's asset purchases or liquidity provision is that these operations reduce excess returns in private intermediation which have become high as a result of disruptions due to the financial crisis.[1] By influencing long-term interest rates and asset prices, these policies seem to have contributed positively to real GDP growth and, as a by-product, to inflation. The latter effect has been useful as there have been and continue to be concerns about deflation.

One consequence of the asset purchase/ liquidity policies has been the decline in intermediation activity in the money and bond markets. Central banks have in effect become "market makers" to a non-trivial degree. This role is not natural for a central bank as it is a much bigger presence than what central banks have in normal times. It could be that the markets get addicted by the low rates and a new market maker. It should also be noted that quantitative easing and liquidity provision policies are likely to impact financial markets and asset risks in some unfavorable ways. A variety of possible problems have been mentioned and further research would seem to be warranted to assess the significance of these effects.

The second type of unconventional monetary policies is usually called "forward guidance", the idea being that the central bank makes public announcements about its policy interest rate plans for the future. The announcements have effects on longer-term market interest rates via expectations and the term structure. If financial markets and monetary policy transmission function well, then forward guidance may well be preferable to the use of asset purchases by central bank.

The forms of forward guidance differ among central banks. The Federal Reserve and Bank of Canada make announcements about future intentions. Some central banks, for example Bank of Norway and Bank of Sweden, go further and show projections of intended policy rates into the future with the aim of enhancing credibility and transparency of monetary policy. Studies of forward guidance suggest that the practices do influence markets rates in the desired ways, though there are also cases – notably in Sweden – where market rates do not seem to align well with the announced policy intentions.

There is by now a fair amount of empirical experience with unconventional monetary policies and there are several studies of their impact on the economy. Further studies are, however, warranted as unconventional policies are likely to stay in the tool kit of monetary policy and they may well be needed at times in the future. To this end I must note that the crisis is far from over and interest rates may stay at very low levels for several more years. This is so even if plans for exit from the low-rate regime are occasionally discussed. We must also recall the Japanese experience. Bank of Japan has kept the interest rates very low and has at times engaged in unconventional policies during the past fifteen years or so.

III. Remarks on exit from current stagnation

I next want to make other remarks about the regime of effective lower bound for interest rates and of unconventional monetary policies. It is often suggested that the policies of central banks and governments have rescued western market economies from a far worse outcome than the Great Recession of 2008–9. Fiscal policy accompanied the strong monetary policies. A second case of unprecedented monetary policy action has been the recent massive 3-year liquidity provision by the ECB. The latter measure was designed to counter the freezing of credit markets in the euro area. In this latter case, there was no accompanying fiscal policy.

Looking at the current mix of policies, the general picture is that central banks in many advanced market economies continue to have policy interest rates near or at the effective

[1] See e.g. Gertler and Karadi (2012) and the references therein.

lower bound and unconventional policy measures are applied occasionally if a recovery is at risk to falter. In contrast, fiscal stimulus is no longer applied or its scale has been reduced in most countries. This state of affairs has two consequences for the changing role of central banking.

First, the mix of macroeconomic policies is placing the main responsibility to central banks for achieving more satisfactory macroeconomic developments. This situation and the use of unconventional policies are straining the conventional boundary between monetary and fiscal policy. Large-scale asset purchases and liquidity provision to banks in the euro area have clear fiscal consequences and there have recently been several political calls for more action from the central banks.

Second, one can ask whether this kind of policy mix can lead the economy back to the "normal regime", where inflation is near the targeted level and the economy grows near its potential. The traditional answer is due to Pigou and Patinkin, who argued that wealth effects at very low inflation levels eventually lead to increased consumer spending and recovery of the economy to the normal regime. It should be noted that efficacy of the Pigou-Patinkin mechanism depends on the degree of private-sector indebtedness – high debts weaken the mechanism.

Modern answers to this question are surprisingly few. Looking at current research, there has been a lot of work in the efficacy of fiscal policies when interest rates are at their effective lower bound.[2] Another major research effort focuses on the significance of financial market imperfections for macroeconomics and for macroeconomic policies.[3] However, I have seen only limited amount of new work that tries to assess the role of monetary and fiscal policies in aiding the path toward the normal regime. A careful approach requires taking a global viewpoint. I do not have time to go into further detail, except to note that this area is in need of much more research.[4]

IV. Interrelations between domains of fiscal and monetary policy

The latest stage of the financial crisis, the sovereign debt crisis, is also affecting the boundary between monetary and fiscal policies. This situation is not new. We know well from economic history that the lines between monetary and fiscal policies and the respective decision-makers become strained from time to time in situation of high levels of public debt. The recent paper by Reinhart and Sbrancia (2012) describes very well the strains in this relationship in the decades after World War I and II.

The current situation has compelled many central banks take a more encompassing view of their mandate in relation to the fiscal authorities. In particular, there are major difficulties in the euro area in this respect, though the debates are also visible in other countries, for example, in the UK and the United States. The ECB is the central bank not for a single sovereign country but for 17 sovereign countries. In this setting there is no one-to-one correspondence between the ultimate owners of the central bank and the ultimate owners of each government's budget. The fact that the ECB has to serve 17 sovereigns also means that the tool kit of monetary policy is more limited than for a single-country central bank.

It follows that the moral hazard considerations related to central bank actions in a monetary union are very different in comparison to a single-country central bank. Even in a country

[2] For example, see Christiano, Eichenbaum and Rebelo (2011) and the references therein.

[3] See Brunnermeier, Eisenbach and Sannikov (2012) for a recent survey of this literature.

[4] Two new papers that take the nonlinearities seriously are Benhabib, Evans and Honkapohja (2012), and Fernández-Villaverde, Gordo, Guerrón-Quintana and Rubio-Ramirez (2012). These papers can be consulted for references to the other literature.

with its own central bank, a government may, for political reasons, be occasionally tempted to resort to monetary financing of fiscal costs, even though the inflationary and financial repression cost will fall on its own taxpayers. But surely such temptation is stronger when the bulk of the inflationary cost falls on not just domestic taxpayers but also other countries' taxpayers.

When the EMU was established, it was often suggested that current account positions between members of a currency union do not matter. There cannot be balance-of-payments crises within a currency union. The financial crisis has proved that this view is fallacious. The sovereign debt crisis carries many of the hallmarks of a balance-of-payments crisis. It is by now obvious that a central bank whose job it is to equalize monetary conditions between the crisis countries and the safe-haven countries will inevitably face a formidable task.

The tradeoffs the ECB has faced during the crisis range from what is necessary to maintain a sufficient functioning of monetary policy transmission mechanism for the single monetary policy to avoidance of making monetary policy a vehicle of fiscal transfers. The path between the two is full of difficulties, and only time will tell whether the euro system succeeded.

V. Conclusions

If one looks at the history of central banking, it is evident that the objectives of central banking and their balance have changed over time. This movement depends on what are the important objectives of economic policies. Before the current crisis the emphasis was on inflation and, depending on the mandate, also more generally on macroeconomic stability. This pre-crisis focus on price stability came in part as a response to the Great Inflation of the 1970's.

The current financial crisis has brought the financial stability tasks to the discussions of central banking objectives and practices. New frameworks and tools for macro-prudential supervision and new regulations on the financial system have taken a central position on current policy and research agendas. This development has come as a response to the financial crisis. Price stability as the macroeconomic objective continues to play an important part in central banking. Inflation targeting with a credible and independent central bank may well survive as the framework for monetary policy. However, interconnections between financial and macroeconomic stability are one topic that needs more attention in the future.

Redrawing the boundaries between fiscal and monetary policy is a second topic that needs attention in the future. There are two reasons for this. First, the roles of fiscal and monetary policy in the Great Recession and in exit from the current stagnation need further assessment. Second, the sovereign debt crisis and the rising debt levels in many advanced market economies may well influence the boundaries between monetary and fiscal policy in the coming years.

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