BIS CCA Conference
Policy Panel

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* The ideas expressed in this presentation are mine and do not necessarily represent those of Banco de la República or its Board of Directors

Content

1. Effectiveness of EME Central Bank policy responses to the pandemic shock and implications for "normal times"

2. Unwinding policy measures in a context of rising inflation, higher debt and pandemic-related structural changes

More questions than answers

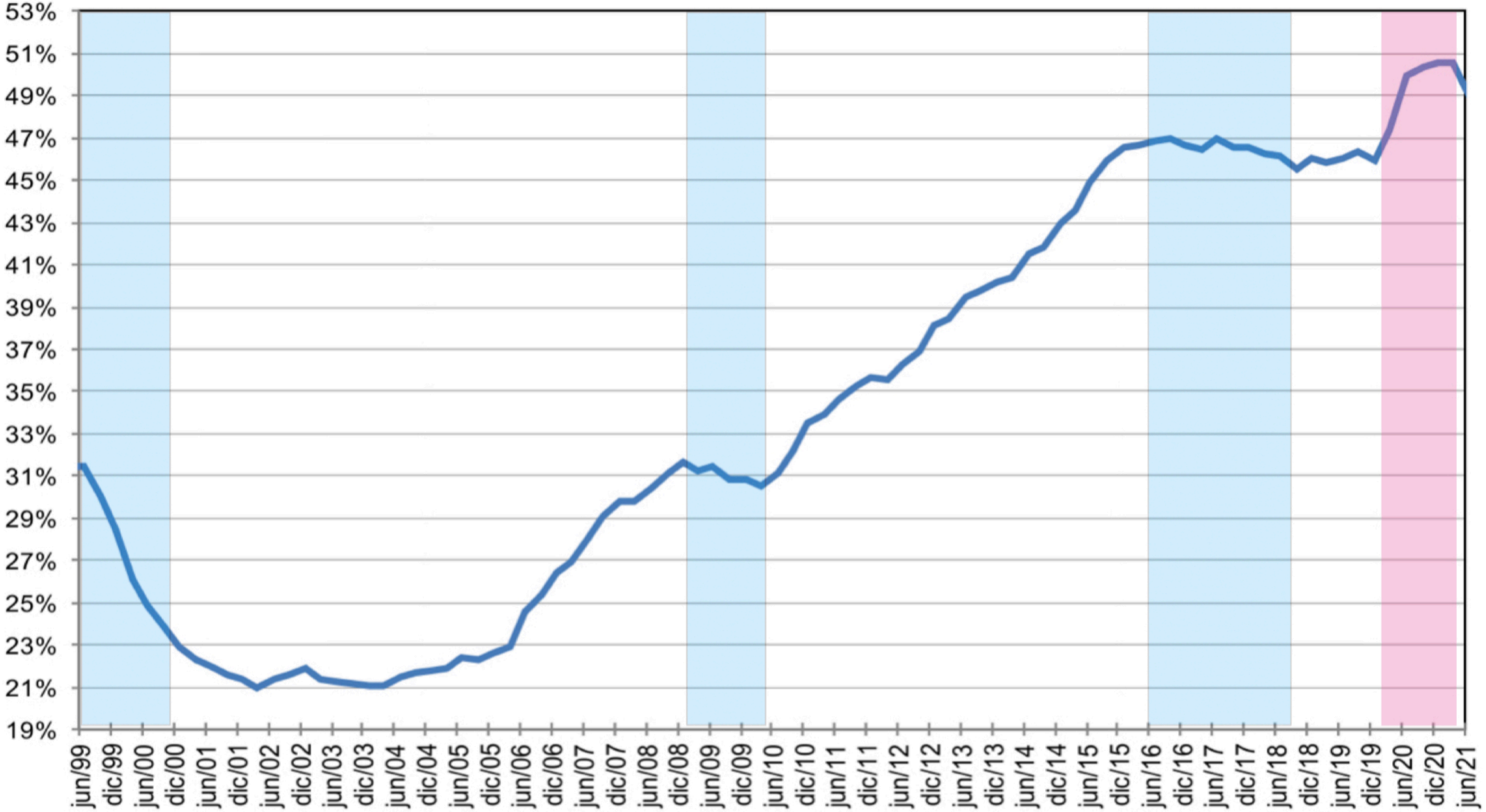
1. Effectiveness of EME Central Bank policy responses to the pandemic shock and implications for “normal times”

- EME CBs policy responses to pandemic shocks can be generally deemed as successful…

  … A large, protracted collapse could have been avoided by the policy responses implemented by EME CBs and governments

- “The financial system was part of the solution and not of the problem”

Colombia: Bank loans as % of GDP



- Key to assess effectiveness of ***specific*** policy measures taken by EME CBs as well as their usefulness in “normal” times

- The Covid-19 shock produced strong disturbances in several markets that CBs had to confront simultaneously…

- Risk aversion skyrocketed, key financial markets seized up, the payments system was under threat, uncertainty on liquidity and credit provision jumped,…

- And economic activity collapsed, but the “supply” and “demand” factors behind were unknown ==> possibly different equilibria that could require different monetary policy responses (Guerreri et al., 2021),…

- …while transmission mechanisms of monetary policy was affected by the shock (e.g. sensitivity of demand or the exchange rate to interest rate cuts)

- Hence, an evaluation of the “effectiveness” of CB policy responses must consider the ***objectives*** pursued with the specific policy measures and the ***robustness*** of the estimated impact under “normal” conditions

- Also, the Covid-19 experience brought interesting questions about the ***effective lower bound*** for interest rates in EME and the policy options available when they are reached

- There was some variation in policy responses across countries and time that could be exploited to estimate specific policy “effectiveness” and monetary policy parameters

- Controlling for differing initial situations, other policy actions (e.g. sanitary, fiscal) and different impacts of the infection is an important challenge

Some potential areas of research

<u>Asset purchase programs</u>

- There is evidence in favor of their effectiveness in curbing excessive depreciation of public and private bonds under stress in EME during the Covid-19 shock (e.g. Hartley and Rebucci (2020), Fratto et al. (2021))

- However, CB intervention in these markets did not necessarily sought to stabilize prices, but to restore liquidity…

- Given this objective, effects on BAS, volumes and turnover are more relevant for policymakers …

- And the extrapolation about the effectiveness and adequacy of QE must be taken with a pinch of salt

- Intervention in some EME occurred in a crisis period (yield overshooting), was relatively short-lived, did not have specific, announced periods or conditions, nor long term interest rate targets,…

- Moreover, volatile external conditions play a significant role in EME long term interest rates…

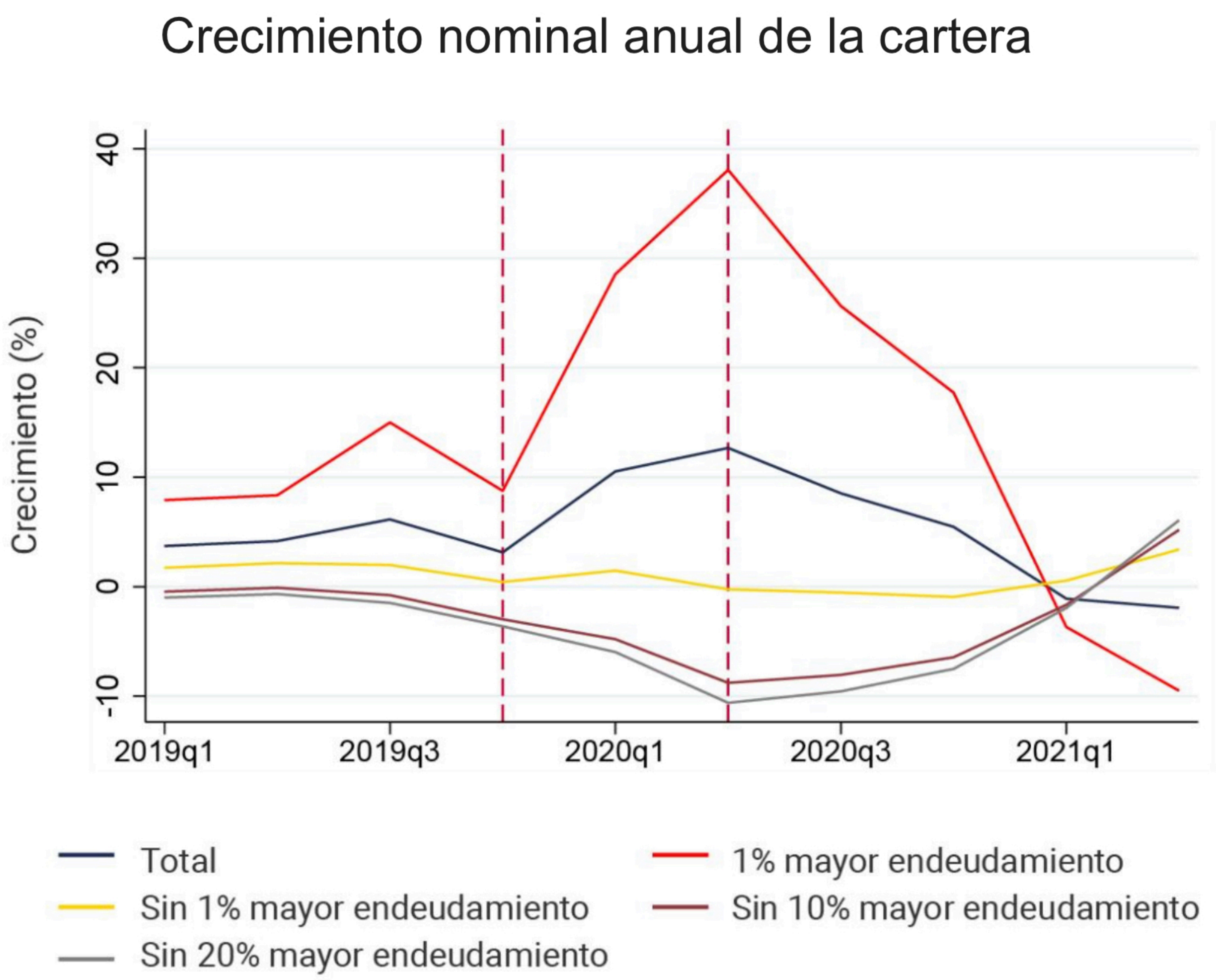
- … undermining lasting effectiveness of CB intervention, or making asset purchase programs time-inconsistent easily (further undermining their effectiveness)

- Tool for crisis events? Doubts about effectiveness in “normal” times

Credit policies

- While some countries pursued credit supply policies specifically aimed at stimulating loan supply (e.g. Perú and Chile), others undertook only general liquidity enhancing responses (e.g. Colombia)…

- There was a significant difference between credit provision for the largest corporates in Colombia and the rest of the firms:



- … Yet, economic recovery and financial system resilience have been strong in all countries,…

- … and it could be argued that the effects of the pandemic on permanent income would have been consistent with a natural decline in credit growth

- Was there a significantly impact of direct credit policies on loan supply, firm survival, short and long term economic activity and efficient resource allocation?

- To which extent did the credit policy effects depend on the other relief measures (guarantee programs, regulatory forbearance)?

- Could the size of the effect change in “normal” times?

- If strong effects are found, should we worry about demands for CB adoption of these facilities on a permanent basis (in “normal” times)? … This would amount to adding a “financial inclusion” objective to CBs

Enhanced liquidity facilities

- Most EME CBs expanded the amounts, admissible collateral, counterparts and maturity of their liquidity facilities in order to preserve liquidity in the financial system and credit supply

- Use of some of these enhanced or new facilities has been low…

- Does it mean that their effectiveness was negligible?…

- … or did their mere presence have a positive effect on financial stability by mitigating perceived counterparty risk? … like the expected effect of LOLR facilities on the stability of deposits

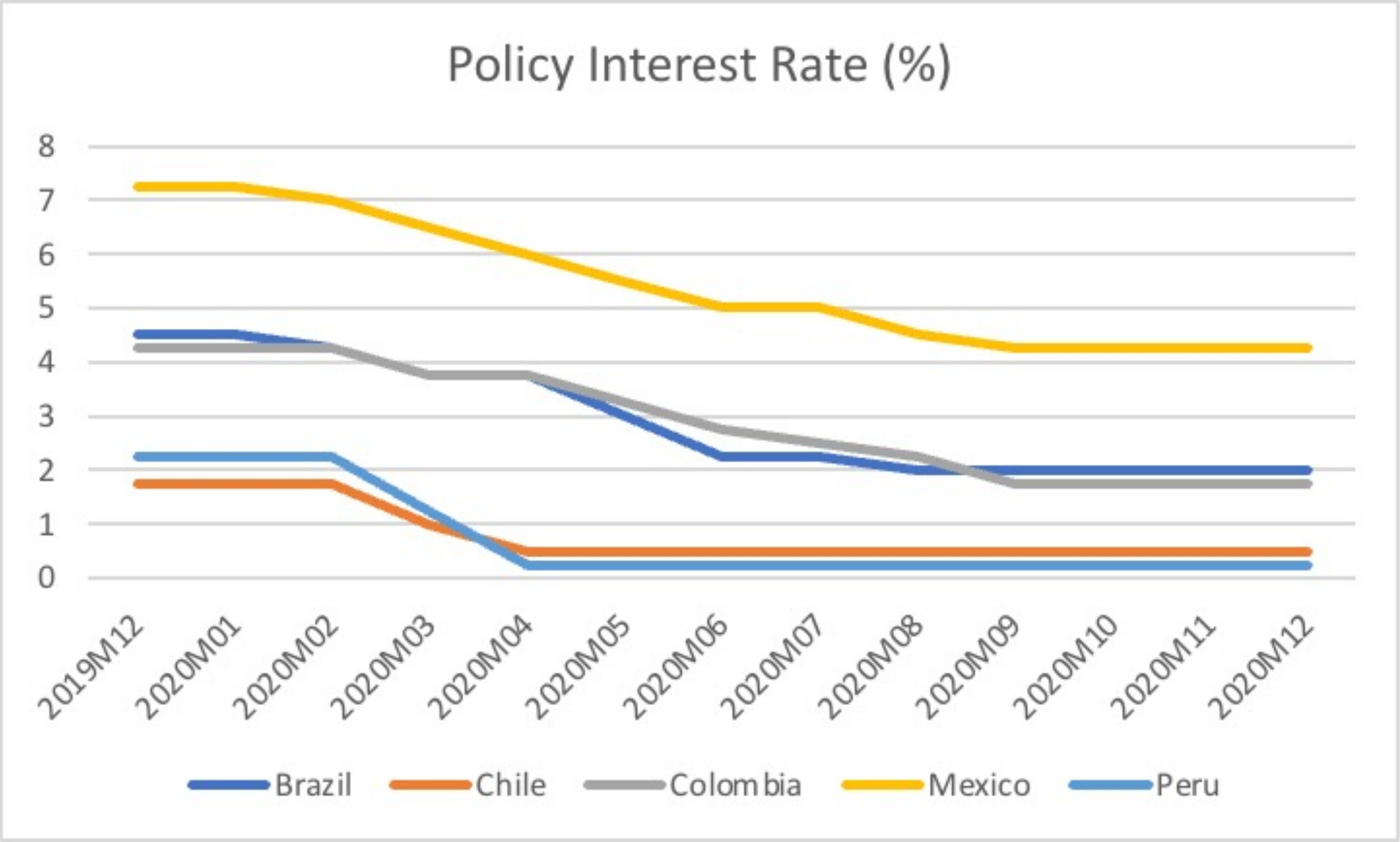
- Challenge: building a counterfactual

- Return to “normal times”: In Colombia we are evaluating the overall liquidity provision scheme after the pandemic…

- Criteria: Ensure ample transmission of monetary policy, minimize impact on money market development, and contain the CB exposure to credit risk (trade-offs)

Effective lower bounds for policy interest rates in EME

- Some CBs in the region reached near-zero interest rates in response to the pandemic (e.g. Chile, Perú), while others stopped at levels well above zero
- Likewise, some CB reduced interest rate faster than others



- What factors determined these differences?

- Public or external debt levels? CB assessment of “supply” and “demand” effects of the shock? Deposit stability? Were there insufficient or excessive responses?

- What monetary options are there at the effective lower bound? Arguably QE may have serious limitations (volatile external or internal context, time inconsistency ==> low credibility)…

- … For the same reasons, Forward Guidance may face important restrictions as well

2. Unwinding policy measures in a context of rising inflation, higher debt and pandemic-related structural changes

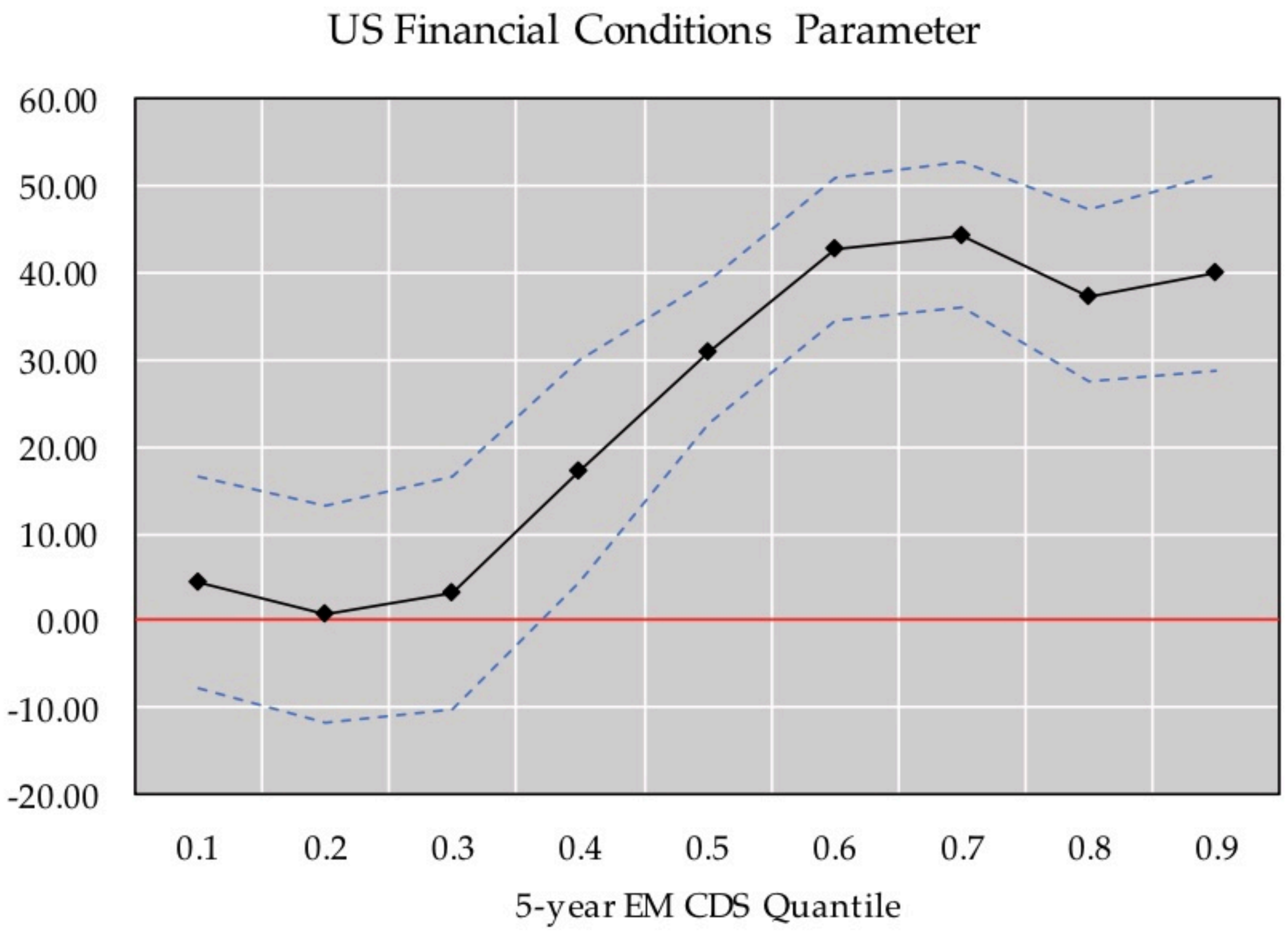
- Unwinding “non-conventional” CB policy measures in EME is relatively easy…
  - Asset purchases stopped earlier, after key markets became stable
  - Liquidity facility use is demand-driven
  - Direct credit support measures can be wound down as the economy and financial system credit recover
- Policy interest rates have already been raised rapidly in many Latam economies, in the face of a surprisingly strong economic recovery and rapidly rising inflation (due mostly to external supply shocks)

- More challenging issues:

  - With higher EME debt levels after the pandemic, risk aversion and capital flows may become more sensitive to changing external conditions (Romero et al., 2021),…

    … this is especially worrisome if AE CBs experience large and persistent inflation surprises ==> more constraints on EME monetary policy

Sensitivity of EME 5 year CDS to US Financial Conditions (panel quantile regression)



- What is the trend of “neutral” interest rates in EME? Pent-up demand and fiscal expansion in AE + higher debt and fiscal/economic policy uncertainty in some EME

- How about potential GDP and NAIRU? Will sectoral shifts in demand and output persist? Will fiscal/economic policy shifts and uncertainty affect investment?

- … and looking more into the future, what will be the effect of automation and climate change transition on productivity, ToT and the REER in EME?

Thank you