Comments on A Durré and H Pill's paper "Central bank balance sheets as policy tools"

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The paper identifies two features of financial markets that justify the use of CB balance sheet (BS) size or composition (in addition to the short term interest rate) to affect the macroeconomy:

- Imperfect substitution between different financial assets (eg "portfolio balance approach").
- Asymmetric information (adverse selection) that may cripple financial markets in a crisis (eg the interbank market).

The paper rightly acknowledges the limited scope of the first mechanism (portfolio balance approach) …

… So the net benefits of CB balance sheet policy tools are greatest as EX-POST measures aimed at dealing with the effects of a crisis in some key financial markets ("market maker of last resort").

- ***Comment # 1***: The availability and use of CB balance sheet tools in case of crisis is helpful (even crucial), but it may create moral hazard and therefore require regulation of the relevant markets …

  … in the same way that LOLR facilities are complemented by liquidity or reserve requirements in the banking system.

  And it may be better to minimize the probability of crisis through the use of sound countercyclical policies…

- ***Comment # 2 (Question)***: Is there a role for CB balance sheet tools as EX-ANTE policy measures aimed at preventing or dealing with a crisis in EMEs?

  The paper suggests that the preemptive accumulation of reserves in EMEs could fall in this category …

  … Even the imposition of URR and supporting exchange rate pegs through sterilized intervention are discussed as possible measures to "build a balance sheet structure that is resistant to sudden stops".

  These are key issues for CBs in EMEs and most of them have used such measures at some point …

  … but a general framework is necessary to determine when and how to use these additional policy tools.

  Some sketchy ideas follow in this regard …

A starting point is that any admissible measure must not compromise the CB long term policy objectives.

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- These typically include:
  - Ö Price Stability
  - Ö Maximum sustainable output
  - Ö Financial Stability
- Policy actions are deemed too costly if they seriously put these objectives at risk.
- For example, URRs on capital inflows are undesirable if they severely hamper credit supply and competition in the financial system for long periods of time (when effective) …
- … or if they redirect flows toward riskier, non-monitored modes (when ineffective).

A second criterion is that any admissible measure must not severely limit exchange rate flexibility.

- The ***alternative*** (peg) is simply ***worse*** for many countries (the lessons from history):
  - Ö Implies pro-cyclical monetary policy and credit supply → risks on inflation or financial stability …
  - Ö … or entails large quasi-fiscal costs.
  - Ö Encourages "one-side bets" and excessive currency and term mismatches risks on financial stability.
  - Ö Amplifies the effects of external real shocks.
- For example, prolonged and large sterilized FX intervention may involve costs in the last three dimensions.

A third criterion is that the CB Balance Sheet measures not go against real long term trends.

- Using these tools to contain a trend may be ***ineffective*** …
- … Markets will find ways to circumvent long-lasting CB BS measures that go against long term incentives of agents (eg URRs or excessive domestic reserve requirements) …
- … or sterilized FX intervention could lack credibility and attract more capital inflows if undertaken against a long-term trend in the RER.
- But even if effective in the long run, these measures may be ***inefficient*** substitutes for appropriate macro policy responses...
- For example, it may not be wise to permanently repress the financial system to compensate for the insufficient fiscal savings required to offset a real appreciation resulting from an enlarged commodity-exporting capacity.
- Hence, the additional CB policy tools should be used to deal with risky or costly ***deviations*** of macroeconomic or financial aggregates from trend.

Some Examples from Colombia

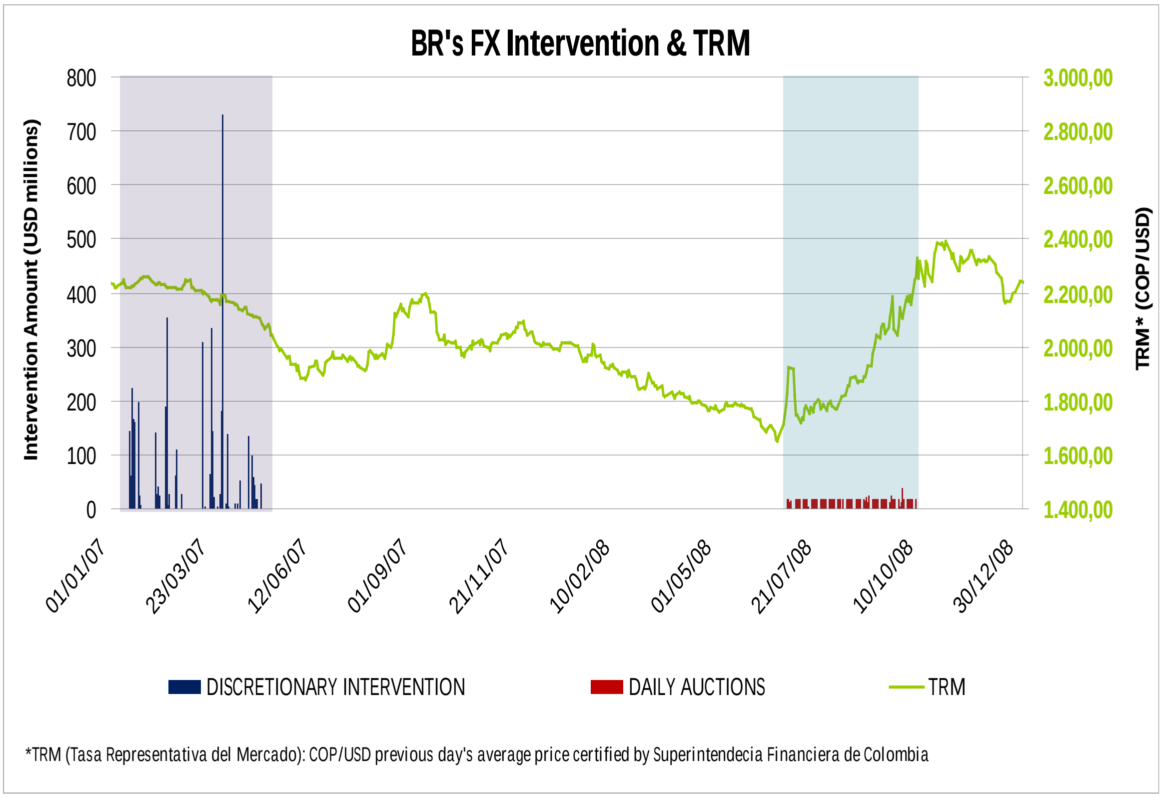
Effectiveness of Sterilized Intervention:

- In early 2007 and mid-2008 the CB made sterilized FX purchases.
- In both cases the currency was appreciating and the CB was raising or about to raise the policy interest rate (to curb inflation and/or overheating of the economy).

- Yet in 2007 intervention failed (the currency appreciated and more capital inflows were attracted), while in 2008 the appreciation was stopped (before the Lehman crisis).
- The difference was the level of the (real) exchange rate at which the intervention was undertaken and the modality of the intervention.
- ***Lesson***: Sterilized FX intervention is likely to be ineffective in the absence of large ***deviations*** from RER trend and with strong credibility of the inflation target (the modality of the intervention may also matter).

Some Examples from Colombia

Effectiveness of Sterilized Intervention



Some Examples from Colombia

The effectiveness of CB BS measures to face a sudden stop:

- The CB established a URR on foreign indebtedness in the early nineties, long before the Russian crisis.
- The CB established a URR on foreign indebtedness and marginal reserve requirements on domestic deposits in May 2007, 1½ years before the Lehman crisis.
- Between 1998-Q1 and 1999-Q3 (Russian crisis) the growth rate of the Colombian economy fell by 8.8 percentage points, a decline second only to Argentina's decline (-11 percentage points) and close to Chile's (-7.9 percentage points).

- Between 2008-Q3 and 2009-Q3 (Lehman crisis) the growth rate of the Colombian economy fell by 2.5 percentage points, the smallest decline among the largest Latin American economies.
- Beyond the differences in the shocks' source, impact and size, the contrast between the response of the economy after the two shocks is striking.
- Some local factors may be important in explaining the contrast:
  - Ö In the 1990s the strong end of an exchange rate target zone was defended, implying a strong expansion of credit …

    … In the 2000s there was a substantial degree of exchange rate flexibility and monetary policy was countercyclical
  - Ö In the 1990s there was a sharp expansion of public expenditure and public debt (as % of GDP) …

    … In the 2000s there was fiscal consolidation and a reduction of public debt (as % of GDP).
- ***Lesson***: Ex-ante CB balance sheet policies do not replace sound macro policies, and depending on the nature of the crisis may have only second-order effects.

A final minor comment

- A simple model of the aggregate financial system balance sheet is used to illustrate the effect of a disruption in the interbank market on the supply of loans.
- The result of the model is that "the aggregate impact of declines in the interbank deposits is greater than what would be suggested by simply summing the individual bank impacts, as there is a feedback effect through the contraction of the interbank market".
- It is easy to agree with the result, but it is not clear how the model captures the channel the authors intend to show.
- In their model, the greater aggregate effect is the result of the assumption of a fixed leverage ratio. This implies that a decline in interbank deposits must be matched by a reduction in equity, which in turn explains the contraction in aggregate loan supply.
- In the face of an interbank disruption, one would expect equity to remain stable and leverage to fall.