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2

Conventional Wisdom Challenged? Monetary Policy after the Crisis

Guillermo Ortiz

As Olivier Blanchard has pointed out, the global economic crisis of the early twenty-first century has challenged some aspects of the conventional wisdom regarding the conceptual framework and implementation of monetary policy. In my view, it has also reinforced the case for continuing the implementation of other aspects. Although the epicenter of the crisis was in the developed world, I believe that relevant lessons can be taken from previous emerging-market crises. In this chapter, I examine some of these lessons and discuss my own views.

Inflation Targeting

During the global economic crisis of 2008, emerging markets showed more resilience than advanced economies, and by 2011 they were exiting the global crisis at a much faster pace than advanced economies (figure 2.1). This reflects sizable government policy support, favorable external conditions, and solid macroeconomic policy fundamentals that proved helpful before, during, and after the global financial turmoil.

Since the crises of the 1990s and early 2000s, most emerging markets have imposed much stronger policy frameworks (figure 2.2). This was of course facilitated by a benign external environment characterized by positive terms of trade effects. To achieve economic stability and sustained growth, they

- Strengthened fiscal positions and increased international reserves,
- Developed domestic capital markets, and
- Developed a consistent framework of monetary and exchange-rate policies with flexible exchange rates and inflation targeting.

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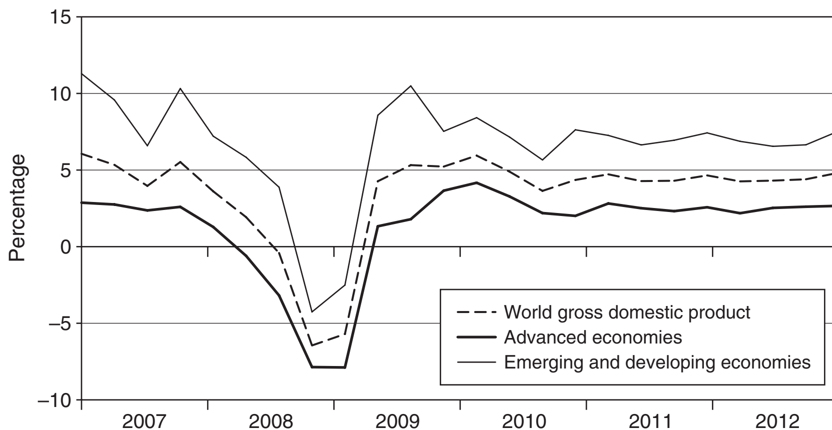

Figure 2.1
Global gross domestic product growth (percentage, quarter over quarter, annualized). *Source:* International Monetary Fund, *World Economic Outlook Update*, January 2011.

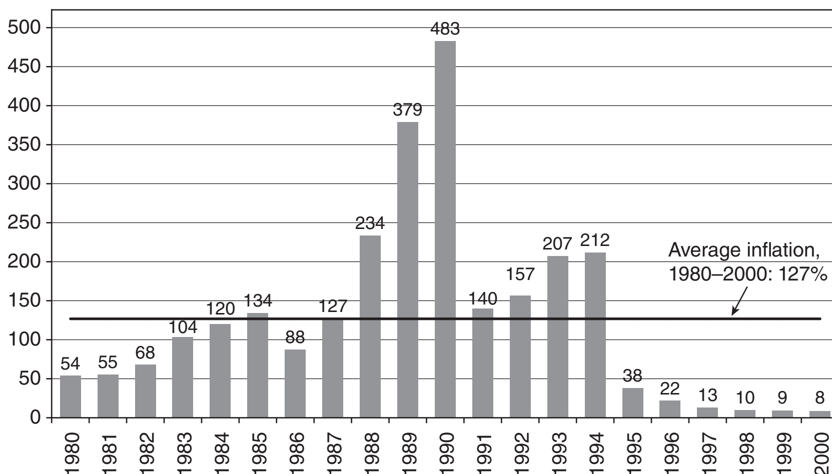

Figure 2.2
Inflation in Latin America and the Caribbean (percentage change, average consumer prices). *Source:* International Monetary Fund, World Economic Outlook database, October 2010.

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Academic research has documented that the "great moderation," the reduction of fiscal dominance (greatly helped by the reduction of the debt overhang of the 1980s after the Brady Plan) and the adoption of inflation targeting, was very helpful in reducing inflation in emerging markets, particularly in Latin America, which was an inflation-prone region.[1] The average inflation rate in Latin America was 136 percent per year in the 1980s and 240 percent per year in the first half of the 1990s. Brazil's inflation rate exceeded 1,000 percent per year in five of the six years between 1989 and 1994. Inflation in the region did not begin to moderate until the mid-1990s: it averaged less than 20 percent per year from 1995 to 1999 and only 7 percent from 2000 to 2009.[2]

Some inflation-targeting central banks may have paid little attention to monetary aggregates, credit expansion, and leverage of households and businesses. Its operational simplicity may have provided the wrong view to some policymakers, in the sense that implementing monetary policy was almost mechanical. The models that were developed to guide central banks' decisions under inflation targeting did not explicitly develop a nontrivial financial sector, so the issue of financial shocks to the real economy was not explicitly considered. Thus, economists need to build up better analytical tools for understanding interactions between the real sector and the financial system, among markets and institutions, and between monetary policy and macroprudential tools.

One positive lesson that emerged from the recent crisis was the effectiveness of the inflation-targeting framework, particularly in emerging markets. Although the crisis prompted large relative price adjustments, inflation remained under control. Recent research shows that, relative to other countries, inflation-targeting countries were able to maintain better anchored inflation expectations during the crisis and, with their flexible exchange-rate regimes, saw sharp real depreciations that helped reduce the output contraction.[3]

Early in the crisis, the Mexican peso depreciated sharply against the U.S. dollar, and more recently, commodity prices have increased dramatically. However, inflation in Mexico has remained under control while expectations remain anchored. The inflation-targeting framework and the credibility gained over the years through a solid fiscal stance and a well-capitalized financial system have ensured that Mexico's central bank can adjust its policy stance in response to business-cycle fluctuations. Of

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course, access to the newly created Flexible Credit Line (FCL) and the swap lines from the U.S. Federal Reserve helped to strengthen the reserve position during the crisis (thus reducing perceived country risk). This was a radical departure from previous episodes, which resulted in inflation and severe financial dislocations.

Most emerging-market inflation targeters have intervened recurrently in the foreign-exchange market before, during, and after the crisis. The objectives have varied depending on each country's circumstances. Interventions have generally aimed to reduce exchange-rate volatility, smooth abrupt exchange-rate fluctuations, and accumulate (or in some cases reduce) international reserves. This issue has generated considerable discussion (and confusion) and given rise to the notion of "fear of floating," since exchange-rate intervention is at odds with the theoretical framework of inflation targeting. Most emerging-market exchange-rate interventions have not aimed at targeting a certain level of the exchange rate because it is not possible to achieve two targets with one instrument. However, the most recent episode of the so-called currency wars has revived this issue. In my opinion, the more frequent and intense interventions recently observed in the foreign-exchange market reflect the different macroconditions and speeds of recovery in developed and emerging markets. They also reflect the increasing importance of China's exchange-rate policy in influencing monetary and exchange-rate policy in other emerging markets, particularly in Asia.

Emerging countries did not experience the constraint of the zero lower bound for interest rates because the risk of deflation was never the threat that it is in developed countries. Central banks in developed countries have been able to offer a toolkit (such as quantitative easing and price-level targeting) to fight the zero-bound constraint, but the risks of the zero-bound constraint should not be minimized. Because the risks of ensuring price stability are asymmetric, central bankers are better equipped to fight inflation than deflation.

These instruments are not necessarily useful for overcoming the zero-bound constraint, so we are fortunate that the toolkit was not fully tested. But no central bank (not even Japan's) opted for changing the inflation target or targeting a price level. These instruments could overcome the zero-bound constraint by making the real rate negative, but the

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long-term consequences of these policy decisions are less clear. In fact, the strategy to undo quantitative easing remains untested, and inflation risks persist in the eyes of many observers.

Financial Stability and the Role of Central Banks in Banking Supervision

For emerging markets, the great crisis of 2008 and 2009 was a fundamental stress test—of the ability of the domestic financial system to withstand a global financial crisis and of the ability of the real economy to absorb a very large shock and to experience a sharp policy-induced rebound. No emerging-market economy in Asia or Latin America that suffered a financial crisis in the 1990s and early part of this century suffered a domestic financial crisis as a consequence of the global crisis. This remarkable situation shows that emerging markets learned from their mistakes. Their banks did not load up with toxic assets and were well capitalized heading into the crisis.

Given the nature of emerging-market crises, policymakers focused on macroprudential considerations in the aftermath of these episodes. They may not have done so by establishing a formal macroprudential framework (as is being done today in several countries), but they implemented preventive regulations, such as avoiding the currency mismatches and excessive leverage that led to credit booms and collapses in previous episodes. That is a missing piece in Olivier Blanchard's graphs of the monetary framework in emerging markets (see chapter 1).

The great crisis was a massive institutional failure, involving financial institutions, regulators, rating agencies, and international organizations. A deficient regulatory and supervisory framework for the financial system at an international level reflected the widespread belief that market discipline (and its pillars) was sufficient to promote financial stability, even in the absence of a strong framework for financial regulation and supervision.

The crisis showed that price stability alone does not imply financial stability. Lightly regulated financial markets that are subject to the forces of market discipline are not sufficient for allocating resources effectively and managing risk. In addition, the global financial crisis demonstrated

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that the financial system tends to reinforce the economic cycles, a bias that is amplified today by the highly interconnected nature of financial institutions and markets.

Therefore, the role of central banks as guardians of financial stability must be rethought, much as has happened in many emerging markets after their financial crises. This has been the subject of much discussion and debate in academic and multilateral forums, with particular attention paid to central banks' involvement in the design of financial regulation and in banking supervision. Central banks need to have a bank supervisory responsibility that reinforces their responsibilities for ensuring the stability of financial systems (like the central bank of Canada).

Nevertheless, the central bank's supervisory role should not interfere with its independence in conducting monetary policy. Although central banks justifiably oversee the payment systems and market positions, which have a direct effect on the stability of the financial system, allowing them to take a much broader responsibility (such as supervising banks or the capital adequacy of banks) can distort the conduct of monetary policy and eventually blur the role of monetary and fiscal policies.

A government institution should undertake the broader role of bank resolution. Since these institutions usually determine when to intervene or recapitalize banks, they should be part of the government. These institutions should have the means to carry out their mandate. Only fiscal policy can be burdened with these permanent interventions.

Asset-Price Targeting

Another lesson from the crisis is the need to consider asset-price targeting. The housing bubble in the United States, the United Kingdom, Ireland, and Spain is one example. Two questions seem key to this ongoing debate:

- First, were monetary authorities too complacent, easing too much for too long?
- Second, can central bankers identify and disinflate asset bubbles while avoiding the business-cycle side effects?

If excessive looseness was the root of the financial crisis, then authorities failed to normalize on time, and there probably is no need to introduce

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explicit asset-price targets for central banks. But if monetary policy was not the cause and the asset-price bubbles were exogenous, then there could be an argument for targeting asset prices. The answer probably lies somewhere between these two perspectives and varies from case to case.

Even if central banks are mandated to target asset prices, the operational aspects could complicate monetary policy immensely and may well result in conflicts between objectives. The difficulty is twofold—to identify asset-price bubbles and to stabilize asset prices while minimizing their negative effects on the business cycle. Although desirable, it is not clear that asset prices should be targeted explicitly. A challenge for central banks and regulators is to develop early warning indicators that bubbles are forming in asset prices so that authorities can try to mitigate them.

One alternative is to deal with asset-price bubbles in the framework of macroprudential policies in which central banks must play a central role. The appropriate tools for dealing with bubbles may require an array of measures (including margins, reserves, and credit limits), many of which are being currently applied by several Asian countries that are experiencing property bubbles. One important lesson on this subject is pragmatism—the willingness to prevent and overcome political or special interests that often are behind the formation of bubbles.

Monetary and Fiscal Policies

The special lending facilities to the financial sector and to sovereign debt support (such as the ones undertaken by the U.S. Federal Reserve and the European Central Bank) have blurred the boundaries between monetary and fiscal policies. There are two justifications for this—political constraints and the economic crisis that began in 2008. Although it is difficult to assess how binding such constraints were, the lack of consensus in the U.S. Congress to unleash a quick support for the financial system was evident. Moreover, the lack of political agreement in the United States regarding medium-term fiscal sustainability is not only influencing the current stance of monetary policy (that is, the second round of quantitative easing) but is, in my view, one of the major threats to financial stability for the world economy.

Second, and more relevant for this discussion, the crisis justified a broader policy response than would have been called for by orthodox

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economic theory. Monetary and fiscal policies usually are linked in the long term by the budget constraint and should be kept separate in the medium term. However, the crisis challenged this purist approach as monetary and fiscal authorities had to assess the tradeoff between battling a banking and debt crisis or increasing indebtedness and thereby ensuring stability in the banking and monetary union. It is difficult to say when to intervene and how much is too much, but the consequences of no intervention probably would have been worse. Again, this response was relatively new to developed countries but has been the response of most emerging-market economies to financial crises, where the line between monetary and fiscal policies has been often blurred.

Despite this departure from the orthodox view, monetary and fiscal policies generally have been kept separate. The United States, United Kingdom, and European Central Bank justified intervention by noting that their charters required them to maintain the stability of the financial system and the monetary union. Moreover, expansions in their balance sheet could be perceived as temporary and should not jeopardize the long-term conduct of monetary policy. They should be able to shrink their balance sheets when conditions normalize. The perception was—and there has been some recent evidence in this direction—that the drop in asset prices was the result of extreme risk aversion and justified the intervention of monetary policy to prevent a confidence crisis.

On the fiscal front, policy focused on providing more permanent support, as occurred in the recapitalization of banks in the United States and in long-term lending to countries in macroeconomic stabilization programs in Europe. To support highly indebted countries, Europe developed the Stabilization Fund, which was funded or guaranteed by the government members. The European Central Bank's intervention in the sovereign bond market attracted criticism, but these were short-term interventions and backed by Europe's governments and should not influence the long-term conduct of monetary policy or long-term inflation expectations.

International Coordination

International cooperation remains a source of tension. During the 2008 to 2009 crisis, international cooperation improved, and the evidence was

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the U.S. Federal Reserve's swap lines, the International Monetary Fund programs, and the new bank regulation negotiated within the Group of Twenty countries. However, developed-market and emerging-market monetary cycles moving in opposite directions have resulted in a source of tension. The monetary-policy expansion in developed countries has resulted in excess aggregate demand in emerging markets, which has distorted local asset prices, such as exchange and interest rates.

Some have argued for more monetary-policy coordination, but it is unclear that this will happen. Unfortunately, the lack of coordination has resulted in a buildup of imbalances and more interventionist policy by countries such as China. There are no parallels in history when this has happened, and new challenges could emerge when developed central banks start compressing their balance sheets. The International Monetary Fund could play a welcome role in this area by aiming at greater coordination or at least by making countries aware of the international dimension of domestic policy choices and minimizing their side effects.

Notes

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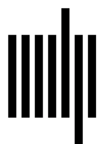

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