

Is Monetary Policy Effective During Financial Crises?

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INTRODUCTION

- **Common View that monetary policy has not been effective during recent financial crisis because it is pushing on a string.**

Lowering policy rate such as fed funds rate has not lead to lower interest rates or more lending, so can't help stimulate economy.

QUOTES

“We are already, however, well into the realm of what I call depression economics. By that I mean a state of affairs like that of the 1930s in which the usual tools of monetary policy – above all the Federal Reserve’s ability to pump uyp the economy by cutting interest rates – have lost all traction.”

Paul Krugman, New York Times, Nov . 14, 2008.

“Some members were concerned that the effectiveness of cuts in the target federal funds rate may have been diminished by the financial dislocations, suggesting that further policy action might have limited efficacy in promoting a recovery in economic growth.” *FOMC Minutes from meeting of October 28-29, 2008,*

INTRODUCTION

- **This view is just plain wrong**
- **This view is dangerous: If were true it would have two important implications for policy**
 1. If monetary policy is ineffective then there is no reason to use it to cope with crisis.
 2. Easing monetary policy should not be done because it can weaken credibility of monetary authorities to keep inflation under control. Thus it is only inflationary.

I strongly disagree with both these implications

FINANCIAL/LIQUIDITY CRISES AND MACROECONOMIC RISK

- **Financial system performs essential function of channeling funds to agents with productive investment opportunities**

Financial/liquidity crisis disrupts flow of credit because shocks interfere with information flows necessary for efficient functioning of financial system

- **Financial institutions work to collect information to solve adverse selection and moral hazard problems and are crucial to *price discovery* so that assets can be valued**

FINANCIAL/LIQUIDITY CRISES AND MACROECONOMIC RISK

- **Two types of risk that interfere with price discovery**

Valuation Risk

Difficulty in valuing assets because of increased by complexity of security or opaqueness of credit worthiness

Macroeconomic Risk

Probability that financial crisis causes significant deterioration in economy that increases uncertainty.

Particularly problematic in financial crisis because get adverse feedback loop (financial accelerator of Bernanke and Gertler):

F-crisis \Rightarrow Economic activity $\downarrow \Rightarrow$ Uncertainty in valuing assets $\uparrow \Rightarrow$ F-crisis worsens

Destroy value of collateral => adverse selection and moral hazard problems worsen

Destroys balance sheets => financial institutions cut lending => adverse selection and moral hazard problems worsen

Adverse feedback loop is very nonlinear so possibility raises macroeconomic risk substantially and hinders price discovery

STORY OF CURRENT FINANCIAL CRISIS

- **Has happened before in History of Financial Development**

3 Precipitating Factors

1. Mismanagement of Financial Innovation
 - a. Originate-to-distribute has agency problems
 - b. Complex contracts destroy information
 - c. Credit Rating Agencies have conflicts of interest
2. Asset Price Bubble that bursts
3. Deterioration of F-institution balance sheets

STORY OF CURRENT FINANCIAL CRISIS

- **Lending stops \Rightarrow C and I $\downarrow \Rightarrow$ Economic Activity $\downarrow \Rightarrow$ House prices $\downarrow \Rightarrow$ Asset prices $\downarrow \Rightarrow$ Deterioration of Balance sheets $\downarrow \Rightarrow$ Lending \downarrow**

Nonlinear adverse feedback loop that raises macroeconomic risk

STORY OF CURRENT FINANCIAL CRISIS

- **Combination of increase in valuation risk and macroeconomic risk, along with liquidity shortages, has led to huge increase in credit spreads**

TED spread very high, although has diminished since October

Junk bond spread over Treasuries over 1800 basis points, worst in its history

- **Result: Despite aggressive cuts in fed funds rate, interest rates relevant to household and business spending decisions have risen, along with credit rationing**

IS MONETARY POLICY INEFFECTIVE?

- **Does this mean that fed funds cuts have been ineffective?**

NO

- **Consider counterfactual:**
What if Fed had not aggressively cut rates during this crisis?

IS MONETARY POLICY INEFFECTIVE?

- **Valuation risk would still be as high, while macroeconomic risk higher because likelihood of non-linear adverse feedback loop higher**
- **Credit spreads would have been higher and with level of Treasury rates higher, interest rates relevant to household and business spending decisions would be much higher than now**

Aggregate spending would be far lower and recession much more severe

IS MONETARY POLICY INEFFECTIVE? **BOTTOM LINE**

- **Monetary policy has been very effective during recent crisis and more potent than in normal times**

Not only lowered interest rates on default-free securities, but also helps lower credit spreads

Without easing, financial crisis and economic downturn would have been far more severe

- **Argument does not mean that monetary policy is able to offset massive contractionary shock from current financial crisis**

IS MONETARY POLICY INEFFECTIVE? **BOTTOM LINE**

- **Need other tools to contain crisis:**

Liquidity facilities: TAF, TSLF, PDCF, AMLF, CPFF, MMIFF and TALF

Fiscal Stimulus

Can it be done right?

WHY MONETARY POLICY NEEDS TO BE AGGRESSIVE DURING FINANCIAL CRISES

- **Financial disruptions have particularly nonlinear affects because they lead to adverse feedback loop**
- **LQ framework that supports gradualism is inappropriate**

Strong argument for risk-management approach in which monetary policy takes out insurance against tail as I advocated in speech in January 2008

Also zero-lower bound problem, which is now highly relevant, provides further argument for aggressive easing.

CONCLUSION

- **Fallacy that monetary policy is ineffective during financial crises is dangerous because it promotes policy inaction**

Monetary policy actually more potent because it can reduce macroeconomic risk

- **Supports risk-management approach in which monetary policy is far less inertial**

Should move decisively through conventional and nonconventional means to counter downside (tail) risks

Should take back insurance quickly if financial markets recover or there is upward shift in inflation risks