Lessons from the Global Crisis: The Role of Monetary Policy

Binod B. Bhoi and Pankaj Kumar
Department of Economic Analysis and Policy
Reserve Bank of India

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Structure of the Presentation

- Introduction
- Causes of the Global Crisis
- Evolution of the Crisis and Policy Responses
- Lessons for Monetary Policy from the Crisis
- An Evaluation of Indian Monetary Policy
- Conclusions

Introduction

- Severest crisis since the Great Depression – sub-prime to financial to global economic crisis
- Did the crisis struck suddenly or were there early warnings ?
- Was there a policy of 'benign neglect' ?
- Debates remain unsettled on many issues
- But an enquiry into causes and policy responses to the crisis throws many lessons
- Role of Monetary Policy – prime focus of this presentation

Causes of the Global Crisis

Macroeconomic causes –

- Global imbalances (Portes, 2009)
- Current Account Balance: Deficit (US), Surplus (China)
- Savings-Investment imbalances: Low savings (US), High savings but underdeveloped financial intermediation (China)
  - Global savings glut
  - Capital flowing from capital-poor to capital-rich countries
- Export-led growth and leverage-led growth (BIS, 2009; Farhi *et al.*, 2008)

Causes of the Global Crisis

Macroeconomic causes –

- Low interest rates supported by accommodative monetary policy (Taylor, 2008; ECB, 2007)
  - Fear of deflation – Dotcom bust
  - "Great Moderation" - good policies (explicit focus on price stability), benign structural economic changes (institutional reforms, globalization and technological progress), or simply good luck (smaller and infrequent shocks)
- Accommodative monetary policy replicated elsewhere
  - Credit boom, asset bubbles – Domestic imbalances
- Monetary policy did not respond adequately to the build-up of risks due to narrow focus on price-stability
- Lack of recognition of asset prices in policy formulation (White, 2008; Borio and Lowe, 2004; Detken and Smets, 2004).

Causes of the Global Crisis

Microeconomic causes –

- Search for yield in a low interest rate regime increased the incentives for risk taking and rapid financial innovations – Excessive leverage
- Systemic risks were underestimated:
  - Faith in market mechanism on pricing of risks and efficient allocation of credit
  - Assumption of diversification of risks through products and institutions
  - Improved macroeconomic performance
- Regulators' relied mostly on micro-regulation and ignored systemic implications of shadow banking activities

Causes of the Global Crisis

Microeconomic causes –

- **Market failure:**
  - Flawed incentive structure for consumers, asset managers and credit rating agencies (BIS, 2009; Bernanke, 2009)
  - Flaws in measuring, pricing and managing risks (BIS, 2009)
- **Regulatory failure:**
  - Capital requirements encouraged pro-cyclicality in lending behavior (Rose and Spiegel, 2009)
  - Escalation of securitisation
  - Incentivised banks to move activities off-balance sheet (Demirguc-Kunt and Serven, 2009)
  - Implicit credence to the "too big to fail" perception of conglomerates

Evolution of Crisis and Policy Responses

First phase – Sub-prime related funding problem

- Sharp cuts in policy rates in the US
- Special/emergency liquidity provisions in the US and Europe
- Establishment of US dollar swap lines
- Liquidity management operations – flexible supply of reserves, interest rate on standing deposit facilities and remunerating reserves – concentrated on the liability side of the central banks' balance sheet

Second phase – Transforming to a financial crisis

- Concern for funding liquidity now became concern for bank solvency; Equity prices and credit spreads came under renewed pressure
- Monetary policy faced difficult choices as headline inflation overshot implicit or explicit targets in many countries
- Policy rates were left unchanged or, in fact, increased in some EMEs
- The idea of decoupling was in vogue

Evolution of Crisis and Policy Responses

Third phase (from Mid-Sept.2008) – Full-blown global crisis

- Sudden plunge in confidence set off a chain of deleveraging putting extreme pressures on the credit, bond and equity markets
- Recession in major industrial economies, contraction in trade flows
- EMEs drawn into the crisis through trade, finance and confidence channels
- Co-ordinated rate cuts – close to zero in some advanced economies
- Limits of conventional policy was reached under dysfunctional monetary transmission mechanism
- Unconventional policies for alleviating credit market stress, especially non-bank sector such as commercial paper, asset-backed securities, corporate bonds and public sector securities
- Operations mostly on the asset side - size and composition of the central banks' balance sheet greatly altered.

Lessons for Monetary Policy from the Crisis

- A ‘single target’ (i.e., price stability) and a ‘single instrument’ (i.e., short-term policy interest rate) based monetary framework has come under question.
- Narrow pursuit of price stability is no more considered sufficient. It needs to be complemented with financial stability objectives.
- The deficiency of short-term interest rate in influencing overall financial conditions (failure of transmission mechanism) calls for additional indicators – money and credit are back in the picture.
- There should be willingness to “lean against the wind” of asset bubbles and excessive credit growth.
- Expanded mandate of financial stability highlights the role of counter-cyclical monetary and regulatory measures.
- Monetary policy should recognise the build up of inflationary pressures whether due to food and energy prices or asset prices.

How was India Impacted?

- Indian banks were not hit directly by the global crisis on account of limited exposure to the troubled assets abroad. Financial sector showed resilience.
- India was, however, indirectly impacted after the Lehman collapse through:
  - Capital outflows – impacted forex market and then money market
  - Moderation in capital inflows – ECB, Trade Credits substituted with domestic credit
  - Contraction in exports impacted the real economy – growth decelerated from 9.0 % to 6.7 % in 2008-09.
- Swift reversal in policy stance by RBI

RBI's major policy response

- **Injection of dollar liquidity**
  - Forex swap with agent banks
  - Special market operations to meet oil companies demand
  - Adjustment in ceiling rates on export credit, NRI deposits and ECBs
- **Injection of rupee liquidity**
  - CRR cuts (400 bps), reduction in SLR (by 1% to 24%)
  - Special refinance facility for SCBs (1% of their NDTL)
  - Term Repo Facility under LAF to help banks meet non-banks' demand
  - Buyback of MSS securities
- **Policy rate cuts**
  - Reduction in repo rate (by 425 bps to 4.75%)
  - Reverse repo rate (by 275 bps to 3.25%)
- **Outcome**
  - Stress in financial markets eased by Dec 2008; LAF shifted to absorption mode (currently Rs. 1.3 trillion even with large government borrowings)
  - Augmentation of actual/potential liquidity of Rs. 5.6 trillion
  - Slowdown in growth continues, signs of revival in capital flows

An Evaluation of Indian Monetary Policy

- Financial stability has received greater attention as a monetary policy objective even before the crisis.
- Countercyclical monetary and prudential measures during the upside enabled swift unwinding during the downside.
- Multiple indicator approach helped – broad spectrum of interest rates; money, credit served as information variables.
- Multiple instruments provided operational flexibility – Repo and Reverse Repo Rates, CRR, OMOs including LAF and MSS, Special Liquidity Facility.
- Liquidity management has been an integral part of monetary policy.
- This strategy has served well even in dealing with the adverse impact of the current global crisis.
- Going forward, policy focus is to reverse the expansionary measures to anchor inflation expectations and subdue inflationary pressures while preserving the growth momentum.
- Exit policy need to be modulated according to evolving scenario.

Conclusions

- Critical importance of macro-financial stability
- Need to incorporate macro-financial parameters (money, credit and asset prices) in policy making
- Need for macroprudential regulation and supervision
- Role of countercyclical monetary and regulatory measures
- Informed judgements and effective communication remains major challenges

THANK YOU