Some Lessons for Monetary Policy from the Recent Financial Crisis

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1. Introduction

It is a great pleasure and honor for me to participate in a panel with Ben Friedman on very topical themes for a central banker. The financial crisis that began in August 2007 changed the role of monetary policy. In particular, it blurred the borderline dividing monetary policy from fiscal policy, and gave rise to new questions. In my remarks for this closing panel of the Conference in Honor of Ben Friedman, I would like to address some aspects of this issue.

2. Role of Monetary and Fiscal Policy

Let me begin with a few words about the traditional role of monetary and fiscal policy. The broad consensus among both economists and politicians is that central banks are responsible for guaranteeing price stability in the medium term. As long as inflation expectations remain well anchored, monetary policy can—and arguably should—also contribute to the stabilization of output. Monetary policy works in a timely and effective manner. It is a task which is delegated to technocrats who are entitled to act in a constrained discretionary manner, free of political influence but with a clear legal or constitutional mandate. There is also general agreement that monetary policy has, or should have, only limited distributive effects. Acceptable distributive effects of monetary policy are those arising from changes in interest rates which benefit or adversely affect savers and investors. By contrast, fiscal policy is governed by decisions taken by elected politicians. Fiscal policy entails strong distributive effects through decisions about taxes and public spending. Moreover, since fiscal policy lost its luster in the heyday of the 1960s, many professional economists and policymakers have opposed the use of discretionary fiscal policy for purposes of deliberate countercyclical stabilization. The role of fiscal policy is now considered to be limited to that of the automatic stabilizers. The reason for opposition to the use of discretionary fiscal policy is a concern over persistently large budget deficits, unsustainable debt levels, and doubts over the political system's ability to make tax and spending decisions quickly enough to achieve the desired stabilization.

3. Monetary Policy in the Recent Crisis

After decades of resistance, fiscal policy once more became discretionary in many countries during the recent financial crisis, while monetary policy shifted even more to the center of macroeconomic policymaking, moving from constrained to almost unconstrained discretion. In addition to reducing interest rates to historically low levels, a large group of central banks reacted to the crisis in three ways: They implemented unconventional monetary policy measures such as quantitative easing and credit easing on a large scale, expanded the list of financial instruments deemed acceptable as collateral by lowering the quality requirements, and adopted far-reaching lender-of-last-resort measures to save troubled banks. As a result of these policies, central banks gave preference to some debtors (industrial companies, mortgage banks, governments[1]) and sectors (export versus domestic). In turn, the distributional effects of monetary policy were much stronger than in normal times. These measures are sometimes referred to as "quasi-fiscal policy." This is, or may be considered, a misnomer so long as exceptional monetary policy measures are compatible with the central bank mandate. On the other hand, these measures have a fiscal element, which has clearly blurred the traditional allocation of responsibilities among policymakers.

[1]Note that unlike many countries, Switzerland did not enact fiscal measures directed at stimulating economic activity. Switzerland has posted budget surpluses in the last few years. Another difference to other countries is that the Swiss National Bank (SNB) did not purchase Swiss government bonds for monetary policy purposes.

4. Consequences for Central Banks

What issues for central banks arise from these developments? First, as a result of the measures implemented during the crisis, central banks took much more risk onto their balance sheets, which could potentially lead to substantial losses. Second, as a consequence of the distributional and risk effects of their actions, central banks attracted a great deal of public and political attention. Increased political attention is not without risk, because it can lead to changes in central bank legislation and threaten the principle of independence. Third, the resolute interventions of central banks carry a serious risk of moral hazard among market participants. If market participants know the central bank will backstop the financial system, there will likely be less market discipline to avoid excessive lending, leverage, and risk taking.

5. Lessons and Conclusions

All the actions taken by the central banks were warranted by the severity of the crisis and were inevitable. Nonetheless, in my view there are five main lessons related to the conduct of monetary policy to be learned from the recent crisis. First, there is no doubt that central banks have to play a role in an economic crisis at the market level as well as at the level of individual systemically important banks. In order to act appropriately, they need room to maneuver, which implies a sound central bank balance sheet with sufficient equity. In normal times, the distribution of central bank profits needs to be limited to achieve this objective. In order to be capable of acting in a crisis, the central bank balance sheet has to be able to contract again after an extension caused by the implementation of unconventional measures. Second, it is important to ensure that responsibility is not simply passed on to the central bank, thereby misusing its situation. When acting on behalf of another authority, central banks should be very careful (even if they receive a guarantee on their balance sheet risk). Moreover, when they extend their reach of action, it is important that they remain within their mandate. Third, central banks must guard against finding themselves in a position where they are forced to take action because of other institutions' inactivity. Fourth, when adopting unconventional monetary policy, it is important that central banks carefully evaluate its side effects and map out a clear exit strategy from the beginning. Fifth, in the future, appropriate regulatory measures will need to be taken to contain the moral hazard resulting from massive interventions to stabilize the financial system.