THE RIMINI CENTRE FOR ECONOMIC ANALYSIS

PR 04_10

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CANADIAN MONETARY POLICY: LESSONS FROM THE CRISIS

The following is a report from a panel of the same title held at the Rimini Conference in Economics and Finance, Rimini, Italy, 10-13 June 2010, and organized by the Rimini Conference for Economic Analysis (RCEA). Panel Chair: Angelo Melino (University of Toronto and RCEA). Panelists: David Andolfatto (Vice President and Economist, Federal Reserve Bank of St. Louis; Professor of Economics, Simon Fraser University; RCEA), David E.W. Laidler (Professor Emeritus, University of Western Ontario; Fellow-in-Residence, C.D. Howe Institute; FRSC; Honorary Senior Fellow RCEA), John Murray (Deputy Governor, Bank of Canada).

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Rimini Conference in Economics and Finance (RCEF), Rimini, June 10-13, 2010
Organized by the Rimini Centre for Economic Analysis (RCEA)

Panel II: Canadian Monetary Policy: Lessons from the Crisis

Chair:

- Angelo Melino (University of Toronto and RCEA)

Panelists:

- David Andolfatto (Vice President and Economist, Federal Reserve Bank of St. Louis; Professor of Economics, Simon Fraser University; RCEA)
- David E. W. Laidler (Professor Emeritus, University of Western Ontario; Fellow-in-Residence, C.D. Howe Institute; FRSC; Honorary Senior Fellow RCEA)
- John Murray (Deputy Governor, Bank of Canada)

The panelists each made a 15 minute presentation, followed by questions from the floor.

Andolfatto Presentation

Andolfatto took the US perspective and gave 5 lessons learned that he believes are relevant for other countries.

1. *Financial Market Frictions Still Matter*
   Economists were mistaken to ignore financial frictions—while emphasizing price rigidity—in their models. Going forward, it will be important that we think clearly about which financial frictions matter (limitations in commitment, record-keeping, enforcement, private information, etc.) and keep in mind that banks (chartered, shadow, central) are institutional responses to these frictions.
2. *History will Repeat Itself*
   Although this crisis was concentrated in the shadow banking industry, it had much in common with the banking crises of the U.S. National Banking Era (1863-1913). Repo market looks a lot like traditional banking (short-term debt financing long-term capital). The crisis once again highlighted the importance of the lender-of-last-resort role for the Fed.
3. *Old Tricks Still Work*
   The Fed's various liquidity facilities succeeded in reducing spreads. For example, after the introduction of the Commercial Paper Funding Facility, spreads on A2/P2 CP relative to one-month OIS began to drop dramatically (see graph). The Fed was extremely aggressive in providing liquidity to various markets and participants and its balance sheet grew dramatically; short-term lending to financial firms and markets grew to over USD 1,600. But these various liquidity facilities are now almost completely wound down (except for central bank swaps).
4. *New Tricks Might Work*
   The Fed aggressively pursued "qualitative easing", shifting the composition of its portfolio away from traditional government bills and bonds and towards long-term private sector assets. The evidence suggests that its actions have been effective in lowering the 30-yr fixed mortgage rate.
5. *Central Bank Balance Sheets and Inflation*
   The link between the size of the CBs Balance sheet and inflation has not been as tight as many had expected (or feared). Graphs of CPI inflation and the monetary base (both in Japan and the US) show enormous growth in the base that did not show up in inflation. It mattered that the growth was not due to a 'helicopter drop' of money—it was an asset swap of interest paying reserves for

newly issued prime mortgages. Interestingly, the Fed has made a lot of money this year on its investments! Also, the Fed's expansion of its balance sheet simply met a sharp increase in the world demand for USD liquidity. Expectations of inflation have remained well-anchored; the Fed's credibility has not yet been challenged (although there are mounting concerns about US fiscal problems).

A final thought…Monetary Policy and Asset Bubbles
The FOMC can't wait to get its balance sheet back to just government bills and bonds. But given that purchasing private mortgages did not lead to inflation, and have earned the Fed (and therefore the Treasury) lots of income, perhaps the Fed should continue to hold these instruments in its portfolio. Since purchases of private mortgages lowered mortgage costs, sales should increase them. This provides a tool for dealing with future bubbles. The private mortgages in the Fed's portfolio could be sold to increase mortgage rates, if housing prices get out of line again. The same logic could apply to different asset classes.

<u>Laidler Presentation</u>

Laidler focused on the lessons from the crisis for the renewal of the Bank of Canada's inflation targeting agreement with the Department of Finance in 2011.

- For political reasons, the new agreement will have to give a larger role to issues of Financial Stability. The challenge is how to introduce these additional concerns with a minimum of damage.
- Should the Bank of Canada continue to target the inflation rate or should it move to target a time path for the price level?

1. There is no obvious link between low inflation and financial market stability. You can have inflation targeting without generating financial instability. On the other hand, we have long known that stable consumer prices are no guarantee of stable asset prices
    - Inflation was falling in the US during the 1920s as the stock market boomed
    - Inflation was low and stable in Japan during 1985-1990 as the Nikkei almost tripled and then crashed
    - Inflation was low and stable in Canada during 1993-1998 as the TSX doubled
2. Inflation targeting has a good deal of 'lean' against asset price bubbles built in which evidence suggests would help restrain excessive asset price growth too. That's because the transmission mechanism by which inflation targeting works is to reduce money growth and credit, which feeds into lower asset prices as well.
    - US was a sort of informal inflation targeter but it allowed inflation to grow fairly sharply before the crisis. If it had resisted inflation more, and raised its target rate higher and sooner, it would have helped to stave off the housing bubble. The PCE core preferred by the Fed gave a misleading signal about inflation relative to other measures.
    - UK suffered from targeting the wrong inflation rate as well. It is important to use a measure that captures housing costs. Both the UK and the US, which were the centers of the crisis, came into it with monetary policy that was too loose and inflation that was too high.

    This is not to blame monetary policy alone for asset market crises in either country, for their causes were complex, but it didn't help.

3. Price-level targeting presents many challenges, particularly in the way it can complicate problems for the private sector when they form inflation expectations.
    - Recent experience provides an example. The latest episode has seen prices in Canada fall below the 2% trend line. Price level targeting would require the Bank of Canada to make up this deficit by inflating more than 2% for a period. How do you communicate this to the public without losing the credibility that it has earned in fighting past inflation?
4. Bank of Canada should follow the ECB and have a monetary pillar as well
    - There is useful information in broad money aggregates about low frequency movements in the price level. Although not useful as a target, more emphasis on these patterns could help identify risks that are missed by the central bank's other projections. Discussion of these movements could also help communicate to the public low frequency movements in future inflation and build an understanding that could be exploited, especially in a price-level targeting. Such procedures would also lead to the regular monitoring of the effects of money and credit growth on asset markets.

<u>Murray presentation</u>

Murray emphasized the Bank of Canada's responses to the crisis and its lessons learned.

1. Benefits of an explicit Inflation Target
    - Aggressive easing and use of innovative measures was made easier
    - Inflation expectations appear to have been better anchored even though policy rates reached historic lows (very short term expectations of inflation fell, but medium term expectations stayed close to 2%)
    - Other benefits included clearer communications and reduced uncertainty
2. Need for a Broader Range of Liquidity Facilities
    - Going into the crisis, the Bank's main liquidity tool was an overnight loan to a small group of financial institutions. This worked well when financial markets were functioning as arbitrage spread the liquidity out to other participants and other markets.
    - Many central banks found that existing liquidity facilities were too restrictive
    - A broader range of lending mechanisms had to be created
    - Bank's efforts directed by guiding principles and Bagehot's precepts
    - Bank of Canada's balance sheet expanded by 80 per cent, but was easily reduced; expect that the nonstandard assets held to provide liquidity will roll of the balance sheet by the end of July 2010.
    - Some facilities were little used, but their presence served to reassure markets—they were there if needed
    - Some of the facilities (e.g. Term PRA) will remain in place and ready for quick reactivation
3. Unconventional tools were shown to be effective
    - It's difficult to gauge the usefulness of unconventional monetary policies. Much work will be done over the next few years, but initial impressions were promising.
    - Bank of Canada only needed to use one these tools -- a conditional commitment
    - There was clearly an 'announcement' effect on the entire term structure. And the removal of the conditional commitment in late April 2010 caused the term structure to increase across a broad range of maturities.
    - Evidence suggests its specific nature made the conditional commitment more effective.

- Other unconventional tools, such as credit and quantitative easing, were shown to be effective elsewhere. Announcement and subsequent purchases of MBS by the Fed helped lower the cost of 30-yr fixed mortgages. Quantitative easing in the UK helped push down yield on 10-yr bonds.
- Bottom-line: the Bank retains considerable flexibility at the zero-bound

4. Outstanding Monetary Policy Issues Related to the Crisis
   Three main questions have emerged or resurfaced
   (1) What is the optimum level of inflation?
   (2) What advantages might price-level targeting offer?
   (3) Should monetary policy give more recognition to financial stability goals?