Towards a new Framework for Monetary Policy

Jacques DE LAROSIÈRE

A number of central bankers and their economic advisors consider that monetary policy played little or no role in the run-up to the crisis. On this view, the financial upheaval was mainly the result of an external macroeconomic shock, made worse by the imprudent behaviour of some financial institutions. Their argument can be summarised as follows:

– Inflation (CPI) has been low and stable in recent years, showing that the fundamental objective of monetary policy (price stability) has been achieved;

– The financial crisis was basically the result of "excess savings" and the balance-of-payment surpluses of major emerging economies. This caused the surge in housing and other asset prices, and enabled the US current-account deficit to be financed. The excess liquidity created by these imbalances was not caused by monetary policy;

– Another factor that explains the crisis is the behaviour of a number of financial institutions (in particular "non banks", hedge funds and investment banks) that went too far in leveraging their capital.

The Explosion of Credit

I believe this argument is seriously misleading and that the explosion of credit –which is a monetary phenomenon – was a major factor behind the crisis.

The facts are indisputable. For example, the ratio of US private sector debt to GDP skyrocketed from 112% in 1976 to 295% in 2008. In Britain, the ratio of households' mortgage debt to disposable income surged from 80% in 1991 to 140% in 2008. In the United States, credit expanded by around 10% to 15% per year from 2004 to 2008 when economic growth in nominal terms was around 5% (the corresponding figures for the eurozone are 8% to 10% for a nominal GDP growth of 4%.)

This explosion of debt was bound to have monetary consequences. "Loans create deposits" as the textbooks used to teach us. The fact that many central banks – and in particular the Federal Reserve –allowed real interest rates to hover around zero for several years, pushed up credit expansion which, in turn, impacted on the monetary aggregates.

On the external front, we know – from the research done by Jacques Polak in the 1960s – that it is the evolution of net domestic assets (credit to the economy and to the public sector) that is the main determinant of current-account imbalances.

So, given the importance of credit for both domestic and external monetary stability, it is something of a mystery that central banks do not seem to have paid much attention to it as an indicator, even though traditionally credit growth has been a major element in the analysis and tool box of monetary-policy makers. At the very least, the magnitude of the credit bubble should have raised questions about the adequacy of monetary policies.

Central bankers' response to this view often goes something like this: *"As inflation (CPI) remained subdued, it would have been irresponsible for us to tighten our policies and increase interest rates at the risk of curtailing economic growth and increasing unemployment."* But the implication of such an answer would be to limit the operation of monetary policy to the achievement of a strict concept of inflation targeting – prices of goods and services or of a "non inflationary potential growth targeting" as was the case in the United States.

Now, after the crisis has struck and left such massive casualties in its wake, even the most convinced defenders of central banks' past policies should concede that it would have been appropriate to monitor the credit indicators more closely. In any case, they agree on the proposal for a "systemic risk council" in order to avoid a repetition of past experience. Some even agree that if regulatory instruments prove insufficient, monetary policy could be used as a supplementary tool.

At this point in the analysis, I would like to stress some of the "monetary" aspects of the credit bubble:

- The expansion of credit was a powerful contributor to the increase in asset prices. Furthermore, high asset prices produce wealth effects which, in turn, feed into the credit bubble (the richer you believe you are, the more you are tempted to borrow especially when the banking sector – as it was particularly the case in the United States and Britain – is able to "extract value" from rising housing prices). Strong risk appetite in an environment of low interest rates led to a deterioration of risk quality, to a weakening of due diligence and to very thin spreads. Further, the adoption of "mark-to-market" accounting compounded the surge in asset prices and its wealth effects, since "paper" profits and valuations increased in "good times".

- The systemic pegging to the dollar of a number of structural surplus countries (China, Middle Eastern countries etc), entailed a significant increase in liquidity and has resulted in lower interest rates. No one can deny that intervention on the foreign-exchange markets is a monetary-policy decision. The International Monetary Fund and its shareholders allowed the massive accumulation of excess dollar denominated reserves by surplus countries, thus condoning the consequent surge in international liquidity.

- Deregulation and financial innovation allowed financial institutions (particularly investment banks and hedge funds) to increase their leverage.[1] The abuse of off-balance-sheet operations (SIVs, conduits etc) and of securitisation of complex products significantly contributed to the expansion of credit. For a given amount of regulatory capital, these institutions could lend much more by accelerating the "rotation" of their own funds and getting off their balance sheets the loans they had extended to their clients. The conjunction of an easy monetary policy and weak regulation favoured the expansion of financial products (like adjusted rate mortgages – ARM) with rates indexed on short-term interest rates. This considerably increased the transmission channel of monetary policy and contributed to the crisis.

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1. Traditional controls on credit expansion by central banks were eliminated in the 1970s and 1980s. In 2004 US investment banks were practically exempted from leverage ratios. This decision played a major role in credit expansion.

One can understand, given the high leverage of US investment banks in particular, how much the financial system got into debt (ie, in the US, from 1978 to 2008, the net debt of financial institutions related to GDP soared from 16% to 121%).

When liquidity and credit surge in an environment of low interest rates while the CPI remains stable (in large part because of the low wage costs associated with imports from emerging countries) and as exchange-rate flexibility can no longer play its role as a safety valve, the only outlet is an increase in asset prices. The bubbles were a natural accompaniment of low interest rates and of an inappropriate and asymmetric monetary stance. Indeed, monetary policy was eased to avoid a downturn with far greater speed and decisiveness than were displayed during periods of gradualist tightening when the economy was overheating.

Central Banks' Role

To avoid the repetition of such events, central banks will have to start monitoring the expansion of credit and therefore bubbles again. The objective is certainly not to "target" asset prices. Central banks cannot, of course, determine "the right" value of assets. This "targeting" objective is often presented, by those who defend the central bank "status quo", as if it were the alternative solution. This is, in part, aimed to discredit the idea that we need central banks to react sufficiently early on to emerging bubbles.

You did not need to determine scientifically the "right" value of, for example, houses in the United States in 2005-06, to know that there was an excessive rise in prices. We all knew it. The National Bureau of Economic Research has recently published a paper[2] that shows how "rising home prices, falling mortgage rates and more efficient refinancing … lured masses of homeowners to refinance their homes and extract equity at the same time, increasing systemic risk in the financial system." The paper establishes that these three trends have explosive results when they occur simultaneously. It shows "that home-equity extractions alone can account for the dramatic increase in systemic risk posed by the US residential market, which was the epicentre of the financial crisis of 2007-08."

What should central banks do under such ominous circumstances? Should they remain inactive? I believe that they should "lean against the wind" and that they can use different policy options to that effect:

a) Adopt a less accommodative monetary policy. This can provide the market with the right signals, to make the anti-inflationary stance (in its most comprehensive definition) of policy more credible and thus help to anchor future price expectations;

b) Adopt regulatory measures to moderate credit expansion in general or in specific sectors (ie, setting dynamic provisioning, increasing reserve obligations, setting more stringent rules regarding loan to value ratio etc.) These could be used either as an alternative to (a) or as a supplement to it.

Some might object that (a) is too blunt an instrument to prevent a bubble from bursting and that regulatory measures are not always within the competence of central banks. These arguments are not convincing: interest rates should be used when needed to lean against the wind, and regulatory measures should be promoted by central banks if they are required to prevent financial instability. This is why the report on the reform of the European supervisory system has proposed the creation of a "Systemic Risk Board"

2. See Amir Khandari, Andrew Lo, and Robert Merton, "Systemic Risk and the Refinancing Ratchet Effect," NBER Working Paper number 15362, (December 2009).

grouping the EU central bankers and supervisors to detect early enough systemic risks and to propose precise measures (including regulatory ones) to deal with them.[3]

Lastly, some may argue that if central banks were responsible not only for price stability, but also for financial stability, this could entail conflicts between the two objectives and could weaken their main mission (price stability) or even their independence.

In the light of what has happened over the past two years, this is not a convincing argument.

Firstly, central banks have traditionally been in charge of both missions. The practice of the last ten years should not lead us to forget basic historical facts. Furthermore, a number of central banks are in charge of micro-supervision of banks. Secondly, bestowing on central banks and regulators the responsibility of acting to prevent financial crises can only strengthen their authority (and independence). And lastly, let us consider the monetary consequences of not acting to prevent bubbles. We have seen:

- the wealth effects of asset prices and the consequence of excessive credit expansion: they have, by themselves, undermined the foundations of a stable financial system (the ongoing deleveraging process will have major negative economic consequences); and
- once asset prices started to fall, the whole financial sector almost collapsed: enormous injections of central bank liquidity – short and medium term – and of public support were needed. We see how difficult it is for central banks to start thinking of an exit strategy. Is that massive intervention consistent, in the longer run, with monetary stability? Some fear that inflation will come back when the huge liquidity created finds its way in the financing of the real economy. Some believe that the present degree of slack points more toward the risk of deflation. The fact that these expectations are so different poses a new challenge to central banks and to their credibility.

All in all, there seems to me little doubt that monetary policy contributed significantly to the emergence of the crisis.

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To conclude, the time has come to question the "operational model" of monetary policy that has prevailed over the past 10 to 15 years. Its basic principles have been tested throughout the crisis and have not withstood the test.

It is somewhat paradoxical that in a world of increasing financial complexity, central banks have tended to oversimplify their operational policy. One single and narrowly defined objective has prevailed (with some limited variations): CPI targeting. One single policy tool has dominated: the use of official interest rates. And a blind eye has been turned by most to credit expansion and to the surge in asset prices. Actually, extracting value from high asset prices has become a main instrument for some important policymakers to sustain growth. We have seen the dangers (destruction of value and generalised recession) of such artificial methods. I would also underline that this "consensus" on monetary policy is rather recent and that the history of central banking provides a host of more comprehensive objectives and operational tools.

Contrary to this so called "consensus" and avoiding any dogmatic approach, I consider that:

- financial stability should be part and parcel of the objective of promoting stable monetary conditions;
- asset bubbles can be recognised and eventually acted upon by central banks;[4]
- credit expansion should be closely monitored and moderated when needed;

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3. The high level Group on Financial Supervision on the EU chaired by Jacques de Larosière, Brussels, 25 February 2009.
4. Asset prices that are significantly higher than "fundamentals" (ie, the present value of probable future cash flows) are a sign of inflationary expectations.

- when action is to be taken, the earlier the better;
- actions and tools should be multifaceted (interest rates, reserves, changes in regulation etc);
- and anchoring inflationary expectations on a long-term horizon is crucial.

Nothing of this would or should lead to a weakening of central banks' independence. On the contrary, providing central banks with a more comprehensively defined stability mandate could only enhance their credibility.