Calibrating Monetary Policy in the Current Global Turmoil

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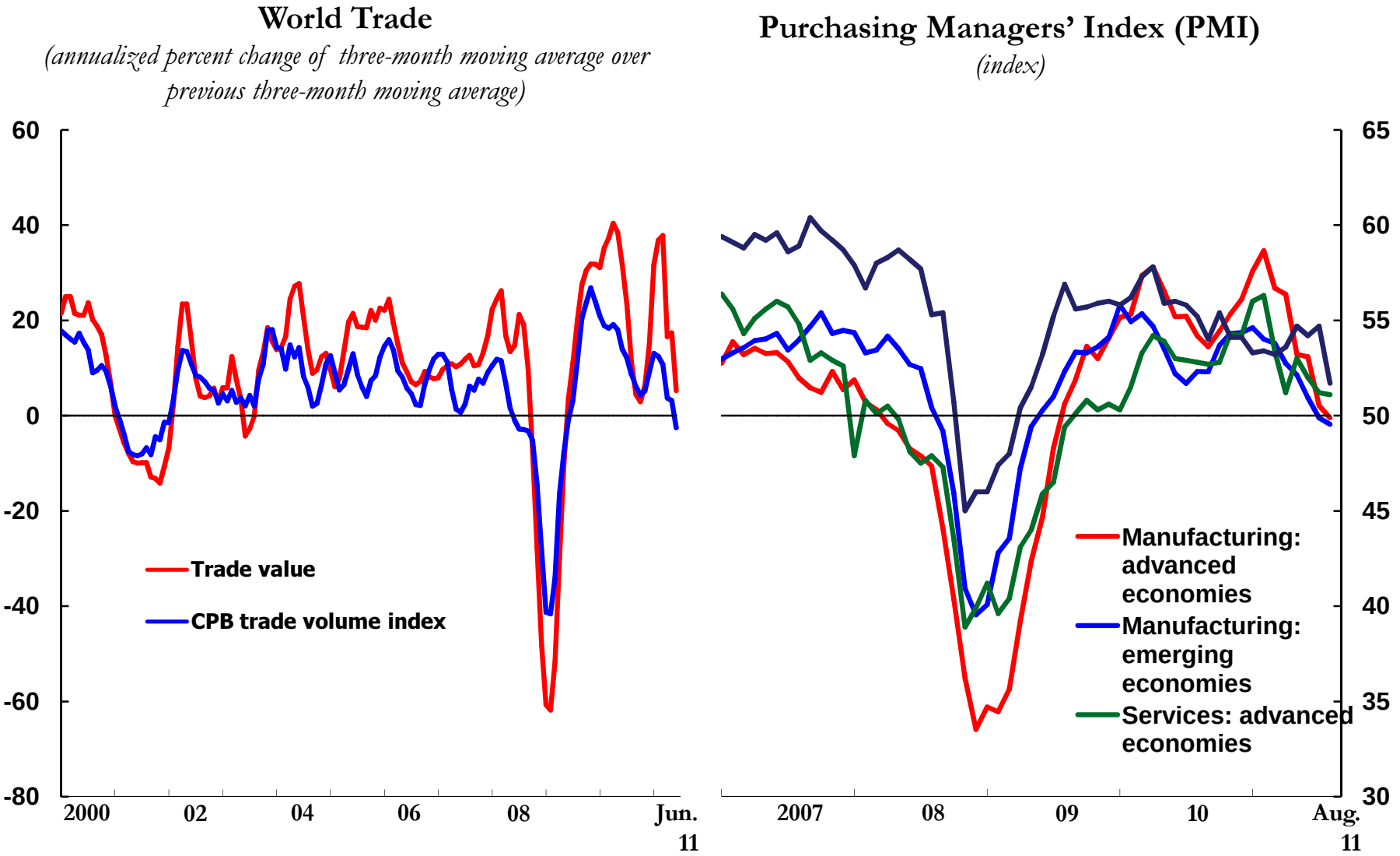
THE GLOBAL OUTLOOK

Activity is under threat. Policy requirements are:

Rebalancing I	From fiscal stimulus to private demand in AEs: fiscal **repair** and support for recovery; **bank capital**, housing markets; **vision for euro area**
Rebalancing II	From ca surplus countries to ca deficit countries: medium-term fiscal adjustment in AE; structural reforms and exchange rate flexibility in key EM
Reforms	Financial regulation, new macroprudential tools, strengthen global financial safety net; reform global financial system; trade

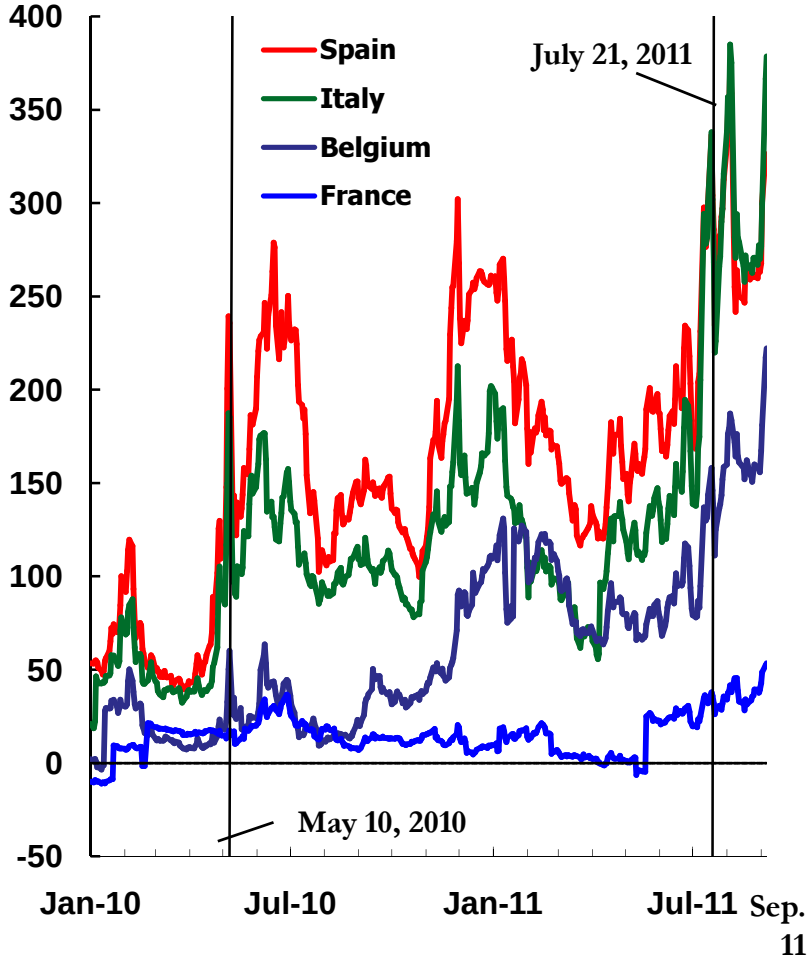
Global activity has slowed noticeably



Financial stability risks have increased dramatically, especially in the euro area

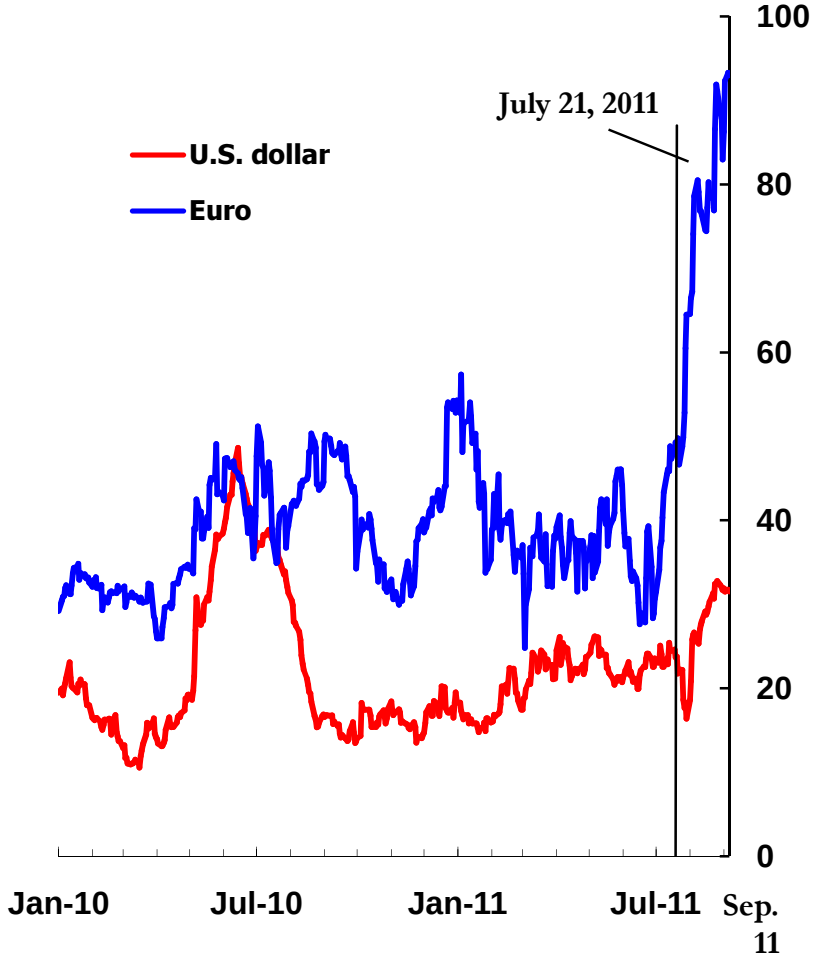
Government Bond Spreads

(two-year yield spreads over German bunds; basis points)

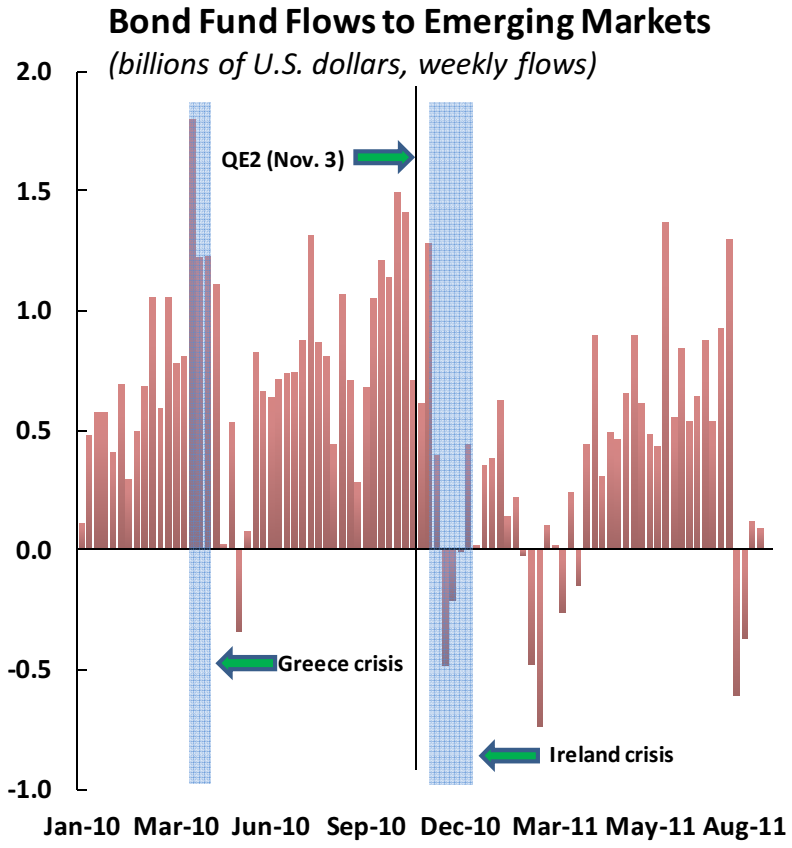


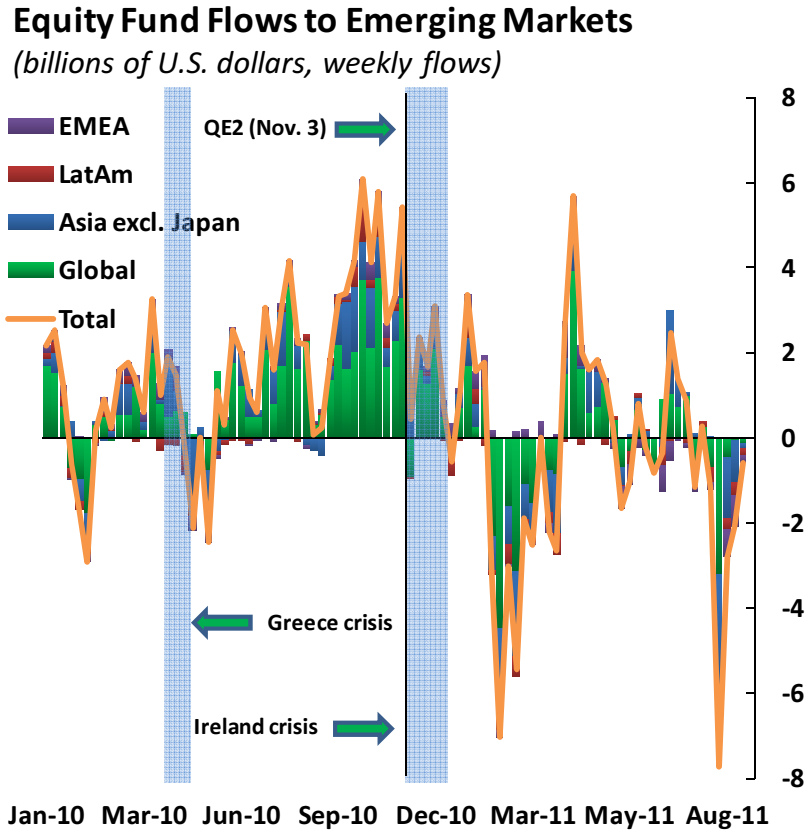
Interbank Spreads

(three-month London interbank offered rate minus three-month government bill rate; basis points)



Capital flows to EM have turned negative



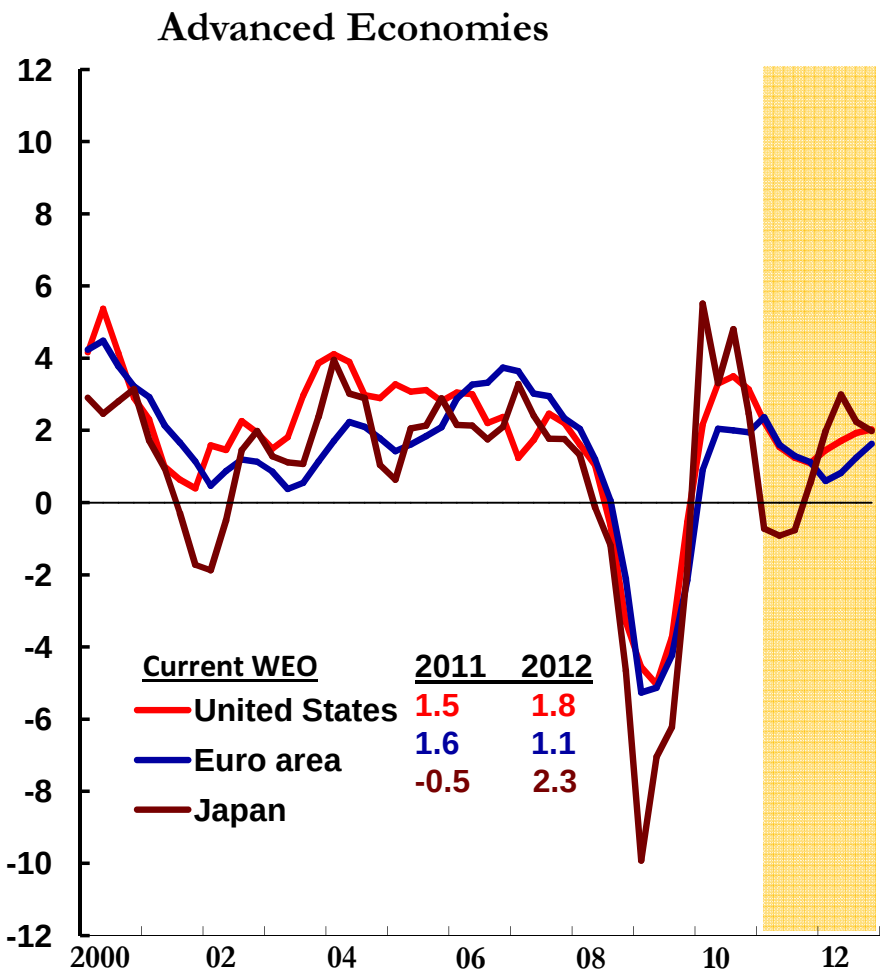


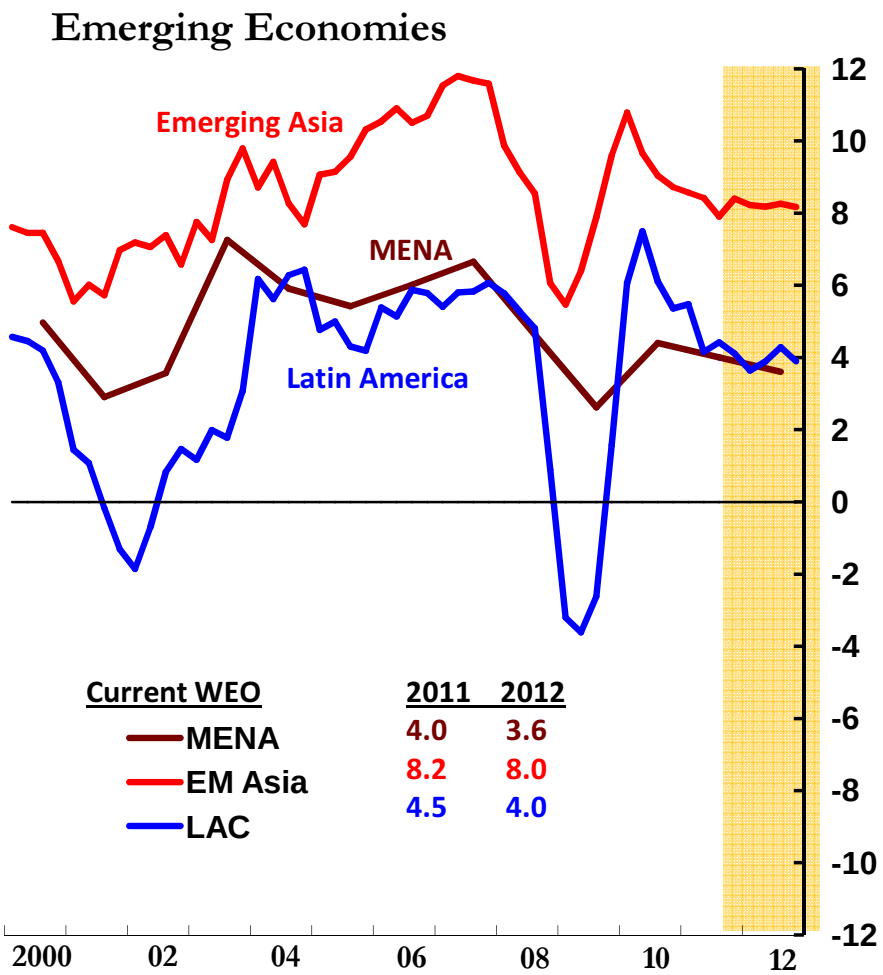
Source: EPFR Global.

Global growth 4 percent, but EM and AE very divergent

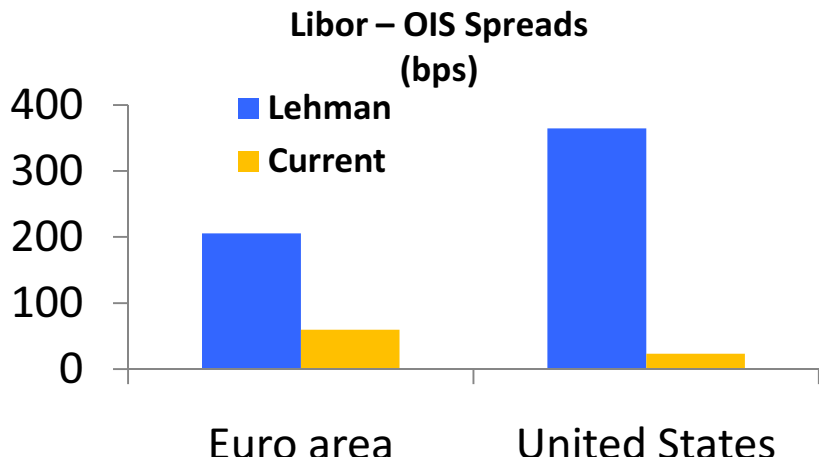
Real GDP Growth

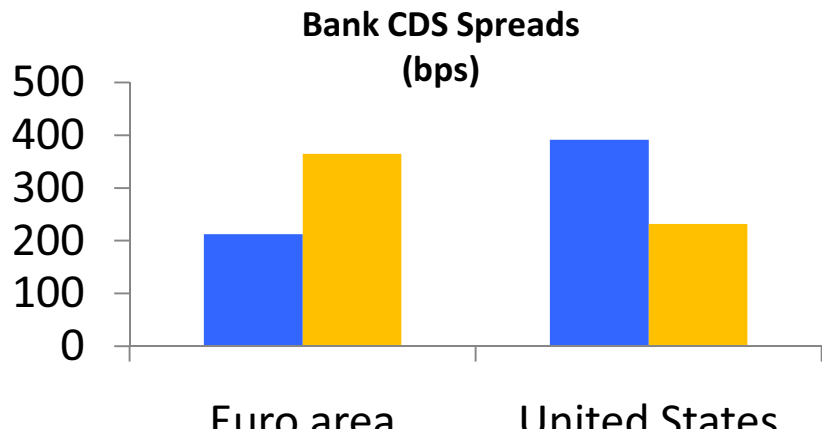
(percent change from a year earlier)

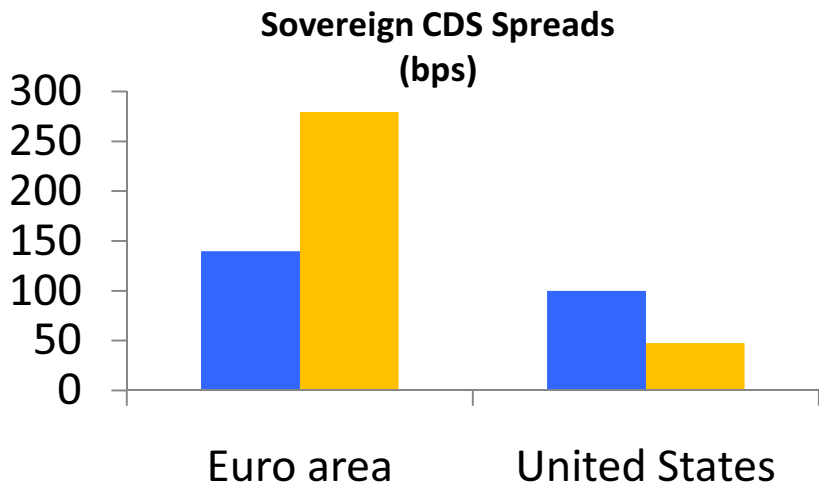




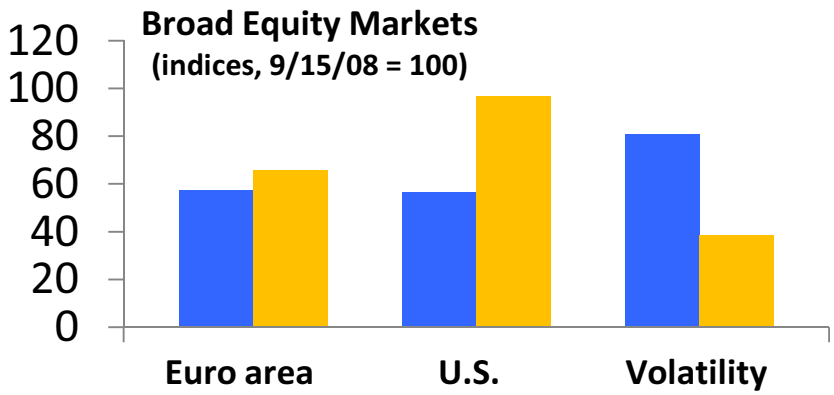
What's different from "Lehman"?





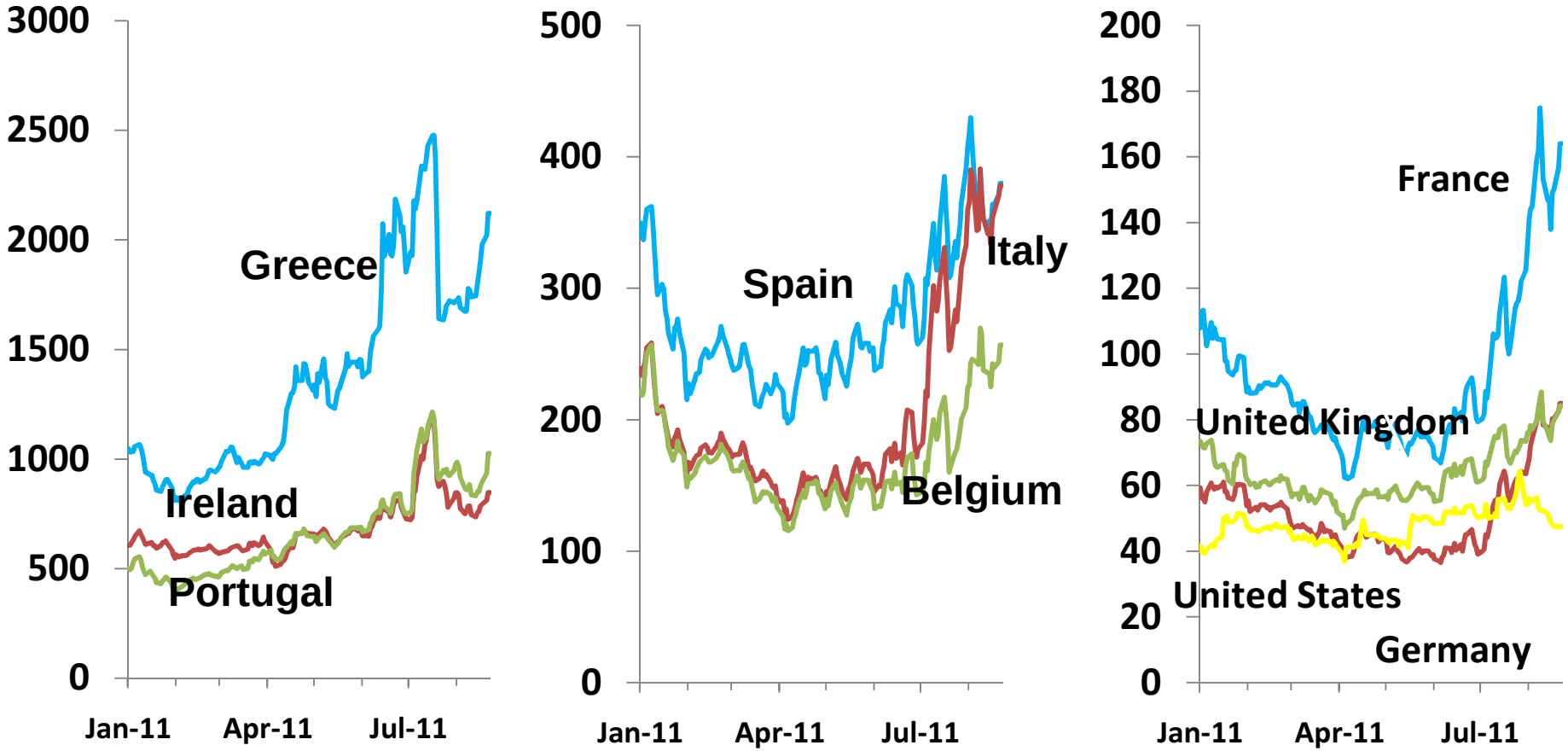


… with stress rising on broad markets …

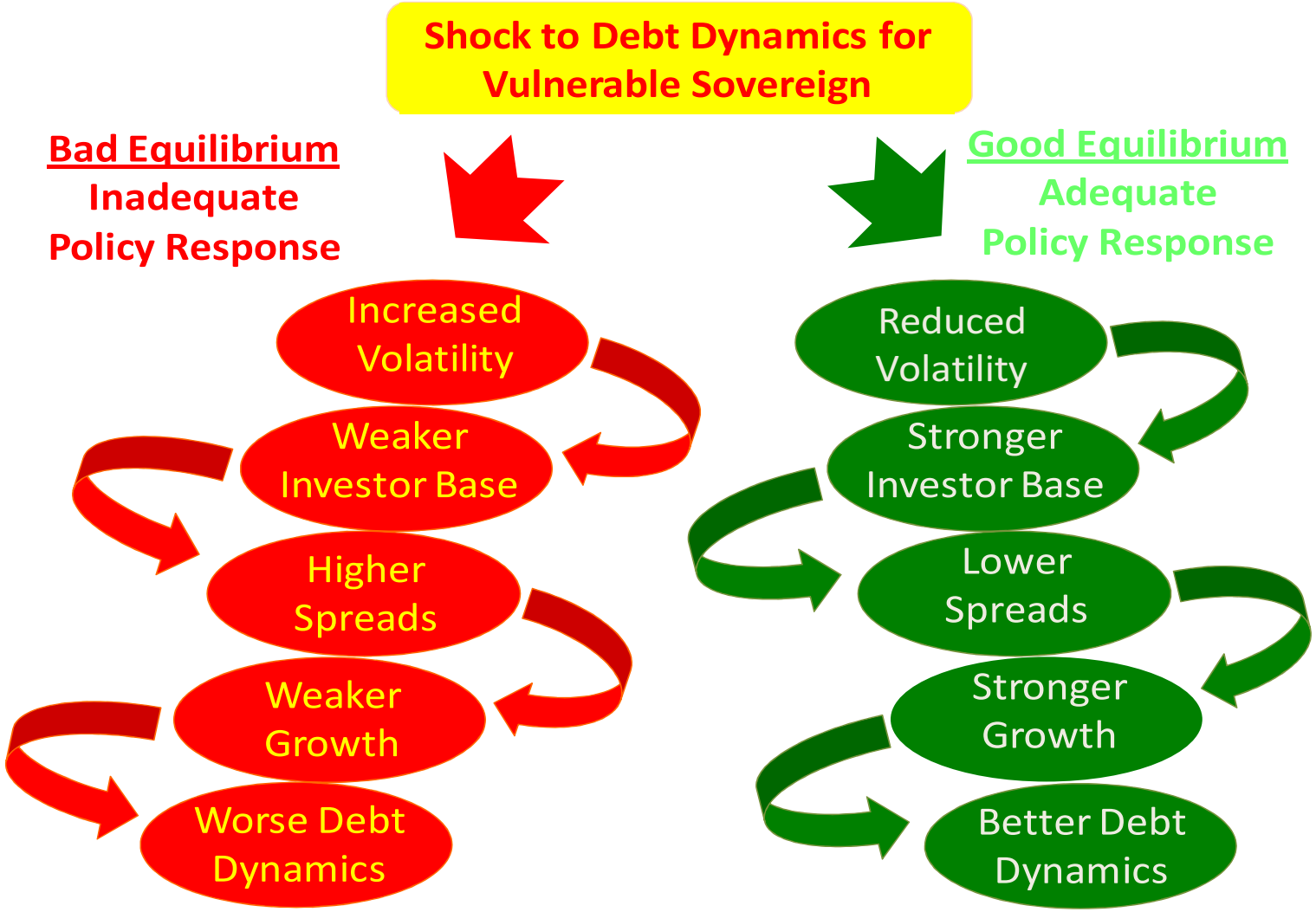


Sovereign strains becoming more widespread ...

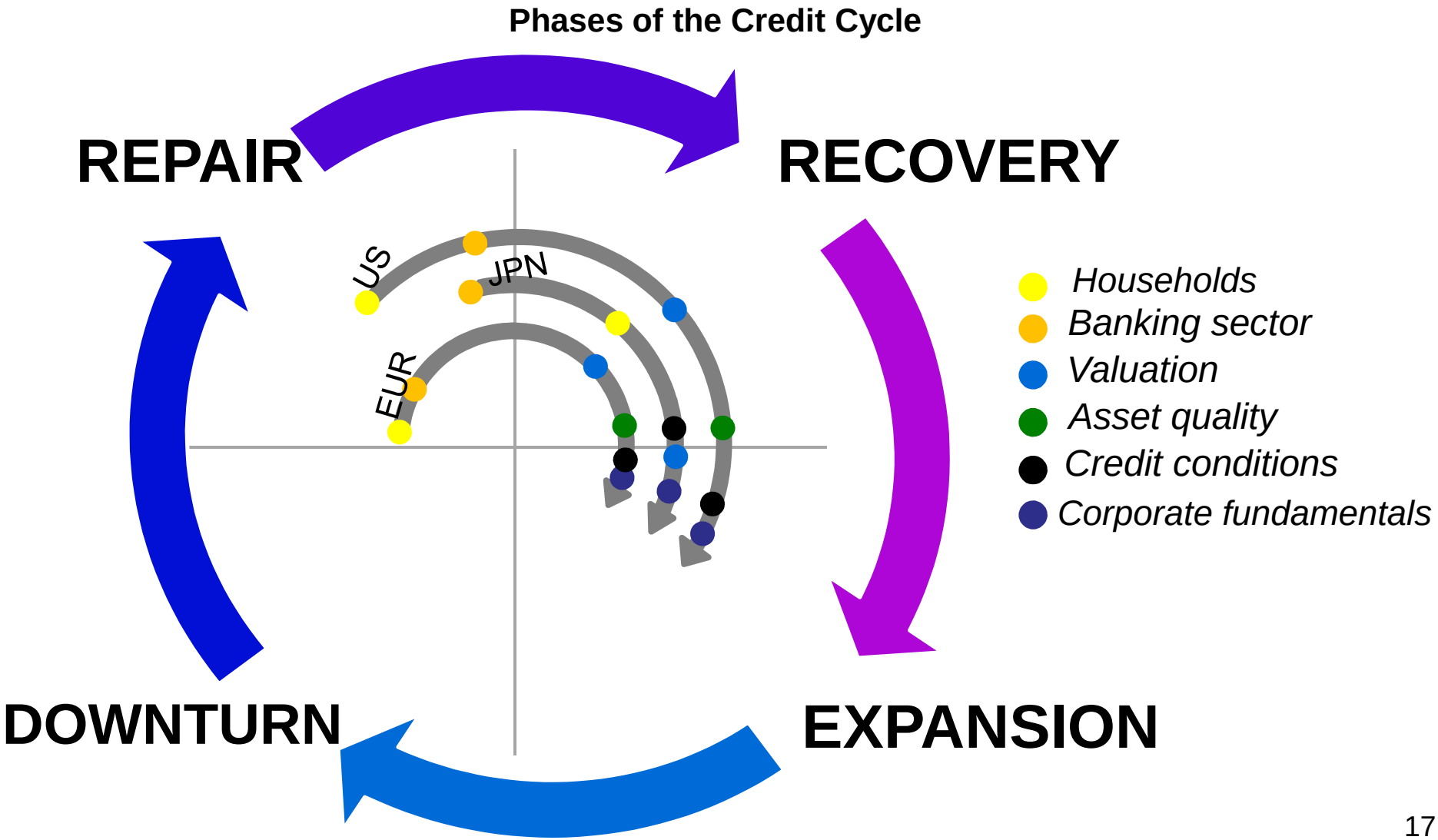
Credit Default Swap Spreads
(basis points)



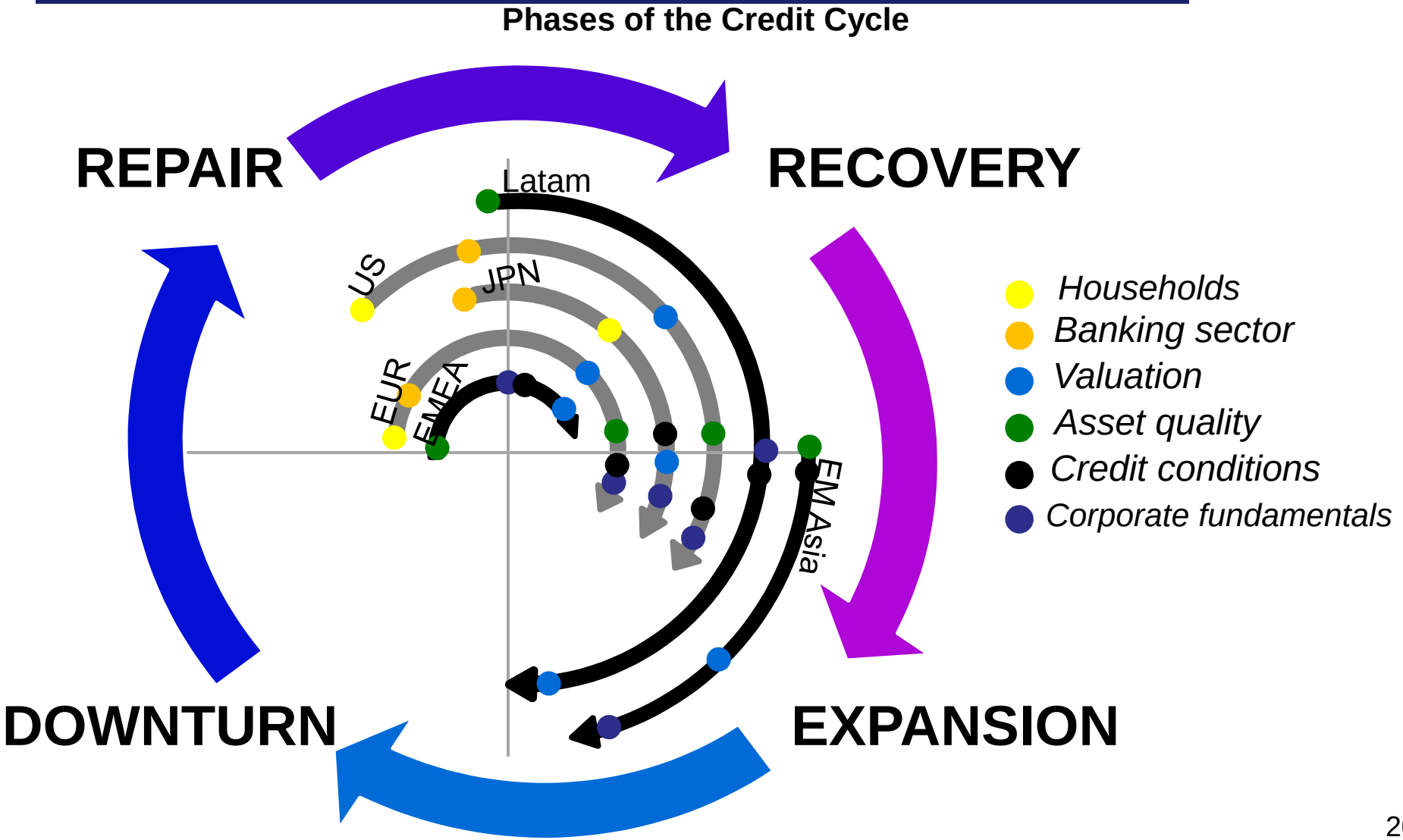
... threatening a shift towards a bad equilibrium



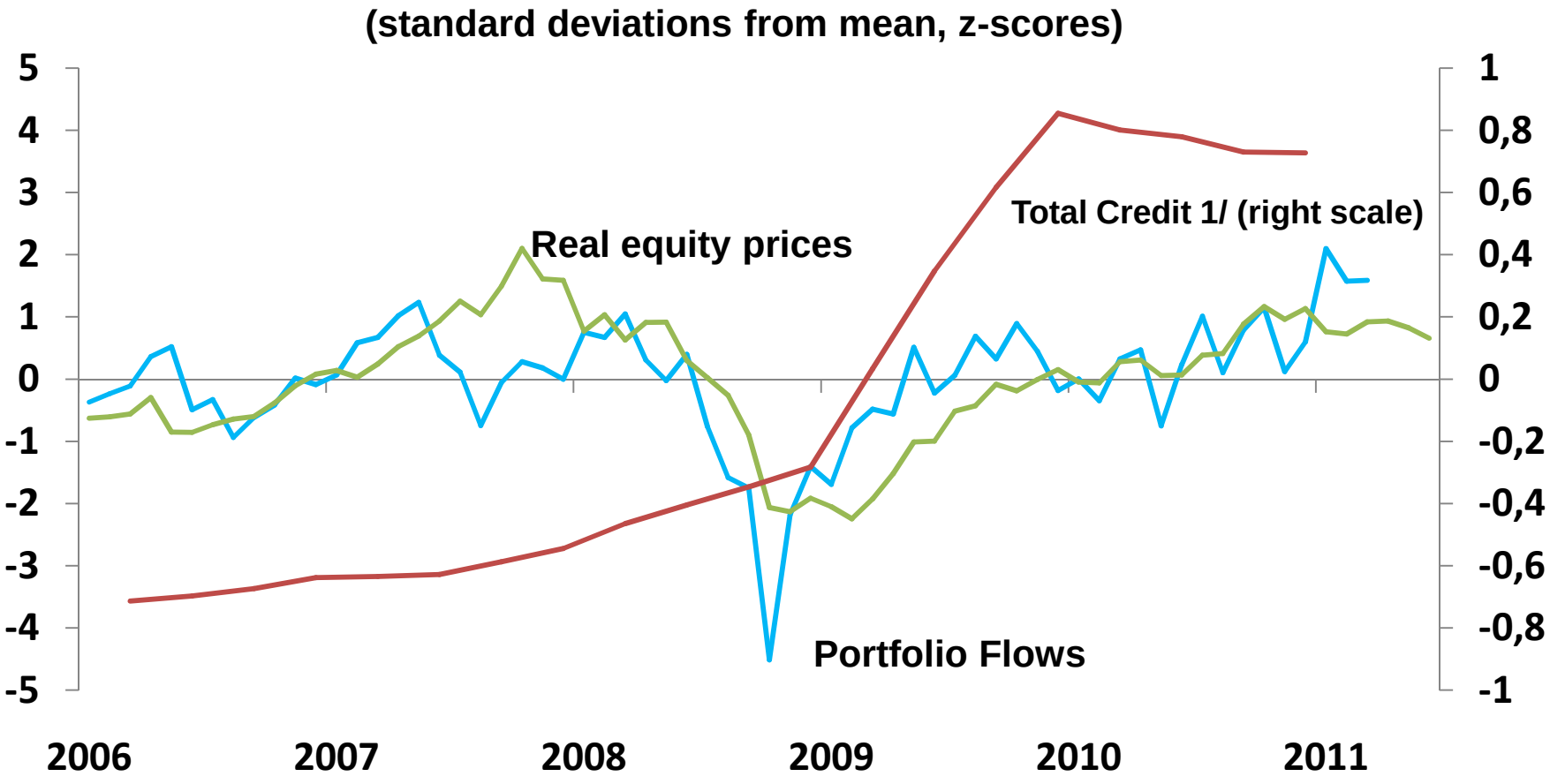
Advanced economies are stuck between repair and expansion phase of the credit cycle



Emerging economies are further along in the credit cycle

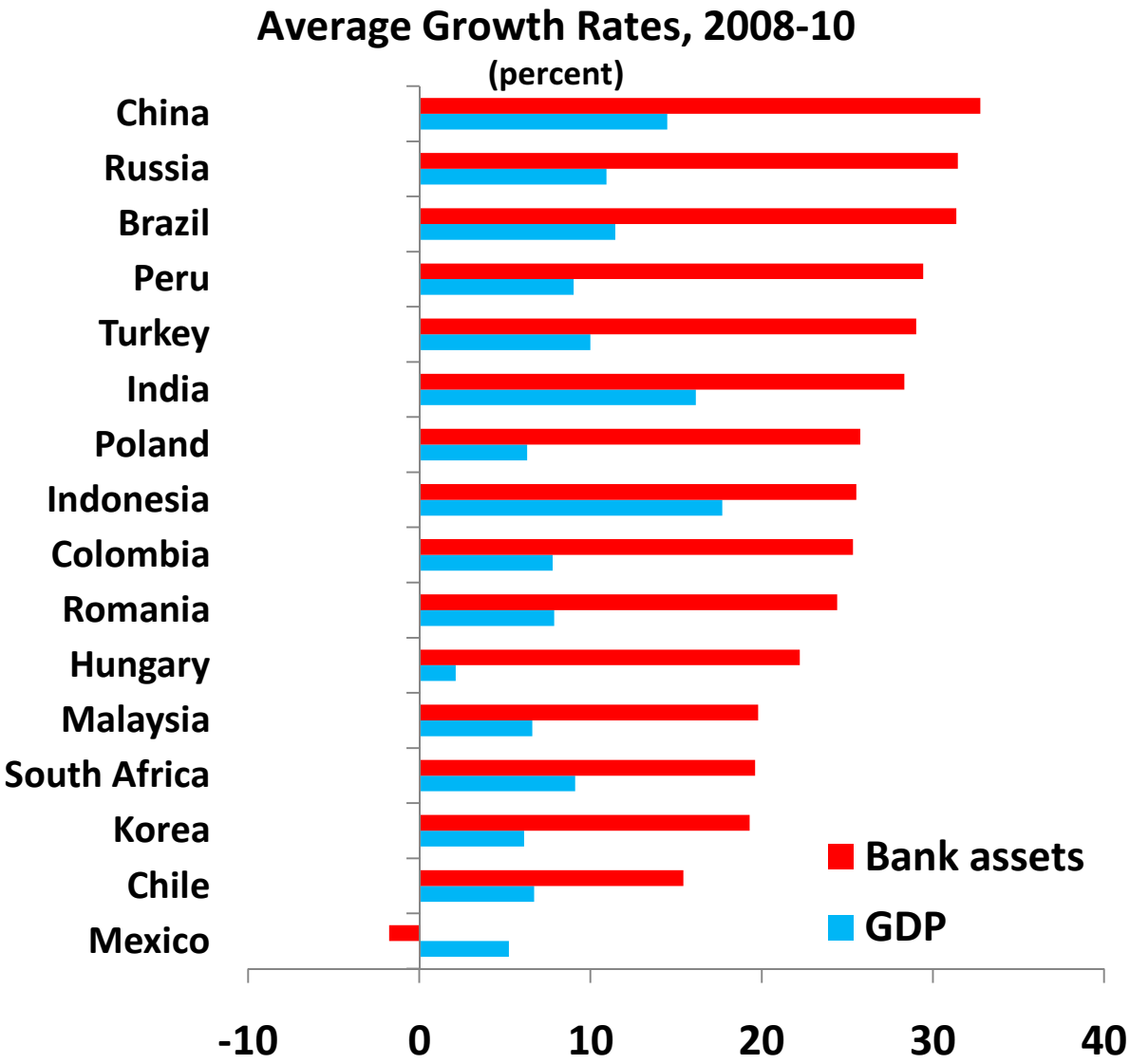


Emerging markets are in the expansion phase



1/ In percent of GDP

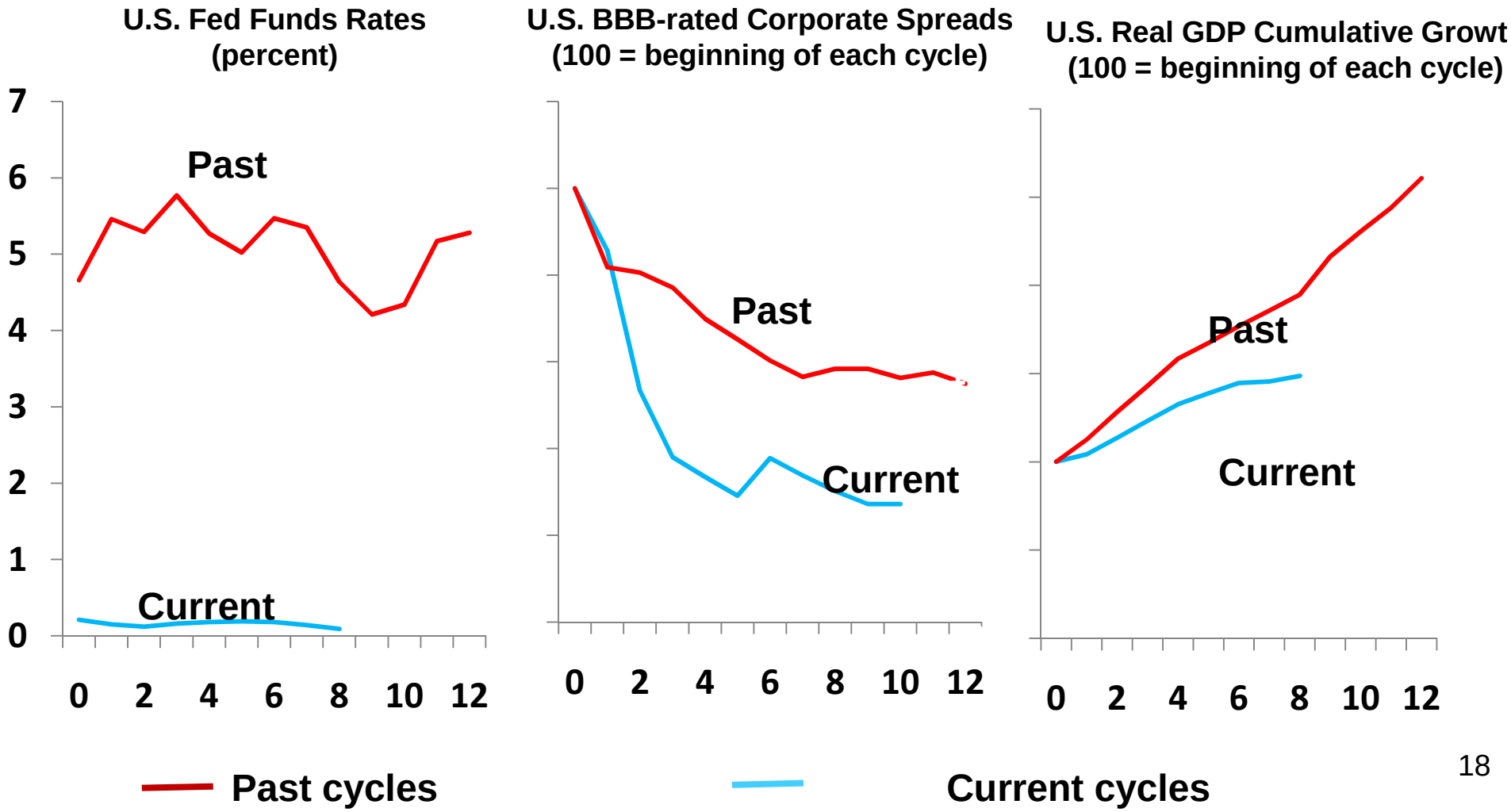
… and in many economies credit is running well ahead of GDP



IMPLICATIONS FOR MONETARY POLICY

Low policy rates encourage a "search for yield"

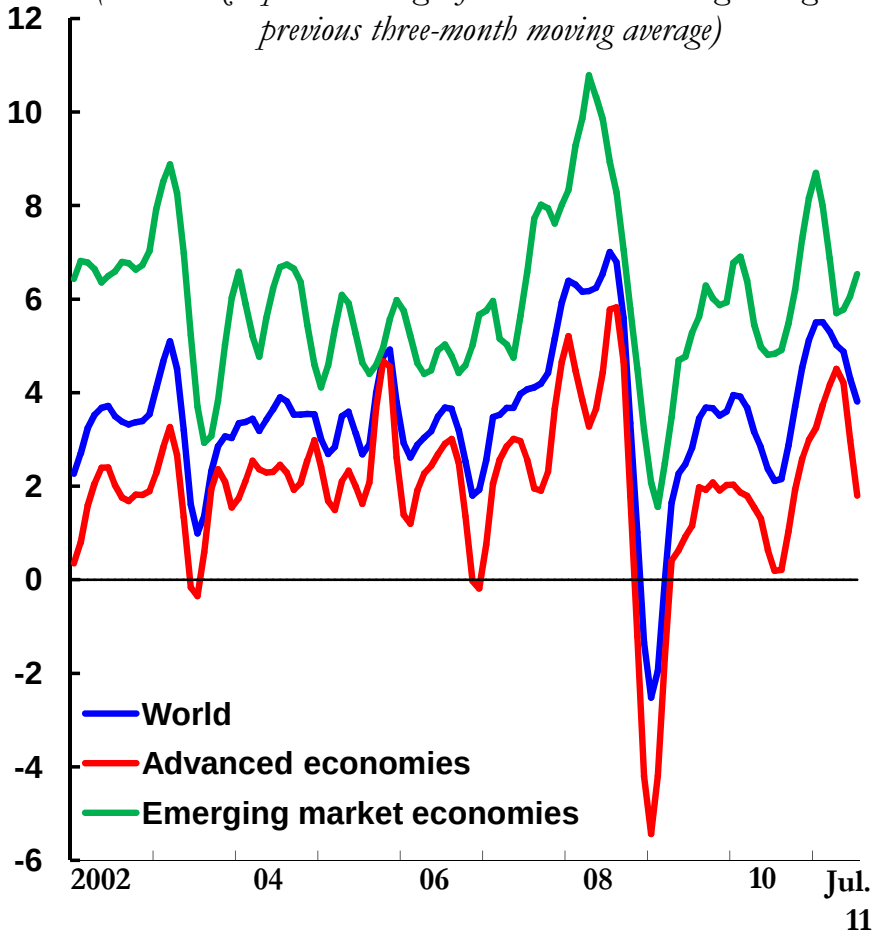
Fed Funds Rates, BBB-rated Corporate Credit Spreads, and U.S. Real GDP Cumulative Growth



Inflation has begun to moderate.

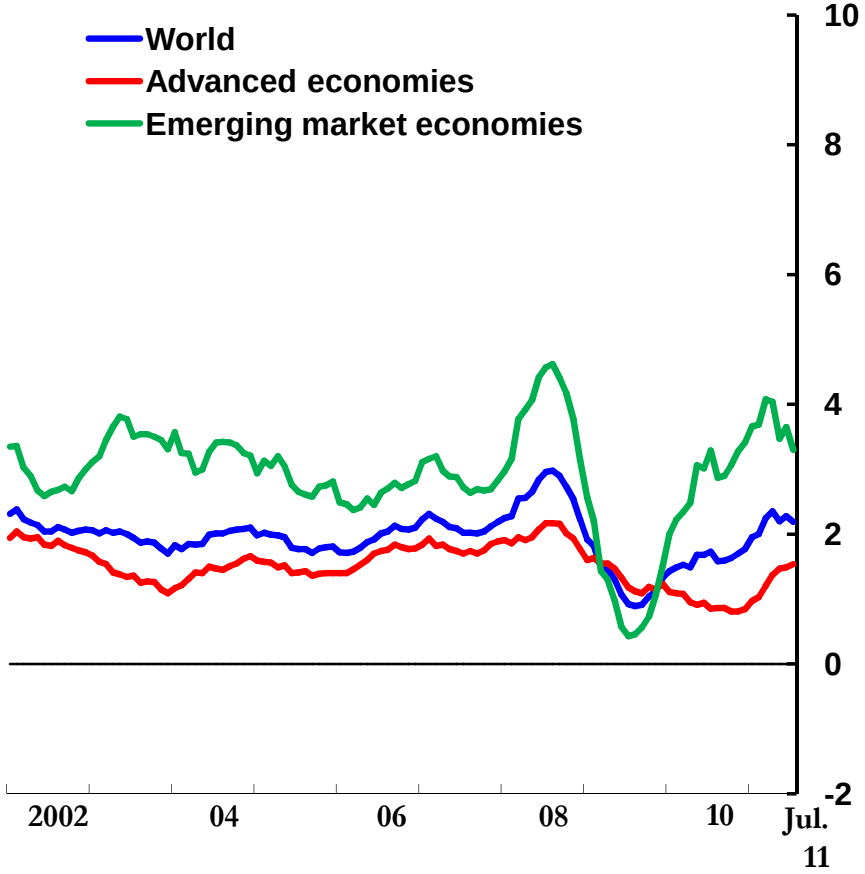
Headline Inflation

(Annualized percent change of three-month moving average over previous three-month moving average)

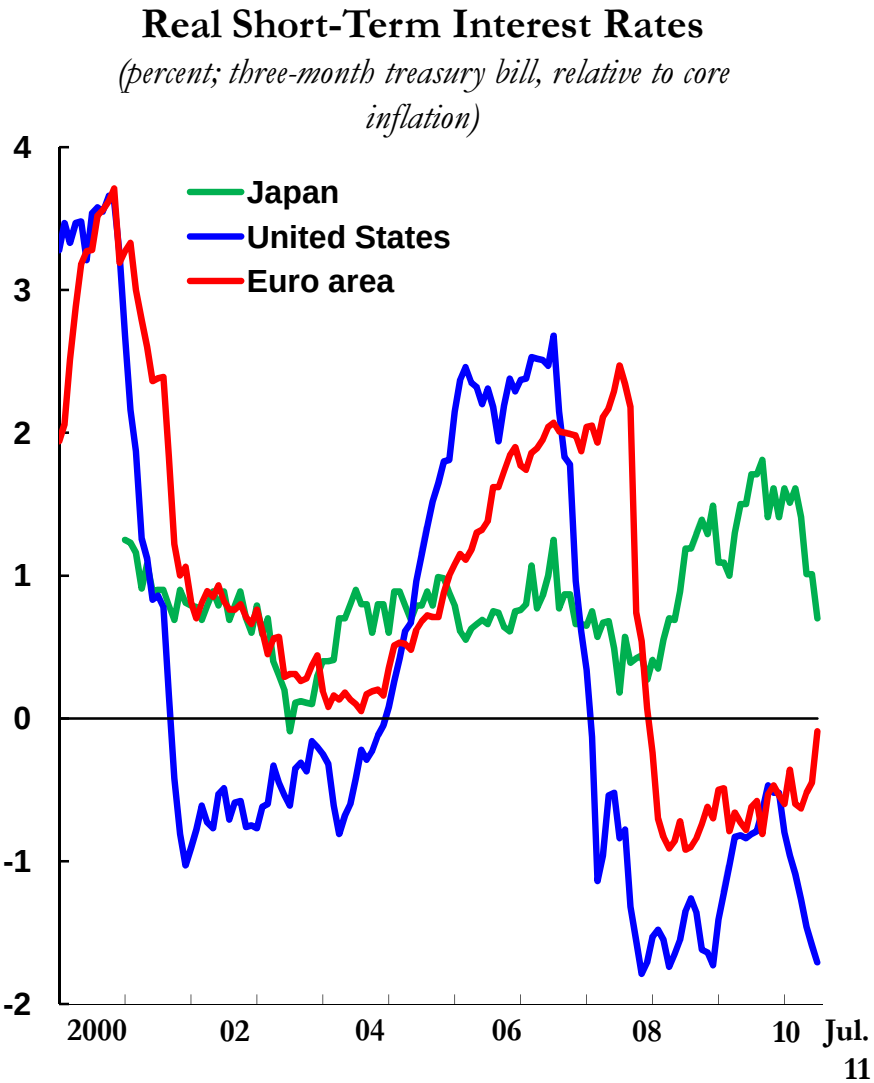


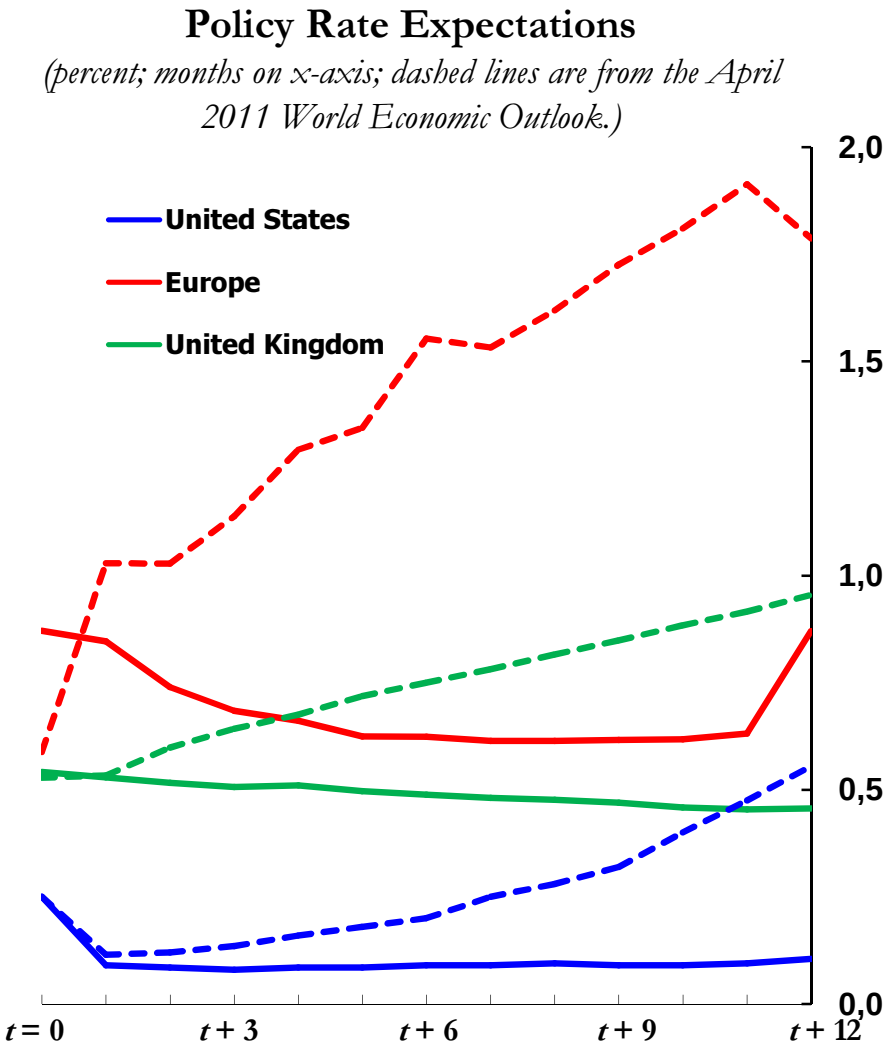
Core Inflation

(Twelve-month change)

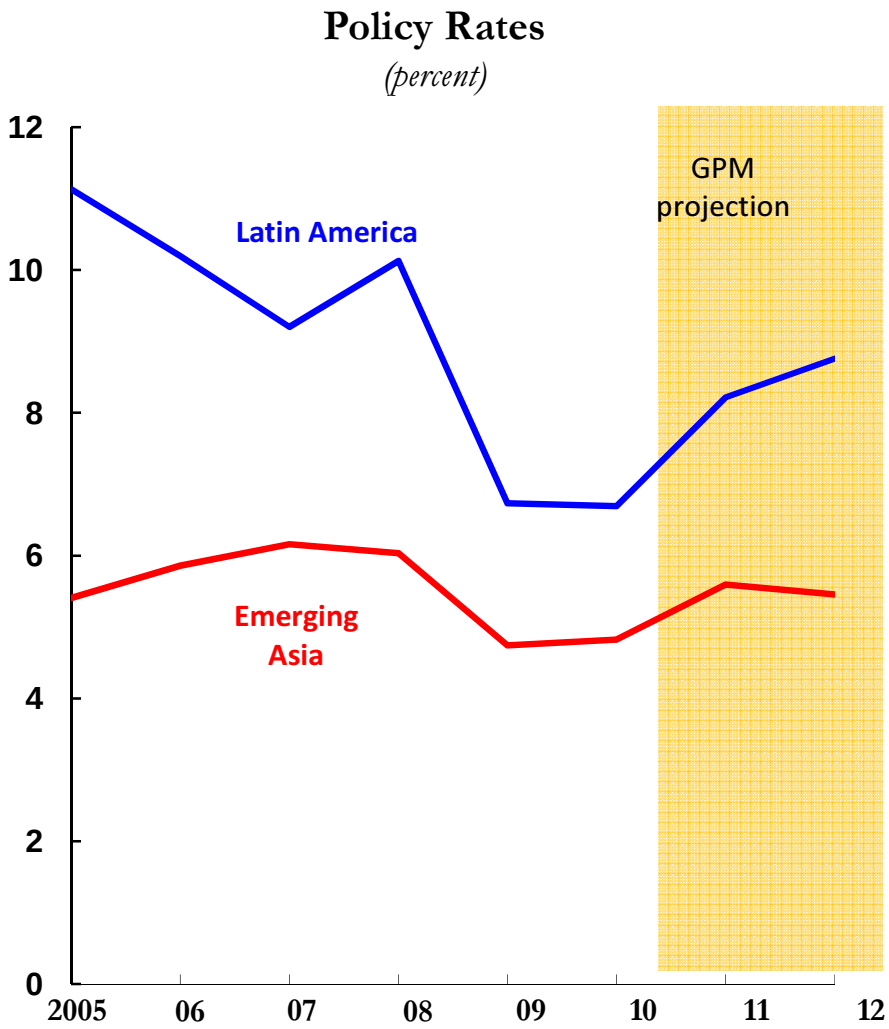


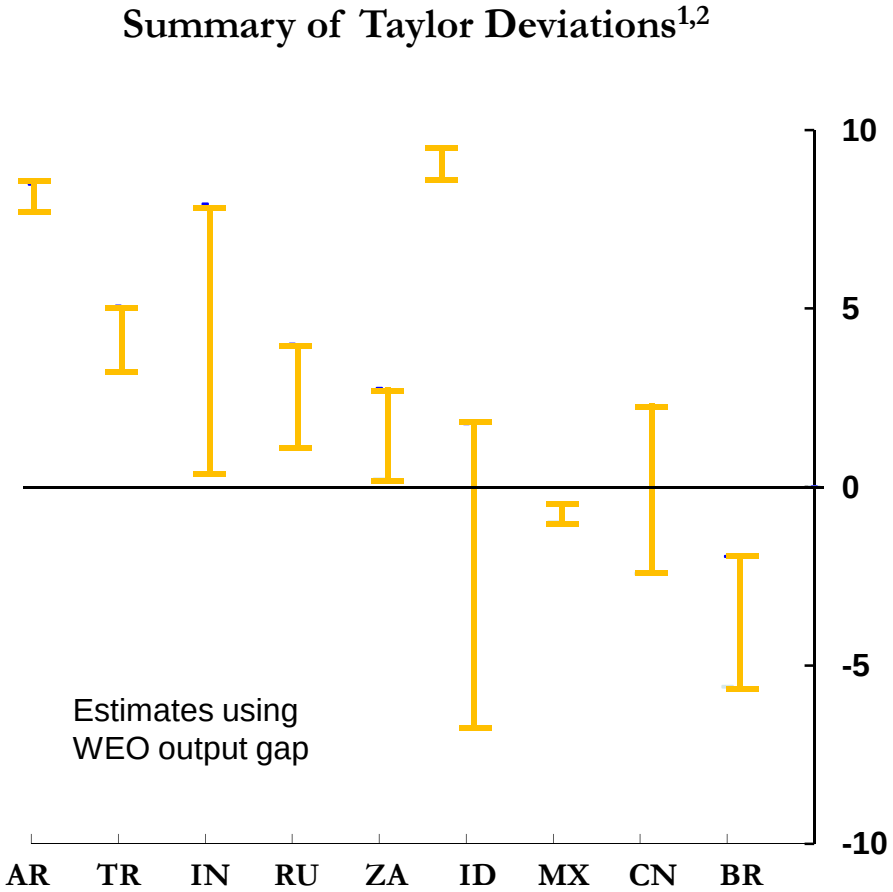
AE monetary policy can stay very accommodative; stand ready for more unconventional support.





EM still need to tighten but a number of them can "wait and see" before normalizing further.





[1]AR: Argentina; BR: Brazil; CN: China; ID: Indonesia; IN: India; MX: Mexico; RU: Russia; TR: Turkey; ZA: South Africa.

[2]Taylor rule in the form of i = infl + r* + 0.5(infl – infl*) + 0.5(ygap). i is the policy rate (prescribed); infl is actual inflation, core inflation, and two-year WEO projected inflation; r* is the equilibrium real rate = 2; infl* is 2 percent for advanced economies and 4 percent for emerging economies; ygap is the output gap (WEO) and output relative to the precrisis trend in percent.

WHAT HAS CHANGED FOR MONETARY POLICY IN THE WAKE OF THE GLOBAL CRISIS?

Lessons– where are improvements in monetary policy needed

- Monetary frameworks
- Liquidity frameworks
- Macroprudential policies: assessment of systemic risk and responsibility of central banks for financial stability
- Other issues:
  - Managing capital flows
  - In countries with large fiscal deficits, constraints on monetary policy

Monetary policy

- Price stability should remain the primary objective of monetary policy…
- …but should take more into account systemic risks
- Other considerations:
  - Should interest rate policy take into account asset prices?
  - Lengthen monetary policy horizon to address financial stability concerns?
- Communication and risks warnings may be a help, supplemented by macroprudential measures

Liquidity management

- Key elements of pre-crisis operational frameworks should be retained
- But some broadening of frameworks could increase resilience of the system
  - Higher reserve levels
  - Wide range of counterparties
  - Maintain sufficient collateral
  - Reduce stigma
  - Effective liquidity absorbing tools

Macro-prudential regulation

- Designed to address
  - Systemically Important Financial Institutions (SIFIs)
  - Lessen pro-cyclical tendencies
  - Structural issues
- The key is that many of the tools are micro-prudential, but the motivation is to address systemic risk

Institutional set-ups for macro-prudential policy frameworks

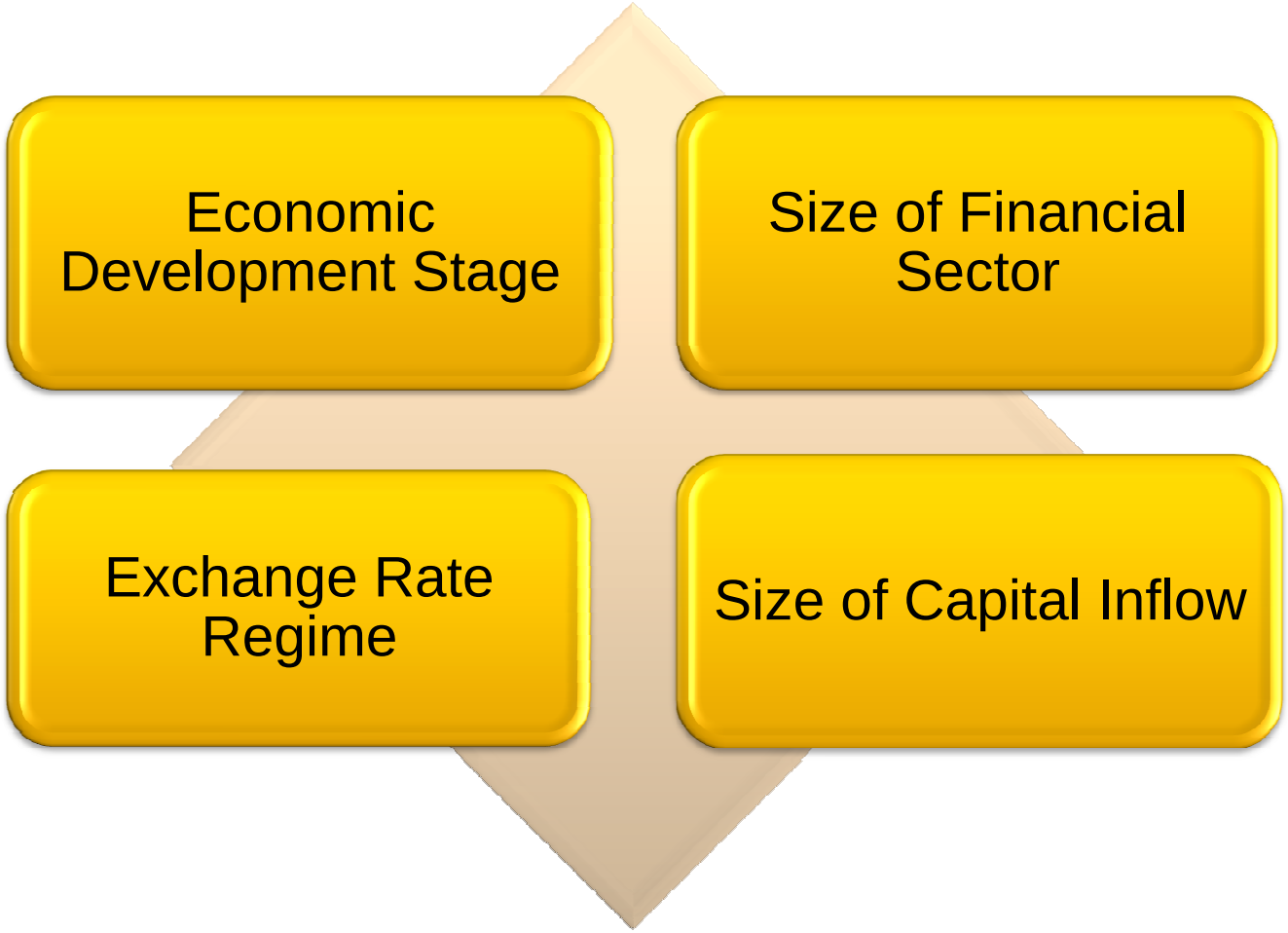
- The central bank should play an important role.
- Fragmentation of institutions should be avoided, and strong coordination mechanisms are needed.
- Systemic risk prevention and crisis management are different functions that should be supported by separate arrangements.
- Macroprudential policy frameworks should not compromise the autonomy of other established policies
  - including monetary and microprudential policy
- Country-specific factors are crucial

Instruments and risks

- Credit-related:
  - caps on the loan-to-value (LTV) ratio;
  - caps on the debt-to-income (DTI) ratio;
  - caps on foreign currency lending;
  - ceilings on credit or credit growth.
- Liquidity-related:
  - limits on net open currency positions/currency mismatch (NOP);
  - limits on maturity mismatch;
  - reserve requirements.
- Capital-related:
  - countercyclical/time-varying capital requirements;
  - time-varying/dynamic provisioning;
  - restrictions on profit distribution.

- Risks generated by strong credit growth and asset price inflation.
- Systemic liquidity risk.
- Risks arising from excessive leverage and the consequent de-leveraging.
- Risks related to large and volatile capital flows.

What affects the choice of instruments?



Effectiveness of instruments

Dampening procyclicality

- of credit growth?
- of leverage?

Limiting interconnectedness in exposures

- to wholesale funding?
- to foreign funding?

Three Approaches

1. case study
2. simple correlation
3. panel regression

Panel regression: Statistically significant (✔) or not (✘)

Reductions in:	Procyclicality of		Interconnectedness	
	Credit	Leverage	Foreign funding	Wholesale funding
Caps on LTV	✔	✘		
Caps on DTI	✔	✔		
Limits on Credit Growth	✔	✔		
Limits on NOP			✔	✘
Limits on Maturity Mismatch			✘	✔
Reserve Requirements	✔	✔		
Time-varying/Dynamic Provisioning	✔	✔		
Countercyclical/Time-varying Capital Requirements	✘	✔		

Using instruments: guidelines

Single vs. **Multiple**:

- use **single** when risk is well-defined from a single source;
- use **multiple** to tackle a risk from various angles but do not overdo.

Targeted vs. **Broad-based**:

- use **targeted** to minimize cost or distortion;
- use **broad-based** to limit the scope of circumvention.

Using instruments: guidelines

Fixed vs. **Time-varying**:

- Use **fixed** to provide a minimum buffer with a low cost;
- Make **adjustments** with changing circumstances - on sound and transparent principles.

Rules vs. **Discretion**:

- Use **rules** when risk of inaction is high or risk management capacity is weak ;
- Use **discretion** when structural changes occur but with constraint.

Thank You!

For more information:

IMF Website: www.imf.org
IMF Turkey Website: www.imf.org/Ankara