

Comments on:
*The Federal Reserve's Policy Actions
during the Financial Crisis
and Lessons for the Future*
by Don Kohn

By David Longworth

Adjunct Research Professor *in fieri*, Carleton University

Former Deputy Governor, Bank of Canada

CMFE Conference on “Economic and Financial Crisis: Lessons from the Past and Reforms for the Future,” Carleton University, 13-14 May 2010

General Comments

- Don has done an excellent job of describing the Fed's policy actions and their effects
 - For BoC liquidity policy, see Zorn et al. (2009) and Longworth (2010)
- From these, he's drawn lessons for the future
- I agree with almost all of what he says
- So I will:
 - Emphasize the completion of policy frameworks
 - Compare and contrast with policy and policy discussions internationally and in Canada

Policy Frameworks Before Crisis

	Liquidity Policy	Monetary Policy
For Normal Times	√	√
For Crisis Times	Far from complete	Some thoughts on ZLB

- It is important to have frameworks for central bank policies, and to complete them when they are incomplete
- The experience of the crisis showed that the policy frameworks were not complete for crisis times
- As well, the crisis raised the question of the relationship between monetary policy and financial stability policy

Key Elements of Frameworks

Policy frameworks should include:

- Objective
- Target (perhaps quantitative)
- Instrument(s)
- Principles for use of instruments in crises, booms
- (Assumed) Transmission mechanism
- Communication strategy (transparency)
- Decisions regarding operational issues
- Relationship with other policies (normal, crises)
- Governance and accountability

Outline

- I. Relationships with other policies
- II. Lessons for Liquidity Policy
- III. Lessons for Monetary Policy

I. Relationships with other policies

See Borio & Disyatat (2009) for related material
Boundary of responsibility (esp. in crisis times):

1. Debt management issues
 - Which maturities are bought by central bank
2. Fiscal policy issues
 - Allocation of credit

Complementarity of policies:

1. Policies for continuously open markets
2. Liquidity policy and liquidity requirements
 - Avoidance of moral hazard

II. Lessons for Liquidity Policy

1. Having legal authority

- Fed's authority under section 13(3)
- Canada: amendments to Bank of Canada Act in summer 2008

2. Limiting moral hazard (*)

- Tight regulation, conservative liquidity policy, not TBTF
- CGFS(2008): "introduce ...safeguards against distortion of incentives"
- BoC (Engert et al., 2008; Longworth, 2010): limit intervention; regulatory reform; flexible strategy
- OSFI (Dickson, 2010): embedded contingent capital

3. Having a resolution facility (*)

- One of major U.S. policy deficiencies (non-banks) going into crisis
- G20 (April 2009): support efforts on cross-border bank resolution
- Canada: powers to restructure deposit-taking instit. (CDIC, OSFI)

II. Lessons for Liquidity Policy

4. Being transparent about unusual facilities

- Fed: more detailed types of reporting (web site, Congress)
- CGFS: “enhance...communication with market participants and the media”
- BoC: expanded information on web site

5. Avoiding stigma of facilities

- Fed: danger of measures being adopted that would increase stigma (e.g., more disclosure on individual banks)
- CGFS: “continue...efforts to reduce stigma”
- BoC: TLF auctions, Longworth (2008)

III. Lessons for Monetary Policy

1. Rate commitments must be properly conditioned (*)
 - Do markets understand the conditionality?
 - Fed: normal times and crisis times
 - BoC: crisis times (BoC, 2009) and normal times
2. Need firmly anchored inflation expectations
 - At all times, particularly when policies are “unconventional”
3. Asset purchases at ZLB help ease financial conditions
 - The recent experience (US, UK) help us all calibrate effects

III. Lessons for Monetary Policy

4. Need to care for potential effects on inflation expectations
 - Relates to point 2 above
5. Must have tools to reverse unusual actions
 - Crisis has helped clarify how monetary operations work in both directions
6. Use prudential regulation to lean against developing financial imbalances (*)
 - Most central banks would have monetary policy primarily assigned to price stability (Carney, 2009)
 - Efficacy of new macroprudential policies and instruments is not yet proven, so role of monetary policy in achieving financial stability not yet clear

III. Lessons for Monetary Policy

7. Need to examine housing prices in inflation measure (my point, not Don's*)

- Laidler and Banerjee (2008) note that house prices and implicit rent excluded in some countries, including U.K.
- Yet housing prices are a significant predictor of banking crises (Borio and Drehmann, 2009)
- **Canada is fortunate in essential inclusion of new house price index (BoC, 2006)**

Conclusions

- It is incumbent on each central bank to complete its policy framework after a review of what was learned from the crisis
- On lessons for liquidity policy, the key elements not yet implemented are limiting moral hazard (including, importantly, through contingent capital) and having appropriate resolution regimes.
- On lessons for monetary policy, the key elements requiring further study are: dealing with communication of future policy including future interest rate movements, the measures of housing prices used in targeted inflation measures, and the relationship of monetary policy and macroprudential policy.

References

- Bank of Canada (2006) “Renewal of the Inflation-Control Target: Background Information,” November.
- Bank of Canada (2009) “Framework for Conducting Monetary Policy at Low Interest Rates,” Annex, *Monetary Policy Report*, April.
- Borio, Claudio and Piti Disyatat (2009) “Unconventional monetary policies: an appraisal,” BIS Working Papers No 292.
- Borio, Claudio and Mathias Drehmann (2009) “Assessing the risk of banking crises—revisited,” *BIS Review*, March.
- Carney, Mark (2009) “Some Considerations on Using Monetary Policy to Stabilize Economic Activity,” remarks presented to a symposium sponsored by the Federal Reserve Bank of Kansas City, 22 August.
- Committee on the Global Financial System (2008) “Central bank operations in response to the financial turmoil,” CGFS Report No 31, July.
- Dickson, Julie (2010) “Protecting banks is best done by market discipline,” Letter to the *Financial Times*, published 9 April.

References

- Engert, Walter; Jack Selody; and Carolyn Wilkins (2008) “Financial Market Turmoil and Central Bank Intervention,” Bank of Canada *Financial System Review*, June: 71-78.
- G20 (2009), “Declaration on Strengthening the Financial System,” London, 2 April.
- Laidler, David and Robin Banerjee (2008), “Unstable Foundations: Asset Markets, Inflation Targets, and Canada’s 2011 Policy Choices,” C.D. Howe Institute *Commentary* No. 278, December.
- Longworth, David (2008) “Work in Progress: The Bank of Canada's Response to the Financial Turbulence,” Remarks presented to the Canadian Association for Business Economics, Kingston, 26 August.
(<http://www.bankofcanada.ca/en/speeches/2008/sp08%2D10.html>)
- Longworth, David (2010) “Bank of Canada Liquidity Facilities: Past, Present, and Future,” Remarks to the C.D. Howe Institute , 17 February.
(<http://www.bankofcanada.ca/en/speeches/2010/sp170210.html>)
- Zorn, Lorie; Jack Selody; and Carolyn Wilkins (2009) “Bank of Canada Liquidity Actions in Response to the Financial Market Turmoil,” *Bank of Canada Review*, Autumn: 3-22.