

## **2007-2009 GLOBAL FINANCIAL CRISIS AND CHANGES IN TRADITIONAL MONETARY POLICY UNDERSTANDING**

### **Introduction**

The financial crisis that broke out in August 2007 has resulted in dramatic changes in many countries' monetary policies. Dysfunctional financial system severely made obsolete the traditional tools of central banks such as lower interest rates (BIS, 2009). Hence, central banks were required to handle different tools to tackle the liquidity problem and financial crisis. The major challenge is whether this dramatic shift from central banks' traditional roles as the guardians of price stability can be achieved at the same time with the new functions about financial stability in the long run. One approach claims that both objectives cannot be achieved simultaneously because of the conflict of interest between the objectives.

First, it is not certain yet that current situation will be just a temporary exception in financial history or an indication of permanent changes in monetary policies. Although it requires years to return pre-crisis term, some scholars point out probable exit strategies for central banks. Accomplishing exit strategy is hard but not impossible. On the other hand, financial crisis has proved that financial stability is as crucial as price stability for well functioning economies. Assuming that sole objective of central bank should be the price stability is misleading and can be defined as a taboo. Instead of trying to return pre-crisis situation, central banks might search ways to compromise different objectives with a reasonable loss of their independence and confidence. Clarification of roles and responsibilities among the central banks, fiscal authorities and regulatory bodies, prudent risk management practices, implicitly monitoring financial stability can be some alternatives for a better conciliation of the new and old objectives of central banks.

In the following sections, answers for these questions will be elaborated in more detail. In first section, pre-crisis role of central banks will be presented. Then, financial crisis and its effect on central banks will be stated. Lastly, discussions about future of central banks and their monetary policy will be presented

### **Pre-Crisis Period Monetary Policy and the 2007-2009 Credit Crunch**

The modern central bank independence and inflation targeting as a medium of sustaining price stability were started in New Zealand in late 1980s (Buiters, 2009). Most central banks focus on interest rate operational targets for the purpose of sustaining price stability. In normal times, they aim to provide sufficient liquidity to the financial markets around the policy interest rate; on the other hand, private actors such as the commercial banks and securities firms dealing directly with the central bank in open market operations, distribute liquidity among market participants as needed. There was a reasonably stable relationship between the very short-term interbank rates and liquidity demand and supply (Simon and Stella, 2008).

As an example, Table 1 points out Fed's pre-crisis balance sheet structure. It indicates that Fed (and also most other big central banks) plays minimal role in credit intermediation and financial stability (Stella, 2009).

**Table 1. FBR Consolidated Balance Sheet end-2006**

(In billions of dollars)

| Assets                    |            | Liabilities                       |            |
|---------------------------|------------|-----------------------------------|------------|
| Government Securities     | 784        | FR Banknotes                      | 783        |
| Liquidity providing repos | 41         | Reverse repos w/ foreign entities | 30         |
| Foreign Exchange          | 21         | Bank deposits                     | 19         |
| Gold                      | 11         | Government deposits               | 5          |
| Other assets (net)        | 11         | Capital and reserves              | 31         |
| <b>Total</b>              | <b>888</b> | <b>Total</b>                      | <b>888</b> |

Source: Stella (2009)

Although mechanism of 2007-2009 financial crises is beyond the scope of this paper, a rough summary can help to understand why status-quo for central banks has changed dramatically with the burst of the crisis. According to IMF Report (2009), interest rates were exceptionally low in the years preceding the crisis. The period was also characterized by large global imbalances, namely the large current account deficit of the United States matched by large current account surpluses in the rest of the world. Low interest rates pushed up asset prices from stocks to houses. Moreover, national regulators could not tackle appropriately with the innovations and complexities of highly interconnected financial markets. Thus, the degree of leverage associated with the funding of a boom and the degree of involvement of banks and other financial intermediaries caused a systematic risk and finally paralyse all financial markets. 2007-2009 financial crisis poses high level of systemic risks different than previous crisis, because of increased balance-sheet opaqueness and reliance on wholesale funding which resulted systemic fragility; increased interconnectedness of financial institutions and markets, the sheer size and centrality of U.S. financial markets which intensified negative spillovers and the high degree of leverage across sectors resulted initial liquidity concerns quickly to solvency worries (ibid).

In short, the pre-crisis period monetary policy was characterized by the popularity of inflation targeting and high level of operation independence of central banks. Risks from asset price increases or high leverage levels were not sufficiently considered by central banks and also by other actors as regulators.

### **Post-Crisis Roles for Central Banking and Monetary Policy**

Financial market tensions and the rise in credit and liquidity risk premia impaired the transmission mechanism in markets. So, many central banks required to take additional steps to improve the functioning of credit markets (BIS, 2009). Differences in how each central bank acted are more related to the number of the direct counterparties, the provision of more long-term lending, and the acceptance of a broader array of collateral (Simon and Stella, 2008). These new types of policies of central banks are referred to as balance sheet policies. Balance sheet policies can be implemented regardless of the prevailing interest rate level. Central banks operations generally result in substantial changes in balance sheets in terms of

size, composition and risk profile. For example, the end-2008 Fed balance sheet presented in Table 2 illustrates a radical departure from the preceding steady state displayed in Table 1. It is more than doubled during 2008 to \$2.2 trillion. Stella (2009) defines the Fed's post-crisis position as a sizeable and fundamental quasi-investment bank.

**Table 2. Federal Reserve Bank Consolidated Balance Sheet end-2008**

(in billions of dollars)

| Assets                            |      | Liabilities                      |      |
|-----------------------------------|------|----------------------------------|------|
| Government and GSE Securities     | 502  | FR Banknotes                     | 853  |
| Foreign Exchange Swaps            | 554  | Reverse repos w/foreign entities | 88   |
| Term Auction Credit               | 450  | Bank deposits                    | 860  |
| Commercial paper funding facility | 335  |                                  |      |
| Other loans                       | 194  | Government deposits              | 365  |
| Liquidity providing repos         | 80   | Other Liabilities (net)          | 22   |
| Maiden Lane LLC holdings          | 77   | Capital and Reserves             | 42   |
| Foreign Exchange (other)          | 27   |                                  |      |
| Gold                              | 11   |                                  |      |
| Total                             | 2230 | Total                            | 2230 |

Source; Stella (2009)

According to BIS report, central banks responses in crisis can be divided into three broad categories; The first category consists of measures to ensure that the market rate is consistent with the policy rate. The second involves initiatives to alleviate strains in wholesale interbank markets. The third consists of responses aimed at supporting specific credit markets particularly the non-bank segments and easing financial conditions more broadly. An important difference across countries is the relative emphasis given to private versus public sector securities and bank versus non-bank markets (BIS, 2009). These responses cannot be attributed to only few central banks. Most major central banks have used these tools with different intensity.

In short, both the expansion and change in balance sheet compositions as a result of central banks' response have potential consequences for their financial strength and operational independence and also their future roles.

### **Future of Central Banks and Their Independence**

As indicated in previous section, central banks in many different countries have quickly taken a leading role in stemming financial crises, with varying degrees of success. Technically, central banks conventional net worth or equity can be negative without causing an automatic default (Buiters, 2009). Besides, the global consensus that emerged over the past two decades stressing the benefits of independent monetary policy is worth preserving. However, what *does* become a problem for the central banks is a financial situation that jeopardizes their operational and financial independence which consequently hinder their ability to achieve

traditional policy objectives (Stella, 2009). As Stella (2009) predict for US Fed, exiting from current situation has been difficult and the damage to the balance sheet or central bank institutional reputation in some cases may take decades to fully repair. Although, it seems too hard to return pre-crisis situation, there are some options to alleviate operational independence of central banks to some extent.

Firstly, close coordination between the central bank and the government is inevitable to prevent central banks from losses from low quality assets. As Buiter (2009) indicates, coordination and cooperation does not necessarily mean loss of central bank independence. But, clear demarcation of roles and responsibilities and separation of accountability should be preconditions for closer cooperation and operational independence of central banks.

As another option, Stella (2009) discusses the possibility to transfer financial responsibilities from Fed's balance sheet to Treasury. However, he concludes that Fed is more transparent and its risk management capacity is better equipped than Treasury. So, because of transparency concern, it might be not a good option to transfer low quality assets to the Treasuries or Finance Ministries.

However, he adds that a new institution or governance structure can be formed in the future monitor financial sector stability and to manage financial risks in balance sheets of central banks. Since it is new idea, a new governance structure might be considered an evolutionary rather than revolutionary change.

In addition to the improvement of central banks' independence, another big challenge is whether responding to financial instability should be a task for monetary policy in the future. There is a big concern that how well central banks have discharged their twin duties as the guardians of financial stability and as the defenders of price stability (The Economist, 2007). The benign neglect view posits that central banks should focus on their primary objectives-inflation targeting and growth (IMF, 2009). But, according to the IMF (2009) report, which I also agree with; "*there may be long term benefits for growth and inflation from 'leaning against the wind' during times of asset price booms under certain conditions*". In that context, even though financial stability should not be an explicit target for central banks, it should be taken into account in addition to price stability. Yet, the explicit inclusion of asset price or financial stability as targets may lead to a less credible commitment to inflation fighting (ibid.).

Last challenge for future of central banks credibility is if central banks should be a part of the regulation of financial markets or not. Before the crisis there is trend that central banks are give up their regulatory functions. Financial crisis ignited the debate about central banks returns to regulatory and supervisory roles. However, regulation is highly political activity and sometimes requires though political decisions which may harm credibility of central banks (Buiter, 2009). Thus, conflict of interest among different objectives of central banks

will be inevitable. Therefore, central banks should be cautious about assuming regulatory roles.

### **Conclusion**

The financial crisis that broke in 2007 has resulted in dramatic changes in many countries' monetary policies. Monetary policy easing and last-resort lending showed their limits as the financial system solvency is systemically impaired or in serious doubt. Central banks were required to handle different tools to tackle with the liquidity problem and prevent systemic collapse. The challenge is the expansion and changes in central banks' balance sheet compositions have potential threats for their financial strength and operational independence. Although, it is hard to return pre-crisis situation, there are some options as mention in previous sections to improve operational independence to some extent.

As IMF Report (2009) states; *“...to the extent that the build up of systemic risk can portend a sharp economic downturn, and to the extent that regulation cannot fully prevent such a buildup, it is now clear that policy makers cannot neglect asset-price and credit booms...”*, responding to financial instability should be a task for monetary policy in the future. But, major challenge is how central banks will compromise conflicting objectives and prevent operational independence and their credibility at the same time.

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