Monetary policy will never be the same

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Two weeks ago, the IMF organized a major research conference, in honor of Stanley Fischer, on lessons from the crisis. Here is my take. I shall focus on what I see as the lessons for monetary policy, but before I do this, let me mention two other important conclusions.

One, having your macro house in order pays off when there is an (external) crisis. In contrast to previous episodes, wise fiscal policy before this crisis gave emerging market countries the room to pursue countercyclical fiscal policies during the crisis, and this made a substantial difference.

Second, after a financial crisis, it is essential to rapidly clean up and recapitalize the banks. This did not happen in Japan in the 1990s, and was costly. But it did happen in the US in this crisis, and it helped the recovery.

Now let me now turn to monetary policy, and touch on three issues: the implications of the liquidity trap, the provision of liquidity, and the management of capital flows.

On the liquidity trap: we have discovered, unfortunately at great cost, that the zero lower bound can indeed be binding, and be binding for a long time—five years at this point. We have also discovered that, even then, there is still some room for monetary policy. The bulk of the evidence is that unconventional policy can systematically affect the term premia, and thus bend the yield curve through portfolio effects. But it remains a fact that compared to conventional policy, the effects of unconventional monetary policy are very limited and uncertain.

There is therefore much to be said for avoiding the trap in the first place in the future, and this raises again the question of the inflation rate. There is wide agreement that in most advanced countries, it would be good if inflation was higher today. Presumably, if it had been higher pre-crisis, it would be higher today. To be more concrete, if inflation had been 2 percentage points higher before the crisis, the best guess is that it would be 2 percentage points higher today, the real rate would be 2 percentage points lower, and we would probably be close in the United States to an exit from zero nominal rates today.

We should not dismiss the possibility, raised by Larry Summers that we may need negative real rates for a long time. Countries could in principle achieve negative real rates through low nominal rates and moderate inflation. Instead, we are still facing today the danger of an adverse feedback loop, in which depressed demand leads to lower inflation, lower inflation leads to higher real rates, and higher real rates lead in turn to even more depressed demand.

Turning to liquidity provision: in advanced countries (but, again, the lesson is more general), we have learned that runs are relevant not only for banks, but also for other financial institutions, and for governments. In an environment of high public debt, rollover risks cannot be excluded. An implication, and one of the themes emphasized by Paul Krugman, is that it is essential to have a lender of last resort, ready to lend not only to financial institutions but also to governments. The evidence on periphery sovereign bonds in the Euro area, pre and post the European Central Bank's announcement of outright monetary transactions, is quite convincing on this point.

Finally, turning to capital flows. In emerging markets (and, more generally, in small advanced economies, although these were not explicitly covered at the conference), the evidence suggests the best way to deal with volatile capital flows is by letting the exchange

rate absorb most—but not necessarily all—of the adjustment.

The standard argument in favor of letting the exchange rate adjust was stated by Paul Krugman at the conference. If investors want to take their funds out, let them: the exchange rate will depreciate, and this will lead, if anything, to an increase in exports and an increase in output.

Three arguments have traditionally been given, however, against relying on exchange rate adjustment. The first is that, to the extent that domestic borrowers have borrowed in foreign currency, the depreciation has adverse effects on balance sheets, and leads to a decrease in domestic demand that may more than offset the increase in exports. The second is that much of the nominal depreciation may simply translate into higher inflation. The third is that large movements in the exchange rate may lead to disruptions, both in the real economy and in financial markets.

The evidence, however, is that the first two are much less relevant than they were in previous crises. Thanks to macroprudential measures, to the development of local currency bond markets, and to exchange rate flexibility and thus a better perception by borrowers of exchange rate risk, foreign exchange exposure in emerging market countries is much more limited than it was in previous crises. And thanks to increased credibility of monetary policy and inflation targets, inflation expectations appear much better anchored, leading to limited effects of exchange rate movements on inflation.

However the third argument remains relevant. And this is why central banks in emerging market countries have not moved to full float, but to "managed float," that is the joint use of the policy rate, foreign exchange intervention, macroprudential measures, and capital controls. This has allowed them to reduce the old dilemma that arises when the only instrument used is the policy rate: an increase in the policy rate may avoid the overheating associated with capital inflows, but at the same time, it may make it even more attractive for foreign investors to come in. Foreign exchange intervention, capital controls, and macro prudential tools can, at least in principle, limit movements in exchange rates, and disruptions in the financial system without recourse to the policy rate. Countries have used all of these tools in this crisis. Some have relied more on capital controls, some more on foreign exchange intervention. And the evidence, both from the conference, but also from work at the IMF, suggests that these tools have worked, if not perfectly. Looking forward, the clear (and quite formidable) challenge is to understand how best to combine them.

In short, monetary policy will never be the same after the crisis. The conference helped us understand how it had moved, and where we have to focus our research and policy efforts in the future.