

# Lessons from the crisis for monetary policy and financial stability

Deputy Governor Jan F. Qvigstad, Limassol, 3 September 2010

First I would like to thank you for inviting me and giving me this opportunity to comment on lessons from the crisis.

I will concentrate my talk around three lessons and two questions. What I am going to highlight is by no means revolutionary, rather it reflects a growing consensus on experiences from the crisis. 20 minutes only allows me to briefly touch on the different subjects. For a more in depth analysis and discussion of similar issues that I raise here today, I can recommend the Jackson Hole paper by Charles Bean et.al.

*Chart: Transmission mechanism was affected by the financial crisis*

The first lesson is that monetary policy is more than setting the key policy rate. We also need to monitor the transmission mechanism closely.

The transmission mechanism was affected by the financial crisis. Constraints on banks' access to funding and a heightened level of perceived risk led to higher lending margins and higher bond spreads.

The chart shows developments in our key policy rate and banks mortgage lending rates from August 2007 to November 2008. The widening spread between these two interest rates was not unique to Norway, but occurred in several countries.

Banks also tightened their credit standards in response to the crisis. In Norway, as in most other countries, this was particularly distinct for credit to enterprises.

Both higher spreads and tighter credit standards can have potentially strong contractionary effects on the economy and needed to be counteracted.

*Chart: Liquidity and capital support was necessary to restore credit flows*

The contractionary forces from the financial sector were addressed by providing liquidity and capital to banks, through both regular and unconventional instruments in many countries. Government actions enabled banks to continue to provide credit to households and enterprises.

The crisis demonstrated that the transmission mechanism is important for the effectiveness of monetary policy. It also demonstrated that the relationship between price stability and financial stability must be given due attention.

In Norges Bank there is close integration between the two areas Norges Bank Monetary Policy and Norges Bank Financial Stability. Norges Bank Financial Stability participates at all meetings in the monetary policy process. This ensures that sufficient attention is given to developments in the financial system. It also provided the necessary insight to make well-informed assessments of the transmission mechanism during the crisis.

*Chart: Considerable revision of the interest rate forecast during the crisis*

The second lesson is that inflation targeting seems to have survived the test. In my view, increased transparency and the efforts made to improve the communication of monetary policy to the general public have been very valuable.

The chart shows the baseline scenario for the key policy rate with fan chart from October 2008 and the baseline scenario for the key policy rate as of December 2008, only 2 months later. The large downward shift in the baseline scenario illustrates the size of the shock that hit Norway (and the global economy). Although considerable revisions in the interest rate forecast had to be made during the crisis, this did not lead to any change in the credibility of the central bank.

Explicit interest rate forecasts were introduced in Norges Bank in 2005. The decision to publish the forecast was the next logical step in developing the Bank's communication. When we started publishing our own interest rate forecasts, we had to make sure that financial market participants, journalists, banks and a broader audience understood the framework. A key issue was to convey the contingency and the uncertainty in the forecast. As one of the reasons for publishing the forecast is to improve the general understanding of the Bank's response pattern, it has been important to explain the logic behind the forecast. This includes shedding light on the considerations underlying each interest rate forecast and what their objectives and the trade-offs between them are.

In general, interest rate forecasting has been effective. As market expectations tend to react to economic news largely in line with the Bank's reaction pattern - there is little doubt that the contingency of the forecasts is well understood.

*Chart: Transparency eased communication: an account of the factors behind the revision*

In our Monetary Policy Report, the interest rate forecast is accompanied by a separate chart, shown here, that shows the revision since the previous report due to changes in exogenous factors.

By carefully explaining the reasoning behind the revisions of our interest rate forecasts, financial market participants and other interested parties can make their own judgment as to whether the revisions seem justifiable.

In general, interest rate forecasting has worked well. As market expectations tend to react to economic news largely in line with the Bank's response pattern, there is little doubt that the contingency of the forecasts is well understood.

*Chart: Interest rate forecast and exit strategy*

Another advantage of publishing our own forecast for interest rates is that the exit strategy is an inherent part of the Bank's communication. A key element of any exit strategy is that policymakers must guide expectations. An exit that takes markets by surprise can lead to major reassessments of the yield curve. Publishing explicit interest rate forecasts is a very direct way of guiding financial market participants' expectations.

*Chart: Historical perspective I*

The third lesson is the need for multilateral cooperation and collective action. As the global economic and financial crises unfolded, joint, massive and unprecedented policy responses were put in place around the world so as to avoid another Great Depression. A financial meltdown was averted, economic activity was supported and protectionism was contained.

The chart shows the decline in world trade during the Great Depression compared to the much quicker decline in the recent crisis.

*Chart: Historical perspective II*

But in the 1930's, it took 3-4 years before world trade stopped falling, and the pickup in trade was slow.

This time, a fairly quick rebound of trade has taken place. Some two years after the crisis started, world trade was more or less back to the pre-crisis level.

*Chart: IMF lending*

Early on, the IMF advocated forceful and coordinated measures that the G20 followed up with broad international efforts to stabilize the global economy. Without such prompt and comprehensive action, the consequences of the crisis would have been far greater.

It is in the interest of all that the large and systemically important countries discuss issues of common interest. Their successful collaboration benefits not only themselves, but also the rest of the world.

*Chart: G20, IMF and small countries*

Among the G20 initiatives were the efforts to strengthen confidence in international financial institutions, the IMF in particular, to permit these institutions to play an effective role in tackling the crisis.

Large financial resources were raised by IMF members, many outside the G20. Indeed, the G20 has used the IMF as an instrument of its policy implementation. And yet, the G20 lacks the legitimacy that has historically been associated with a truly multilateral framework. Other countries do not participate, directly or indirectly, but are called upon to contribute to efforts that others have agreed. The vast majority of the members of the IMF have no voice or representation in these discussions, including all low-income countries and most emerging economies.

All in all, multilateral cooperation and collective action functioned reasonably well during the crisis. With the world recovering from the crisis, the G20 should strive for wider acceptance and legitimacy to make sure that the basis for strong multilateral cooperation and collective action is also in place when policies for reform and prevention are implemented. Truly global challenges call for truly global solutions anchored in a multilateral and statutory-based system of representation like the Bretton Wood Institutions. All countries, large and small, rich and poor, should be represented, even if only indirectly through constituencies.

*Chart: General government balances*

These are some lessons learned from the crisis. Still, several unresolved questions remain.

The chart shows general government fiscal balances as a percentage of GDP in selected countries. Many countries had negative fiscal balances through the last decade despite moderate to high economic growth. Spain seemed to be in a different position with a positive fiscal balance, though this was mainly due to unsustainable high growth in the construction sector.

This illustrates the first question, which is how to solve time inconsistency in fiscal policy. It is easier to follow the prescriptions of Keynes in bad times than in good times. This asymmetry may lead to an increase in budget deficits and sovereign debt over time, also referred to as the fiscal bias. As a result, many countries (PIIGS, UK,) have to tighten policy in a period when the real economy would certainly benefit from further stimulus.

The crisis caused fiscal balances to deteriorate by 8-10 percentage points. There is an immense difference between encountering a shock of this magnitude from a positive fiscal balance of 4 per cent and encountering it from a negative fiscal balance of 4 per cent. From a negative balance of 4 per cent, fiscal balances end up at a 12 per cent deficit! Then it is imperative to tighten policy.

A similar time inconsistency problem, the inflation bias, has been a much debated issue in monetary policy. The solution has been central bank independence. So the question is, is there something to be learnt from monetary policy?

*Chart: Ragnar Frisch*

The fiscal bias is not a new phenomenon. And a number of possible solutions have been tried. As far back as in the early 1930s, the Norwegian economist and Nobel Prize winner Ragnar Frisch had the following suggestion:

“It might be an idea to establish a cyclical council to make such decisions, a council that could operate with an independent status similar to that of the Supreme Court. The council should comprise members who do not represent a political party, but a particular field of expertise: business, banking or economics.”

One example of an existing body of this type is the Swedish Fiscal Policy Council, which was established in 2007 as an agency under the government. In the UK, an interim Office for Budget Responsibility (OBR) was recently set up. And in the euro area, the budgetary

surveillance of the European Commission is referred to as the 'preventive arm' of the Stability and Growth Pact.

But, as highlighted by the commission itself:

"In order to function effectively, it requires a common understanding of the economic and fiscal policy challenges in the European Union, and a strong political commitment to addressing them."

How to enforce a strong political commitment to address the fiscal bias is still very much an unresolved question.

*Chart: International coordination is important*

The second question is how to secure adequate international coordination in both crisis prevention and crisis resolution.

As the chart shows, foreign banks' share of the market in Norway is approximately 1/3. In some countries, foreign banks' share of the market is higher or even 100%, with no domestic banks at all.

Today a bank's regulation is laid down and supervised by the authorities in the bank's home country. When foreign banks' share in a market is large, this challenges the concept of a level playing field insofar as national supervisory authorities do not coordinate their work.

This way of organizing regulation will be an even bigger challenge when new regulation designed to hinder the build-up of systemic risk is introduced, since a host country and the home countries of banks operating in the host country may be in different stages of the business cycle.

*Chart : Output gap in the Nordic countries*

This is illustrated in this chart showing output gaps in the Nordic countries. Today most economies are closely integrated with other economies, both through trade and through financial markets. Still there may be significant differences both in the timing (and amplitude) of peaks and troughs in the business cycle and in the functioning of financial markets.

Asymmetries between countries mean that the appropriate regulatory parameters to dampen systemic risk will not necessarily be the same for all countries at the same time. To be effective, regulatory parameters, for instance those calibrated to ensure the build-up of countercyclical buffers, need to encompass all banks operating in the same jurisdiction, as put forward in the July 2010 BIS proposal.

Finally, I will say a few words on crisis resolution. Resolution actions taken in one country in response to a crisis can have effects on banks in other countries that do not choose to introduce the same resolution actions. For instance, issuance of government guarantees in one country can weaken banks in neighboring countries without such guarantees (since

government guarantees provide an incentive to move deposits to banks in these countries). This shows the importance of international coordination also when it comes to crisis resolution.

Thank you for your attention.