Policy Challenges for Central Banks in the Aftermath of the Crisis

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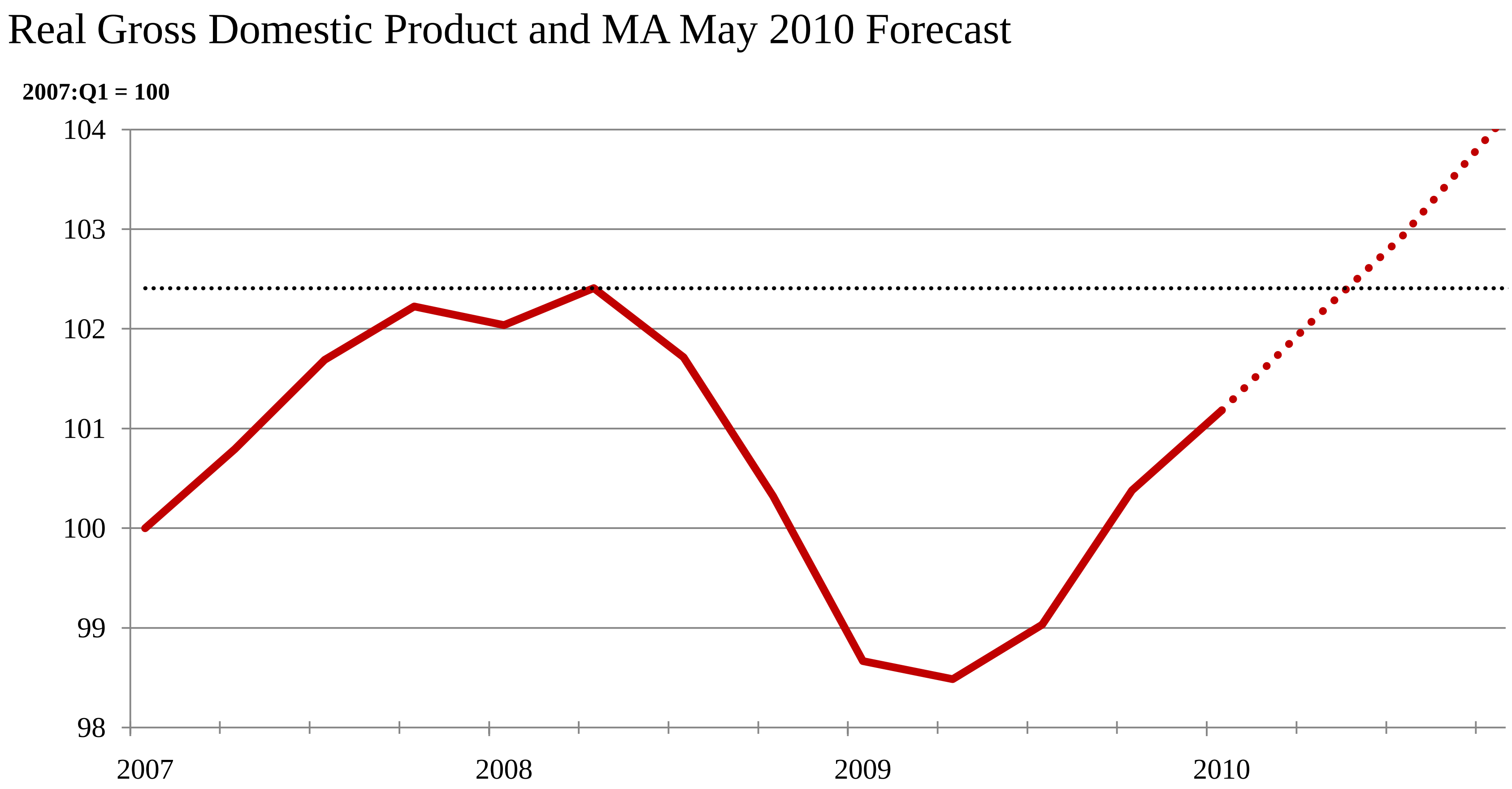
Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee participants.

This talk

- In the U.S. and globally, the recovery is going well, but …
- European sovereign debt: Second major crisis in 21 months.
- Responses to the crisis are necessary, but are also harming the credibility earned through stable, rules-based policy.
- Credibility can take a long time to rebuild.
- Regulatory reform in the U.S. is likely to become law, but cannot fully resolve problems.
- A new, more volatile era seems to be at hand.
- The challenges for monetary policy will be manifold.

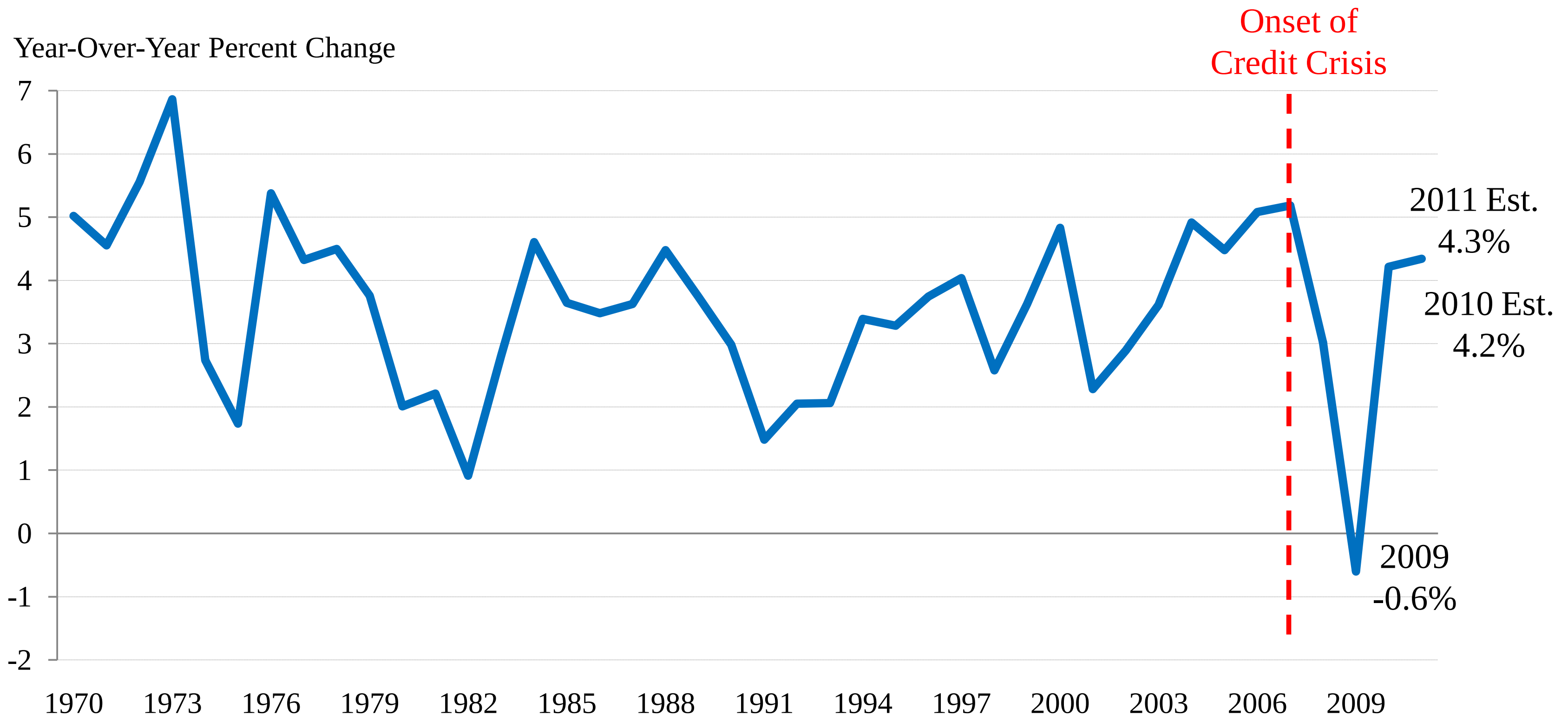
The recovery is on track ...

GDP expected to reach 2008:Q2 peak before year-end



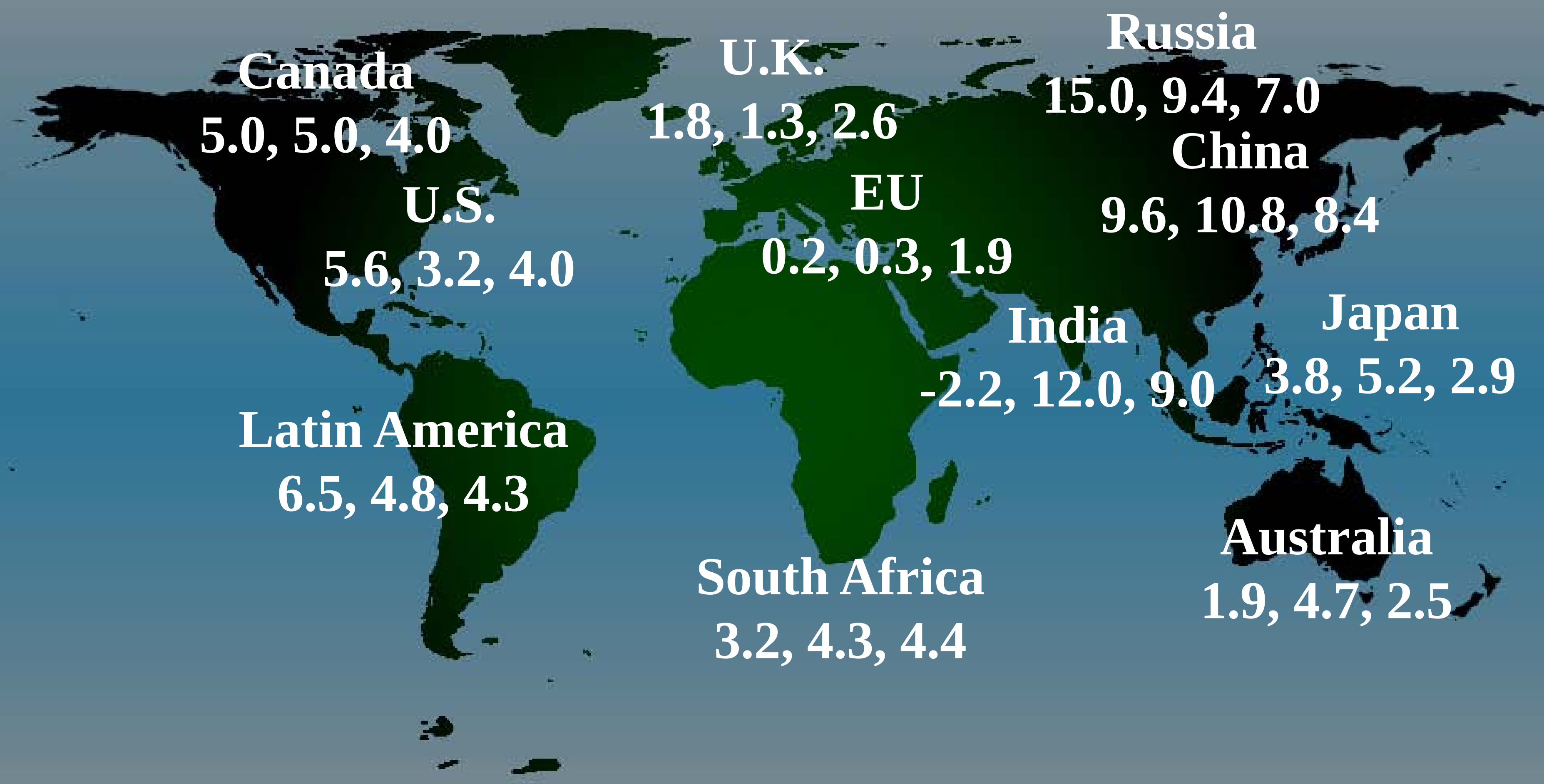
Source: *Bureau of Economic Analysis, Macroeconomic Advisers.*

World real GDP growth is expected to improve



Source: IMF World Economic Outlook , April 2010.

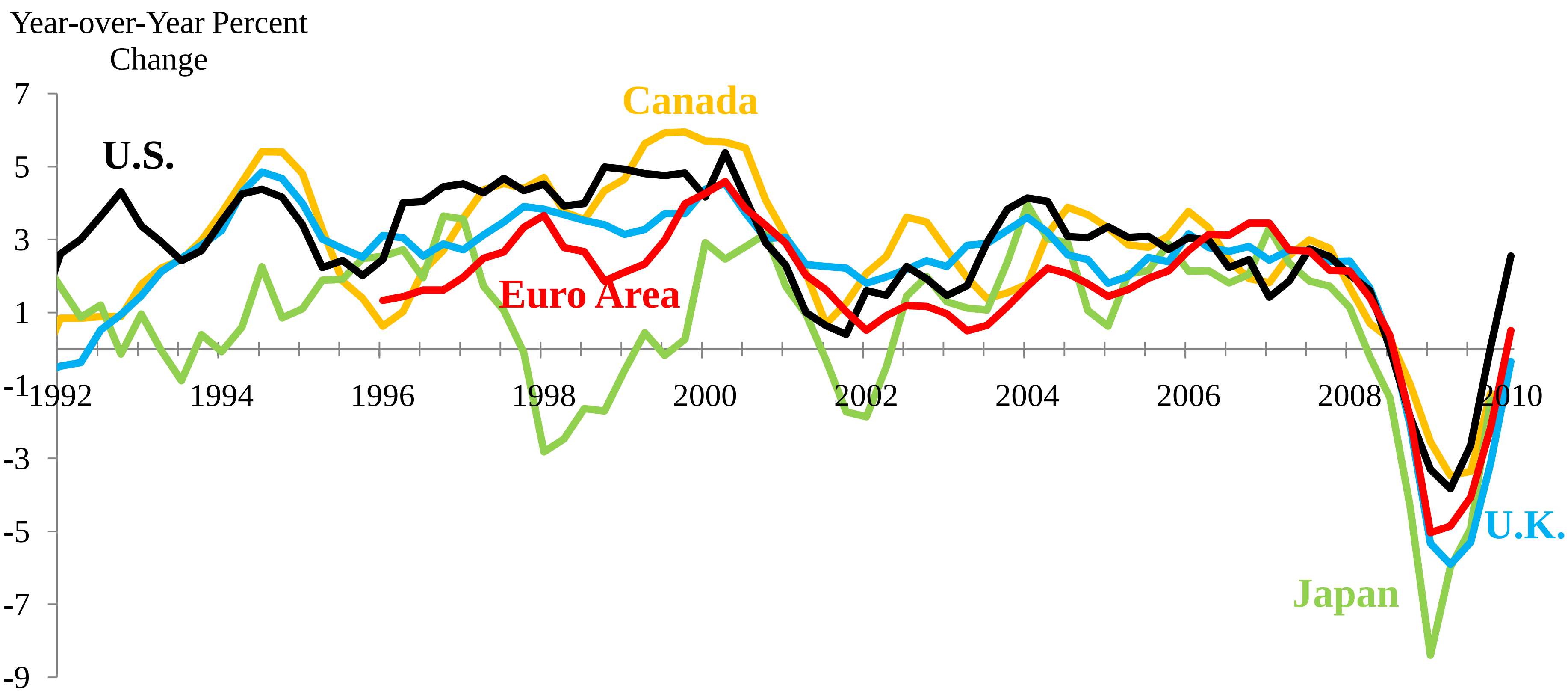
Global growth



Real GDP growth, SAAR, Percent, 2009:Q4, 2010:Q1, and 2010:Q2

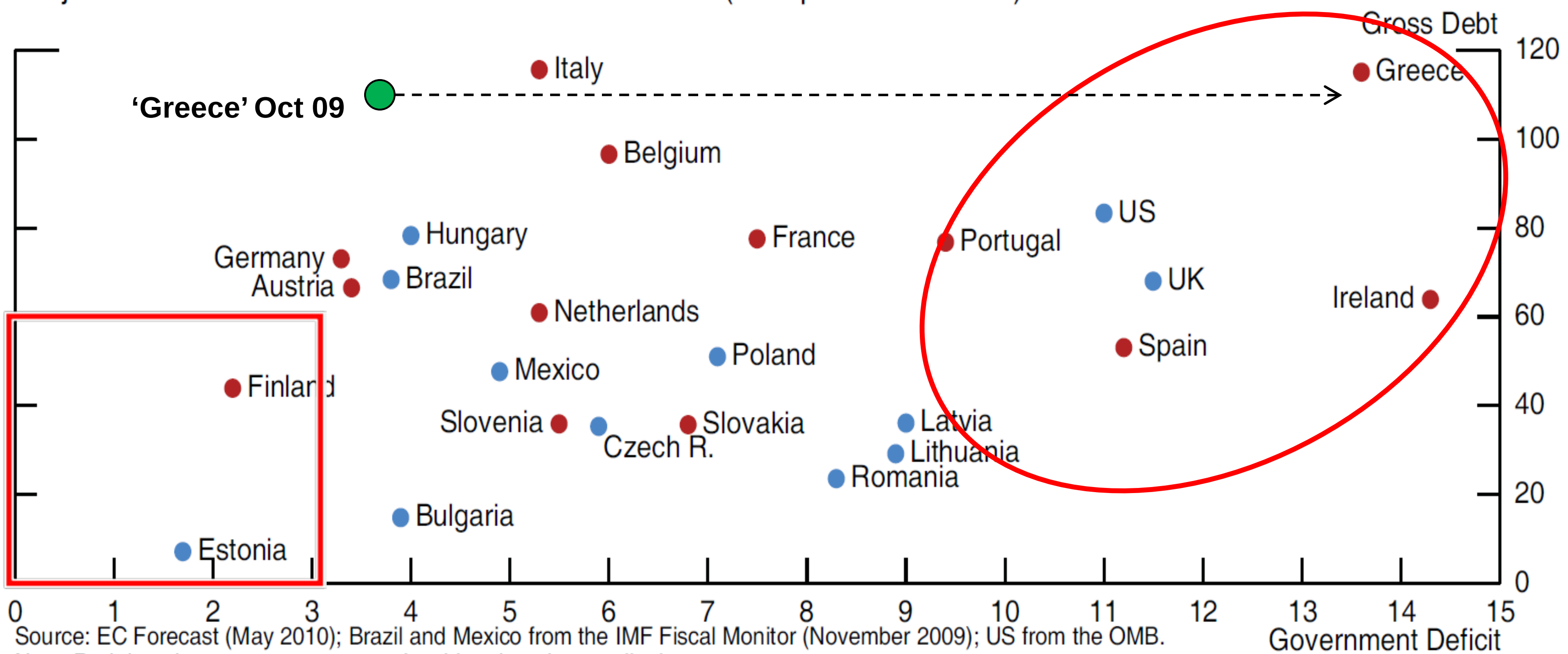
Source: Barclays Capital Global Economic Weekly.

Real GDP for G-7 countries



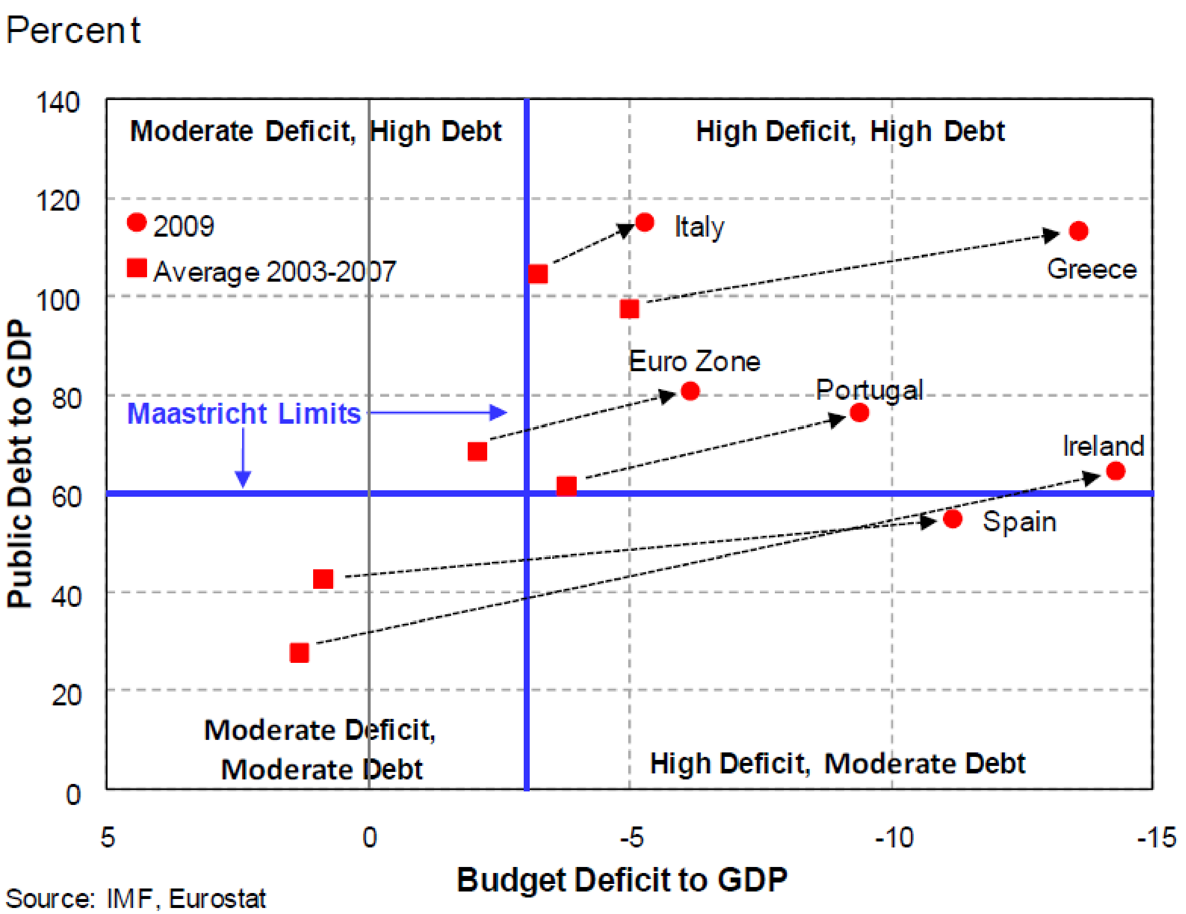
…but the EU Crisis May Be a New Shock

Debt and deficits



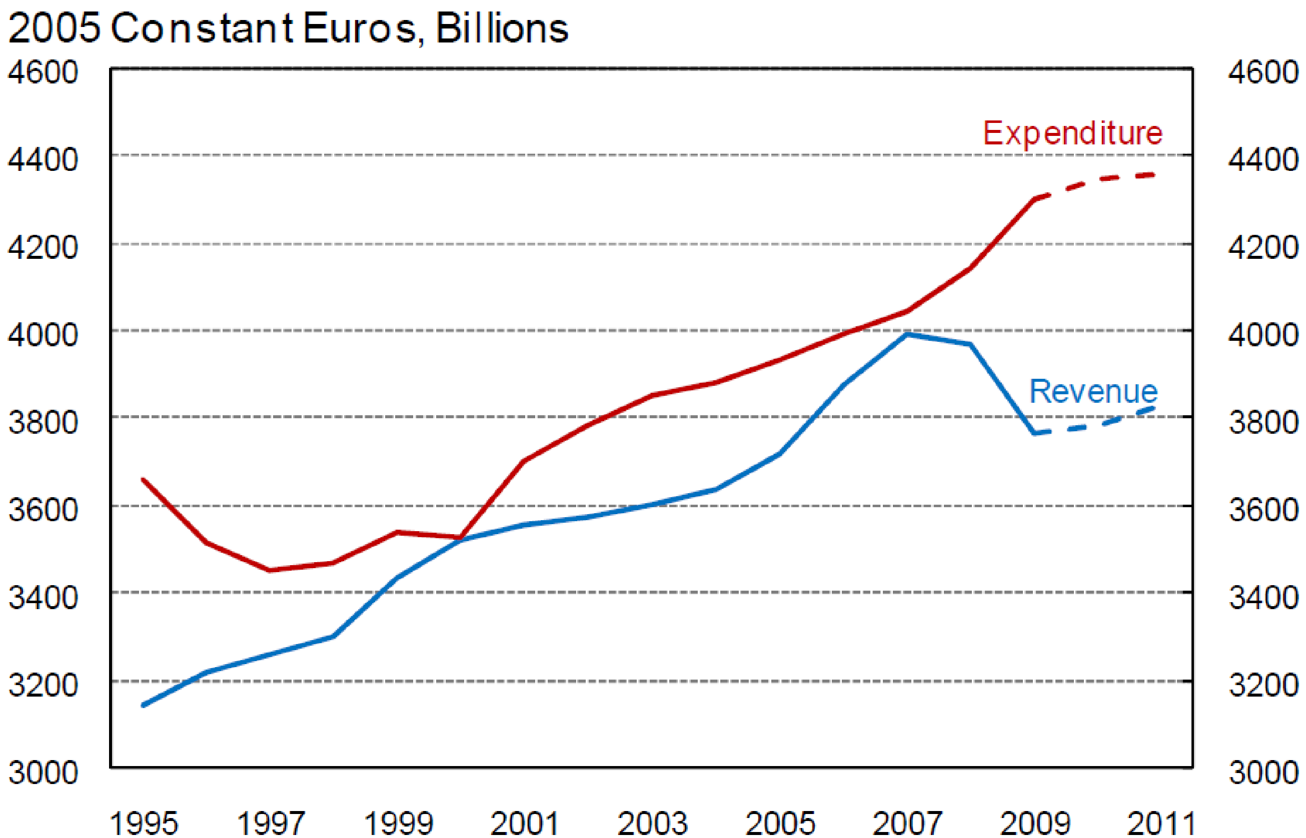
Source: EC Forecast (May 2010); Brazil and Mexico from the IMF Fiscal Monitor (November 2009); US from the OMB.
Note: Red dots denote euro-area countries; blue dots denote all others.

Euro Zone: Fiscal indicators for selected countries



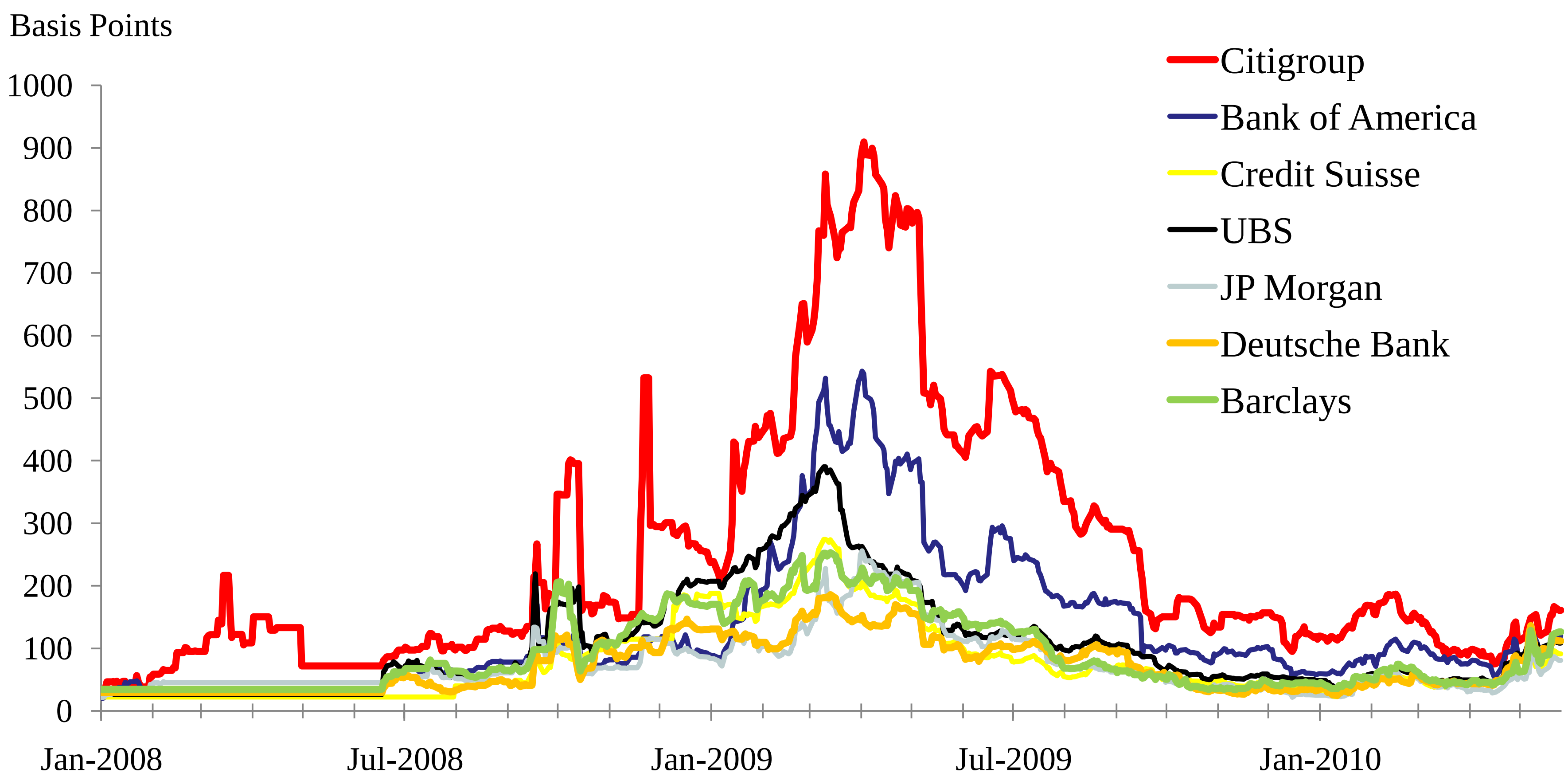
Source: IMF, Eurostat

Euro Area: General government expenditure and revenue



Source: European Commission

Cost of insurance against default by commercial banks



Source: Bloomberg.

The role of government guarantees

- Financial market contagion is a concern.
- One positive is that bank guarantees remain in place—the upside of "too big too fail."
- Governments have made it very clear that they do not think they can allow the failure of very large financial firms at this juncture.
- In 2007 and earlier, "too big to fail" guarantees were not as explicit as they are today, and so markets were more likely to run on large institutions with significant exposure to problem assets.

Credibility Waning

Successful medium-term policy

- A large part of successful macroeconomic policy is clear delineation of how the government will act in various states of the world.
- During the financial panic of 2008 and 2009, and again today, governments have been forced to take unprecedented actions.
- While these policy moves were necessary, they have also eroded credibility.
- We know that credibility is often established only over a long period of time.

Re-establishing credibility?

- One key problem going forward will be how to re-establish credibility for macroeconomic policy.
- Policymakers tried to gain credibility for policies that turned out to be unrealistic:
  - In the U.S., ambiguity over "too big to fail."
  - In Europe, ambiguity over the necessity of meeting debt and deficit targets.
- Credible policies are more effective, but may not be possible in the near term.
- Medium-term policy choice will have to take this into account.

Regulatory Reform in the U.S.

The scope of regulatory reform

- The financial crisis affected firms across industries in both the U.S. and Europe.
- These firms operated in a variety of regulatory environments.
- They often owned different lines of business.
- Very few escaped unscathed, suggesting that a change in regulation is not a panacea.
- One key common denominator: exposure to securitized mortgage products.

Large S&P 500 Financial Firms (As of 2007:Q4)

Firm	Total Assets, Bill. (2007:Q4)	Pct. of Tot. Assets in S&P 500 Fin.	Cum. Percent	Type of Firm (2007: Q4)
Citigroup Inc.	$2,187	10.9%	10.9%	BHC
Bank of America Corp.	1,715	8.5	19.5	BHC
JPM Chase & Co.	1,562	7.8	27.3	BHC
Goldman Sachs Grp.	1,119	5.5	32.9	Inv. Bank
AIG	1,060	5.3	38.2	Insurance
Morgan Stanley	1,045	5.2	43.4	Inv. Bank
Merrill Lynch	1,020	5.1	48.5	Inv. Bank
Fannie Mae	882	4.4	53.9	GSE
FHL Mortg.	794	3.9	56.9	GSE
Wachovia Corp.	782	3.9	60.8	BHC

Large S&P 500 Financial Firms (As of 2007:Q4)

Firm	Total Assets, Bill. (2007:Q4)	Pct. of Tot. Assets in S&P 500 Fin.	Cum. Percent	Type of Firm (2007:Q4)
Lehman Bros.	691	3.4	64.2	Inv. Bank
Wells Fargo	575	2.8	67.1	BHC
MetLife Inc.	558	2.7	69.9	Insurance
Prudential Financial	485	2.4	72.3	Fin. Adv./Ins.
Hartford Financial Svcs.	360	1.8	74.1	Insurance
Washington Mutual	327	1.6	75.7	Thrift
U.S. Bancorp	237	1.1	76.9	BHC
Countrywide Financial Corp.	211	1.0	78.0	Thrift
Bank of NY Mellon Corp.	197	0.9	79.0	BHC
Lincoln National	191	0.9	79.9	Insurance

The *who's who* of the crisis in the U.S.

- About 1/3 of the financial assets in the table are in bank holding companies as the crisis started.
- The less-regulated shadow banking sector played a huge role.
- New regulations need to take a view of the entire financial landscape—otherwise many activities are forced into less regulated entities.
- Pending legislation does not appear to be sufficiently broad in concept to address this concern.

New forms of panic

- The hallmark of the crisis: Runs on non-bank financial firms.
- We know how to address *bank* runs: Deposit insurance plus prudential regulation.
- There is no analog for runs on non-bank financial firms.
- Additional capital requirements do not solve this problem.
- I expect the problem of runs on non-bank financial firms to be with us for the foreseeable future.
- One possible reform: Change the tax code to discourage short-term debt finance.

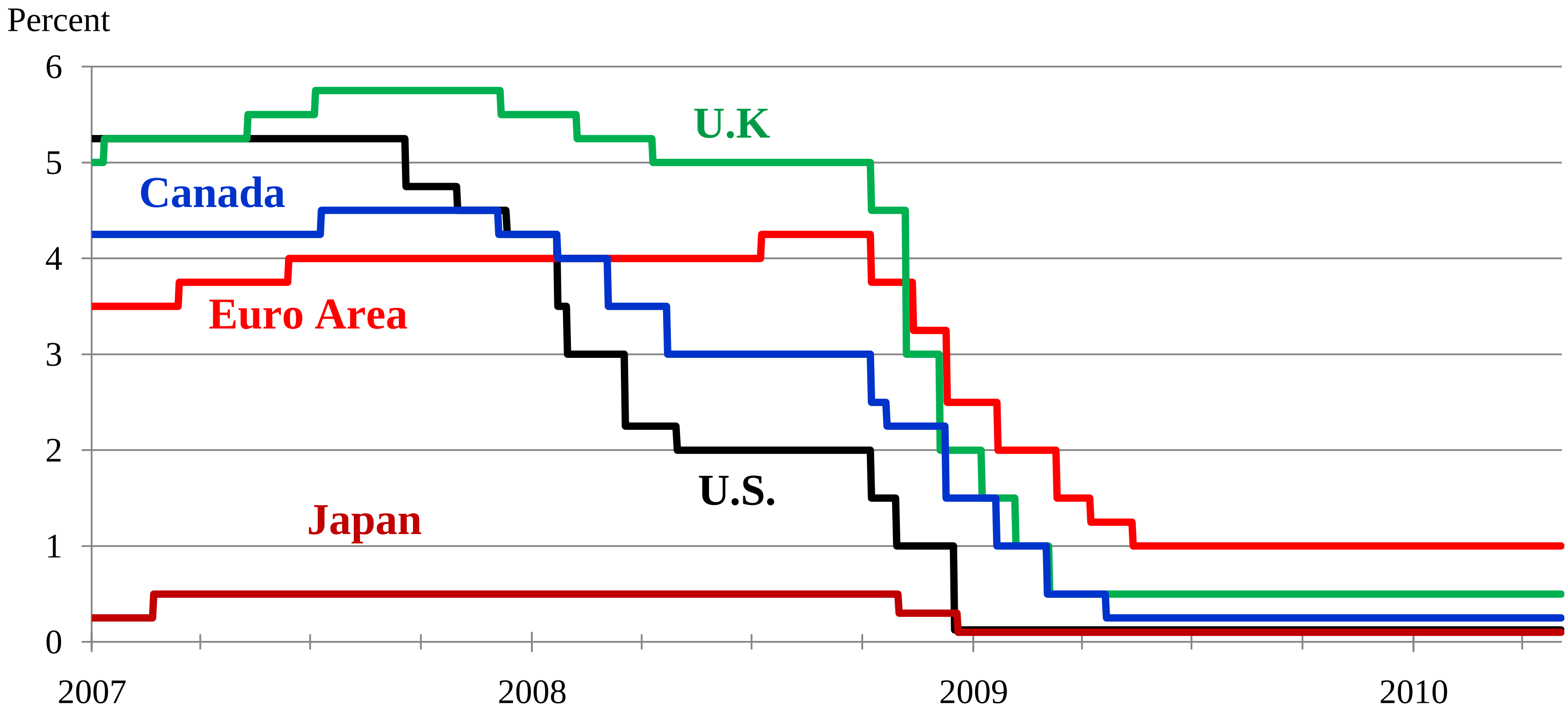
A More Volatile Era?

A more volatile era?

- Credibility is an important part of successful macroeconomic policy.
- The policy actions of the past two years, even while necessary, have eroded credibility.
- There are clear limits to what U.S. regulatory reform is likely to accomplish.
- Important problems will remain unresolved by the legislation.
- I expect less credible macroeconomic policies and lingering unresolved issues to combine to create a more volatile economic environment going forward.

Monetary Policy Challenges

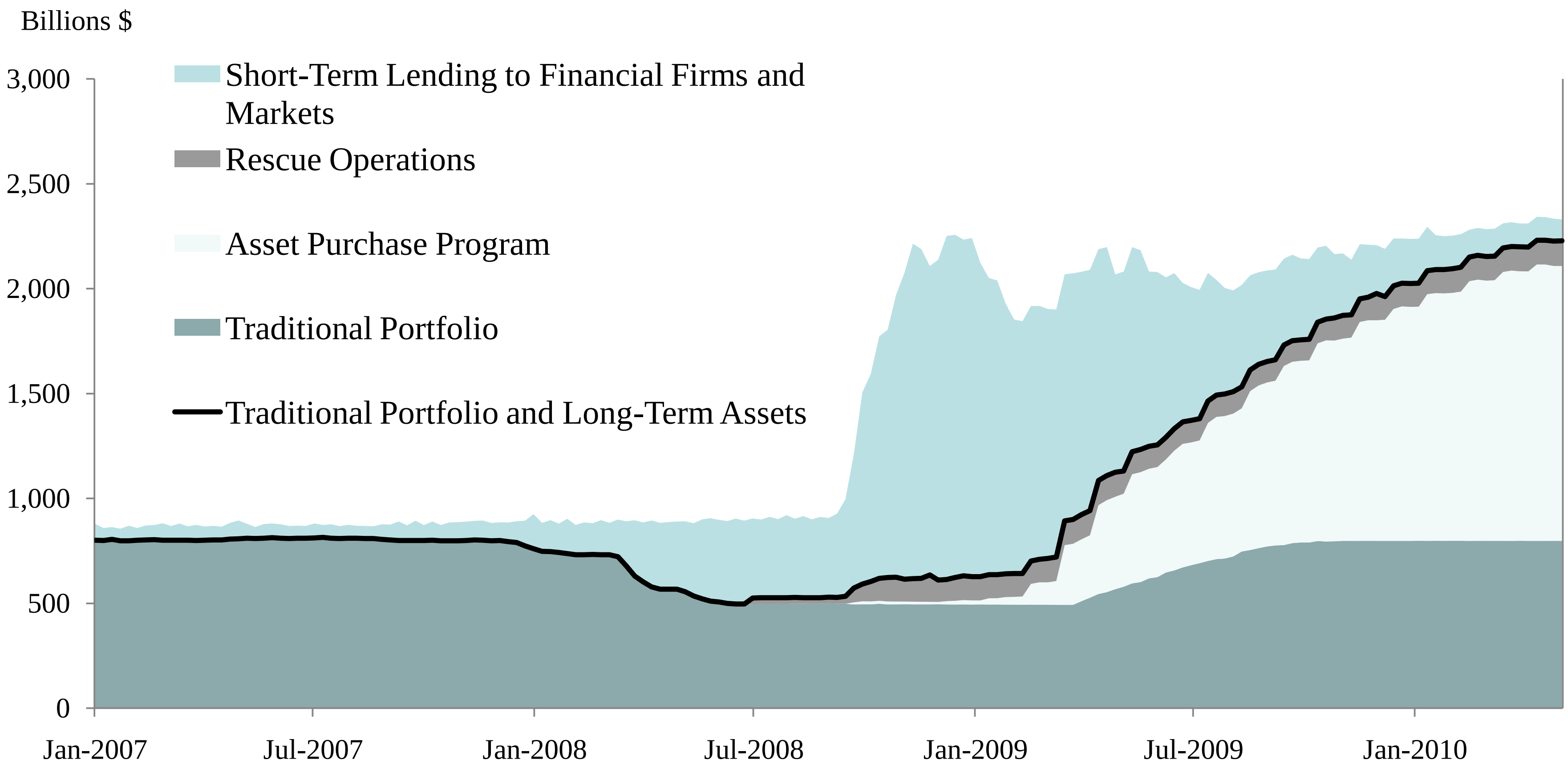
Near-zero policy rates in the G-7



The near-zero rate policy

- The policy to keep rates near zero for an extended period can influence real activity at the zero lower bound according to modern monetary theories, such as Woodford (2003).
- The effects depend on the credibility of the promise.
- The policy carries risks that are not part of the standard analysis:
  - Markets may confuse the policy with the "interest rate peg" policy, in which rates do not adjust in response to shocks.
  - This is one of the worst policies according to the literature.
  - In particular, multiple equilibria or "bubbles" are possible.

Federal Reserve balance sheet



Source: *Board of Governors.*

The quantitative easing policy

- The near-zero interest rate policy has been supplemented with an aggressive quantitative easing policy.
- This program is generally regarded as effective.
- To the extent the QE policy has been successful, the more cumbersome "extended period" policy is called into question.
- The inflationary impact of the QE policy depends on the perceptions of how and when the policy will be removed.
- In theory, any credible commitment to remove the policy in finite time will work well.
- In practice, markets may well lose faith sooner than that.

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