The Financial Crisis and the New Monetary Policy Tools

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Monetary Policy Operating Targets nd Instruments: FED vs ECB

- Monetary Policy Operating Targets are variables in the market for “bank reserves”: could be either interbank rates (overnight) vs reserve aggregates.
- These immediate targets are controlled via a set of different instruments:
  - Official interest rates (on standing facilities)
  - Open market operations (on the “secondary” market, of various type)
  - Mandatory Reserve Requirements
- FED: Main operating target is the fed funds rate (interest rate on 24 -hour interbanking loans)
- ECB: implicitly, “normal” level of reserves (quantity target, Bundesbank inheritance)

FED Instruments pre crisis

- **Discount Lending**, individual loans to about 7500 counterparts, wide range of collateral accepted, at fixed prices:
  - primary credit
  - secondary credit
  - seasonal credit.
- **Open Market Operations**, on a daily basis, outright or temporary (repos and reverse repos), fully (but narrowly) collateralized with a limited number of counterparts (20 primary dealers), conducted at the FRBNY at a bid price.
- **Legal Reserve Requirements** on checking deposits, based on 2 coefficients, no remuneration, maintenance period: 15 days.

ECB Instruments pre crisis

- **2 Standing Facilities**: operations on demand of counterparts, about 2400: **marginal lending facility** at a fixed penalty rate (roof) on a wide range of collateral; **central bank's deposit facility** at a lower than market rate (floor). MLF and CBD create the so called "Official Interest Rate Corridor"
- **Legal Requirements:** full mobilizing, unique coefficient (2% of bank liabilities with maturity < 2 years), remunerated at market rate; calendar establishing the maintenance period
- **OMO** usually vis a vis about 500 counterparts, but potentially 1700, fully but widely collateralised:
  - **Main refinancing operations**, weekly conducted through standard auctions repos of 7-day length, at competitive bid price above a minimum rate
  - **Mid term refinancing operations**, monthly conducted through standard auctions of 3 - month length, at competitive bid price above a minimum rate
  - **Fine tuning and structural operations** of liquidity provision or reduction, conducted either via auctions or over the counter, on either a temporary (repos-reverse repos) or a permanent basis (outright OMO)

FED introduced New Instruments for liquidity provision and financial stability after the crisis

- **TAF** (Term Auction Facilities) for all deposit institutions, introduced in Dec.2007 as a temporary tool during the supbrime crisis, combining features of OMO and DL: wider collateral accepted at bid prices in (anonymous) exchange of cash.
- **TSLF** (Term Securities Lending Facilities), for primary dealers introduced in March 2008, temporary (28 days) swaps of Fed holdings of Tbills with troubled assets
- **PDCF** (Primary Dealers Credit Facility), introduced in March 2008 after the loan exceptionally provided to Bear Sterns, extends overnight (widely) collateralized loans at the discount rate to primary dealers.

  (Notice that, though primary dealers are subject to capital requirements they are less regulated than ordinary members of the Federal Reserve System).

ECB only extended program of interventions

- As a matter of fact, Fed instruments were not adequate (but nobody noticed that in the previous 15 years of celebration of “The Science of Monetary Policy” and its “careful” application , inducing by teh Fed).
- These new “temporary” tools are probably going to survive.
- What will be the consequences of the December move to zero interest rate?
- Strongly negative real rates (inflation is 3%) will penalize once more savers and boost consumption. US trade deficits will be made worse by fiscal deficits (at costless debt). Higher taxes will have to be raised in the future.
- While fiscal and monetary expansions will lead to recovery (and are generally welcome in the world for this purpose), such policies will confirm the model that led to the crisis, inducing moral hazard, new financial risks, a weak dollar and incresing external imbalances

The need for further Policy Cooperation

- Monetary Policy decisions have been efficiently coordinated (although not fully harmonized given different mandates in the EMU and the US).
- Foreign Policy needs more coordination and activity
- Fiscal efforts decisive and require careful thinking and exit strategies (not seen at the moment)
- A new architecture for international financial stability?
- New models for domestic (and cross border) financial market regulation and supervision? Federal systems organized for regulatory objectives seem appealing….
- …..Di Giorgio and Di Noia (2009) for possible solutions on the 2 sides of the Atlantic.