RBA ECONOMICS COMPETITION 2009

Policy Responses to the Global Financial Crisis

First Prize

MADELINE EHLER

The University of Queensland

Since the emergence of the global financial crisis in mid 2007, governments and central banks worldwide have responded to the financial dislocation and economic weakness by taking unprecedented steps in conducting monetary and fiscal policy. It is important at this point, to evaluate the effectiveness of these policy responses and consider both their short and long term implications. This paper argues that the policies chosen are appropriate given the nature of the crisis and the highly uncertain environment. Firstly, the underlying causes and characteristics of the crisis, which are a significant determinant of the chosen policy responses, are considered. Conventional monetary policy, unconventional monetary policy and fiscal policy are then examined. Finally, future issues regarding policy decisions are briefly discussed.

Causes and Characteristics of the Global Financial Crisis

The trigger of the global financial crisis was the deteriorating housing market in the United States and the sharp rise in delinquencies on subprime mortgages. There were global ‘spillover effects’ as banks around the world became more reluctant to lend to each other as a result of a sharp increase in the perceived risk of counterparty default and a constant lack of transparency (Papademos, 2009). As banks began to tighten lending standards, credit became more expensive and world economic activity weakened, resulting in an ‘adverse feedback loop’. This involved the tightening of financial conditions causing restrained aggregate demand, which in turn resulted in credit losses and tighter financial conditions, contributing further to economic weakness (Kohn, 2009a). A number of major financial institutions failed, further undermining confidence.

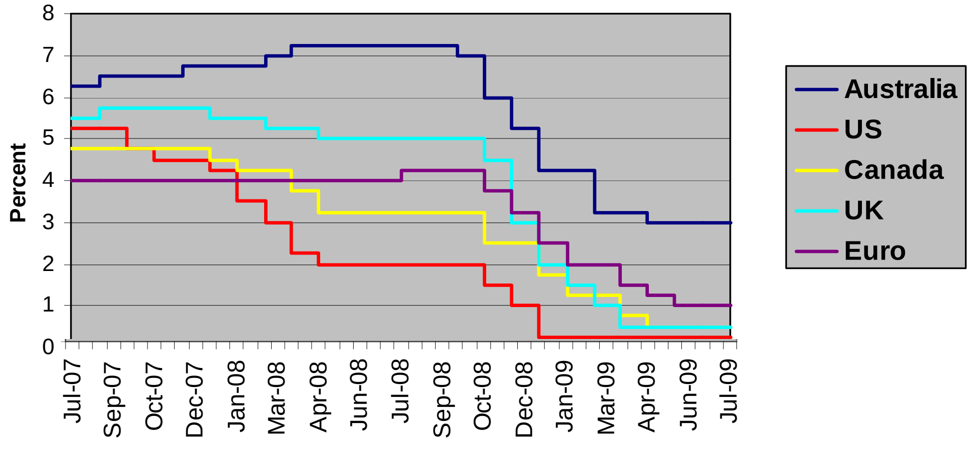
Over the past two years, the global economy has suffered severe financial market turbulence, disrupting the intermediation process and having adverse consequences for economic activity and price stability (Papademos, 2009). Governments and central banks around the world have specifically chosen most of their policies to directly address the causes of the problems they face, that is, focusing on financial institutions and markets and the flow of credit to households and businesses (Kohn, 2009b).

Implementation of Conventional Monetary Policy

In normal times, when financial markets are fully operational, monetary policy decisions around the world are guided predominately by achieving inflation targets and by concerns regarding short run aggregate demand. Since the onset of the global financial crisis, conventional monetary policy has been implemented in response to the substantial contraction in aggregate demand and the deterioration of the global financial market conditions.

Central banks worldwide undertook conventional monetary action with speed and determination. In the United States, the target federal funds rate was cut rapidly from 525 basis points in September 2007 to 0 - 25 basis points by December 2008. Almost every other country followed the same path, reducing interest rates on average by 330 basis points in developed countries and 300 basis points in emerging economies (Battellino, 2009). Currently Australia is one of only four developed economies with official interest rates above 1 percent. Chart 1 below shows the path of interest rates around the world from July 2007 to July 2009.

Chart 1: Monetary authorities have lowered policy rates aggressively



Sources: RBA, US Federal Reserve, Bank of Canada, Bank of England, ECB.

The full cut in interest rates was not passed on to households and businesses and hence substantial and aggressive monetary easing was required. This was due to the wider credit spreads and to the restrictive lending standards that reduced the banks' willingness and ability to lend. Overall, there was a breakdown of the monetary transmission mechanism and this has resulted in interest rates reaching their lowest levels.

Unconventional Monetary Policy Options

In most countries, interest rates have reached zero or their effective lower bound, around 25 – 50 basis points. However, despite these low interest rates, a number of additional policy tools have been utilized; referred to as 'unconventional' monetary policy tools. They directly target the cost and availability of external finance (Smaghi, 2009). The three types considered here are quantitative easing, credit easing and commitments in future interest rates. The choice of tool has largely depended on institutional characteristics and will have a varying impact on financial systems and economic activity.

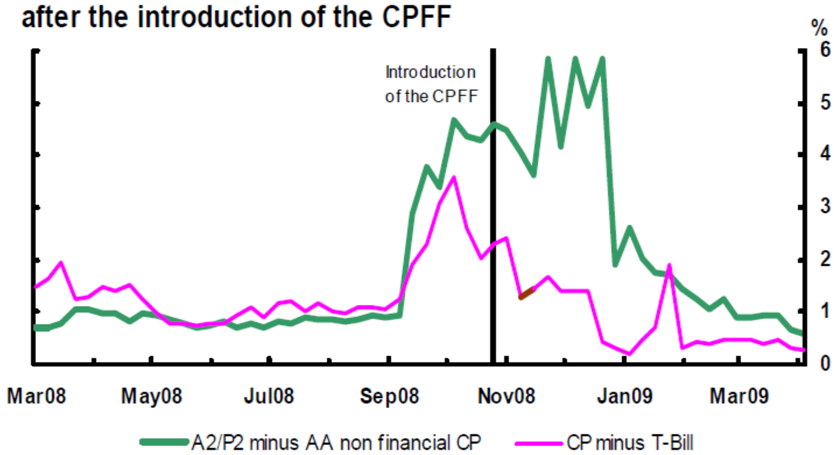
The Bank of England and the European Central Bank have both pursued quantitative easing in 2009. 'Quantitative easing' refers to increasing the size of the central banks' reserves by purchasing securities, traditionally longer-term, in large quantities. This puts upward pressure on their prices and downward pressure on their yield and attempts to stimulate investment in long-term securities. In addition, banks then have access to additional liquidity that can be used to extend new credit (Murray, 2009).

A renowned example of quantitative easing occurred between 2001 and 2006 in Japan. Evidence indicates the increase in money base did little to stimulate bank lending or broader money aggregates, however it did succeed in lowering long term interest rates, flattening the yield curve (Battellino, 2009). The Bank of Japan has concluded that overall there was only a partial impact on aggregate demand and prices (Battellino, 2009). As circumstances differ greatly between countries and over time, there is a limit to which this case is relevant today. During the height of the crisis, when credit markets were at their tightest, quantitative easing has been an appropriate form of policy as it seeks to influence the supply of credit, rather than the demand for credit as in traditional monetary policy.

The next form of unconventional monetary policy resembles quantitative easing in that it usually involves an expansion of the central bank's balance sheet (if unsterilized); however the focus is not on the quantity of reserves but rather the composition of loans and securities on the asset side (Smaghi, 2009). The 'credit easing' approach focuses on easing credit conditions by stimulating more active trade in certain assets and through a process of portfolio substitution (Murray, 2009). The resultant improvement in credit conditions and reduction in credit spreads has a stimulatory effect on aggregate demand.

This policy has been adopted by the United States since December 2007. The Fed established several lending programs essentially to provide liquidity and improve the credit markets. The Term Auction Facility helps to ensure financial institutions have access to short-term credit (Smaghi, 2009). Also, the Commercial Paper Funding Facility (CPFF) has allowed financial and non-financial firms to place their commercial paper, where strains in the credit market had threatened their ability to do so (Kohn, 2009b). Evidence from the US thus far, indicates these initiatives have been effective in reducing interest rates (Chart 2), improving the functioning in the credit markets, providing liquidity and preventing further downward pressure on asset prices (Kohn, 2009b).

Chart 2: : Commercial Paper Spreads in the U.S. before and after the introduction of the CPFF

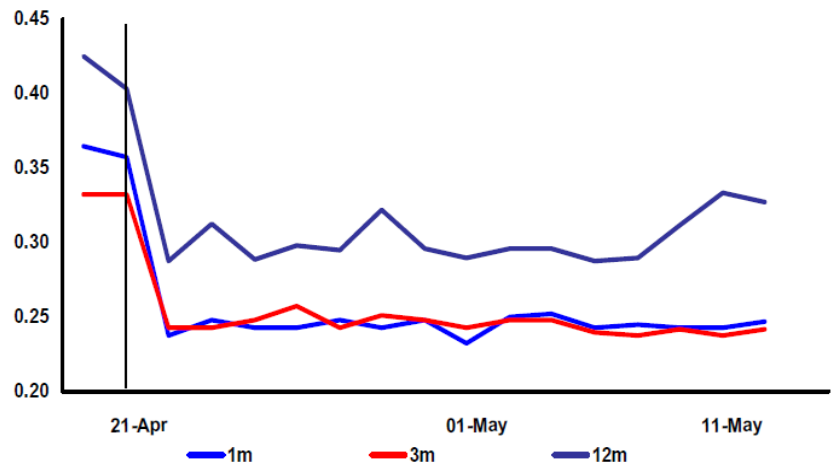


(Kohn, 2009b)

In exceptional circumstances, such as those recently faced, central banks can choose to commit to keeping target overnight interest rates low for an extended period (Murray, 2009). This commitment works by lowering forward interest rate expectations, resulting in lower longer term yields and hence stimulating investment. The success of this policy depends greatly on the credibility of the central bank. The more credible the central bank, the greater the chance of this policy being effective. It is also important that inflation expectations are well anchored (Murray, 2009).

Canada has not engaged in quantitative or credit easing, but in April 2009 the Bank of Canada committed to keep the target overnight rate at 25 basis points until the end of the second quarter of 2010, conditional on the inflation outlook. The result of this policy was deemed by the bank as being significant and lasting, in the form of a 10-20 basis point decline in the implied yields on government bonds out to one year **(Chart 3)** (Murray, 2009). Other countries that have utilized this tool include the United States, United Kingdom, New Zealand and Sweden (Battellino, 2009).

Chart 3: **OIS Yields in Canada before and after the 21 April announcement**



(Murray, 2009)

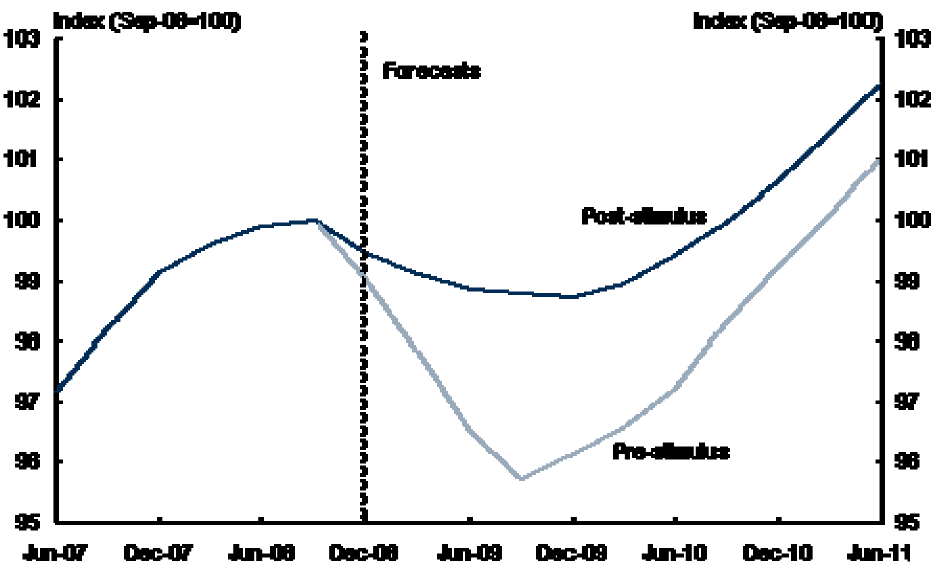
Fiscal Policy Responses

Global fiscal stimulus combined with accommodative monetary policy can have significant multiplier effects on the world economy. The International Monetary Fund has called for fiscal stimulus in as many countries as possible as it works to stimulate spending and economic activity directly, effectively bypassing the financial sector in its first-round effects (Freedman, 2009). Each type of fiscal policy will have a varying impact on economic activity and fiscal balances, whether it is in the form of tax cuts, industry specific support, direct investment, cash handouts or more recently, credit guaranteeing.

Around the world, many countries have cut taxes to strengthen household income, promote investment and increase aggregate demand. In the United States, businesses were given an incentive to expand and create new jobs, with an additional 50% tax deduction on investment costs in 2008 (Godfrey, 2008). In addition, financial support has been channeled to specific industries, most notably the automobile industry in the United States. It was argued that failure in this industry would have had a systematic adverse effect on the economy and therefore immediate facilities to restore liquidity and stability were required (Auto Industry Financing and Restructuring Act, 2008). The aid aimed to preserve 355,000 jobs in the industry and up to 4.5 million in related industries (Auto Industry Financing and Restructuring Act, 2008).

In Australia, the government has delivered a series of stimulus packages. The most recent $42 billion Nation Building Plan focused largely on direct investment in infrastructure. Although having a smaller impact in the short term, infrastructure investment is expected to provide a larger boost in output once implemented and improve the productive capacity of the economy in the longer term (Australian Government, 2009). These packages also comprised incentives to support housing construction and cash bonuses to individuals, which aim to support consumption in the short term (Sherry, 2009). However, a weakness of this stimulus is that there is very limited impact on the economy if the handouts are saved and not spent. The government has maintained that this stimulus has been appropriate; timely, targeted and temporary. There are early signs of a positive impact on economic activity, in particular building approvals, retail trade and consumer confidence. **Chart 4** shows the Treasury's forecast of GDP to June 2011 with and without fiscal stimulus. In the absence of policy action, the forecast unemployment rate would have reached 10 per cent. (Australian Government, 2009).

Chart 4: Effect of fiscal stimulus on Australia's GDP



(Australian Government, 2009)

Internationally, governments have supported confidence in financial markets through credit guaranteeing. In October 2008, the Australian government guaranteed the deposits and wholesale funds of Australian deposit-taking institutions. This was in response to developments in international wholesale funding markets that was restricting banks' access to funding (Australian Government, 2008). The credit guarantee schemes work to provide sufficient liquidity in the short term, ensure financial institutions have access to funds necessary to maintain lending in the medium term and promote robust markets over the long term (UK Debt Management Office, 2008).

A downside of fiscal stimulus measures is that in the short term, countries will experience deterioration in their budget balance. Governments tend to emphasise that the temporary nature of these measures enables the budget balance to improve over the medium term as the support to aggregate demand is withdrawn. However, there has been increasing concern regarding the potential lack of fiscal discipline of some countries, which will be discussed below. Overall, fiscal stimulus has been an appropriate measure to strengthen aggregate demand and ensure the stability of the financial system.

Future Challenges in Policy Responses

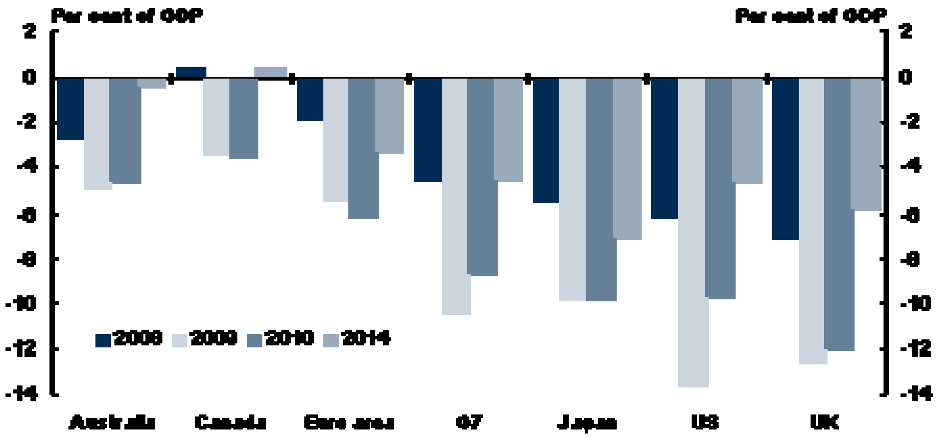
Over the past two years, numerous weaknesses in the financial system and key inadequacies in the regulatory framework have been exposed. In the future, one of the most important priorities at a global level will be the strengthening and broadening of the regulatory framework, as well as conducting macro-prudential supervision (Papademos, 2009). Also, as our world becomes increasingly interconnected, it becomes essential for nations to cooperate as one in their regulatory, financial and economic policies.

In implementing the policies mentioned above, it is imperative to adopt an appropriate exit strategy for the long term. For monetary policy, the first objective is to ensure price stability and firmly anchored inflation expectations. The second objective is to reduce the reliance on temporary support mechanisms in the financial sector and allow for normal functioning of markets (Papademos, 2009). The timing of implementation of these strategies will depend on the pace of recovery and the return to normality in financial markets.

Around the world, there are rising concerns about fiscal sustainability. In the United Kingdom, according to OECD projections, the gross government debt-to-GDP ratio could reach 90% in 2010. The government deficit is expected to be 14% of GDP next year and in the OECD as a whole, 9% of GDP (Blundell-Wignall, 2009). In Australia, the government deficit is one of the lowest, at 4.9%

of GDP (See Chart 5) and a well-formulated exit strategy should see the return to a budget surplus in the medium term (Sherry, 2009). Elsewhere around the world, it is essential that plans be made for rebuilding fiscal balances and ensuring sustainable debt paths in the long term (IMF, 2009).

Chart 5: Budget balance positions for selected countries



(Australian Government, 2009)

In conclusion, the policy responses of central banks around the world to the global financial crisis have been labeled as 'extraordinary'. Central banks have undertaken aggressive cuts to policy interest rates, most taking conventional monetary policy to its limit. They have then had to extend their reach and adopt appropriate unconventional monetary policies. In addition, governments have stimulated economic activity through fiscal policy. The responses have been appropriate given the nature of the crisis. However, consideration must be given to the future challenges of these policy responses including appropriate exit strategies and fiscal rebalancing. A sustained recovery will also require continued stabilization of the global financial system.

Reference List

Australian Government, 2008, "Guarantee Scheme for Large Deposits and Wholesale funding", viewed 4 August 2009.
http://www.guaranteescheme.gov.au/

Australian Government, 2009, "Budget 2009-10", viewed 5 August 2009.
http://www.aph.gov.au/Budget/2009-10/content/bp1/html/bp1_bst4-03.htm

"Auto Industry Finance and Restructuring Act of 2008 (HR 7321)", passed by the U.S. House of Representatives on December 10, 2008.

Battellino, R., 2009 "Global Monetary Developments", Address to *2009 Securities & Derivatives Industry Association Conference* 28 May, Sydney.

Blundell-Wignall et al., 2009, "Dealing with Financial Crisis and thinking about the Exit Strategy", *OECD Financial Market Trends,* Vol 2009/1.

Freedman et al ., 2009, "The Case for Global Fiscal Stimulus", IMF Staff Position Note SPN/09/03.

Godfrey, M,. 2008, "US Fiscal Stimulus Package Agreed", Tax-News.com, 28 January, Washington.

International Monetary Fund (IMF), 2009, "Contractionary Forces Receding But Weak Recovery Ahead" *World Economic Outlook* (July).

Kohn, D., 2009, "Monetary Policy in the Financial Crisis", Speech at the *Conference in Honor of Dewey Daane* 18 April, Tennessee.

Kohn, D., 2009, "Policies to bring us out of the Financial crisis and recession", Speech at the *Forum on Great Decisions in the Economics Crisis* 3 April, Ohio.

Murray, J., 2009, "When the unconventional becomes to conventional- monetary policy in extraordinary times", Speech to *Global Interdependence Center* 19 May, Pennsylvania.

Papademos, L., 2009, "Monetary policy and the 'Great Crisis': Lessons and Challenges", Speech at the *37th Economics Conference* 14 May, Vienna.

Sherry, N,. 2009, "The Road to Recovery - Australia, the global financial crisis and the international path to economic recovery", Address to *The Australian American Leadership Conversation* 13 July, New York.

Smaghi, L., 2009, "Conventional and Unconventional Monetary Policy", Speech at *International Center for Monetary and Banking Studies* 28 April, Geneva.

UK Debt Management Office (DMO), 2008, "2008 Credit Guarantee Scheme", viewed 4 August 2009.
http://www.dmo.gov.uk/index.aspx?page=CGS/CGSIntro