

Monetary policy on both sides of the Atlantic: Current approaches and policy issues

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Three market dis-functionalities and one cause behind the crisis

- ① *Originate-to-distribute model of banking*: banks raised funds through ABS and CDO (repackaging loans)
 - ② *Credit derivative swaps market*: insurance reduced incentives to monitor and created network externalities
⇒ *Credit risk transfer allows for better risk diversification at bank level, but... it worsens systemic risks if the underlying assets are correlated*
 - ③ *Marking-to-market*: implemented after the Asian crisis to overcome problem with historical cost accounting (zombie assets); can amplify bubbles
- One cause: house price bubble burst

Monetary policy strategy

- Long standing discussion: should monetary policy follow strict inflation targeting or should it target asset prices?
- Informative role of M aggregates: ABS and CDO are off-balance sheet items, not entering any M definition (hence a risk of excess liquidity)
- ECB does it (a little) better: the monetary pillar

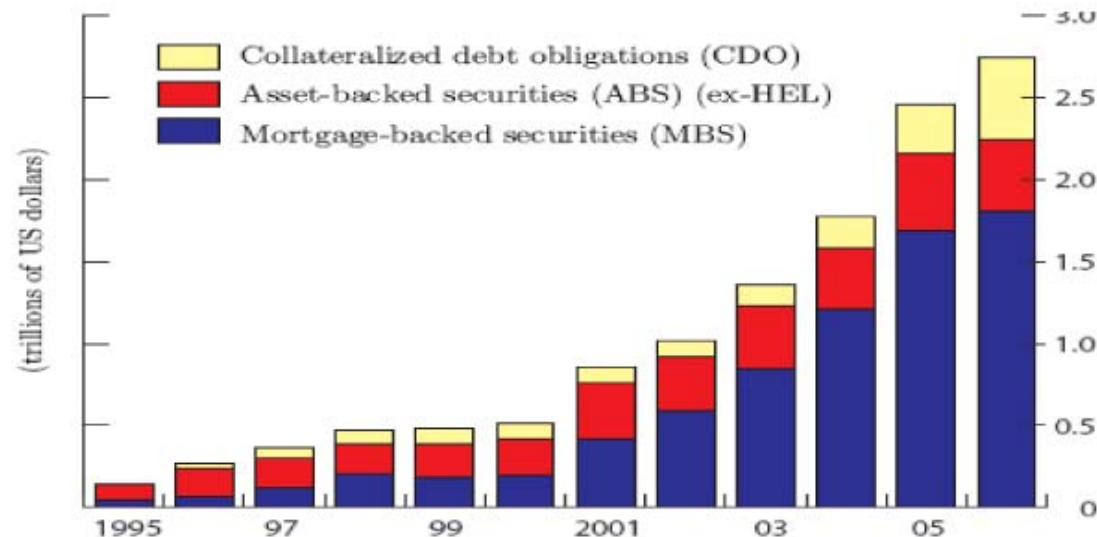


Figure 1: Securitization of bank credit risk. Source: IMF

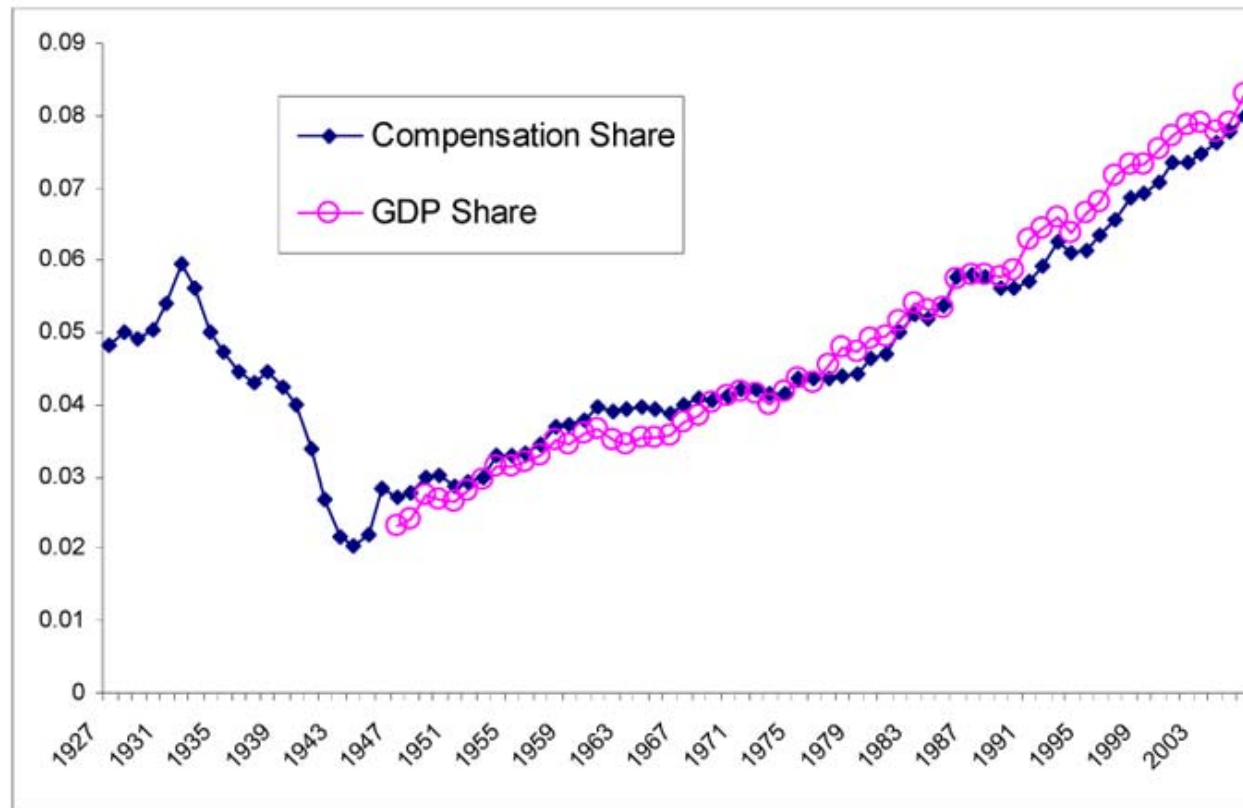
Bank and financial regulation

- Three recent proposals (more from FSF and G20 press releases):
 - ① Credit risk transfer increased risk in the economy: Clearing House as in the derivative market would reduce bankruptcy
 - ② CDS market created network externalities: CoVaR can replace VaR (Adrian, Brunnermeier 2008)
 - ③ Low and inefficient capitalization: a flexible state contingent capital requirement (Kashyap, Rajan, Stein 2008)
- Promising, but regulation cannot be the only cure. Can be circumvented. Monetary policy is effective across the board

New dimensions of moral hazard based on network externalities

- Policy responses so far:
 - ① Short term lending: TAF from the Fed, new collateral policies from ECB and BoE
 - ② Fiscal policy: bail out
- Those policies fuel expectations that policy will always intervene (*let´s all fail or be bailed out together, like the auto CEOs!*)

Figure 1: Income Shares of U.S. Financial Sector



Compensation share is compensation of employees in finance & insurance divided by compensation of all US employees. GDP share is value added in finance and insurance over GDP. Source: Author's calculations, Bureau of Economic Analysis, U.S. National Income and Product Accounts, and Annual Industry Accounts.

Conclusions

- Informational requirements for central bankers: new data, new models
- Combine regulations and monetary policy; only one is not enough
- We are creating new and complex forms of system wide moral hazard
- The financial sector needs to shrink