New tools for central bankers?

The financial crisis has provided an opportunity to test the usefulness of new and previously unused policy instruments, argues Christopher Ragan.

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When financial markets are functioning "normally", monetary policy is essentially about deciding on the appropriate level of the policy interest rate and conducting fairly standard market operations to enforce that rate. Whether this is done in the context of an inflation-targeting regime or some other informal framework, central bankers and academics have a generally accepted view of the transmission mechanism for monetary policy: central banks change the policy rate, which leads to changes in a number of other key interest rates, which in turn leads (through various linkages) to changes in aggregate demand, the size of the output gap, and ultimately on the rate of inflation. In such a "normal" world, an appropriate metaphor for monetary policy is that it determines the rate at which water flows through a set of pipes.

Calling in the plumber

But what happens when, as we have seen in the past year, the monetary pipes become severely plugged and the flow of credit is dramatically reduced? As has been made patently clear to policymakers in recent months, when credit is not flowing in its normal manner, lowering the target for the policy interest rate may not actually achieve anything. Before the start of the global crisis in August 2007, central bankers and monetary theorists spent little time thinking about which tools they have at their disposal to address serious plumbing problems; they simply assumed that the pipes were clear.

This assumption failed dramatically over the last year, and we have therefore witnessed the rise of a new kind of monetary policy, the purpose of which is to

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unblock the monetary pipes. Under this new kind of monetary policy, central banks have gone well beyond their usual commitment to providing liquidity in order to enforce the announced target for the policy rate.

To begin with, policymakers have spent a lot more time talking to the markets about the provision of liquidity, letting them know that borrowing from the central bank is a real option.

More fundamentally, we have also seen all of the leading central banks change their definitions of what constitutes acceptable collateral. We have seen them change the terms under which they accept collateral in exchange for loans. And, more recently, we have seen the U.S. Federal Reserve announce that it will buy corporate paper directly and will also pay interest on depository institutions' required and excess reserve balances. All of these efforts are intended to increase the flow of credit – to clear the monetary pipes – for an unchanged target for the policy interest rate.

Reconsidering conventional wisdom

The range of policies employed over the past year by central banks clearly challenges the traditional view of the monetary policy process. It also calls for at least a partial reconsideration of the conventional wisdom regarding central banks' policy instruments.

After all, these changes were usually made independently of changes in the target for policy interest rates. So what is going on? Our textbooks usually describe a world in which central banks have a single policy instrument – the target for the policy interest rate.

The policy response of leading central banks since the outbreak of the credit crisis makes it clear that there are, in fact, a number of things a central bank can do – and indeed should do – that are independent of changes in the target for the policy rate. It is clearly an oversimplification to stick to the old mantra that central banks have only one policy instrument.

Of course, this new kind of "pipe clearing" monetary policy should be seen as a temporary measure, only to be used when "normal" monetary policy is rendered ineffective by the clogged financial system. But over the last year or so, central bankers and monetary economists have learned important lessons: firstly, about the need to clear the pipes during unusual times; and secondly, about how to actually do it.

As we see gradual declines in the spreads between various market-determined overnight rates and the official policy target in a number of countries, it is clear that central banks have become more effective at implementing this new kind of monetary policy. Of course, policymakers around the world are nervously watching to see if these positive developments persist and become more than just tentative signs that the monetary pipes are once again becoming unclogged and that we are returning again to a world in which "normal" monetary policy is the order of the day.

Rewriting the textbooks

Beyond these immediate challenges, its seems clear that our collective understanding of the tools available to central bankers – even in the relatively specialised activity of implementing monetary policy decisions – has been extended by the broad array of initiatives we have seen since August 2007.

Monetary theory will have to incorporate these new observations and use them to revisit the standard description of the central banker's toolkit. The future editions of the standard textbooks on monetary and macro economics are certain to include a few additional pages. ❑