Monetary Policy in Unconventional Times: a banking perspective

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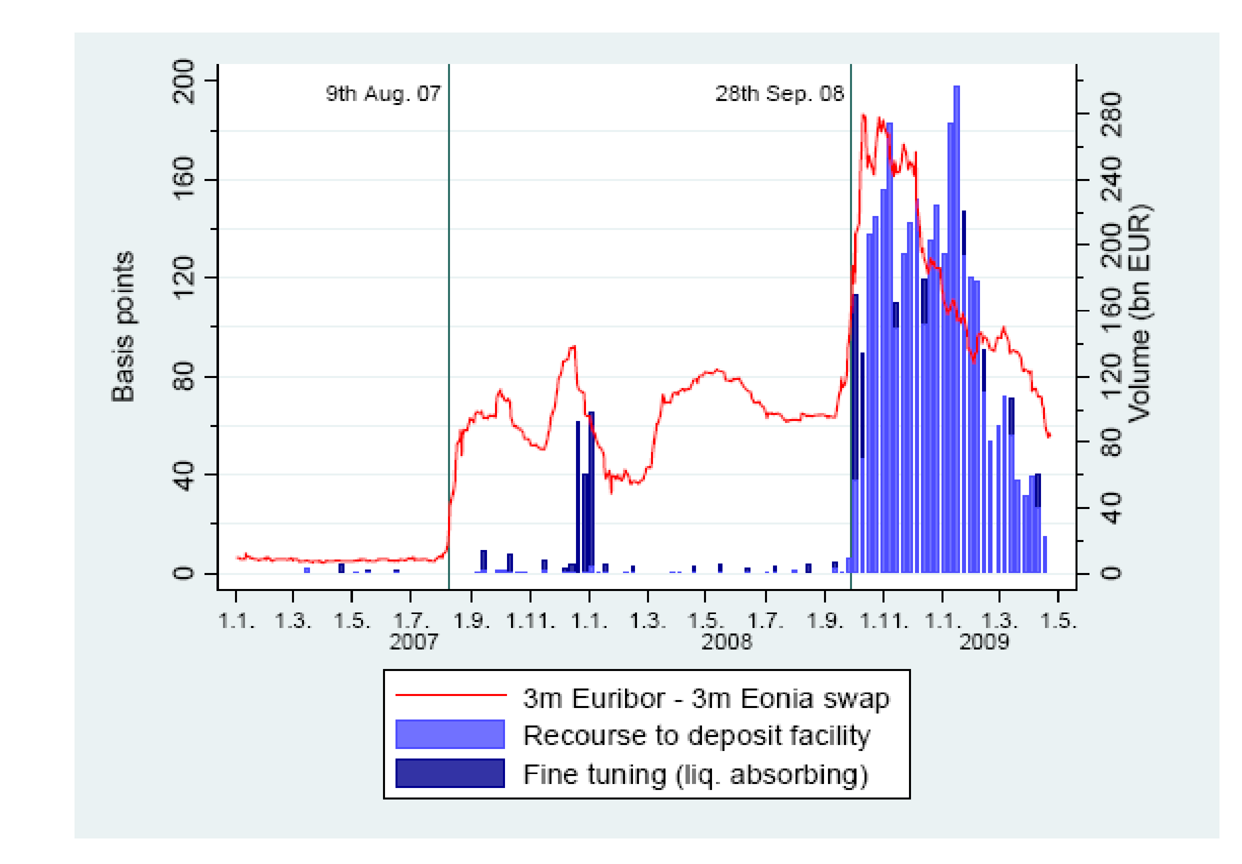
Conventional Wisdom

- Prior to the crisis consensus was:
  - Monetary should focus on inflation. Prudential policy should focus on financial stability
  - Central banks should not take credit risk
  - Safety net to cover banks should not be extended to non-banks
  - Bubbles should not/could not be taken into account in monetary policy

The crisis

- Contagion occurs through liquidity freeze in wholesale markets and asset fire sales
- IMPLICATION: Central Banks have to reinvent their role

Hoarding (Heider, Hoerova and Holthausen)



The crisis as a discontinuity

- A banking/financial crisis is not a downturn in the business cycle

  Differences: inside money implosion, amplification and feedbacks effects, non-linearities, general equilibrium, shadow banking consolidation
- Implication: standard monetary policy models calibrated on business cycles are to be rejected
- Implication: think outside the box.

The lender of last resort

- The XIXth century view: lend to solvent illiquid institutions against good collateral at a penalty rate
- During the crisis: lend to any institution against bad collateral at a low rate
- When the interbank market is missing the frontier between monetary policy and lender of last resort is blurred

ECB vs. FED

- Mechanisms to replace the interbank market
- ECB: unique port of entry; repo only
- FED multiple channels to inject liquidity

Brunnermeier and Sannikov I Theory of Money

- Full equilibrium dynamics
- Endogenous risk
- Acknowledges the importance of inside money and its possible decrease
- In a downturn outside money increase and interest rates decrease can mitigate this effects

The future

- Macroprudential policy
  – Reduce the probability of a crisis
- Microprudential systemic risk policy
  – Prepare crisis management by implementing stress tests,…