

The monetary policy landscape in a financial crisis

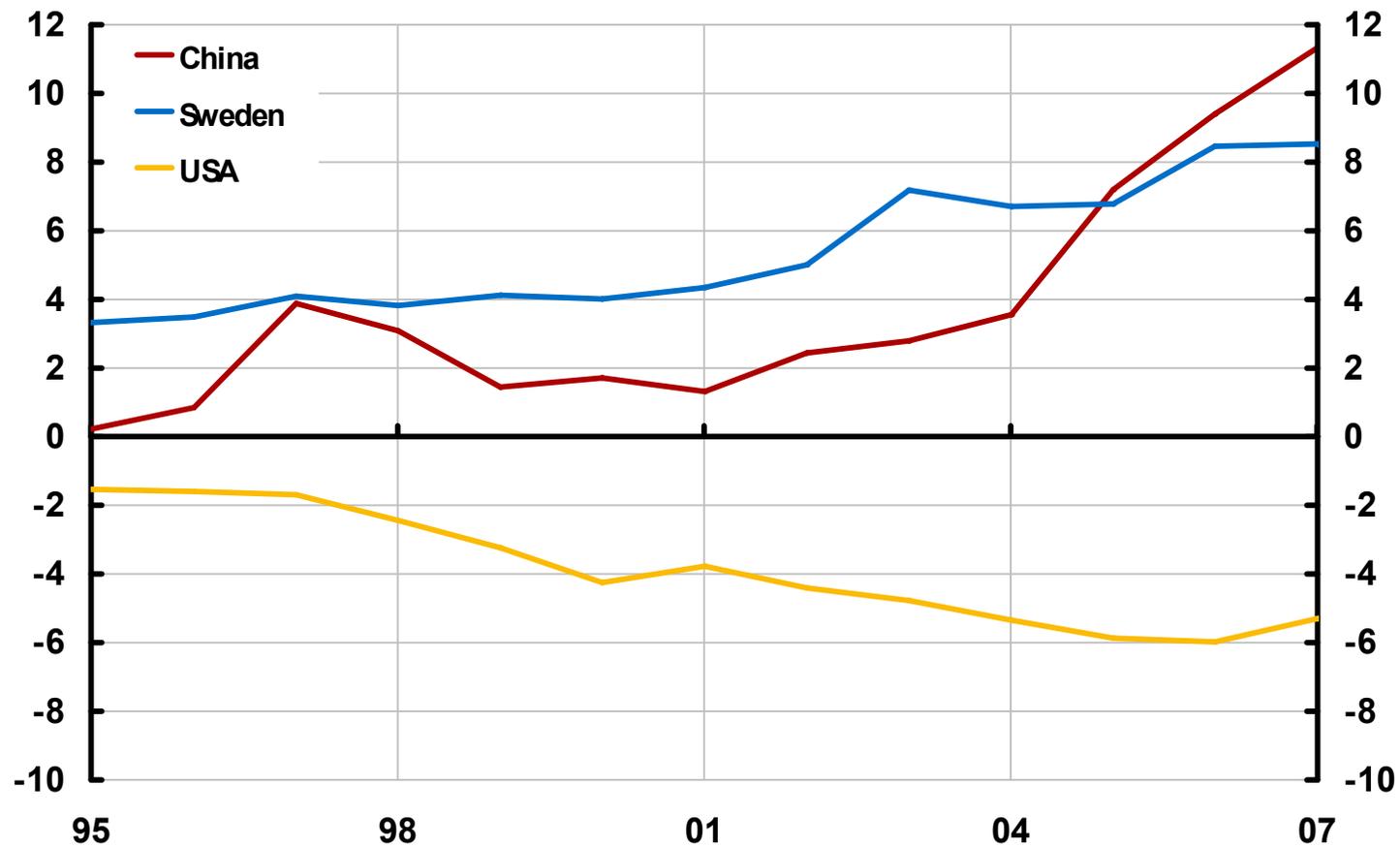
- The *macroeconomic* landscape
- The *financial* landscape
- *Regulatory* landscape

Background to the crisis: The *macroeconomic* landscape

- Global imbalances built up over a longer period of time
 - Large current account surplus in the east
 - Large current account deficit in the west
- Large capital flows and expansionary monetary policy pushed down interest rates

Current account as share of GDP

Per cent



Background to the crisis: The *financial* landscape

- Low interest rates led to hunt for investment with higher return
 - Increased indebtedness
 - Sharp increase in asset prices
 - Extremely low risk premiums
- Securitisation and many new instruments
- Special companies off the banks' balance sheets
 - Implicit and explicit guarantees led risks back into the banks

Background to the crisis: The *financial* landscape (cont.)

- A complicated structure that was difficult to gain insight into
- Much uncertainty over where risks lay
- Fears caused trade to fade away on many markets
- Many banks experienced difficulty refinancing themselves
- When Lehman Brothers fell Swedish banks were also indirectly drawn into the crisis

Background to the crisis: The *financial* landscape (cont.)

- Fundamental failures in risk management
 - The banks' incentives to monitor credit risks partly disappeared
 - The credit rating agencies' models were inadequate and credit ratings were used wrongly.
 - Correlations were underestimated
 - Liquidity risks were underestimated
 - Risks were priced incorrectly
- Fundamental flaws in corporate governance

Background to the crisis: the *Regulatory landscape*

- Gaps in the regulatory framework enabled regulation arbitrage
 - Investment banks
 - OTC derivatives
 - Banks could expand off balance sheet
- Too little focus on liquidity risks
- Insufficient links between supervision and macro factors and systemic risk factors respectively
- Too strong national focus in financial supervision

Massive and unusual measures by authorities

- Large increase in lending by central banks
 - Longer maturities, different collateral
- Special liquidity assistance to individual institutions
- Agreements on currency loans between countries
- Extended deposit guarantee
- Programme for guarantees and capital injections
- Large policy rate cuts

Monetary policy and financial stability

- The ECB has two main tasks:
Monetary policy and
financial stability

Monetary policy	Financial stability
■ Policy rate	■ "Moral suasion"
■ etc.	■ Inject liquidity
	■ etc.

- Normally separate tools are used for these tasks

- During the crisis it has become increasingly clear how closely interwoven the two tasks are.

Monetary policy in a financial crisis

- Interest rates close to zero in many countries
- When the traditional monetary policy tools are no longer effective it is necessary to find new ways
- "Unconventional methods"
 - Different ways of making the financial markets function better
 - Improve the supply of credit

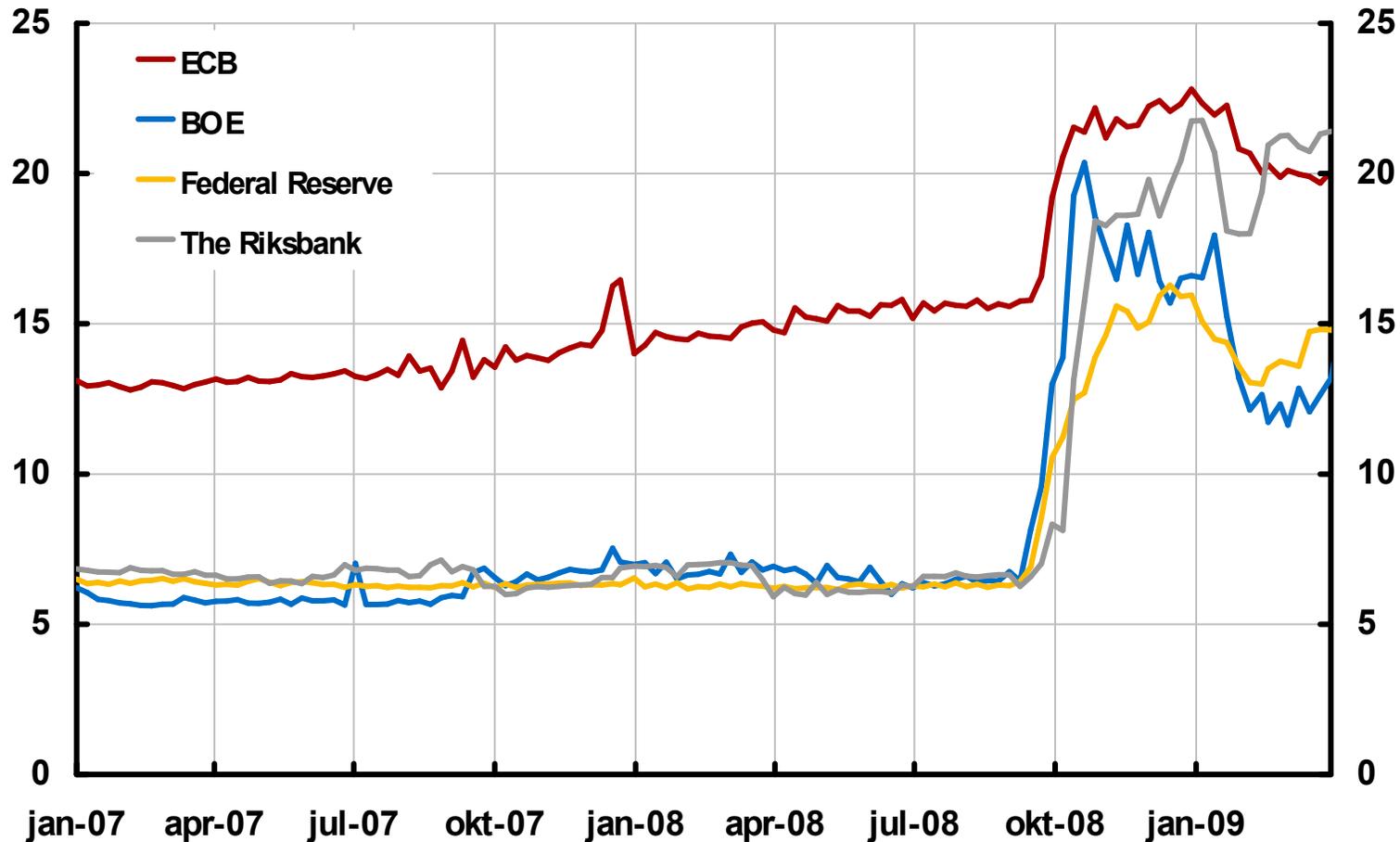
Unconventional monetary policy

A stylised balance sheet for a central bank

Assets	Liabilities
Foreign assets	Banknotes and coins
Domestic assets	Bank deposits
Lending	Equity

Central banks' balance sheets

Percentage of GDP



Sources: Bureau of Economic Analysis, Eurostat, Office for National Statistics, Statistics Sweden and the respective central banks

Monetary policy measures

- The banks' access to means of payment is increasing
- The monetary base (the banks' reserves + banknotes and coins in circulation) is increasing
- The Federal Reserve and the Bank of England have gone a step further than the RB and bought different types of domestic financial assets

Credit easing

Federal Reserve:

- Purchase of certain private financial assets
- Aimed at
 - reducing risk spreads
 - making it easier for companies and households to gain access to credit
- Focus on the asset side of the balance sheet

Quantitative easing

Bank of England:

- Purchase of government securities
- Focus on the liabilities side of the balance sheet
- Instead of *the price*, i.e. the policy rate, the *quantity* of the banks' borrowing, the monetary base, is affected directly

Unconventional measures

- Both Quantitative Easing and Credit Easing are only used under special circumstances
- The situation is new for most central banks
- It may be wise to exercise a good portion of humility with regard to what these measures entail



Other, non-traditional central bank instruments

OBJECTIVE	INSTRUMENT	FORM	EFFECT
Crisis management	Credit tenders	Collateralised loan with longer maturities	Easing credit restrictions
	Currency swaps	FX-swap	Improving foreign currency liquidity
	Securities purchases	Outright asset purchase	Tempering market turmoil
Credit stimulation	Funding for Growth Scheme (FGS)	Preferential (0% interest) refinancing credit	Stimulating credit supply
Supporting self-financing	Central bank IRS tenders	Conditional fixed-for-floating interest rate swap	Stimulating the purchase of domestic securities by credit institutions
	Central bank deposit for liquidity management purposes	Two-week time deposit	Influencing two-week yields/sterilisation
	Three-year collateralised		



Non-traditional instruments used during the global financial crisis (2008-2012)

- Announcement of credit tenders for longer maturities (since 2008)
Objective: stimulating credit supply, tempering strong credit constraints
 - two-week, six-month loan tenders (one-week and three-month at present)
 - two-year loan tender (2012): suspended since April 2013
 - MNB simultaneously extended the scope of eligible collateral (2008)
- FX-swap instruments (since 2008)
Objective: to ease foreign currency liquidity tensions
 - overnight (initially bilateral), three-month FX-swap: the euro liquidity providing instrument is still part of the operational framework
 - one-week Swiss franc liquidity-providing FX-swap (2009), one and two-week euro liquidity-providing instrument (since 2011 on an ad hoc basis)
 - six-month FX-swap instrument: phased out in 2010
- Government bond sale and purchase in the secondary market (autumn 2008);
Objective: treatment of market turbulence
- Mortgage bond purchase programme (2010);
Objective: increasing market liquidity



Funding for Growth Scheme /FGS/ (since 2013)

- It was announced by the MNB in three phases (June 2013 – Sept. 2013 and Oct. 2013 – Dec. 2014, March 2015 – Dec. 2015)
- *Form:* preferential (max. 2.5% interest rate) credit refinanced at 0% refinancing interest rate
 - I. pillar: SME loans (as well as factoring and leasing)
 - II. pillar: converting foreign currency loans into forint (1. and 2. phase), redemption of credit for prefinancing EU subsidies (2. phase)
 - III. pillar: foreign currency swap providing euro liquidity (1. phase, suspended since July 2014)
- *Objective:* easing rigid credit constraints the small and medium sized enterprises (SME) sector of scarce liquidity, strengthening financial stability, as well as reducing the external vulnerability of the country
- Recourse to the facility is bound to conditions: in the I. and II. pillar an amount of SME loan equivalent to the central bank loan drawn down by the credit institution should be disbursed (in the case of the III. pillar the reduction of the short external debt of the credit institution was defined as condition)
- In September 2014 the Monetary Council decided to raise the overall amount available for FGS and to extend the programme by one year
- In March 2015 the Program was supplemented by FGS+



FX spot tenders related to the phasing out of FX loans

- Foreign currency tenders related to early repayment (2011-2012);
Objective: exchange rate protection
- Euro sale tenders (October 2014 – March 2015) and Swiss franc sale tenders related to the settlement and forint conversion of consumer FX loans (August 2015 –).
 - *Form:*
 - Euro sale tenders: conditional instrument: EUR/HUF spot + 1-week EUR/HUF FX-swap; unconditional instrument: foreign currency tenders combined with euro sale transactions
 - Swiss franc sale tenders: CHF/HUF spot + 1-week CHF/HUF FX-swap
 - *Objective:* the treatment and reduction of banks' foreign exchange risk
 - In the case of the conditional instrument: the reduction of short-term (within one year remaining maturity) external debt *as condition*
 - *Expected effects, results:*
 - Foreign currency tenders contribute to a reduction in the foreign exchange exposure of households and of the short-term external debt of domestic banks, therewith the mitigation of the country's external vulnerability
 - The balance sheet total of the MNB can be reduced which might improve the profitability of the central bank



New instruments supporting the self-financing programme – IRS tenders

IRS tender was introduced by the MNB within the framework of the **self-financing conception** in June 2014.

- *Form*: three and five-year forint interest swap transaction – MNB pays floating rate for fixed rate to its counterparties semiannually
- *Objective*: the management and reduction of interest rate risk
- Instrument is bound to conditions: in line with the interest rate swap transactions' volume the participating credit institutions have to increase the adjusted value of their own securities holdings eligible in the transaction
- Securities in the IRS conditions have to satisfy criteria defined for securities eligible as collateral
- *Expected effect, result*: the IRS contributes to the increase in securities holdings of domestic banks, and therewith to the reduction in the external debt of the country