Discussion

"Is there a credit crunch? Possible insights for the conduct of monetary policy"

by Leonardo Gambacorta.

Big Bang Big Crunch Conference

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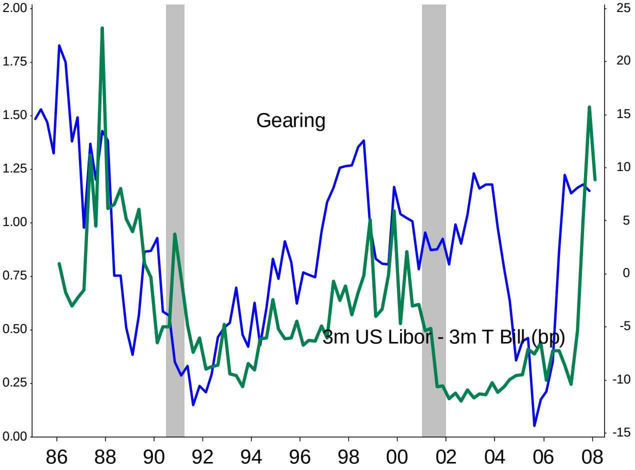
Money and the Conduct of Monetary Policy

- Set of important issues in Gambacorta's presentation
  - spreads widening, lending falling, credit conditions tightening, risk perception rising.
- Prior to crisis monetary policy and regulators failed to pick up asset price debt/spiral so
  - spreads compressed, lending increased, credit conditions eased, risk perception lowered
- DSGE models need to incorporate the banking sector:
  a Range of interest rate spreads
  b Allowing a further propagation mechanism
  c Determined by the interaction between liquidity constrained consumers and a banking sector which makes collateralised loans
- Getting money, spreads and banking in monetary policy models.

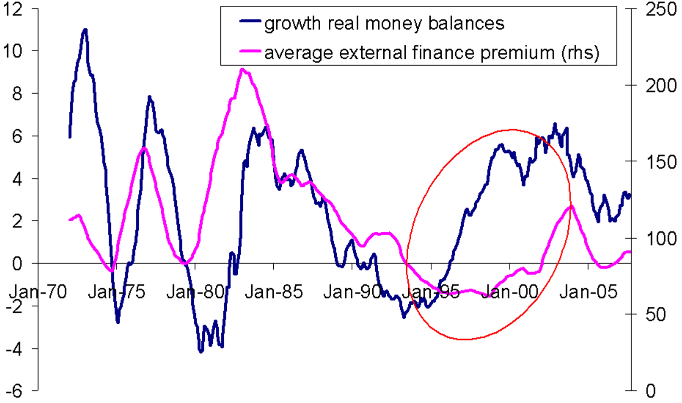
The Bank Gearing: Asset Growth minus Liability Growth and Spreads, US

Source: Chadha and Corrado (2008)



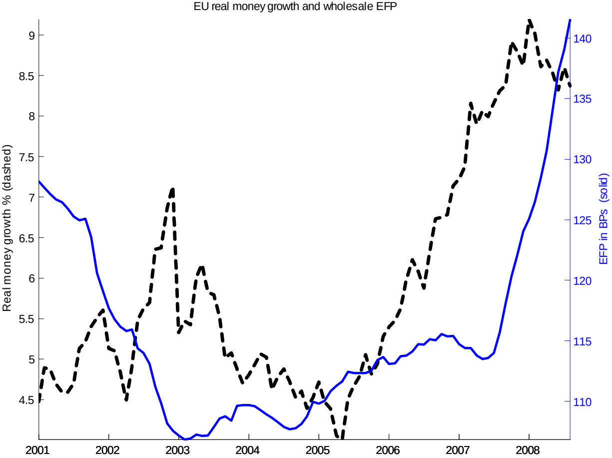
Money and External Finance Premium, US

Source: Chadha and Corrado (2008)



Money and External Finance Premium, Euroland

Source: Chadha and Qi (2008)

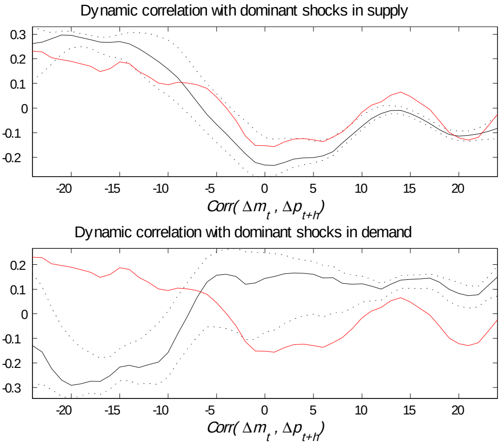


Information for Money

- Role for Monetary Policy and the Monetary Transmission Mechanism:
  - Policy-maker should pay attention to excessive impulses in the economy generated by the banking sector
  - Liquidity affects the supply of broad money generating excess/shortages nominal demand which impacts directly on inflation
  - So money is likely to contain information for future output and inflation because of its impact on financial spreads.
- Important to identify when money supply shocks dominate in order to define a role for money (Chadha, Corrado and Qi 2008)

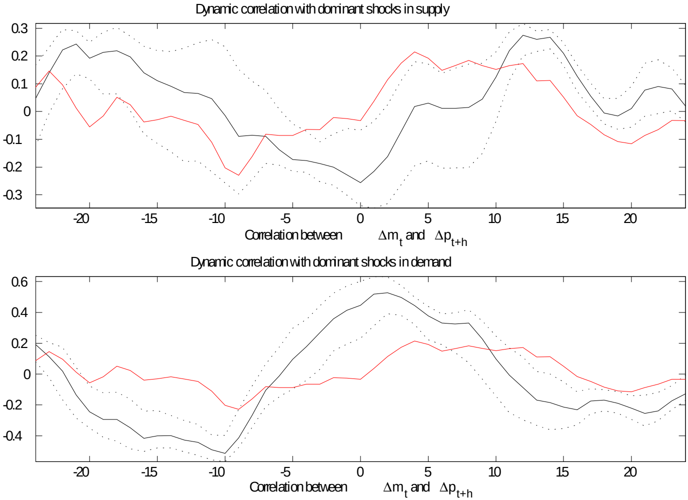
Correlation between Money and Inflation with Dominant Shocks: US

- Supply shocks dominate recent broad money development



Correlation between Money and Inflation with Dominant Shocks. Euroland

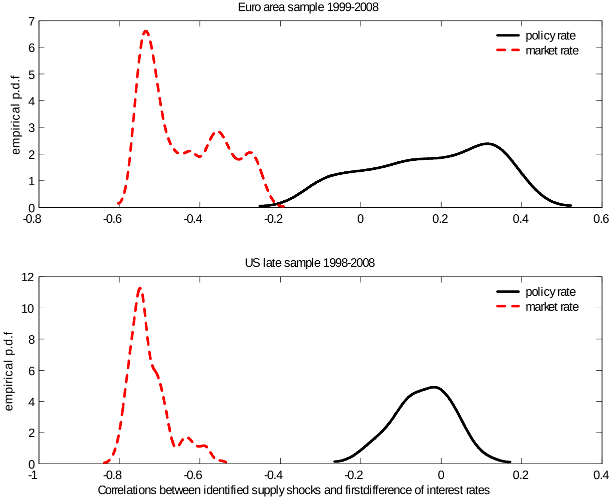
- Less so in Europe where money forms part of the pillar.



Supply Shocks Driven by the Policy Rate or Interbank Rate

Did US policy exarcerbate the lending cycle not responding to supply shocks?

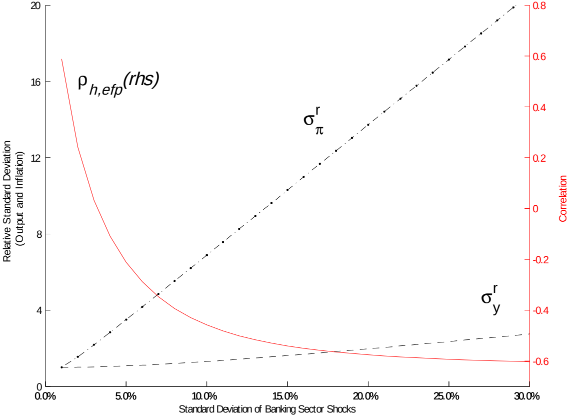
In Euroland policy rates more than offset liquidity creation



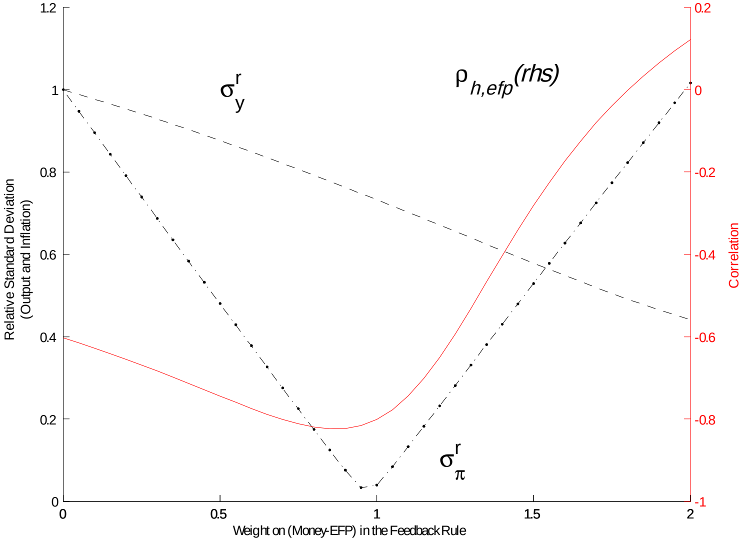
Welfare Effects when Financial Shocks are Dominant

Source: Chadha, Corrado and Holly, 2008

- When the banking sector is the source of the shock not acting will amplify macroeconomic volatility



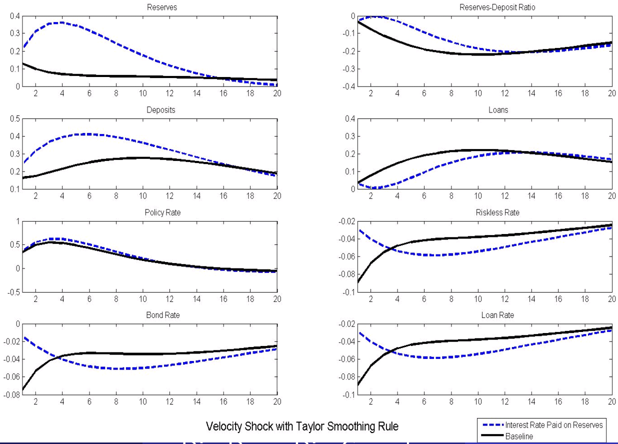
Should Policy React to EFP?



Regulatory Response: Interest-on-Reserve Policy and Velocity Shock

Source: Chadha and Corrado, 2008

- Endogeneous reserves lead to a reduction in the volatility of spreads and loans



Final Remarks

a Financial markets and policy are both responsible.

b Financial conditions matter when setting monetary policy (EU vs US)

c Under some conditions money has good information content for financial conditions and policy may have to respond to supply shocks.

d Providing an incentive for banks to hold reserves will help stabilise this economy.

- Gearing increases risk over the cycle and interest on reserves reduces gearing.

e Further work to be done on price/debt spiral.

Reference Papers

Chadha, Corrado and Qi (2008). Money, *Prices and Liquidity Effects: Separating Demand from Supply*. Cambridge Working Paper in Economics (forth)

Chadha, Corrado and Holly (2008). *Reconnecting Money to Inflation: the Role of the External Finance Premium*, Cambridge Working Paper in Economics CWPE/0852.

Chadha and Corrado (2008). *Widening the Net: The Role of Bank Reserves in Monetary Policy Analysis*. University of Cambridge

Thank You!