Discussion of “Central Banks and the Financial System” by Giavazzi and Giovannini

Philip R. Lane

Trinity College Dublin

Helsinki , June 2010

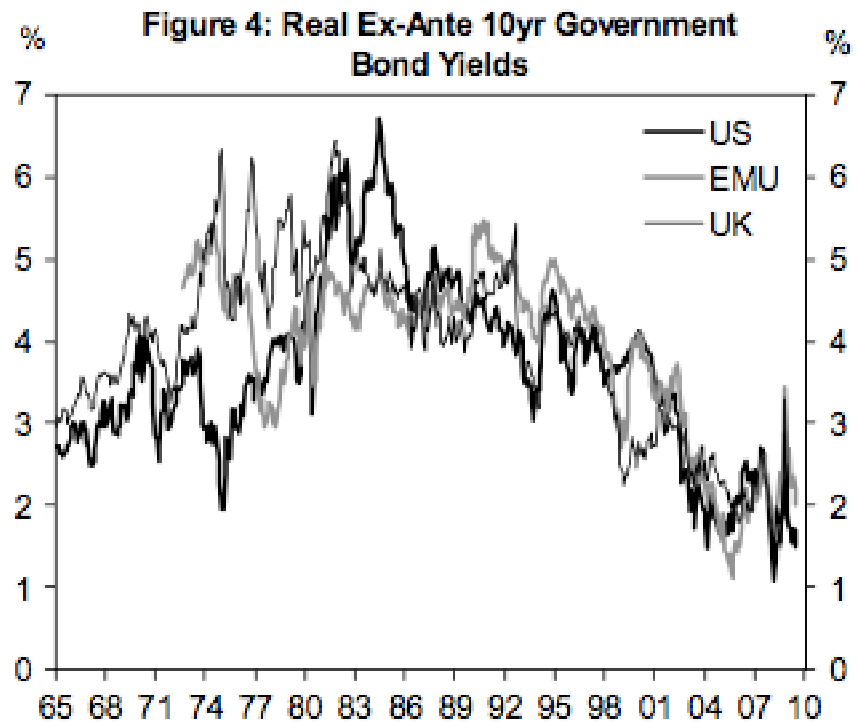
Overview

- Focus on financial stability role of central banks
- Asset Price Bubbles
- Liquidity runs- depositors; securities markets
- Key message: Low interest rates encourage excessive risk taking, excessive borrowing (especially at short maturities) and increase the probability of crises
- Low interest rate trap
- Implication: central banks should maintain a higher interest rate than implied by a traditional Taylor Rule

The Interest Rate Conundrum

- Global decline in long-term real interest rate in last twenty years
- Increase in global equity risk premium (Campbell 2008, Daly 2009)
- Global switch among investors towards ‘safe’ assets
- One response: Manufacture of AAA assets
- Policy challenge: how to set policy rate with trend shift in real interest rates

The Decline in Long-Term Real Interest Rates (Daly 2009)



Notes: Source Author's calculations using national data from index-linked government bond markets and extending the historical series based on the estimated relation with observable variables (see Section 4 for more details).

Higher Policy Rate

- Assenmacher and Gerlach (Economic Policy 2010): significant impact on real activity; limited relationship with asset prices
- To change behaviour, require credible commitment that increases in financial imbalances will be met with increases in policy rates

Higher Policy Rate

- Upward revision to inflation target (IMF)
- More room for activist policy in response to negative shocks
- Less likely to hit zero bound
- [Transition issues]

Higher Policy Rate

- Open economies – currency appreciation and capital inflows
- May exacerbate financial imbalances
- Iceland example

Were Low Policy Rates the Source of Excessive Risk-Taking?

- Financial innovation typically precedes financial crises
- US: sub-prime; securitisation
- Europe: introduction of the euro, expansion in cross-border inter-bank lending
- What level of the policy rate would have counter-acted impact of these innovations?

Financial Reform

- Central counterparties
- Improved management of systemic risk
- Restrictions on the scope of bank activities

Macro-Prudential Risk Management

- Interest rate not the only policy instrument controlled by central banks
- Multiple targets of price stability and financial stability require multiple instruments
- Quantitative limits on lending activity
- Cyclical management of leverage ratios, loan-to-value ratios
- Also: ‘leaning against the wind’ fiscal policy

Conclusions

- Costs of financial crises requires new thinking about the role of central banks
- Main contribution: connection between low interest rates and excessive borrowing and excessive risk-taking
- Low interest rate trap
- Erudite and insightful paper