



**RBA ECONOMICS COMPETITION 2009**

*Policy Responses to the Global Financial Crisis*

**Second Prize**

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A variety of expansionary monetary and fiscal measures have been implemented in response to the worst financial and economic turmoil since the Great Depression. While the financial turmoil is ongoing, strong theoretical arguments and promising initial signs both indicate that these responses were appropriate overall. Nevertheless, the economic crises of the past century demonstrate that the exact nature of the response will matter a great deal because of their impact on short-term stability and long-term viability.

### *Conventional Monetary Policy*

Conventional monetary policies have been pursued in a co-ordinated effort to stimulate growth and stabilise the global financial system with Central Banks cutting their policy interest rates dramatically since September 2007 (Battellino, 2009). For example, the Federal Reserve (0- 0.25%), the Bank of Japan (0.1%), the Bank of England (0.5%) all reduced their policy rate targets to near zero (OECD, 2009).

This somewhat drastic monetary response was appropriate and had sound foundations in macroeconomic theory. The sharp decrease in consumer spending and business confidence that resulted from the financial crisis, reflected by falls in real personal consumption of 3.8% (3<sup>rd</sup> Qtr 2008) and 4.3% (4<sup>th</sup> Qtr 2008) for the United States economy, led to a significant shift to the left of the IS curve in an IS-LM model. The result in the short-run was a substantial decrease in output and if the target interest rate had been maintained, output would have declined further to  $Y''$  as shown in figure 1.

By reducing real interest rates the Central Banks helped stimulate domestic demand through the six channels of the transmission mechanism. In Australia, the Reserve Bank of Australia (RBA) increased liquidity in the overnight cash market through numerous open-market purchases thereby lowering the interest rate through a downwards shift of the LM curve. This helped offset the leftward shift of the IS curve, encouraging the maintenance of output levels at  $Y'''$  in the short-run as indicated in figure 2.

Figure 1:

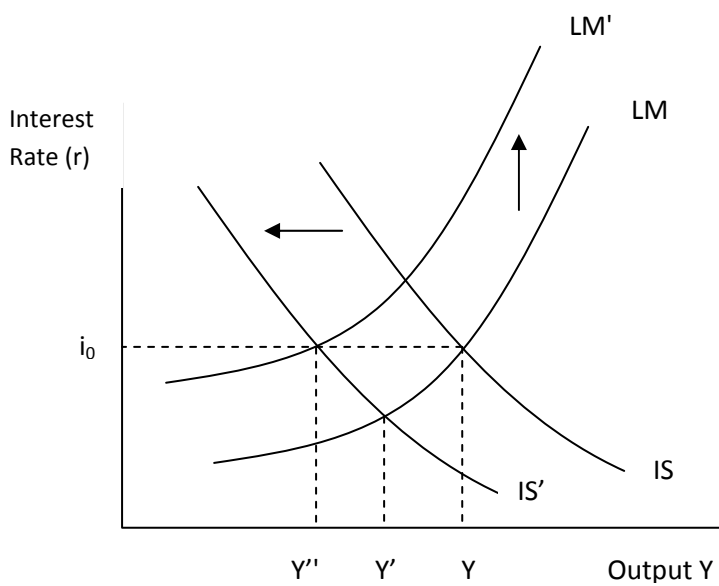
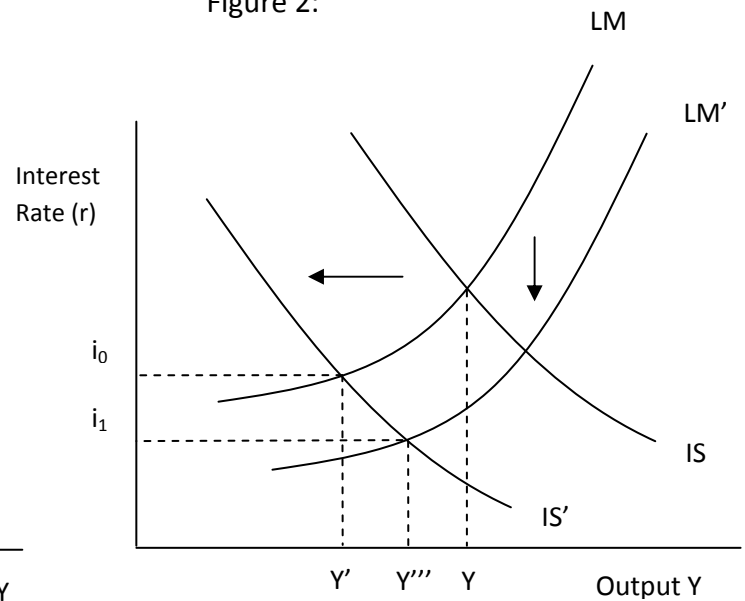


Figure 2:



The expansionary measure was also appropriate because the interest rate cuts countered the upwards pressure on real interest rates from an upwards shift of the LM curve due to increased risk aversion and risk premiums helping maintain investment and output levels. For example, the RBA's 100 basis point cuts in December 2008 and February 2009 were very appropriate due to the reluctance of Australia's domestic banks to reduce interest rates because the breakdown of credit markets caused 'an increase in term premia and credit and liquidity spreads' (Davies et al., 2009).

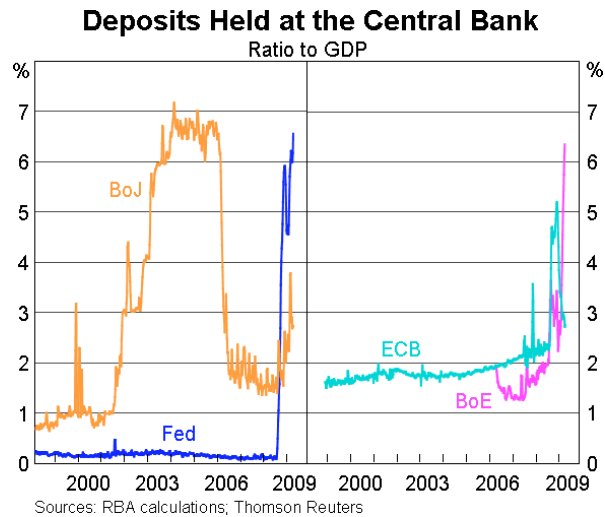
### *Non-conventional Monetary Policy*

Concerns about the integrity and stability of the global financial system have led a number of Central banks to implement adopt non-conventional monetary policies collectively known as quantitative easing. The justification was that in order for the global economy and domestic economies to function effectively, a stable financial system is required (Treasury, 2009b). Three types of actions have been implemented namely, measures to increase bank reserve balances, measures to reduce the term structure of interest rates and credit easing measures (Battellino, 2009).

Measures to increase bank reserve balances have been undertaken by the Bank of Japan (BOJ), Bank of England (BOE) and the European Central Bank (ECB) and the Federal Reserve through expanding their balance sheets by providing liquidity to financial institutions under severe stress (Battellino, 2009) as shown in Figure 3. For example, the Federal Reserve

extended liquidity directly to credit markets by establishing the Term Auction, Term Securities Lending and the Primary Dealer Credit facilities (Bernanke, 2009).

Figure 3:



Source: Battelino, R – Global Monetary Developments

[http://www.rba.gov.au/Speeches/2009/sp\\_dg\\_280509.html](http://www.rba.gov.au/Speeches/2009/sp_dg_280509.html)

Two other non-conventional policies have also been pursued namely providing liquidity directly to borrowers in key non-functioning credit markets and purchasing mortgage-backed securities to free up credit flows by improving financial institution's balance sheets. For example, the Federal Reserve established the Commercial Paper Funding Facility, and purchased \$100 billion in government sponsored enterprise (GSE) debt and \$500 billion in GSE mortgage-backed debt (Bernanke, 2009).

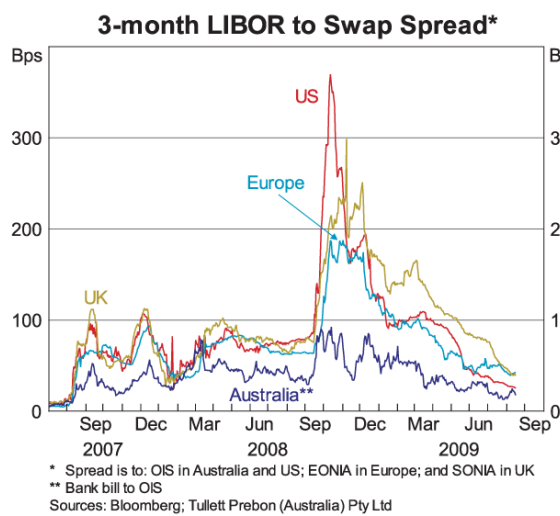
When adopted in the past, quantitative easing has failed to invigorate a stagnant economy through improved lending. Most notably the BOJ between 2001 and 2006 implemented the policy by purchasing asset-backed securities and establishing a fixed current account balance above the reserve level beginning at \$5tn yen and continuing to a peak of \$35tn in 2004 (Ugai, 2006). In terms of stimulating aggregate demand, the policy had very limited success (Battellino, 2009) and despite Central Banks targeting non-functioning credit markets, the BOJ's failure highlights the principal flaw of such a response namely 'it cannot start a recovery because if businessmen have no incentive to invest, the availability of funds does little to stimulate investment (Mayer, 1968). This would suggest that the non-

conventional policy actions undertaken were perhaps not the most appropriate monetary response to the current crisis.

However, policy actions taken during the Asian Financial Crisis present a counter-example. Between 1996 and 1997, capital flows reversed by \$105 billion for South-East Asian countries leading to a total economic crisis (Djiwandono, 1999). In Korea the collapse of the banking system and increased corporate failures led to GDP falling in the first half of 1998 by 5.3% leading the government to implement a \$64 trillion won spending package (approximately 16% of GDP) comprising primarily of measures to purchase subordinated debt (\$20 trillion), recapitalise commercial banks and provide deposit insurance (\$26.6 trillion) (Hunter et al., 1999). These policies led to a remarkable recovery with growth of 10.7% in 1999, a substantial fall in the unemployment from 8.6% in February 1999 to 5.3% in February 2000 and an increase in foreign reserves to historic highs of \$80 billion whilst maintaining inflation at a record low of 0.8% (Shin, 2000).

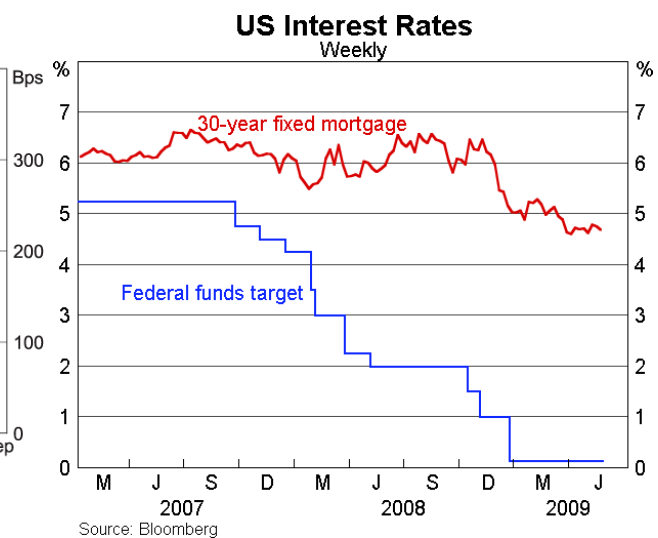
These policies were arguably appropriate for two reasons. Firstly, they reduced investor concerns about the credit risk of lending to corporations. By acting as the lender of last resort, providing institutions with the necessary liquidity to overcome any cash flow problems should the demand for cash increase (Reserve, 2009), Central Banks encouraged stability and confidence. Risk aversion subsequently declined leading to lower risk premiums, longer maturity timeframes and credit spreads as displayed in figure 4. This countered the negative effects of the resistance of longer-term mortgage rates in developed countries to cuts in the policy rate as shown in figure 5.

Figure 4:



Source: Edey, M – Financial System Developments in Australia and Abroad <http://www.rba.gov.au/Speeches/2009/sp-ag-190809.html>

Figure 5:



Source: Battelino, R – Global Monetary Developments [http://www.rba.gov.au/Speeches/2009/sp\\_dg\\_280509.html](http://www.rba.gov.au/Speeches/2009/sp_dg_280509.html)

Secondly, by providing liquidity directly to small businesses and consumers the economic effects of non-functioning credit markets were tempered as the provision of liquidity helped lower the borrowing costs and funding stresses faced by financial institutions through increasing supply which ceteris paribus improved their willingness to lend. (Bernanke, 2009). In an IS-LM model, this would have theoretically, shifted the LM curve downwards stimulating credit flows and therefore the housing market and investment.

### Recent Evidence

While financial conditions remain weak, there is building evidence that the conventional and non-conventional monetary responses have been successful in stabilising the global financial system. As shown in figure 5, financial conditions have improved which the International Monetary Fund attributes to ‘cuts in policy interest rates, continued provision of ample liquidity, credit easing, public guarantees, and bank recapitalization which have appreciably lowered concerns about systemic failure and have supported intermediation’ (IMF, 2009a).

Figure 5: **Financial conditions have turned up**



Note: A unit decline in the index implies a tightening in financial conditions sufficient to produce an average reduction in the level of GDP by  $\frac{1}{4}$  to 1% after four-six quarters. See details in Guichard et al. (2009).

Source: Datastream; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/656466875388>

Source: OECD – Economic Outlook June 2009

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The International Monetary Fund has also refined its forecast upwards, anticipating positive growth of 2.5% for the world economy in 2010 noting improving signs in nearly all the major economies of the world (IMF, 2009b). Thus, while the financial turmoil is ongoing, on balance it would seem the expansionary monetary response was both prudent and appropriate.

### *Future Impact*

The exact nature of these monetary policies will matter a great deal firstly because of their affect on credit flows, influencing the length and depth of the economic crisis. For example, the Federal Reserve's maintenance of the gold standard, a perverse monetary policy which caused an unprecedented depression (Eichengreen and Sachs, 1985), failed to address the decrease in the money multiplier, due to bank collapses and asset fire sales. The subsequent decrease in the nominal money stock (M1) by 27% (US\$26.4 billion to US\$19.4 billion) between 1929 to 1933 (Sheen and Blanchard, 2009) increased risk aversion (Temin, 1989) with the resultant credit crunch cutting off access to credit to household and smaller corporations (Bernanke, 1983) and undermining much of the US economy's recovery (Galbraith, 1955).

In the medium run, the high level of government liquidity in financial markets will need to be decreased, affecting the flexibility of monetary policy and hence its ability to maintain its price target. This would lead to consumers revising their inflationary expectations upwards resulting in an environment of rising inflation and continuing weakness in economic activity (Stevens, 2009a). In addition, the Asian Financial Crisis demonstrates that temporary guarantee arrangements like Australia's bank deposit guarantee tend to build an expectation of government intervention in the event of another crisis, creating a moral hazard (Hunter et al., 1999). The result would be the continuing persistence of excessive risk taking and speculation, undermining the resilience of financial markets in the long run. Furthermore, the level and type of liquidity injected into financial markets will determine whether a devaluation of the currency results from increased supply and worsening investor confidence. This will determine the extent high foreign debt levels will place a balance of payments constraint on countries. Thus, the exact nature of the policies will matter a great deal.

### *Fiscal Policy*

Governments around the world have enacted expansionary fiscal policy to mitigate the impact of the economic crisis. The United States Government has responded with a number of spending initiatives worth 1.1% of GDP to stimulate aggregate demand. Other governments have also responded in kind, with the UK, French, German, and Japanese governments passing discretionary spending initiatives worth 1.5%, 1.3%, 2.0% and 2.0% of domestic GDP respectively whilst in Australia, a \$42 billion Economic Stimulus Plan including targeted cash payments of \$8.7 billion and \$12.2 billion in December 2008 and February 2009 and a \$22bn nation building plan has been implemented (Treasury, 2009a).

Such spending initiatives were appropriate if not vital. The first reason is that an increase in net government spending leads to a rightward shift of the IS curve implying higher output. Secondly, the appropriate use of traditional monetary policies led many countries to fall into a liquidity trap where monetary policy cannot stimulate investment further. The reason is once nominal interest rates are near zero any change in the money supply shifting the LM curve downwards will have no effect on output (Mayer, 1968) as shown in figure 7. Moreover, the situation implies that output is below the natural level of output meaning a

downwards revision of inflationary expectations (Sheen and Blanchard, 2009). This posed a significant risk to economies as an increase in deflation when nominal interest rates are zero increases the real interest rate by Fisher's equation<sup>1</sup>. The higher real interest rate then shifts the IS curve and hence the AS curve left and down respectively, placing an economy in a vicious downward cycle as shown in figure 8. Thus, the fiscal expansions adopted were appropriate to avoid deflation, the consequences of which were seen in the major economic problems in Japan in the 1990s.

Figure 7:

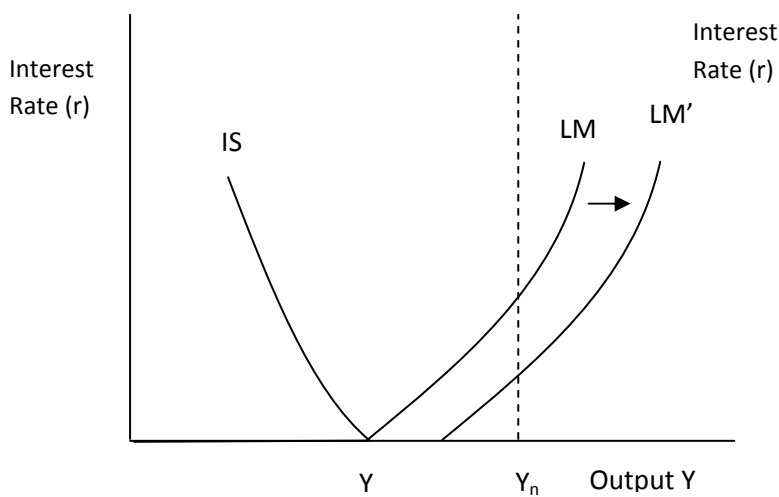
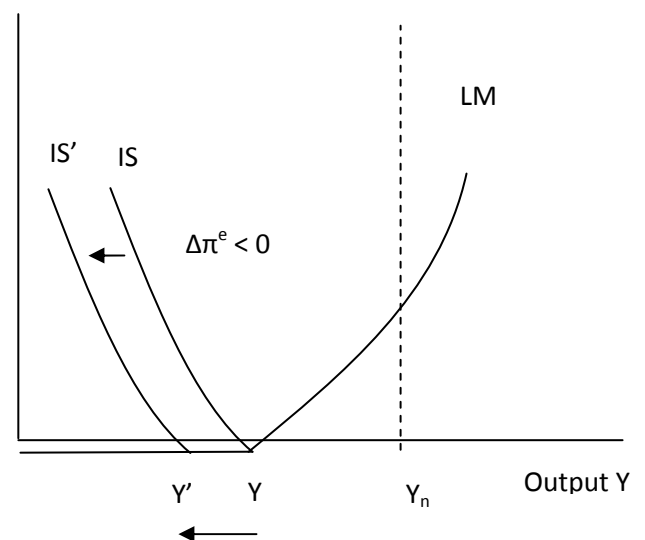


Figure 8:



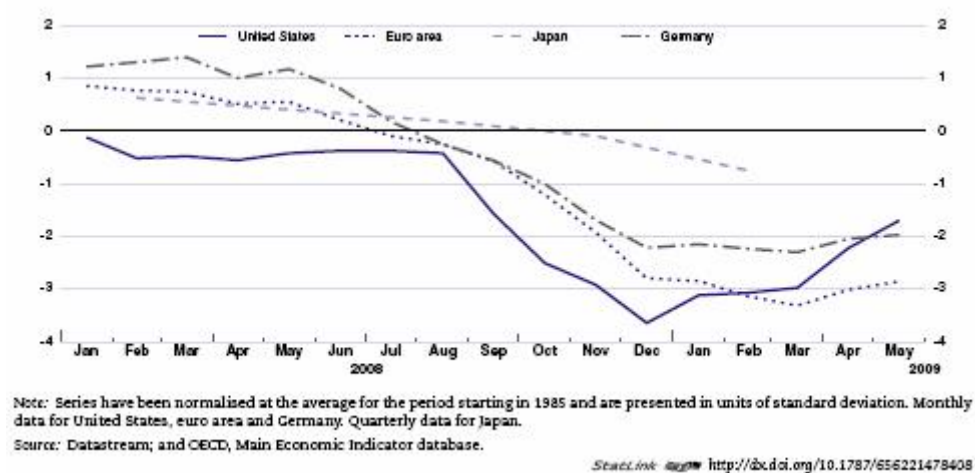
Expansionary fiscal policies have been implemented successfully to avert any onset of a liquidity or deflationary crisis and increase aggregate demand emphasising the appropriateness of the fiscal response. For example, fiscal expansions were used successfully between 1950-1970 for demand management in Australia (Fraser, 2001) and a budget deficit of \$4.6 billion after the 1982-83 recession helped the economy recover (Nevile, 1989). In 1989-1990 a fiscal expansion contributed to Australia achieving growth of over 3.5% throughout the 1990s (Lei Lei and John, 2006). Moreover, a fiscal expansion in the United States in 2001 reduced both the duration and extent of the recession following the Tech bubble burst (Sheen and Blanchard, 2009) and pump-priming measures by the Japanese Government helped stimulate a stagnant domestic economy in 1999, with real GDP growth rate reaching 0.6% (Ishi, 2000).

<sup>1</sup>  $r = i - \pi$ ; where  $r$  - real interest rate;  $i$  - nominal interest rate;  $\pi$  - inflation rate.

## Recent Evidence

Recent forecasts by the OECD of real GDP growth of 0.7% in 2010 and growth in world trade of 2.1% indicate the implemented responses have had a stabilising impact. Moreover, business confidence has been buoyed by fiscal spending as shown in figures 6, pointing to the effectiveness of the implemented responses at achieving short-run stability (OECD, 2009).

Figure 6: **Business confidence shows signs of turning**



Source: OECD – Economic Outlook June 2009

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In addition, improving conditions in nearly all major economies suggest the fiscal response has somewhat ameliorated the current crisis. For example, the US economy had an forecasted annualised real GDP growth of -1% (2<sup>nd</sup> Qtr 2009), compared with -6.4% in the first quarter largely due to improvements in real non-residential fixed investment (-8.9% compared with -39.2%) and real exports of goods and services (-7.0% compared with -29.9%) (BEA, 2009). The unemployment rate has also improved decreasing by 0.1% to 9.4% and housing constructions rose an estimated 8.7% (Filipek, 2009) in June 2009. Moreover, the Japanese economy achieved real GDP growth of 0.9% in the second quarter of 2009 and Australian consumer confidence increased by 12.7% in June 2009. While the global economy remains weak, these figures emphasise the appropriateness of the fiscal policy response.

## Future Impact

The effect of these policies in the short, medium and long run means their exact nature will matter to a large extent. In the short-run, the policies composition will affect its ability to stimulate output. For example, fiscal conservatism in the United States meant that government expenditure only expanded aggregate demand by 0.3% in 1929 (Temin, 1989). Furthermore, protectionist measures (increase in import duties by 40%) created a vicious protectionist cycle resulting in the collapse of international trade and decreased output (Coppe, 1972).

In the medium run, the exact nature of the fiscal expansion will affect the level of inflation and investment. A fiscal expansion's composition determines the rightward shift of the AD thereby affecting the disparity between actual inflation and expected inflation. Since Central Banks would then need to increase interest rates to maintain their inflation targets, shifting the AD curve left as shown in figures 7 and 8, the response's exact nature would influence the extent to which investment is discouraged.

Figure 7:

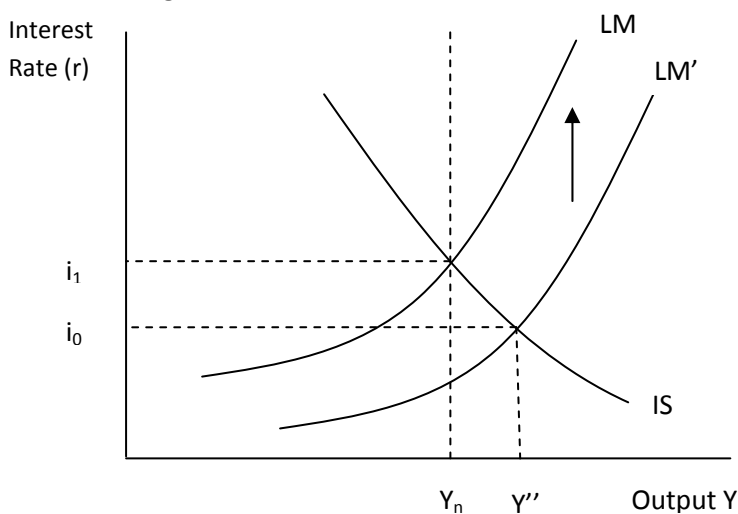
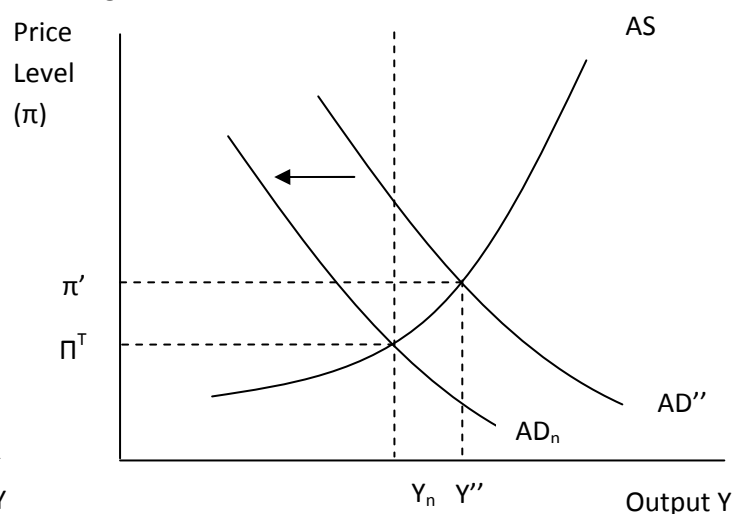


Figure 8:



The discouragement of investment and potential misallocation of spending will mean these policies' exact nature will have an impact in the long-run by lowering productivity and potential output growth. In a Solow-Swan model of growth, the high fiscal deficits projected for developed nations (OECD, 2009) will lead to, *ceteris paribus*, less investment reducing technology and capital growth. Expectations of long and protracted deficits would aggravate this effect by creating an upward pressure on interest rates. The end result will be lower

potential output growth creating a supply shock to the economy (Bernanke et al., 2008), resulting in higher inflation as aggregate demand expands during the recovery.

Furthermore, the exact nature of the policy will determine whether it is sustainable which will prove crucial because 'a stable fiscal environment is essential to enhance the economy's flexibility' (Ishi, 2000). If largely implemented through borrowing then the 'size of the build-up in government debt in some of the major economies will surely become much more of a constraint on their fiscal room for manoeuvre over the next decade' (Stevens, 2009b). As bond rates rise in line with policy rates during the recovery, the interest payments on the debt will also lead to a reduction in living standards through reduced worthwhile structural spending in health, infrastructure and education as well as a balance of payments constraint on growth through a deterioration of the current account. These potential negative effects convey how the exact nature of the policies will matter significantly.

### *Conclusion*

The policy responses that have been undertaken are in principle appropriate given the nature of the economic crisis. From the limited evidence available, the expansionary measures have stabilised output levels and confidence in the global financial system. However, the effect these policies will have in the short to long run means their exact nature will matter to a large extent.

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