Evaluating monetary policy operational frameworks – Handout (Jackson Hole Kansas Fed Symposium, 2016), (U. Bindseil)

2007 consensus:

1) Single operational target: ONR
2) OFs should be simple and focused
3) Separation principle between macro analysis and MPI. Gate: short term interest rate
4) Tool to steer liquidity: credit OMO with allotment volumes set by central bank
5) Symmetric SF corridor around target rate most effective ONR control technique
6) If RR, then for smoothing autonomous factor liquidity shocks; RR should be remunerated

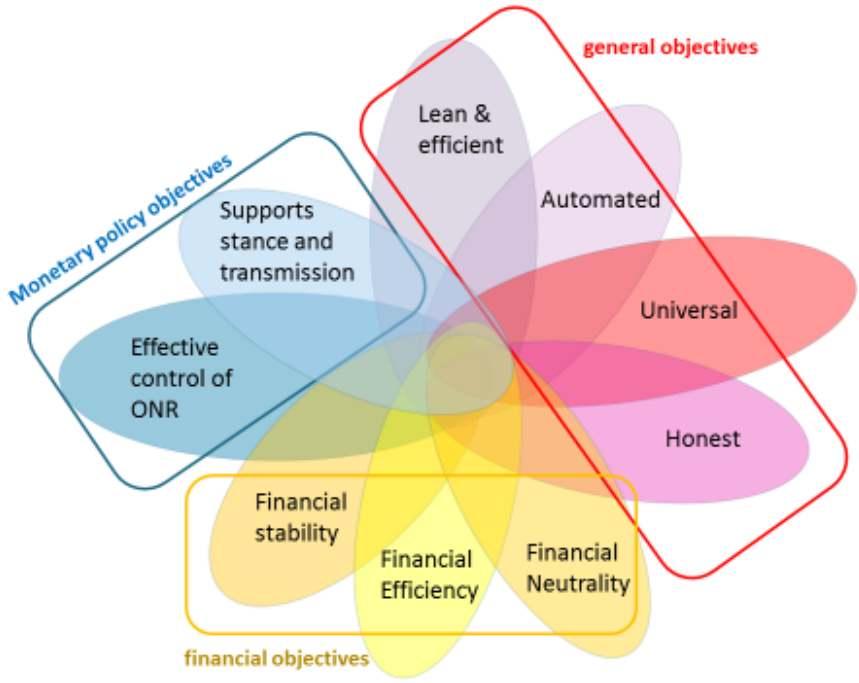
Where convergence of views and practices had not taken place:

1) Optimal banks' liquidity deficit vis-à-vis the central bank to be covered through credit OMOs
2) Sovereign exposure: good or evil?
3) Collateral and counterparty sets: Broad or narrow?
4) RR and 200 bp corridor or no RR with 50 bp corridor?

Extra lessons from the last nine years

1) OFs need to support ability to address possible future crises (or ZLB) forcefully and quickly
2) Avoid contributing to build-up of future financial crisis
3) Post-crisis OF should allow when needed to push down "effective lower bound" (ELB)
4) Cope with the new regulatory environment and its implications on financial markets.

Universal guiding principles to evaluate alternative OFs . Universality of optimal OF broadly holds for large advanced monetary areas



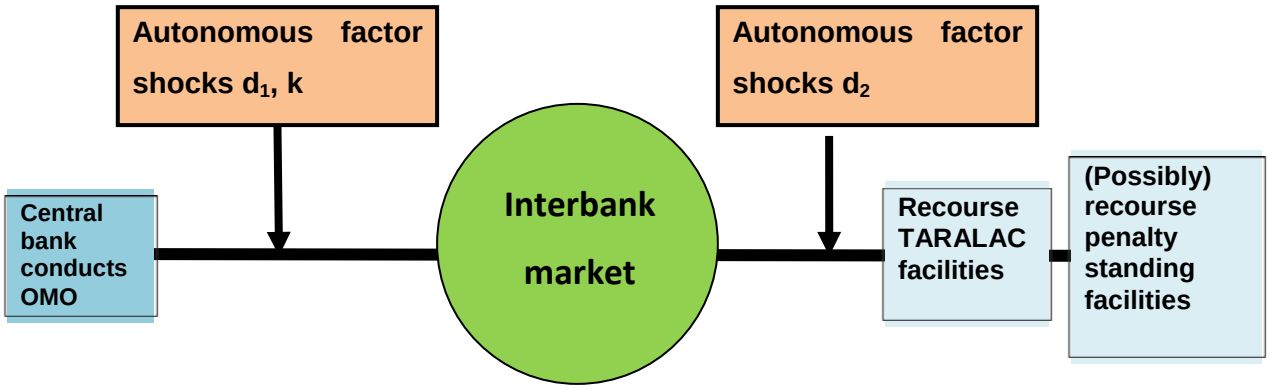
Control of operational target (Section 4)

Symmetric corridor: still advantages compared to alternatives:

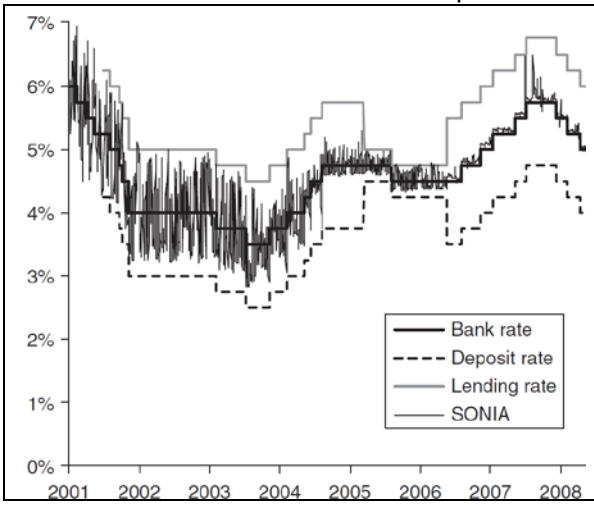
1) Mixed asymmetric approaches (e.g. target rate is at ¾/¼ distance to two SF rates. Volatility of various liquidity shocks is relevant for adequate OMO volume in non-trivial way
2) Fully asymmetric approaches (floor or ceiling). Low MM turnover, longer CB balance sheet
3) Approaches which steer overnight rates within a corridor of two same-sided standing facility rates. ONR control non-trivial + potentially similar issues as fully asymmetric approaches.
4) Approaches with only one standing facility as the Fed's pre-2007 approach. Violates separation principle and same issues as mixed asymmetric approaches.

Control of the operational target while preserving money market turnover.

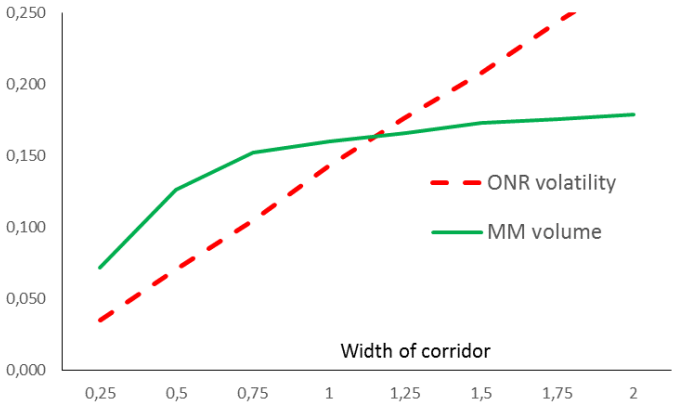
Interest rate setting equation: $i = P(\text{TARALAC})i^* + P(\text{credit facility})i_c + P(\text{deposit facility})i_d$



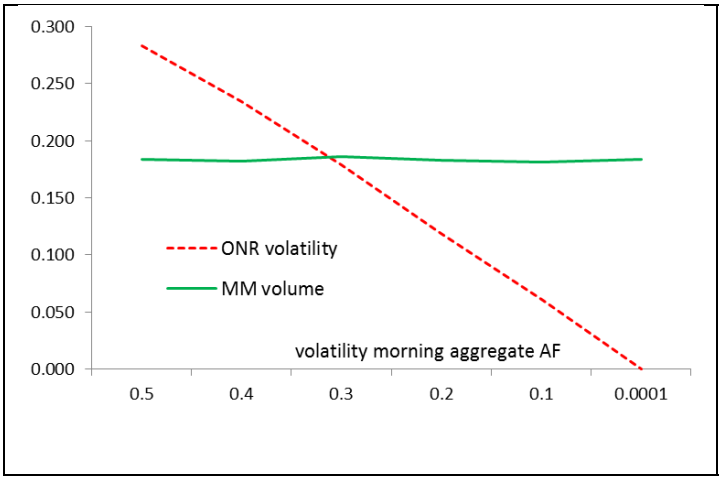
BoE ONR control 2001-2008 as example



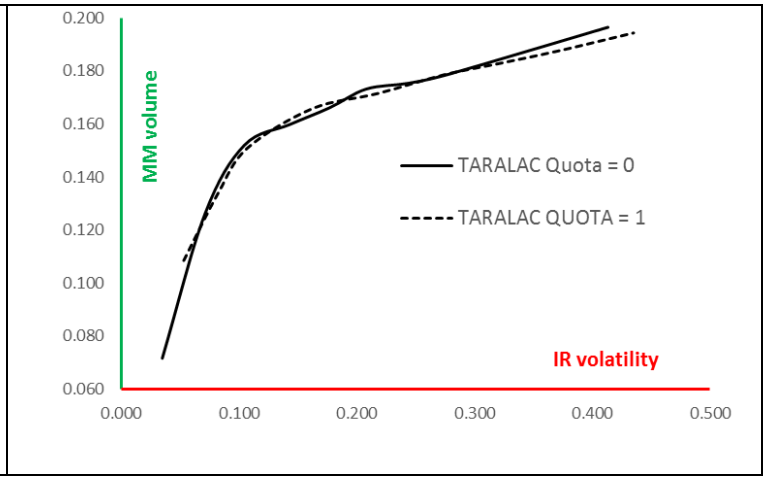
Impact of corridor width on MM turnover and ONR vola



Role AF forecasting / timing OMO



TARALAC facility redundant?



Conclusions on control of operational target (short term interest rate)

1. "ONR" to remain operational target; sole instrument to adjust monetary stance over time
2. Advantages of symmetric corridor approach remain
3. Control reserve scarcity through credit OMOs, but if demand for excess reserves remains unpredictable due to new regulation, fixed-rate-full-allotment operations may be preferable
4. Doubts on efficiency of reserve requirements with averaging
5. ONR control can be improved in various ways; choose those who preserve money market
6. TARALAC facility potentially attractive, but superiority in achieving better combinations of money market activity and overnight rate stability still to be established.

Balance sheet structure- Considerations for NPC assets (Section 5)

"Lean" CB balance sheet still seems natural in long term, normal context.

Still: ONR control "at the margin" => CBs leeway on decisions regarding "NPC assets"

1) Duration, liquidity, credit riskiness and diversification of NPC assets?
   - CB is type of "investor" that has capacity to bear those risks=> accept financial returns
   - Expertise building ensuring that CB understands financial markets and stability issues
2) The role of government debt in NPC assets?
3) No interference of NPC asset management with monetary policy
4) Should outright portfolios *aim at* impacting the monetary policy stance in normal times? No (although they will impact at least slightly)

LOLR in OF and collateral framework (Section 6)

LOLR also embedded in OF (collateral framework, tender procedure, corridor; possible OPBF). For given overall LOLR-willingness, preferable to have large parts in OF, small part in "discretionary" form (such as ELA, or changes of OF-LOLR in stress timed).

Collateral most important determinant of LOLR-OF. How broad should collateral set be?

Arguments in favour of broad collateral set are:

1) Sufficiency of collateral for monetary policy implementation
2) Supports *ex post* financial stability and *ex ante* maturity and liquidity transformation.
3) Potential for collateral diversification, reducing central bank risk taking.
4) Equal treatment of issuers; minimise collateral eligibility premium (price distortion)

Arguments against too broad collateral set are:

1) "moral hazard", reduced market discipline, excessive leverage
2) narrow set reduces complexity, less credit risk, due diligence work for central bank;
3) broad set requires more diversification of haircuts and more monitoring;
4) if set narrow in good times, then more broadening potential in crisis times

How segregated should collateral sets be?

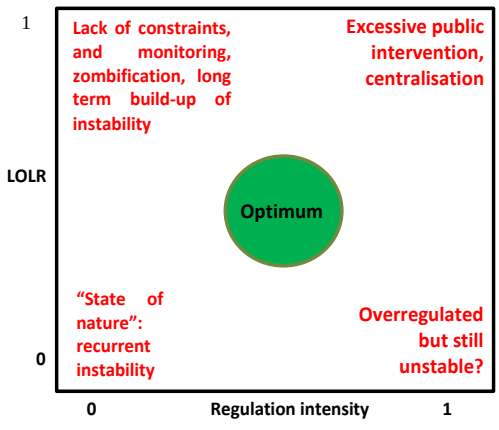
How much overall LOLR should a central bank provide? ,

Two extreme LOLR approaches (both without elements of E(ΔLOLR), E(ELA)):

- **Maximum LOLR OF**: Accept all bank assets at fair value; no haircuts; full allotment.
- **Minimum LOLR OF**: Only through outright purchases and sales of risk free assets

Implications of these two frameworks on four dimensions:

	Banks' liquidity transformation	Financial stability	Economic efficiency, growth, welfare	Central bank risk taking
Min LOLR	Low	Low	**Long term credit scarce**	Low
Max LOLR	High	Short term fine, but…	Zombification	High



Further issues.

1) Risk endogeneity ("only brave plan is safe plan")
2) LOLR and monetary policy, in particular at ZLB
3) Moral hazard measurable as CB losses?
4) Avoid stigmatization of LOLR
5) OF to support fulfilment or liquidity regulation?
6) Over proportional borrowing framework (OPBF)