1. Introduction

Economic downturns often put pressure on monetary policymakers to conduct countercyclical to stabilize output and the timing of the policy response is crucial. In the 2008 Global Financial Crisis, most emerging market economies have escaped with their growth rates relatively unscathed or have rebounded quite quickly in its aftermath (Blanchard et al. 2010). One of the factors explaining the unprecedented quick recovery is that, unlike in previous financial crises, emerging market economies were able to conduct swift and credible countercyclical measures (Didier, et. al 2011).

But what does a “fast” monetary policy response mean? Unfortunately, literature on the speed of monetary policy response is scarce; thus, a widely agreed method to measure it or to determine fast monetary responses has not yet been established. Furthermore, the contribution of fast monetary responses in mitigating recession severity has not yet been explored in an empirical study. This study aims to fill in the gap in literature by examining monetary policy responses in 390 recession episodes from 1964-2010 in 66 countries.

The objectives of this study are to determine the speed of countercyclical monetary policy, to examine its impact on the depth and length of recessions, and to investigate its determinants. Monetary policies, in particular, are of interest in this study because monetary policy can be swift; it can be used as an output stabilization tool; and it can prevent adverse feedback loops from the financial sector (Mishkin 2009). This study is particularly timely and necessary for policymakers as the importance of the timing of monetary policy in influencing output during economic downturns came to light during policy discussions about the 2008 global financial crisis (Mishkin 2009).

2. Defining Monetary Policy Responsiveness

I begin the empirical investigation by determining monetary policy responses, i.e. fast response, slow response and no response. First, I identify the short term interest rate as an appropriate quantitative measure to gauge the policy stance of the monetary policymakers. The short term interest rate can signal whether policymakers have conducted countercyclical monetary policy because short term interest rates move along with changes in the policy instruments of monetary authority (Disyatat 2008, 2).

Second, I measure the time it takes for policymakers to implement a countercyclical monetary policy in a recession. Applying the Harding and Pagan (2002) algorithm to the movement of output and short term interest rates, I identify recession episodes as well as periods of monetary expansion coinciding with the identified recessions.

Third, I determine whether the policy response undertaken is “fast” or “slow” by comparing the timing of the actual countercyclical monetary policy response on the one hand, and the model-based predicted response on the other hand. In other words, the monetary policy response is deemed “fast” when the actual response is faster than the “typical” response of policymakers. I estimate the typical response of monetary authorities in each country by conducting a 10-year rolling regression of a modified Taylor Rule model (Mohanty and Klaau 1993) using quarterly data for noncrisis periods.

3. Recession Severity and Monetary Policy Responsiveness

I conduct an event analysis of recession episodes and monetary policy responses and find that a “fast” countercyclical monetary policy response is associated with shorter and shallower recessions. By examining the summary statistics of the length and depth of recessions and by employing the Tobit model to analyze recession episodes and their respective monetary policy responses, I show that the relationship between a fast countercyclical monetary policy response and a shallower and shorter recession holds, even after controlling for other variables which are deemed to affect recession severity such as the fiscal policy response, financial crisis, and policy environment factors such as level of economic and institutional development, inflation targeting and exchange rate stability.


Using an ordered probit model, I show that policy choices such as financial openness, exchange rate stability, and inflation targeting, as well as macroeconomic factors like large holdings of international reserves or external debt can affect the probability that policymakers will implement rapid countercyclical monetary policy responses. In particular, this study finds that monetary authorities, pursuing higher exchange rate stability, are more likely to implement fast countercyclical policies if they hold a large amount of international reserves which may lower the risk of sudden depreciation. Monetary policymakers adopting inflation targeting regime also tend to be more responsive during downturns by building credibility to maintain stable inflation through inflation targeting. In addition, policymakers in more open financial markets are more responsive during economic downturns, suggesting that policymakers respond quickly to prevent a prolonged recession, which can increase the perceived and actual macroeconomic and financial risk of a country. Finally, this study shows that holding a large external debt can impede the implementation of a rapid countercyclical monetary policy response.

References


