Monetary Policy since the Global Financial Crisis

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Introduction

- The focus of this contribution is on monetary policy since the Global Financial Crisis (GFC) and the subsequent Great Recession (GR);
- Since then monetary policy makers have in effect abandoned the main policy instrument of manipulating the rate of interest to achieve an IT;
- This is so in view of the rate of interest reduced to nearly zero, and below zero in some countries, along with QE, to achieve still an IT;

Introduction

- Central banks around the world turned their attention to enhancing the liquidity of their banking sectors, as well as to restore confidence in the financial system and to contain the impact of the crisis on the real economy;
- A unique element of the reactions of policy-makers in terms of the emergence of the GFC is the activist role played by central banks and Treasuries around the world;

Introduction

- Their responses, and in many countries, not just the main ones, around the globe have become very accommodative;
- Central banks have responded by flooding the financial markets with liquidity;
- ‘Unconventional’ monetary policies, QE along with near zero/negative interest rates, have been employed extensively and in an unparalleled way in the history of similar crises.

Introduction

- In addition to these new ‘unconventional’ policies, financial stability has also been introduced, both microprudential (concerned with individual financial institutions) and macroprudential (concerned with the whole financial system) type of policies;
- In what follows three main economies, namely the US, the UK and the Economic and Monetary Union (EMU), form the background of our discussion;

Introduction

- We proceed after this short introduction with a discussion of the ‘unorthodox’ monetary initiatives in view of the GFC, and the subsequent GR, beginning with QE, and then proceed to discuss near-zero and negative interest rate policies;
- Financial stability is then discussed;
- Finally, we summarise and conclude.

Unorthodox Monetary Policies Following the GFC and GR

- **Quantitative Easing**
- QE includes two types of policy:
- (i) the conventional unconventional type, whereby central banks purchase government securities;
- and (ii) the unconventional unconventional type, whereby central banks buy high-quality, but illiquid corporate bonds and commercial paper;

Unorthodox Monetary Policies Following the GFC and GR

- There are the following possible channels of QE;
- Liquidity channel: adding to institutions' holdings of cash, which can be used to fund new issues of equity and credit; bank lending is thereby influenced, which affects spending; the purchase of high-quality private sector assets is to improve the liquidity in, and increase the flow of, corporate credit;

Unorthodox Monetary Policies Following the GFC and GR

- Portfolio channel: changing the composition of portfolios, which affects the prices and yields of assets, thereby affecting asset holders’ wealth. The cost of borrowing for households and firms is also affected, which influences consumption (also affected by the change in wealth) and investment;

Unorthodox Monetary Policies Following the GFC and GR

- Expectations management channel: asset purchases imply that, although the Bank Rate is near zero, the central bank is prepared to do whatever is needed to keep inflation at the set target; in doing so the central bank keeps expectations of future inflation anchored to the target;
- The success of QE depends on four aspects:
- What the sellers of the assets do with the money they receive in exchange from the central bank;

Unorthodox Monetary Policies Following the GFC and GR

- The response of banks to the additional liquidity they receive when selling assets to the central bank;
- The response of capital markets to purchases of corporate debt;
- And the wider response of households and companies, especially to attempts at influencing inflation expectations;

Unorthodox Monetary Policies Following the GFC and GR

- There are doubts in terms of its effectiveness in view of productive investment is unlikely to materialise for investors prefer to hold more cash than investing in view of poor growth expectations and uncertainty;
- A further problem is that if QE funds flow into the real estate market, and if mortgage rates remain low, expansion in buy-to-let lending and property investment could be followed by upward pressure on house prices, thereby producing the precursor of financial crises;
- There is also the inequality problem, in that QE has increased it through boosting asset prices, as house prices, stock and bond markets have soared;

Unorthodox Monetary Policies Following the GFC and GR

- However, one advantage is clear: QE has made it easier for governments in terms of their fiscal policies because there is a ready buyer for government debt;
- Without this facility, there would be difficulties and may force governments to contain the degree of their fiscal initiatives;
- There is another relevant proposal, which is similar to Friedman’s (1969) ‘helicopter drop’ of money;

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- This proposal refers to the case where lower taxes or higher government expenditure is financed by printing money by the central bank rather than the government increasing its debt;
- It does not require increasing borrowing to work; therefore, the proponents argue, such policy does not increase future tax burdens, thereby providing greater impetus to household spending, which would generate aggregate demand that is urgently needed;

Unorthodox Monetary Policies Following the GFC and GR

- The increase in the money supply associated with ‘helicopter money’ should lead to higher inflation, a desirable current outcome in this view;
- A further advantage is that a helicopter drop would avoid the distributional consequences of QE in that it would reach every household, unlike the QE, which enhances only the value of the owners of the relevant assets;

Unorthodox Monetary Policies Following the GFC and GR

- The problem with this approach is governance in that who decides and how to proceed with ‘helicopter money’ is a very relevant and important question;
- Close coordination of monetary and fiscal policies would be necessary, which would put at risk the central bank independence - if independence is desirable;
- If such coordination is not possible there is the subordination of monetary policy to fiscal policy, and also the possibility that monetary policy is abandoned forever;

Unorthodox Monetary Policies Following the GFC and GR

- Also, stubbornly low interest rates and QE may produce the end of central-bank independence in view of their inability to generate strong growth, and also because of their monetary financing of government debt, which is contrary to the objective of an independent central bank;
- There is also the ‘People’s QE’, which is different from the QE already undertaken by central banks;
- It would support infrastructure, whereby its financing would be undertaken by the government via borrowing the necessary amount of money from the central bank;

Unorthodox Monetary Policies Following the GFC and GR

- The distinction between people's QE and ordinary QE, is that QE involves swap of one set of financial assets for another and infrastructure QE involves use of real resources;
- Also whether the government or the central bank has control of the monetary process is another distinction;
- The 'People's QE' ends the operational independence of the central bank since it is the government, not the central bank, that would decide whether to increase the money supply to stimulate demand;

Unorthodox Monetary Policies Following the GFC and GR

- There is a further problem with this proposal. This is that in effect it amounts to an explicit monetisation of government debt;
- For although a powerful effect on public's expectations may very well materialise, the risk is that markets may destabilise in view of the temptation by the fiscal authorities to continue using it in a way that may cause instability;

Unorthodox Monetary Policies Following the GFC and GR

- However, whether the markets appreciate or not the impact of such policies on growth is an interesting question.
- **Near-Zero and Negative Interest Rates**
- Near-zero and negative interest rates is another recent unconventional monetary policy;
- As central banks pursue QE, options for further QE diminish; thereby near-zero and negative interest rates become a new toolkit of monetary policy;

Unorthodox Monetary Policies Following the GFC and GR

- Indeed a number of central banks have pushed their interest rates into near-zero or negative territory, in an attempt to increase inflation expectations and raise inflation rates to their targets, as well as enhance growth rates;
- In June 2014, and again in September 2014, the ECB became one of the first major central banks to venture interest rates below zero on the deposits commercial banks held with the ECB;

Unorthodox Monetary Policies Following the GFC and GR

- The ECB changed rates again on 10 March 2016, charging banks 0.4% to hold their cash overnight;
- Rates below zero have never been used before in an economy as large as the euro area;
- This monetary policy experiment would be successful if banks are encouraged to lend;

Unorthodox Monetary Policies Following the GFC and GR

- Near zero/negative interest rates are viewed by policymakers as part of their strategy to raise worryingly low inflation rates and downward pressures on inflation expectations;
- They are expected to drive down borrowing costs for business and consumers, and thereby direct capital into investments, and to persuade savers to spend;
- Furthermore, lower interest rates are expected to weaken the country's currency, thereby stimulating growth through more competitive exports;

Unorthodox Monetary Policies Following the GFC and GR

- Such results would also increase inflation rates towards the central banks’ IT targets;
- Its introduction, though, has been accompanied by doubts as to whether this can be achieved in view of widespread volatility in financial markets, stagnant economies and thereby poor economic growth, and especially poor expectations for future growth;
- In the case of the EMU negative interest rates, despite having produced a situation where half of the euro area sovereign debt trades with negative yields, have not been helpful in terms of the inflation front;

Unorthodox Monetary Policies Following the GFC and GR

- A problem when interest rates of all debt maturities are near-zero/negative is that those who rely on bonds for their income suffer substantially;
- This is particularly so in the case of banks, insurance companies and pension funds sectors through lowering their incomes;
- Under such circumstances banks, insurance companies and pension funds may shift the composition of their portfolios to risky assets, thereby adding to asset price bubble pressures;

Unorthodox Monetary Policies Following the GFC and GR

- Near zero/negative interest rates can also hurt life insurers and pension funds in view of their liabilities having a longer maturity than their assets;
- In more general terms very low interest rates can put financial institutions, and investors as well as savers, under strain;
- It is indeed possible that savers, in view of low returns on their savings, may be forced to save more, rather than spend and stimulate the economy;

Unorthodox Monetary Policies Following the GFC and GR

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Unorthodox Monetary Policies Following the GFC and GR

- This would be in an attempt to increase savings to make up for what is perceived permanent loss of returns;
- This would lead to lower consumption and lower GDP growth as a result; thereby making the low/negative interest rate policy counterproductive;
- This would be especially so for those savers who are prevented from getting the returns they need for retirement;

Unorthodox Monetary Policies Following the GFC and GR

- A further serious concern is the impact of negative interest rates on the rather fragile banking sectors, especially in the EMU;
- Those institutions that are unable to pass the costs of negative interest rates on to their depositors face a serious squeeze on their profits with severe implications on their ability to provide credit;

Unorthodox Monetary Policies Following the GFC and GR

- Indeed, a prolonged period of low and negative interest rates may discourage lending as the net interest rate merging becomes smaller, thereby leading to a contraction in the supply of credit;
- Low and negative interest rates could also produce reductions in the velocity of circulation of money;
- Economic agents may very well take their money out of the banking sector;

Unorthodox Monetary Policies Following the GFC and GR

- And indeed keep it in 'home safes', and in more general terms money could be kept out of circulation in the economy;
- Such a reduction in money velocity of circulation increases deflationary pressures;
- Under negative interest rates, banks may increase their cash holdings to cover their interbank transactions instead of holding working balances with central banks;

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- It is the case that none of the economies that have introduced the unorthodox near zero/negative interest rates policy measures has returned to robust growth let alone full employment;

Unorthodox Monetary Policies Following the GFC and GR

- King (2016) suggests that “The failure to recognise the need for a real adjustment in most major economies, and the continued reliance on monetary policy as the ‘only game in town’ constitute an error as much of theory as of practice and are the cause of weak growth today” (p. 49);
- Under such circumstances it is not surprising that the IMF (2016a) calls for policymakers in large economies to identify and implement policies that would boost growth and contain risks;

Unorthodox Monetary Policies Following the GFC and GR

- Such policies, in this view, should include: structural reforms, fiscal support - most valuable at this juncture it is suggested - and monetary policy to lift inflationary expectations;
- Above all, of course, stimulating aggregate demand, through expansionary fiscal policy, is paramount;
- Indeed, coordination of fiscal with monetary policy is the best way forward.

Financial Stability

- **Financial Stability**
- Financial stability is an aspect, which although had been discussed prior to the GFC, no firm propositions were clearly delineated;
- Since the GFC, though, countries have undertaken relevant initiatives;
- Also, a number of contributions that support financial stability policies have emerged;

Financial Stability

- The conclusion from these contributions is that financial stability and monetary policy should be the responsibilities of the central bank, which means that financial stability becomes an added objective;
- This raises the issue of whether financial stability can be incorporated in the IT framework. An IMF (Aydin and Lall, 2011) study raises this issue and investigates this possibility in an open economy DSGE model, with financial frictions;

Financial Stability

- It concludes that financial stability can help smooth business cycles fluctuations more effectively than a standard IT framework;
- Such an additional objective, though, raises the issue of how to incorporate financial stability in the loss function of the central bank in view of the fact that it is impossible to measure such a variable;
- Contributions on this score are lacking with a couple of exceptions;

Financial Stability

- Blinder (2010) raises the issue, along with the suggestion that “the right loss function is actually lexicographic, with financial stability logically prior to the other goals” (p. 4);
- Another relevant suggestion that goes beyond the issue of a loss function is coordination of financial stability with other policies;
- In this context, full coordination of both monetary and financial stability policies with fiscal policy, along with discretion in applying them, is the way forward;

Financial Stability

- Such coordination has become even more relevant recently in view of the weak impact of QE and negative interest rates as argued above;
- The coordination aspect would be helpful if the financial stability policy dimension would not be located inside the central bank;
- This is so in view of the fact that too-centralised decisions in one institution may produce time-inconsistency problems in the sense that one target may be pursued more actively than the rest;

Financial Stability

- Such coordination should also include debt management, which should help the central bank to influence interest rates across the yield curve;
- Still it is important to explain further the argument that financial stability is a necessary extra tool;
- The events leading to the GFC testify to this important requirement;

Financial Stability

- The focus of financial stability should be on proper control of the financial sector so that it becomes socially and economically useful to the economy as a whole and to the productive economy in particular;
- Banks should serve the needs of their customers rather than provide short-term gains for shareholders and huge profits for themselves;

Financial Stability

- With the objective of financial stability, central banks would be responsible for policies, which seek to influence the credit and lending of the full range of financial institutions;
- Re-establishing a system designed to meet the needs of the real economy and the users of financial services, rather than to merely benefit financial intermediaries themselves is paramount;

Financial Stability

- An interesting development has emerged from the Bank of England’s Financial Policy Committee (FPC) in its assessment and implementation of financial stability tools;
- It begins by suggesting that it is important to assess “the outlook for financial stability by identifying the risks faced by the financial system and weighing them against the resilience of the system. In doing so, its aim is to ensure the financial system can continue to provide essential services to the real economy, even in adverse circumstances” (Bank of England, 2016);

Financial Stability

- As a result of the risks in the UK banking sector the FPC decided at its 25th of May, 2016, meeting to increase the UK countercyclical capital buffer rate (or systemic risk buffers), which would ensure that banks could "provide lending and other essential banking services in times of financial stress" (Bank of England, op. cit.);
- The countercyclical buffer would apply to "all UK banks and building societies and to investment firms that have not been exempted by the Financial Conduct Authority (FCA). Under European Systemic Risk Board rules, it will apply to branches of EU banks lending into the United Kingdom";

Financial Stability

- However, the Governor of the Bank of England announced on the 5th of July 2016 (at the launch of the Bank of England's financial stability report) that the countercyclical capital buffer imposed on the UK commercial banks would be relaxed by the FPC (from 0.5% to 0% until at least June 2017);
- This is to boost lending to business and households (estimated to be £150bn); this became necessary because of financial stability risks in view of the UK vote to exit the EU;

Financial Stability

- In view of mounting consumer credit (car loans, personal loans and credit card debt), though, which increased 10.3 percent in the 12 months to April 2017, and with the household debt closely to 140 percent in relation to income, the Bank of England imposed on the 27th of June 2017, the ‘counter-cyclical capital buffer’ from zero to 0.5 percent of the lenders’ risk-weighted assets;

Financial Stability

- The buffer would rise by a further 0.5 percent in November 2017;
- Banks will have a full year from then to raise the 11.4bn as needed;
- The countercyclical buffer is a way of forcing banks to set aside capital in good times in order to keep lending steady to the wider economy , even during an economic downturn;
- The buffer can be ‘turned off’ in bad times;

Financial Stability

- The Bank of England also increased the minimum requirement on the leverage ratio, a bank’s capital to its total assets, from 3 percent to 3.5 percent;
- Lenders do not have to include central bank reserves in their total balance sheets when accounting for the leverage ratio;
- In addition, and on the 27th of June 2017, the Bank of England ‘clarified’ that in terms of mortgages, lenders should carry out affordability checks for new borrowers;

Financial Stability

- If difficulties arise with households in terms of their repayments, two problems may emerge;
- Households may reduce their spending to be able to keep up with debt repayments, especially those with high levels of mortgage debt;
- Households may default on their loans, thereby putting banks at risk.

Financial Stability

- As we highlighted in publications and previous conferences, a number of proposals have been put forward to strengthen financial stability;
- These proposals include: the US Dodd-Frank Act of 2010, the UK Vickers Report, the European Liikanen Report, the IMF and the Basel III;

Financial Stability

- Whether these proposals contain radical measures to enhance financial stability and avoid another crisis, similar to the GFC one, is an interesting question;
- As suggested in a previous conference, “financial stability remains unresolved and elusive”, despite these proposals;

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- A couple of examples since then make the point;
- A good example is the case of the ‘Volcker Rule’ of the US Dodd-Frank Act of July 2010. The ‘Volcker Rule’ was thought to be one of the key provisions of the July 2010 Act. It took five years to enact it – 21 July 2015;
- The aim of the rule is to prohibit banks from indulging in speculation. But it could be that despite this rule, bank trading may very well shift to the unregulated ‘shadow banking’ sector;

Financial Stability

- Especially so when the activities of commercial banks and the risk-taking investment banks are together;
- Along with absence of strict regulation of the financial services industry;
- It would thereby produce a situation whereby financial risks become harder to identify;
- In any case, the new US President wishes to deregulate the financial sector and review the landmark of the 2010 Frank-Dodd Act;

Financial Stability

- In fact, the President ordered a review of Dodd-Frank in early February 2017 with a relevant report promised by early June 2017;
- More recently, there have been suggestions that introducing a ‘water-down’ version of the Glass-Steagall Act may be a better way forward than the Dodd-Frank Act;
- The House of Representatives voted in early June to replace the 2010 Dodd-Frank Act with their own sweeping financial regulatory bill, the Financial Choice Act;

Financial Stability

- The focus of the Choice Act is to repeal the Dodd-Frank's Volcker Rule;
- The Senate is working on another measure that is more focused on easing regulations on banks;
- The White House is open to a ‘21st century’ version of the Glass-Steagall Act;
- Most of the Wall Street banks, though, do not like the Glass-Steagall revival;
- Their argument is that the economy is much better currently, especially so since a ‘split’ would impair their ability to invest.

Financial Stability

- The US Treasury released on 12 June 2017 a report on financial regulation reform;
- The report suggests that the current system of excessive financial regulations has undermined the ability of banks to provide credit to account for the needs of the economy; and has constrained economic growth;
- In terms of the Dodd-Frank Act, the report claims that the "Dodd-Frank has increased the burden of regulatory compliance without adequate cost-benefit analysis and that Dodd-Frank has prolonged the moral hazard arising from regulations that could lead to taxpayer-funded bailouts";

Financial Stability

- Although it does not reject the Dodd-Frank Act proposals, it recommends that they are applied with less rigour, more discrimination and greater consultation with the industry;
- In terms of the Volcker rule, it proposes that it is only applied in the case of very big banks engaged in large scale operations.

Financial Stability

- Another relevant case is the Basel III proposal, which has failed to achieve agreement on its key risk measure;
- The countries involved could not agree at their meeting of the 28/29 of November 2016 on the ratio of equity to risk-weighted assets (RWAs);
- A subsequent relevant and planned meeting on the 7/8 January 2007 was postponed;
- Their disagreement was on the definition of the RWAs;

Financial Stability

- In terms of the UK Vickers Report, the regulators are concerned that banks may fail to meet the 2019 deadline of their ‘ring-fencing’ retail operations from their investment banking activities;
- It is also argued by Vickers (2016), who chaired the Vickers Committee, that the recommendation of the banks ring-fencing extra capital equivalent to 3% of their RWA, the systemic risk buffers, has not been adopted by the Bank of England;
- The latter suggests that 1.3% would be sufficient;

Financial Stability

- There are similar problems with the other proposals referred to above;
- King (2016) suggests that although all these proposals “have made banks more resilient by reducing their leverage and limiting their ability to put highly risky assets on the same balance sheet as deposits from households”, they still “have not changed the fundamental structure of banking” (pp. 40-41).

Summary and Conclusions

- We have discussed and focused in this contribution on relevant monetary policy initiatives since the GFC and GR;
- Monetary policy since then has abandoned the main policy instrument, namely manipulation of the rate of interest to achieve the central bank's IT;
- In view of the rate of interest reduced to nearly zero in many countries after the GFC, and has stayed there ever since in most cases, monetary policy makers introduced unconventional means to still achieve an IT;

Summary and Conclusions

- QE has been introduced along with near-zero and negative interest rates in some cases;
- A new, and additional, objective has been introduced, namely financial stability, but IT is still around to be achieved through the new ‘unorthodox’ instruments of monetary policy;
- Financial stability has been discussed to conclude that not much real progress has been achieved;

Summary and Conclusions

- Our main conclusion is that the unorthodox instruments have not been effective in terms of achieving their objectives, especially that of inflation targetry;
- In terms of financial stability, although proposals have been put forward to achieve it, not much is evident in terms of implementing these proposals, and thereby avoid a future crisis of the GFC type;

Summary and Conclusions

- It is true, nevertheless, that central banks managed to bypass a complete collapse of their financial systems and their real economies after the emergence of the GFC and GR;
- However, monetary policies have been very ineffective in restoring a robust recovery. The enormous expansion of the monetary base has had little effect on the broader monetary and credit aggregates, let alone on inflation and the level of economic activity;

Summary and Conclusions

- Our suggestion on this aspect is that proper coordination of monetary and fiscal policies along with financial stability is the best and probably the only way forward to produce and maintain healthy growth in the economy.