UNCONVENTIONAL MONETARY POLICY AND FINANCIAL STABILITY: THE NEW ROLES OF CENTRAL BANKS

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INTRODUCTION

- In many countries, central banks (CBs) have been decisive in avoiding the collapse of the Financial System after the Global Financial Crisis of 2007-2009.
- They have also done their best to restart the economies after the “great recession” that followed.
- CBs are using new forms of intervention: large scale asset purchases, forward guidance,…

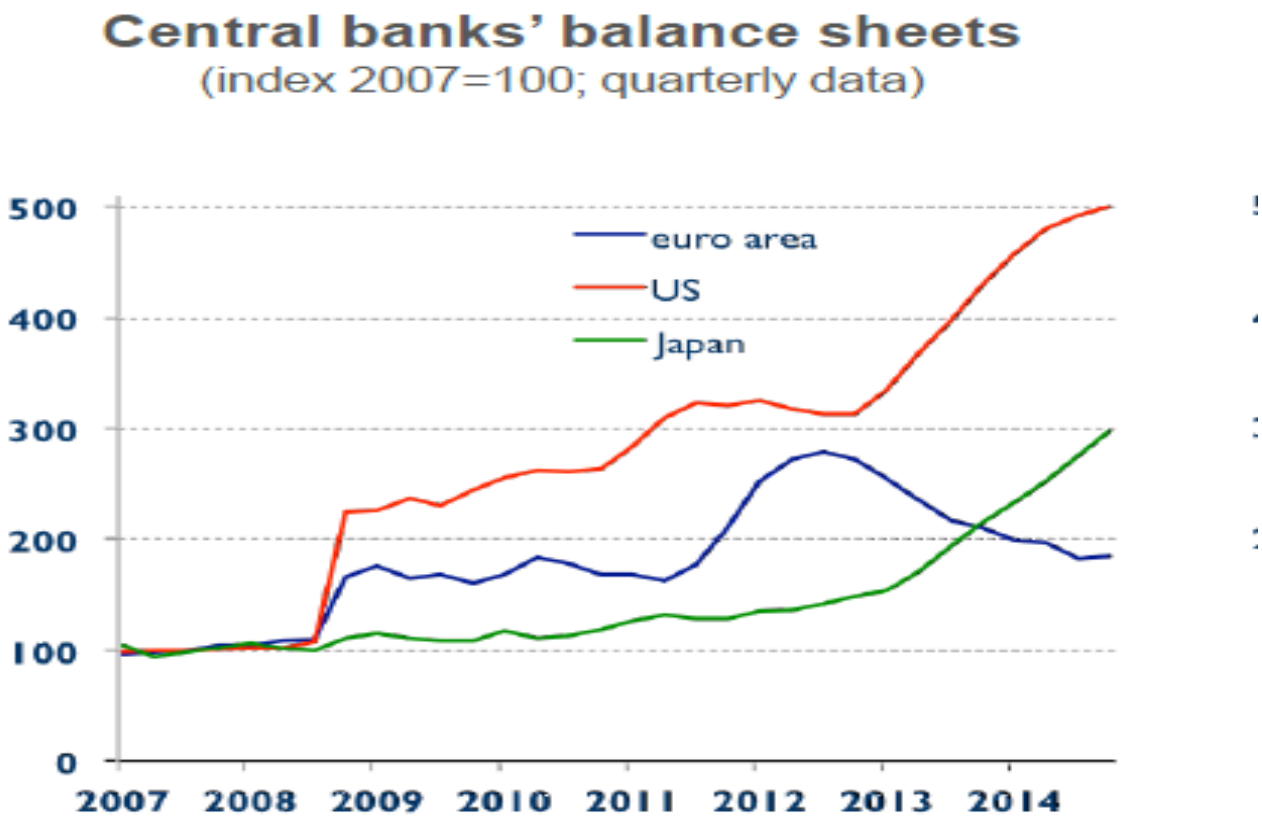
INTRODUCTION (2)

- As a result, central banks have become very big, very powerful and quite opaque.
- What are they doing and why they are doing it, is not always very clear.
- This presentation will defend the view that central banks' monetary policy mandates should be changed and their intervention modes made simpler and more transparent.

INTRODUCTION (3)

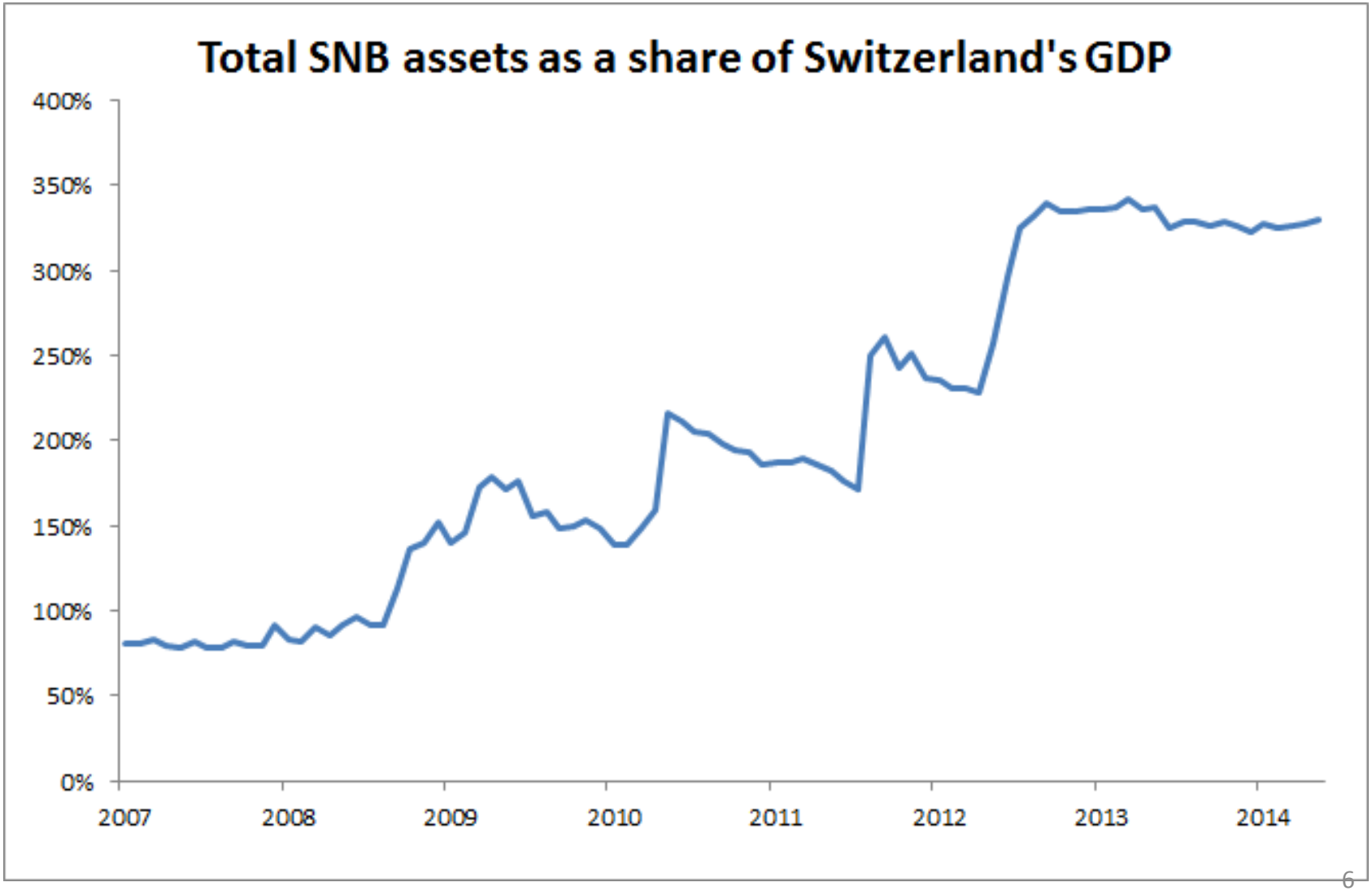
- Transparency of central bank policy is all the more important that most central banks also have now regulatory and supervisory powers (financial stability).
- Arguably, central banks have become the most powerful player in most economies.
- How can they be made accountable to the citizens while preserving their independence?

CENTRAL BANKS HAVE GROWN MUCH BIGGER SINCE THE GFC OF 2007-09



Sources: ECB, Federal Reserve Board, Bank of Japan and ECB staff

WHAT ABOUT SWITZERLAND?



What's in the Balance Sheet of the SNB (Dec 2015, Billions ChF)?

ASSETS		LIABILITIES	
GOLD RESERVES	35	BANK NOTES	73
CURRENCY RESERVES	598	RESERVES OF BANKS	428
CLAIMS FROM REPOS	4	OTHER LIABILITIES	78
OTHER ASSETS	3	EQUITY	61
TOTAL ASSETS	640	TOTAL LIABILITIES	640

Switzerland's currency reserves are huge

Countries	Reserves in Bn US$	GDP in Bn US$	Reserves/GDP
1) CHINA	3406	10357	33%
2) JAPAN	1248	4602	27%
3) EUROZONE	701	13410	5%
4) SWITZERLAND	602	704	86%
5) TAIWAN	425	530	80%

600 Billions of ChF represents roughly 168 kChF per Swiss family.

IS THIS GOOD OR BAD?

- Of course having a lot of reserves is rather a good thing.
- However these reserves could be used to finance some public projects (who will select them?).
- Moreover, the investments of Central Banks' (both abroad and domestically) are risky.
- In fact, central banks are assuming in part the role of private banks: provision of credit to the economy.

A SMALL DIGRESSION

J.C. Lambelet “Le Franc Fort” (Slatkine, 2016)

- In May 1996: T. von Ungern-Sternberg, Professor at Lausanne, wrote a paper arguing that the SNB had an excess of gold reserves of 1300 metric tons (roughly 21 billion ChF at the time).
- August 1999: several political parties suggested that BNS should sell this gold and use proceeds to fund various public projects (“Why didn’t we think of it by ourselves?...”)
- September 2002: rejected by popular vote (52%).

Punchline of this presentation

- Central Banks have increased their sizes, their powers and their opacity: it is not always clear what they are doing and why.
- They may have gone beyond their mandates: instead of focusing on money, they want to control also credit (and exchange rates...).
- That is not necessarily bad, provided this is done in a transparent and efficient way.

The power and independence of central banks

- Peter Conti-Brown has written a fascinating book "The Power and Independence of Federal Reserve" (Princeton U.P., 2016).
- He analyses the history of the Fed since 1913 and explains why its governance is so complex and opaque.

The exercise should be done in other countries:

- What are central banks exactly doing and why?
- Should their mandates be reformed?
- How can democratic control be exerted while preserving CB independence?

Central banks independence

- Essentially means a separation of central banks from politicians for purposes of maintaining low inflation.
- Classical metaphor (Homer):

  Ulysses and the Sirens.
- To guide his ship safely across seas populated with dangerous sirens (who were charming sailors by their songs), Ulysses asked his men to tie him to the mast.

Central banks independence (2)

- The central bank is Ulysses. Tying oneself to the mast means a commitment not to print too much money). The political parties are the sirens.
- Modern metaphor (W.McChesney –Martin): There is a party going on and people start enjoying themselves and drinking punch.
- The central bank is the chaperone who removes the punch bowl precisely when the party starts to warm up.

Central Banks accountability

- Ex post democratic control over monetary policy decisions is only possible if central banks have explicit mandates: “price stability” (SNB), “2% inflation” (ECB), “ price stability with a regard to employment” (Fed).
- However since the GFC, Central Banks have adopted (implicitly?) wider remits: exchange rate (I will not address this delicate issue here) and credit growth.

Central Banks are doing their best to stimulate credit

- The Fed has created several facilities for providing credit to financial intermediaries.
- In its short term lending to banks, the ECB has enlarged the collateral pool of eligible securities and eliminated any quantitative limits ("Whatever it takes"….).
- Large Scale Asset Purchases.
- Forward guidance: CBs try to influence not only short rates but the whole term structure of interest rates.

As a result, Central Banks interventions have become very complex

ECB	Fed	BoJ
2008 - Fixed-rate full allotment - FRFA	2008 - Term-Auction Facility - TAF; Term Securities Lending Facility - TSLF	2008 - Securities Lending Facility - expansion
2008/2009/2011 - Long-term Refinancing Operations (6m, 1Y, 3Y) - LTRO	2008 - Primary Dealer Credit Facility - PDCF	2008 - Outright purchases JGBs
2009/2011/2014 - Covered Bonds Purchase Programme (s) - CBPP	2008 - Asset-Backed CP MMMF Liquidity Facility - AMLF (and MMIFF)	2008 - CP repo operations - expansion; Outright purchases CP
2012 - Outright Monetary Transactions (announcement) - OMT	2008 - Commercial Paper Funding Facility - CPFF	2008 - Special Funds-Supplying Operations to Facilitate Corp. Financing
2013 - Forward guidance	2009 - Term Asset-Backed Securities Loan Facility (ABS CMBS) - TALF	2009 - Outright purchases Corporate Bonds
2014 - Targeted Long-term Refinancing Operations - TLTROs	2009 - Liquidity to credit markets - consumer, small business CMBS - TALF	2010 - Asset Purchase Programme - APP
2014 - ABS and Covered Bond Purchase Programme - ABSPP, CBPP	2008/2010/2012 - Large-scale Asset Purchases - QE1, QE2, QE3 - LSAP	2012 - Loan Support Programme
2015 - Expanded Asset Purchase Programme - APP	2008/2011/2012/2014 - Forward guidance (qualitative and quantitative)	2013 - Quantitative and Qualitative Monetary Easing

Tension between stability and growth

- After the GFC, the main concern was financial stability.
- The target was to reduce drastically the leverage of banks (and shadow banks).
- More capital, less deposits financing (in %).

However there are two forces against this:

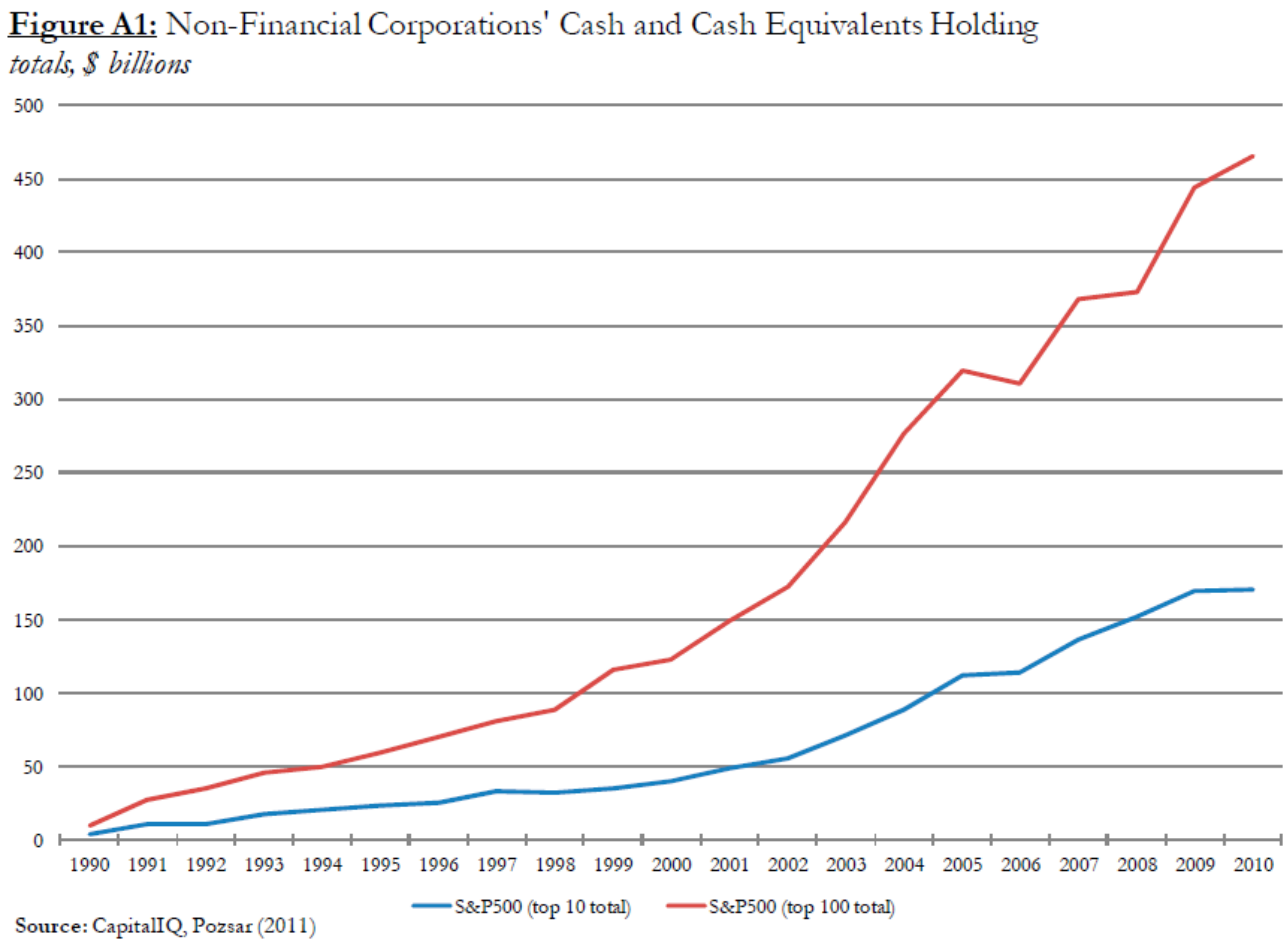
- As we saw, CBs want to stimulate credit.
- Also: there is a large demand for safe assets.

Shadow banking and the demand for safe assets

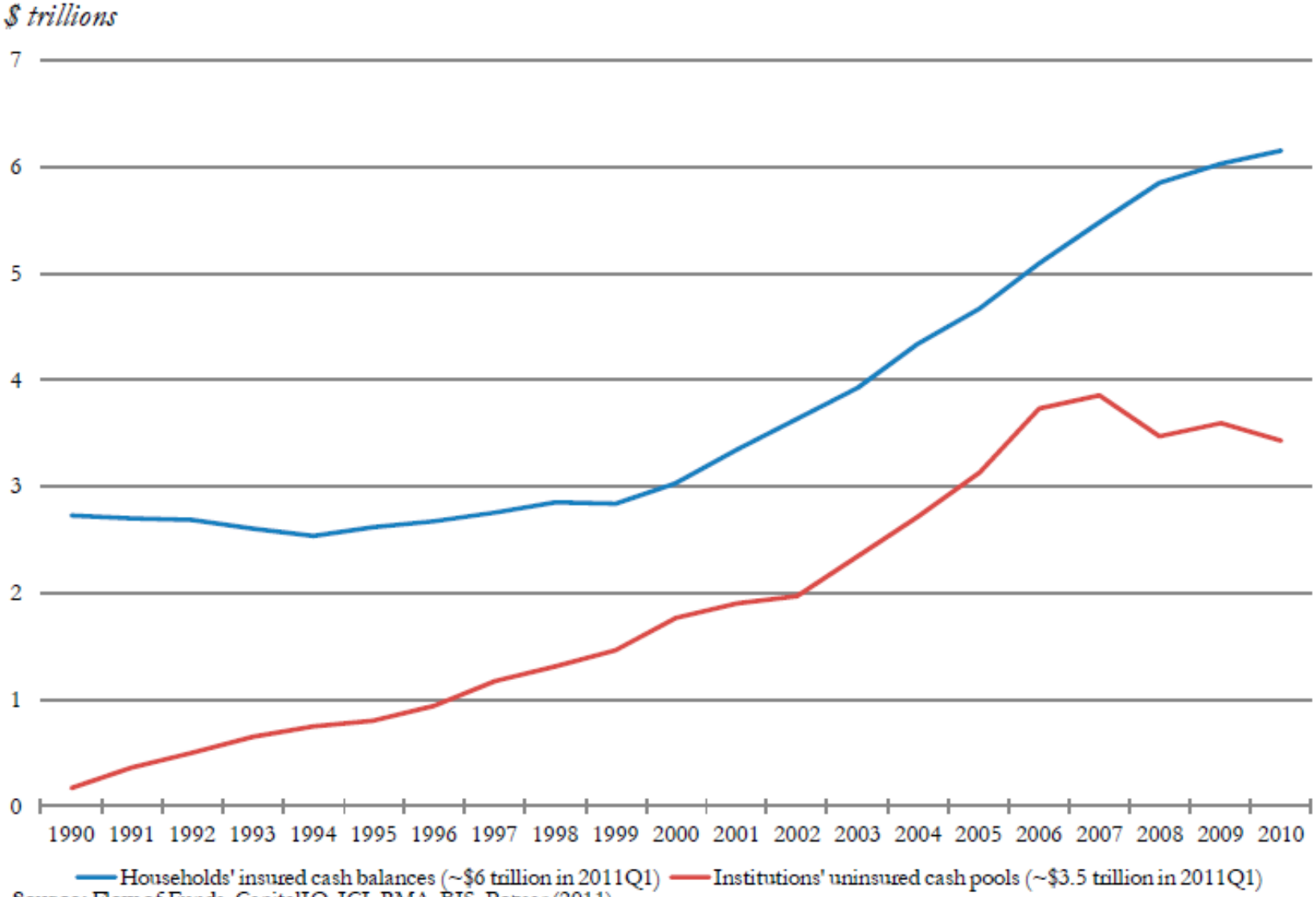
Gorton- Metrick (2010, 2012) and Pozsar (2012) explain the rise of shadow banking by a rise in the demand for safe assets

- Corporations, Money Market Funds and foreign investors want more of safe and liquid assets.
- Treasury Bills are the best choice for these investors but their supply is insufficient.
- The shadow banking system arose to fill this gap.

CASH RESERVES OF US CORPORATIONS

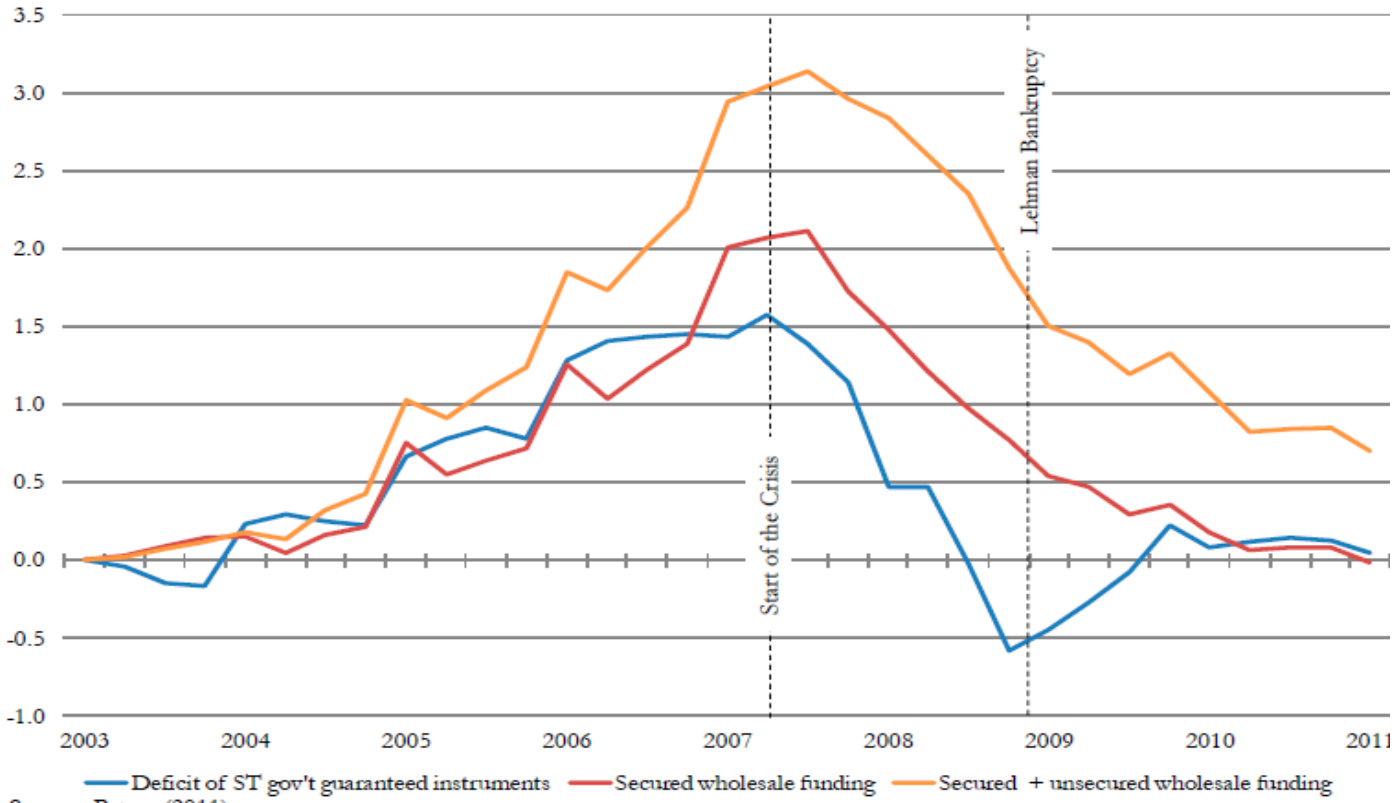


Insured and uninsured "money"



Source: Flow of Funds, CapitalIQ, ICI, RMA, BIS, Pozsar (2011)

The deficit in US safe and liquid assets



Source: Pozsar (2011)

Blue line: holdings of foreign investors+ volume of cash pools minus short term government securities

Tension with financial stability

AGGREGATE BALANCE SHEET OF BANKING SECTOR

ASSETS	LIABILITIES
RESERVES	RETAIL DEPOSITS
SECURITIES	WHOLESALE DEPOSITS
LOANS	CAPITAL (EQUITY+ LT DEBT)

Tension between
1) Higher preference for liquidity (both by investors and banks)
2) Need to stimulate credit (more loans).

Our proposal

1) Increase in bank reserves, either compulsory (changing regulatory ratio) or voluntary (paying interest).
2) Central bank purchases long term debt of banks at chosen price (implicitly defines a "credit policy" rate)

ASSETS	LIABILITIES
INCREASE IN RESERVES	RETAIL DEPOSITS
RESERVES	WHOLESALE DEPOSITS
SECURITIES	LT DEBT PURCHASED BY CB
LOANS	CAPITAL (EQUITY+ LT DEBT)

Our proposal (2)

- Benefits: more reserves (lower risk of bank run), more capital (lower risk of bank default), compatible with more wholesale deposits and more credit to the economy.
- Main idea is that CB lends to banks not only ST (monetary rate) but also LT (credit rate).
- To some extent, this is what CB already do, but in a less transparent fashion.

Two objectives, two instruments

- Central banks are trying to control two objectives (money and credit) with only one instrument, the short term rate.
- Why not giving them a second instrument, by allowing them to lend to banks also at longer horizons at another policy rate: the credit rate.
- It would be much more transparent and more efficient than using quantitative easing and forward guidance

Would this give too much power to central banks?

- CBs would not necessarily get more power than what they already have.
- However it would be more transparent and easier for citizens to monitor them ex post.
- In any case, this proposal would prompt the necessary debate on the power and independence of central banks in our economies.

Would this expose central banks to credit risk?

- Again, they are already exposed to it, but in a less transparent fashion (choice of eligible collateral, choice of haircuts).
- Central banks could lose money on their loans to commercial banks, but this would be priced in ex-ante.
- Moreover, as macro-prudential regulators and supervisors of big banks, central banks are in a good position to control this risk.

Favoritism

- The main concern may be that this reform would set in stone the current, post-crisis, situation, where central banks are assuming in part the role of the private sector, namely to decide which projects are financed and which are not.
- This is reminiscent of bad memories, when governments were controlling credit, which typically led to favoritism.

Conclusion

- Central banks have become the most powerful player in our post-crisis economies.
- However they are not transparent: it is not clear what they do and why they are doing it
- The reform we propose would make central bank policies more efficient and more transparent.
- Necessary debate on the power and independence of central banks.