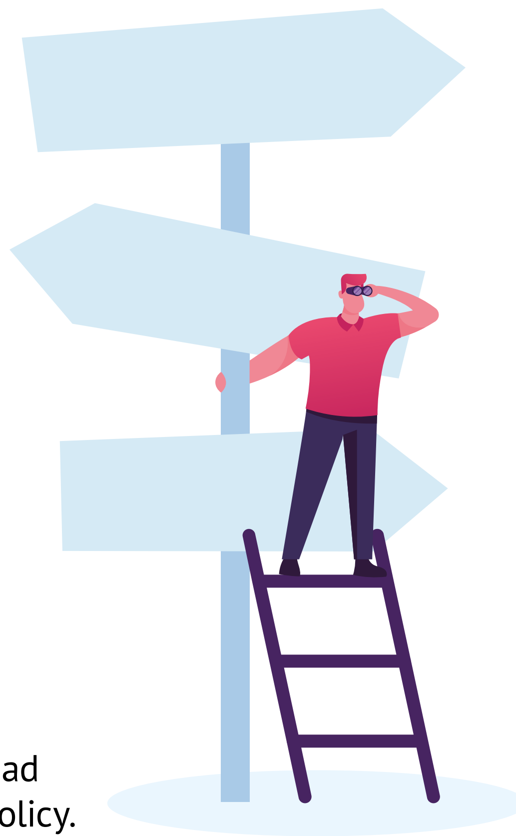
UNCONVENTIONAL MONETARY POLICY

Where next for monetary policy?



Central banks are increasingly choosing the road less travelled in their approach to monetary policy.

Over the past 10 years, central banks have increasingly turned to unconventional means to steer the economies of individual countries in the right direction. From quantitative easing (QE) and forward guidance to negative interest rates, central banks are now prepared to intervene in new ways. Is this unconventional monetary policy becoming the new normal, and, if so, what are the implications of this? For example, is a there a danger of untested policies fixing existing problems – while creating new ones?

“I would argue that unconventional monetary policy [UMP] already is the new normal,” says James Athey, Senior Investment Manager at global asset manager Aberdeen Standard Investments. “My biggest concern is not only that it’s ineffective but it’s self-defeating.

“For example, basic economic theory says that if you raise interest rates, people will borrow less and save more – and this will slow economic activity. If you lower interest rates, the theory is that people will borrow, spend and invest more, and save less, and this will increase economic activity.

“But what we’ve really observed is a psychological phenomenon where saving actually increases when you lower interest rates. If you’re lowering interest rates because the world is a very scary place, people are worried they may lose their jobs. That’s a more important driver of their behaviour – their confidence about the world – than where interest rates are. Not only that, if you’re closer to retirement, you may well have either explicitly or implicitly set a savings goal, a retirement target that you want to retire by a certain period of time – and you need a certain amount of savings to do so. If interest rates fall, you may save more to try to stick to your original retirement goal. So that’s one of the mechanisms where theory and reality seem to disagree with one another.”

Risky assets

Another potential risk of UMP is known as financialisation, where governments effectively become players in financial markets in ways that might trigger changes – intentional or otherwise – in market behaviour. For example, one of the biggest impacts of unconventional interventions such as QE has been to encourage investment in risky assets like equities and corporate bonds.

“It encourages risk taking, but it doesn't necessarily encourage responsible risk taking,” Athey says. “Corporates seem to have responded to this new world by investing less and less in their business and in the real economy, and more and more in financial markets.

> “Unconventional monetary policy already is the new normal.”
> James Athey,
> Aberdeen Standard Investments

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One of the trends we've observed in the past two years is companies buying back their own shares. And in doing so, they're not investing in plants or paying higher wages. They're piling the money back into equity prices, which then increase and make it look as if the company is more profitable. But, underneath that all, they're possibly sacrificing future growth. And that appears now to be setting us up for further economic weakness."

Industry concentration is another unintended consequence of the 'cheap' money created when central banks pump liquidity into a market.

"At the most extreme end of concentration, you have a monopoly – one company which covers an entire sector," Athey explains. "If there are two companies, that's a duopoly. If it's a small number of large companies, that's what's called an oligopoly.

"These are generally viewed as undesirable extremes because there is too much control and too much pricing power within a small group of companies. And that tends not to be efficient. It tends to reduce the benefit to consumers because sellers can spike the price of goods. And what we've seen, actually, is an increasing concentration of industry because the price of money has been kept artificially low.

"In most countries, monetary policy is still working 'pedal to the metal', but can do no more."

Stephen Grenville,
The Lowy Institute

"That means large companies are able to easily access and borrow money to buy small competitors. We see this most extremely in the tech sector, but it has happened in lots of other sectors, too. Again, the incentive for these companies to pay higher wages or to invest in their business is reduced, because there isn't sufficient competition to drive them to do so.

"If I was to summarise all of that in one phrase, I'd say we are breaking capitalism – and leading the way to inefficient resource allocation."

Unintended consequences

Dr Simone Giansante, Assistant Professor of Finance at the University of Bath School of Management, is an expert in financial systems. He recently led research papers on whether QE in the UK boosted bank lending to the real economy or led instead to banks reallocating their assets.

"We know from the aggregated stats that lending to the real economy in the UK actually declined during QE instead of improving, and that's the problem that we look at in our papers," Dr Giansante explains. "Basically, we've just tried to understand why banks didn't increase their lending to the real economy after the QE money injection. From the supply side, the banks might have decided that lending to the real economy was not the best choice.

"Or on the demand side, it could be that corporates found an alternative way to fund their activity, instead of borrowing from the banks. Because when interest rates go down, it's cheaper for corporates to borrow in the capital markets.

"But actually, what we are claiming in our paper is that banks were using this money to do something else that the central bank wouldn't have intended."

Instead of increasing their lending to the real economy with this injection of liquidity, banks invested in assets that shored up their own capital strength, Dr Giansante and his team argue.

After the 2008 financial crisis, banks were forced to increase their capital to absorb any potential losses in the future. Minimum capital requirements under the Basel III international accord were designed to promote financial stability and efficiency in economic systems around the world.

Dr Giansante continues: "The thinking is that, with every asset they purchase, banks also have to raise a percentage of capital, also known as risk-weighted based capital requirement. Equities and corporate bonds would have offered good returns and been a

better substitute for the assets sold back to the QE programme. But these are assigned with high risk-weighting, so would require the banks to hold higher capital. Instead, what we found is that banks preferred to invest in government debt – sovereign bonds and government securities in general. A lot of these had been Triple A-rated before the sovereign debt crisis but were downgraded a few years later. It meant the banks could invest as much as they wanted in these bonds without raising any capital, providing them with a good risk-weighted return."

Bursting the bubble

Portugal, Ireland, Italy, Spain and Greece were among the European countries to benefit as the wall of money flowed overseas in search of good returns from highly rated government debt that was regarded as low risk.

Dr Giansante says: "In the finance literature, they refer to this as regulatory arbitrage, because, although it's not arbitrage per se (benefiting from the price difference between two or more markets), banks were trying to take advantage of this risk-weighting approach to capital requirements.

"Banks were pumping and building this big bubble that then burst. Greece was downgraded, Portuguese bonds were downgraded, Italian bonds were downgraded and so on.

"If we look back at all of the original intentions and objectives of QE, you can really see that the lack of credit going to the real economy was a failure, and that promoting the sovereign debt bubble was an unwanted consequence. Because of lower yields due to QE and capital requirements, banks preferred not to lend to the real economy, but to invest in these other products instead."

Stephen Grenville, a former deputy governor of the Reserve Bank of Australia, is a non-resident Fellow at the Lowy Institute, an independent policy think tank in Sydney, Australia.

He argues that one problem in evaluating QE is that it is hard to distinguish its impact from that of forward guidance, which was often provided at the same time, either implicitly or explicitly.

"Forward guidance provided financial markets with additional information about the future intent of monetary policy," he explains. "When central banks succeeded in changing the market's perception of the future path of interest rates, this influenced asset prices and exchange rates, so was effective. However, markets sometimes misinterpreted the message, and began to focus more on analysing policy pronouncements and less on the prospects for the economy."

Disappointing results

Negative interest rates drew headlines and spirited academic discussion, but were the least important of the UMP measures, Grenville adds.

"For practical reasons, interest rates can only be trivially below zero and the main impact was on exchange rates," he says. "This leaves countries open to accusations of 'beggar-thy-neighbour' exchange rate manipulation – enacting a policy that benefits them at the expense of their neighbours or trade partners. Real interest rates (adjusted for inflation) are what matter for investment and these have often been negative in the past, so there seems little important distinction between low rates and negative rates."

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> Dr Simone Giansante,
> University of Bath School of Management

'Helicopter money' – the provision of direct cash grants funded by the central bank – is another unconventional policy that was mooted – but no country ever enacted it.

"Over time, it came to be accepted that helicopter money was just a form of fiscal policy, funded by the banking system's forced holdings of excess reserves," Grenville says. "On mature consideration, bypassing the normal parliamentary processes and handing over effective fiscal policy to the central bank didn't have wide appeal."

For all the boldness of these initiatives, the results were disappointing, Grenville notes.

QE1 – the first US foray into QE in 2008 in a bid to rescue the financial system – mainly involved buying back 'toxic' mortgage-backed securities and was universally seen as a huge success. But later QE episodes directed at a different objective – stimulating growth and inflation – had patchy results.

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"Longer-term interest rates fell, asset prices rose and exchange rates depreciated, but bank lending remained weak," Grenville says. "US bank lending fell after QE1 began, and didn't recover its pre-crisis peak until more than three years later. In Europe and the UK, bank lending was even less responsive. Japan, the country with the longest experience of QE, remains mired in slow growth and below-target inflation to this day."

Here to stay?

Looking ahead, Grenville says QE is proving hard to unwind, as the financial system has become accustomed to operating with substantial excess central-bank money.

"Whether it can be weaned off its dependence on excess liquidity remains to be seen, but central banks are less enthusiastic about QE than they once were," he says. "And, of course, the need for QE1-type crisis action has gone. Forward guidance seems set to stay, even though it presents central banks with a minefield of misinterpretation possibilities. Markets are always demanding more information, so the current stream of official speeches and predictions seems likely to remain the norm. There seems little enthusiasm for negative interest rates."

Unconventional monetary policies have probably done no great harm, and maybe some overall good, Grenville believes. But the basic problem remains: none of these policies has been very effective in stimulating growth or getting inflation back to target.

Side effects

In October 2019, a report titled: *Unconventional Monetary Policy Tools: A Cross-country Analysis,* was published by the Committee on the Global Financial System (CGFS), which monitors developments in global financial markets for central bank governors.

It is part of the Switzerland-based Bank for International Settlements (BIS), which represents 60 central banks around the world and aims to foster international cooperation on monetary and financial stability.

Philip Lowe, Governor of the Reserve Bank of Australia, chairs the Committee on the Global Financial System and summarised some key observations of the report in an address to the Australian Business Economists Dinner last November.

"There is strong evidence that the various liquidity support measures and targeted interventions in stressed markets were successful in calming things down and supporting the economy," Lowe said. "When markets broke down and became dysfunctional, the actions of central banks helped stabilise the situation and helped avoid a damaging gridlock in the financial system."

However, he noted various side effects of the different unconventional measures.

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"Extensive use of unconventional monetary tools can change the incentives of others in the system."

Philip Lowe, Committee on the Global Financial System

"Developed economies have lost their mojo," he adds. "The lesson ought to be that monetary policy did a good job in handling the unfolding 2008 crisis and has helped the recovery. But has not been powerful enough to offset the many headwinds: the longer-term effects of the financial crisis (including balance-sheet effects), structural and systemic problems, over-sensitive risk concerns, trade-based global uncertainty, short-termism and distorted investment incentives, and the misjudged budget austerity of the 2011 to 2015 period.

"In most countries, monetary policy is still working 'pedal to the metal', but can do no more. If more is needed, it will have to come from fiscal policy and structural changes that unleash investment-enhancing productivity."

in the system, perhaps in an unhelpful way. It is possible that the willingness of a central bank to provide liquidity reduces the incentive for financial institutions to hold their own adequate buffers, making episodes of stress more likely in the future.

"It is also possible that the willingness of a central bank to use its full range of policy instruments might create an inaction bias by other policymakers, either the prudential regulators or the fiscal authorities. If this were the case, it could lead to an over-reliance on monetary policy.

"A second side effect is the impact on bank lending and the efficient allocation of resources. Persistently low or negative interest rates and a flattening of the yield curve can damage bank profitability, leading to less capacity to lend. In some countries, there are concerns that low interest rates allow less-productive (zombie) firms to survive. There are also financial stability risks that can come from low interest rates boosting asset prices (and perhaps borrowing) at a time of weak economic growth."

A third side effect is a possible blurring of the lines between monetary and fiscal policy, Lowe continued. "If the central bank is buying large amounts of government debt at zero interest rates, this could be seen as money-financed government spending. In some circumstances, this could damage the credibility of a country's institutional arrangements and create political tensions.

"Political tensions can also arise if the central bank's asset purchases are seen to disproportionality benefit banks and wealthy people, at the expense of the person in the street. This perception has arisen in some countries despite the strong evidence that the various monetary measures supported both jobs and income growth and thereby helped the entire community. These are all side effects we need to take seriously."

Lowe concluded that a package of measures works best, with clear communication that enhances credibility. Exactly what that package looks like varies from country to country and depends on the specific circumstances. But clear communication from the central bank about its objectives and approach is always important.

Ultimately, there may be better solutions than monetary policy to solving the problems of the day.

Summing up, Lowe said "We need to remember that monetary policy cannot drive longer-term growth, but that there are other arms of public policy than can sustainably promote both investment and growth". CB

THE UMP TOOLKIT

Negative interest rates **(see page 50)**
Reducing rates below zero, so cash deposits incur a charge for storage at a bank, rather than receiving interest. First deployed by Sweden's central bank in July 2009, Denmark, the Eurozone, Hungary, Norway, Switzerland and Japan followed. Rates have been lowest in Switzerland, at -0.75%.

Extended liquidity operations
Approaches differed across countries, but included expanding the range of collateral accepted; extending liquidity volumes and eligibility and providing funding to banks at below market cost.

Quantitative easing
First used by Japan in 2001, this is the outright purchase of private sector financial assets by central banks, who pay for those assets by creating central bank reserves. Central banks mostly bought government securities (government debt). Before the 2008 financial crisis, the major central banks owned securities equivalent to around 5% of GDP. In recent years, this has risen to nearly 30%.

Forward guidance
Giving markets a steer on the direction of monetary policy. This generally looks ahead for a specific time period, such as a year, or links money policy to economic factors including changes in unemployment or interest rates. The US Federal Reserve started using forward guidance during the recession of the late 2000s. The Bank of England launched forward guidance in 2013.

Yield curve control
By promising to buy government bonds if yields rise a certain distance, central banks can influence government bond yields further into the future. This is a policy designed to give the impression of looser financing conditions to encourage borrowing, investing, spending and risk taking.

Helicopter money
The provision of direct cash grants funded by the central bank was discussed, but never implemented by any central bank.