Monetary Policy and its Unintended Consequences (MIT Press)

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What is this book about?

"Tonight's story is about sustainable economic growth without quantitative easing."

Introduction

- Two issues.
  - High inflation, worries about fiscal and financial dominance.
    - Do central banks have any responsibility here?
  - How should central bank frameworks change?
    - Inflation/financial stability
- Use Fed often as an example.

What led us to the current monetary situation…

- Recent events …
- But much had changed before them
  - Post GFC lowflation

Pressure on central banks before pandemic

- From the political side
- Pressure from the foreign exchange market
- Central bankers also did not reject the responsibility.
- No obvious playbook though at ZLB.

What did the central banks do?

- Embarked on unconventional monetary policy.
  - Repairing markets
  - Alter asset prices through asset purchases, including of government debt (QE)
  - Forward guidance
  - Directed credit programs

What did the central banks do? Contd.

- Changed framework
  - Commit to being more relaxed about inflation (or rationally irresponsible in Paul Krugman's words).

Micro effects of these actions

- Asset prices rose and leverage built up.
- We have some evidence for the micro-effects of unconventional monetary policy.

Macro effects of these actions

- At the macro level on rates
- But broader macro impacts, including on real activity, are harder to discern.

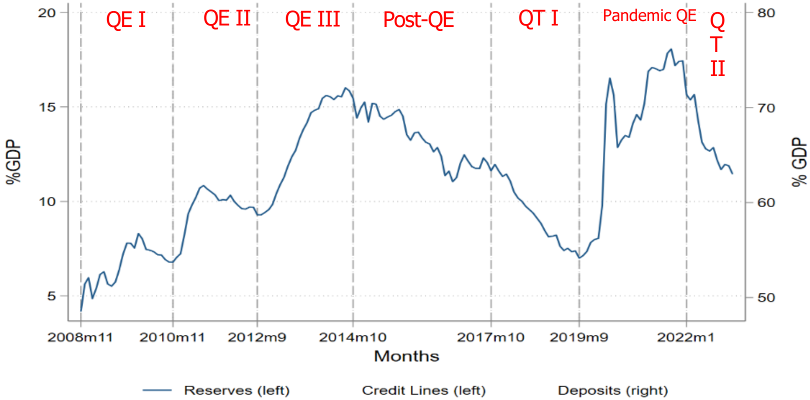
Other effects, intended or otherwise: Future fiscal pressure

- Anaesthetize government bond markets
- Shorten maturity
- When interest rates move up....
- Fiscal dominance?

Other effects: Commercial bank balance sheet expansion

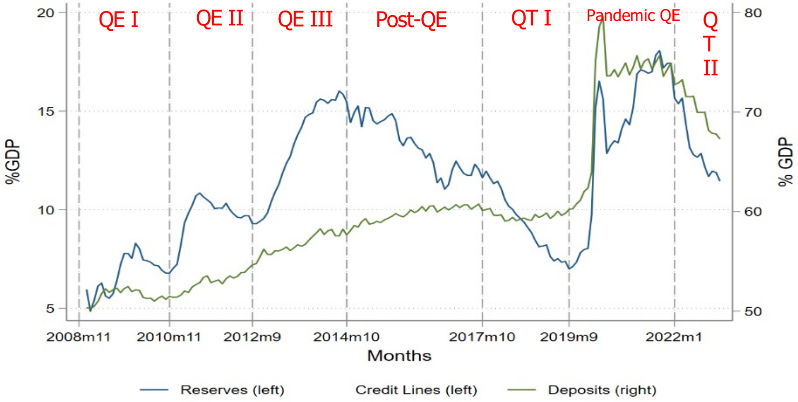
- Under QE, central bank balance sheets have expanded
- Commercial bank balance sheets also have expanded
  - Commercial banks increase holdings of reserves, financed with uninsured demandable deposits.
  - Reduce time deposits
  - Increase credit lines

Reserves and Claims (% of GDP)

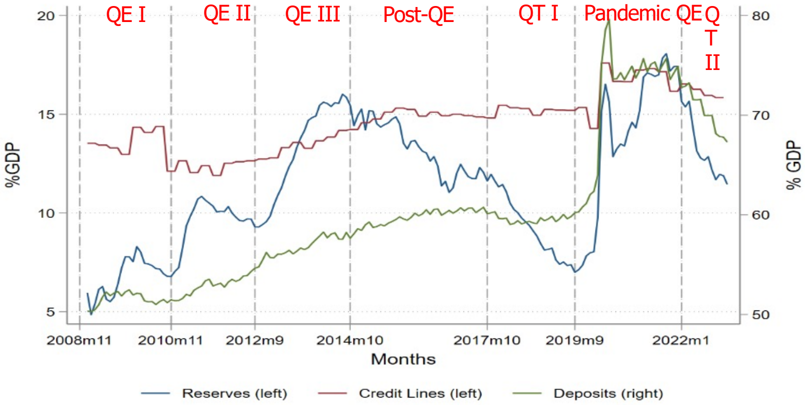


Acharya, Chauhan, Rajan, and Steffens (2023)

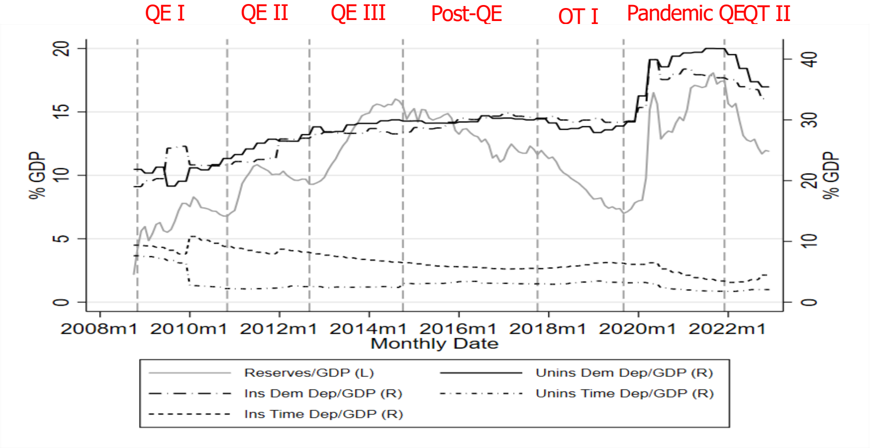
Reserves and Claims (% of GDP)



Reserves and Claims (% of GDP)

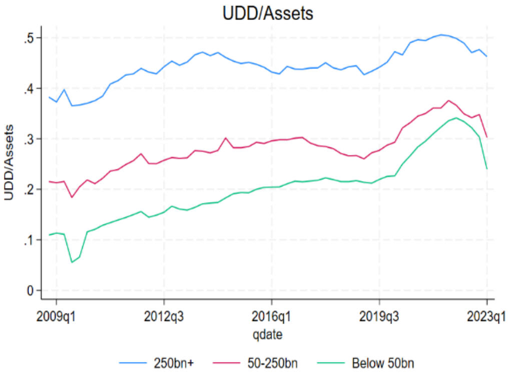


Uninsured/Insured Demandable/Time Deposits (Prop. of GDP)



Ratcheting-up of Uninsured Demand Deposits

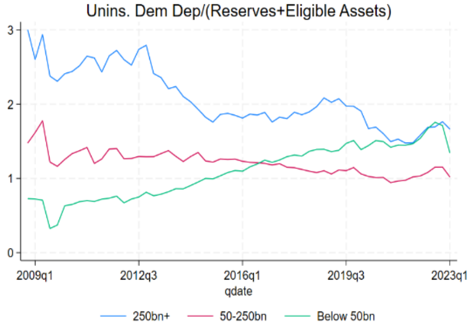
Date	>$250 billion	$50-250 billion	< $50 billion
2008Q3	35.8	20.9	10.4
2014Q3	46.1	30.1	18.3
2019Q3	**44.1**	**27.7**	**21.9**
2019Q4	**45.1**	**28.7**	**22.5**
2021Q4	50.4	37.6	33.5
2022Q4	**49.8**	**34.8**	**30.3**
2023Q1	**46.2**	**30.2**	**23.9**



Ratcheting-up of Liquidity Risk

Claims to Liquidity/Potential Liquidity = Uninsured Demandable Deposits /(Reserves + Eligible Assets)

Date	>$250 billion	$50-250 billion	< $50 billion
2008Q3	3.77	2.5	0.76
2014Q3	1.93	1.35	0.95
2019Q3	**1.97**	**1.11**	**1.47**
2019Q4	**1.97**	**1.15**	**1.51**
2021Q4	1.48	1.02	1.47
2022Q4	**1.76**	**1.15**	**1.71**
2023Q1	**1.66**	**1.02**	**1.34**



Largest banks becoming safer, smallest banks increasingly at risk of illiquidity

Consequences of all these changes

- Unfortunately, covid upset the best laid plans.
  - Real disruptions, fiscal expansion, monetary easing, including balance sheet expansion.
  - Cannot react to inflation early.
  - So the Fed delayed and then had to catch up.

Risks also were higher in banking system

- Already shown liability side changes.
  - Also, reserves moved to liquid long term securities.
- When rates start rising, and QE shifts to QT…
  - Liquidity risk and solvency risk come to the fore
  - Deposit inflows turn to outflow.

Even with little QT,

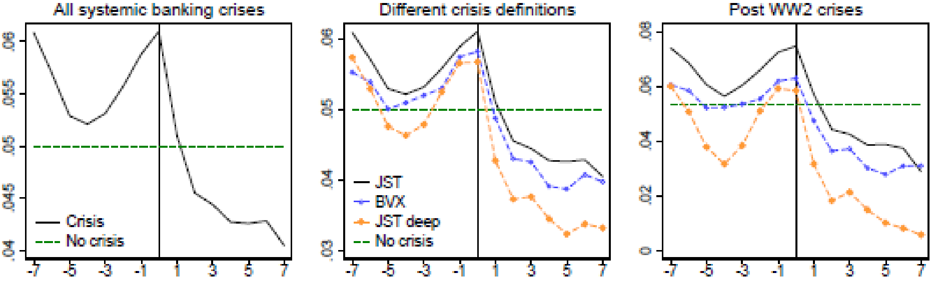
- Failure of 4 US banks in March 2023, and subsequently some mergers.
- Unprecedented Fed and Treasury intervention
- Converted a possible panic into a slower burning problem.
- Financial dominance?

Bottom line 1

- Financial stability and monetary policy have become deeply intertwined.
  - Many central bankers would not agree.
    - Separation principle?

Jimenez, Kuvshinov, Peydro, and Richter (2023)

Figure 2: *The average level of monetary policy rates around past crises*



Not even addressed fiscal dominance

- Role of QE in limiting fiscal concerns as Congress/Parliaments spend.
- Consequences of QE in raising interest sensitivity of consolidated debt
- Unpleasant fiscal arithmetic (Sargent and Wallace).

What should central banks do going forward?

- Augustin Carstens (GM, BIS) pointed out to the possibility of two inflation regimes.
- Low inflation regime – price shocks do not feed on each other
  - Inflation may be too low – below targets
- High inflation regime – price shocks become more correlated and become generalized inflation quickly
  - Need to react quickly to head off generalized inflation.
- Maybe need a different framework for each regime.
  - Is that possible?

A framework for all seasons

- Need framework for all regimes: pick your poison
- Transition between low to high inflation regime under a relaxed framework is really problematic
  - Wait too long
  - Financial risks build up when policy accommodative
  - Financial instability as central bank tries to catch up by raising rates quickly.

Bottom line 2

- Pick the framework that contains high inflation
  - Don't worry too much about low inflation unless it becomes galloping deflation.
    - The cure may be worse than the disease.
- Central banks can achieve more by doing less.