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MONETARY POLICY AFTER THE GFC: LESSONS FROM HISTORY

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SUMMARY

- This seminar analyses a new revolution in monetary policy
- Three huge shocks – the GFC, the near-collapse of the euro and COVID-19 – led central banks on a path of unprecedented balance sheet expansion.
- Understanding these policies is helped both by finance theory and by knowledge of earlier monetary policy frameworks.
- COVID has led to increased budget deficits largely financed by central banks.
- Persistent inflation undershoots led the Fed in August 2020 to adopt through-the-cycle inflation targeting. But then COVID-induced supply shocks and the war in Ukraine led to a large and persistent rise in inflation.
- Monetary policy during 2022 tightened substantially, growth prospects darkened, the market prices of bonds and equities fell. Central banks faced difficult policy dilemmas.

The Global Financial Crisis (GFC) revealed major failings in the international monetary and financial system. At first, the monetary policy reaction of central banks was inadequate. But the threat of global deflation after the Lehman collapse in September 2008 led central banks to cut interest rates. The Federal Reserve and the Bank of England also made “unconventional” asset purchases on a large scale. The ECB decided to limit monetary expansion, but was eventually forced to take radical action by the near-collapse of the euro. As the threat of global deflation receded, the Fed began a gradual withdrawal of monetary stimulus, and others wished to follow. But the arrival of COVID-19 depressed activity and caused market panic. This dashed any hope of near-term “normalisation” of monetary policy. On the contrary, central bank balance sheets reached new heights. They continued to expand even after markets had normalised. By late-2021, central banks struggled to contain inflation.

Such “unconventional” policies added decisive macroeconomic stimulus in the worst crisis since the second world war. The policies adopted reflected many lessons that economists had learnt from the macroeconomic policy failures of the Great Depression in the

1930s. Deliberately lowering risk premia in financial markets proved to be very effective notably in sustaining market functioning and avoiding a credit implosion. It did not produce the financial crisis that some feared. This was partly because banks had been forced to apply tougher credit risk assessments and to build up larger capital and liquidity buffers.

Nevertheless, most central banks felt uneasy about their growing balance sheets from the beginning. But new demand-depressing events time and time again forced central banks to back away from their declared plans to "renormalize" monetary policy. The 2013 "taper tantrum" forced the Fed to slow their planned tightening. The very gradual tightening by the Fed that began in December 2015 did not go very far, and was not followed by others. The increased risks of slower global growth led the Fed in January 2019 to halt further interest rate increases. As the Fed cut the funds rate, monetary policy was eased worldwide. The onset of COVID-19 rapidly led to further monetary stimulus, and renewed growth in central bank balance sheets.

Then in 2022 came the Great Monetary Tightening, with an end-point that remains unclear still. One question that loomed large in 2022 was: how much should tightening take the form of higher policy rates and how much the form of reduced balance sheets?

Preparation for Monday 6 March

Read Chapter 1 (pp 3-17) of Philip Turner (2021) "The new monetary policy revolution: advice and dissent." NIESR Occasional Paper no 60. The first part of the seminar will be a discussion of the issues raised in this chapter. Two volunteers to introduce speaking for about 5 minutes or so. One to summarise how the analysis of monetary policy could benefit from taking greater account of finance theory and practice. The other to discuss why the expanded tool-kit of monetary policy can help to counter future financial and macroeconomic shocks. Then a tour de table of all students: please pick one or two points from the chapter of interest to you.

The second part of the seminar will consider Quantitative Tightening (QT)

In the case of **most countries**. QT means the central bank selling bonds. The notes are (1) Allen, Chadha and Turner "Quantitative Tightening: protecting monetary policy from fiscal encroachment" VOXeu NIESR Policy Paper 27, 28 July 2021 and Turner "Quantitative Tightening: missed opportunities." Two volunteers, one for each paper.

In the case of **Switzerland**, QT means the SNB selling its foreign assets. On this read, Gerlach, Lengwiler and Wyplosz "Monetary policy options" SNB Observatory no 6 (December 2022). One volunteer to summarise the paper, and a second volunteer to say whether the SNB is too worried about a strong Franc. Then a tour de table.

There is a major new debate about the “new normal” for monetary policy. Some argue for a higher inflation target. The Fed announced in August 2020 that it would maintain its 2% as its through-the-cycle target but it would allow periods of above-target inflation. At that time, some argued that, with the equilibrium real short-term interest rate (r*) likely to be close to zero for some time, central bank balance sheets would continue to be used more actively as the main monetary policy tool to counter downturns.

Controversy has always surrounded negative rates, which were only used because the ECB felt constrained about what assets it could buy. There is no consensus as to which of the new policy tools employed have fewer undesired side-effects (on fiscal dominance, on the exchange rate or on financial stability).

Many current debates on what central banks should do can be illuminated by historical controversies, some of which remain unsettled. The pre-GFC neo-Keynesian theoretical paradigm (monetary policy is mainly setting the overnight interest rate without explicit balance sheet policies) represented a backward step from the richer analyses of Keynes, Tobin and others who incorporated key elements of finance theory and practice in their analysis of monetary policy. The GFC made earlier monetary theories based on portfolio choice under uncertainty and on the need to influence market risk premia/collateral practices seem crucial. Radical re-thinking about monetary theory has begun. How to develop models of monetary policy which do not rely on rational expectations and take a more realistic perspective on market failure in financial markets?

<u>Preparation for Tuesday 7 March</u>

Read “Monetary policy in a world of radical uncertainty” a speech by Mervyn King. Institute of International Monetary Research Conference Paper. November 2021. Two volunteers to lead off, speaking for 5 minutes each (and working out between yourselves how to divide your discussion). Then a tour de table.

The second half of the seminar will discuss the Great Monetary Tightening of 2022. There has been a lively debate about how central banks should respond to the recent surge in inflation. On how to interpret signals from bond markets, see “Is a bond market crisis imminent?” by Marina Misev and Philip Turner. See the course powerpoint “The great monetary tightening of 2022.” Two volunteers to lead off on the inflation risk (one arguing that central banks are behind the curve and the other that they are not). There are also questions about equilibrium real interest rates in the future. A third volunteer to talk about r*. Short readings are:

Philipp Hildebrand “The old inflation playbook no longer applies.” FT 28 Jan 2022

Rick MIshkin “Flaws are evident in the Fed’s approach to inflation.” FT 17 Jan 2022

Chris Giles et al “Central banks haunted by fears of stagflation.” FT 5 Oct 2021

Jorma Schäublin and Philip Turner “A latent rise in r* to upend monetary policy?” *Central Banking Publications* 31 March 2021.

None of these issues is settled. In this seminar, we consider from an historical perspective some of today’s controversies. Key elements in the history of monetary theory will be outlined, with an emphasis on the finance dimension. The aim is to explore, using several sources, themes of particular relevance for monetary economics today.

The five main themes to be covered are summarised in the ***Outline of topics,*** below. The seminar will begin with a brief comparison of the different approaches to central banking since the 19th century (with particular attention to macroeconomic features of the 1929 Great Depression). Changes in monetary policy frameworks, exchange rate mechanisms and the regulation of the financial system inevitably influence central bank policies.

Next, there will be a brief discussion of different historical strands of monetary theory – classical versus Keynesian, rational expectations versus radical uncertainty and so on. Historically, some analyses have focused on prices (e.g., the interest rate) and others on quantities (e.g., the central bank balance sheet). In theory, any quantity has a price dual. Monetary policy responses over the past decade have given greater importance to the central bank’s balance sheet (and less to the policy interest rate which has remained close to zero for years) than was the case in the pre-GFC period.

Finally, the seminar will consider how other policy frameworks – fiscal policy, the exchange rate and financial regulation – could influence or constrain monetary policy. One key debate is about how to mitigate the unintended side-effects of central bank balance sheet expansion on non-monetary policy objectives.

Organisation

The seminar depends on students taking an active part in discussing what are live and controversial questions. A critical attitude is essential. Making presentations is an active way of learning both individually and from others, and is an important skill to acquire for any job. So is the capacity to comment constructively on the views expressed by colleagues.

The three requirements are:

1. A class presentation about 1-2 article(s) relevant to the seminar

2. A term paper and a discussion of the term paper of a fellow student

3. Active discussion

The powerpoints prepared for this seminar have been designed to be readable on their own. They seek to lay out the main points in a non-technical way. **The relevant powerpoint should be read before each seminar.**

During the first half of the semester, each student will be invited to prepare a **short presentation** with a powerpoint (speaking 10 minutes or so) on one or two articles (or a section of a book) relevant to the theme of the seminar that day (topics 3-9, 11-17). The first student presentation, on the topic of Lecture 3 which is interest rates and monetary régimes, is expected to be around Monday 13 March. They should explain the point of the articles, say on what they agree or disagree and perhaps identify reasoning they did not understand. They can suggest a few key questions for the class to discuss. There will be two or three guest lectures by economists close to the policy debate within central banks.

The second requirement is to write an **essay on a monetary policy issue relevant to the recent crisis.** Each student will be asked to select a relevant topic/question: the ***Outline*** suggests several possible themes and students may wish to propose others. The essay should be around 3,500 to 4,000 words (maximum of 5,000 words) plus a bibliography and a few well-chosen graphs and tables.

Each student will be asked to give a 20-minute powerpoint presentation on that essay and to act as a discussant for another student's presentation.

Outline of topics

Seminars marked with an * will start with a 10-minute presentation by a student

<u>Two lectures of introduction</u>

1. **Central banks: a brief historical overview.** Macroeconomic and financial stability objectives. Quantity or price of money as analytical focus. The gold standard and debt deflation. "Real bills" doctrine, the Fed's 1923 principles and the liquidationist thesis. Managing money in a credit economy (Thornton, Wicksell, Bernanke-Blinder).

2. **How activist should the central bank be?** Classical; Fisher (non-neutrality of money); Keynes (radical uncertainty); Keynesian; New Classical (rational expectations); New Keynesian; Financial frictions (multiple equilibria).

<u>Interest rate policy under different monetary regimes</u>

3. **Interest rates and monetary regimes.*** Gold standard. Wicksell and the natural rate of interest. Keynes and liquidity preference. Tobin and portfolio choice under uncertainty. Woodford and monetary policy without money.

4. **The long-term interest rate.*** Term premium and expected future short rates. Secular trends; QE makes the LT interest rate a key policy variable; financial regulation depresses benchmark LR rates. The Fed's triple mandate.

The central bank balance sheet

5. **The central bank (CB) balance sheet.*** Assets or liabilities as analytical focus; channels of transmission; macroeconomic impacts; the liquidity of the balance sheets of banks; domestic impact of CB purchases of foreign exchange.

6. **Is a large and active balance sheet a new permanent instrument for central banks?*** Or major dangers if the exit is badly managed?

7. **The CB as lender of last resort (LOLR) and as market-maker.*** The liquidity regulation of banks.

8. **The Federal Reserve's balance sheet.*** First mover, gradual exit, reversal from January 2019 and strong post-COVID-19 expansion

Monetary policy and fiscal policy

9. **Monetary policy and government debt: key historical themes.*** A market for government bonds. Special status of government debt. Monetary versus non-monetary finance

10.a COVID-19: a marriage between monetary and fiscal policy? Very large increases in budget deficits financed by central banks. Guest lecture.

10.b The challenges facing the Federal Reserve. Guest lecture.

Monetary policy, international adjustment mechanisms and the exchange rate

11. **International adjustment mechanisms.*** Fed *de facto* world central bank. Dollar debt markets dominated by non-US residents. International saving and investment balances.

12. **Global liquidity***

13. **Spillovers*** from monetary policy in the advanced economies to EMEs.

14. **Fixed exchange rates of the euro area.*** The loss of the exchange rate not only for adjustment but also as a vehicle of international financing. Target2 was an unplanned but very powerful international financing mechanism. Negative rates. Monetary policy dilemmas for Switzerland.

14.a Challenges facing the ECB: lessons from fighting a near-collapse. Guest lecture.

Monetary policy and financial stability

15. **Macroeconomic and financial stability objectives.*** Keynes versus Hayek. Tinbergen's rule: does the balance sheet as an instrument of monetary policy independent of the policy rate open new possibilities for multiple objectives?

16. **The debate about LAW ("leaning against the wind").*** Should the CB tighten monetary policy more than needed on macroeconomic grounds in order to limit credit expansions/asset price bubbles?

17. **Macroprudential policies.*** The link with monetary policy. The virtual failure to address capital market intermediation.