

# Unorthodox monetary policy

Presentation to The European Federation of  
Financial Analysts Societies

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Monday, 23 February 2009

# Stylised US balance sheets, end June, 2007, \$bn

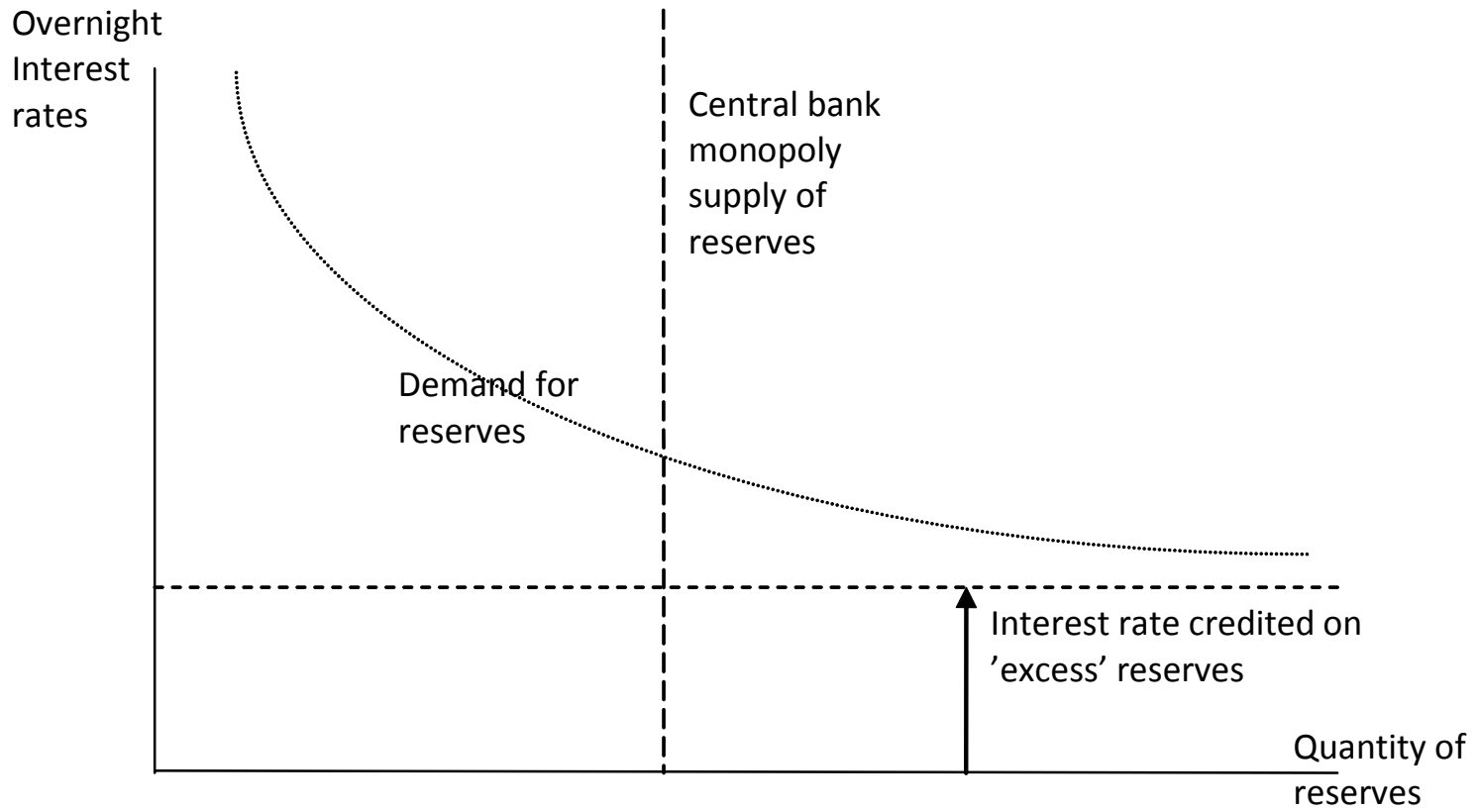
<b>1. General government, municipals and GSEs</b>			
<i>Assets</i>		<i>Liabilities</i>	
Central bank deposits	20	Public debt	14000
Bank deposits	500		
Loans to non-banks	5000		
Future taxes	8480		
<b>Total</b>	<b>14000</b>	<b>Total</b>	<b>14000</b>

<b>2. Central bank</b>			
<i>Assets</i>		<i>Liabilities</i>	
Public Debt	770	Reserves	10
C Bank repo	25	Gov deposits	20
Private paper	0	Note issue	800
Gold, Forex, SDR	35		
<b>Total</b>	<b>830</b>	<b>Total</b>	<b>830</b>

<b>3. Commercial and other banks, money market mutuals and ABS structures</b>			
<i>Assets</i>		<i>Liabilities</i>	
Reserves	10	Deposits	13,425
Loans	12,500	Govern deps	500
Public debt	2,000	C Bank repo	25
Traded debt	1,400	Long term debt	1,500
Bank Notes	40	Equity	500
<b>Total</b>	<b>14,950</b>	<b>Total</b>	<b>14,950</b>

<b>4. Non-bank private sector &amp; rest of the world</b>			
<i>Assets</i>		<i>Liabilities</i>	
Deposits	13,425	Loans	17,500
Public debt	11,230	Traded debt	1,400
Bank l t debt	1,500	Future taxes	8,480
Bank equity	500	Gold, Forex, SDR	35
Bank notes	760		
<b>Total</b>	<b>27,415</b>	<b>Total</b>	<b>27,415</b>

# Orthodox monetary policy implementation



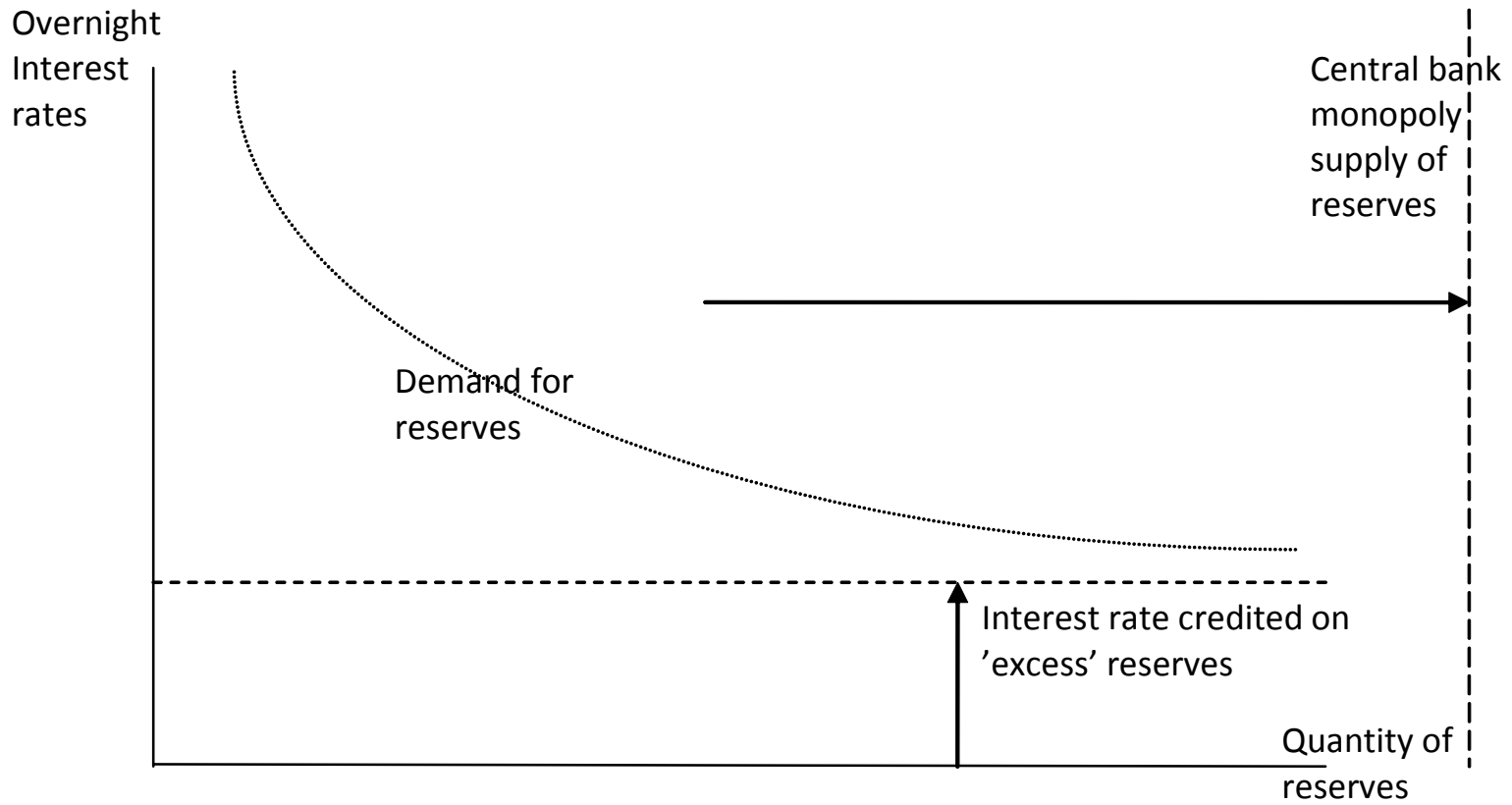
# Some background issues:

- No fixed money multiplier
  - (Kaldor) "money" created by commercial bank lending decisions
- Interaction of fiscal and monetary policy
- Lender of last resort
  - Response to systemic flight from bank liabilities
  - Sept-Oct 2008
    - Reserves held at Fed rose by more than 8,000 per cent
    - Balance sheet nearly tripled to \$2,200bn
      - Holdings of US Treasury debt reduced to \$550bn
      - Loans/deposits from government rose to \$380bn
    - Similar response by ECB, BoE

# Supporting credit markets

- Using interest rates as an operational target, this limits scale of central bank balance sheet
  - purchase of large amount of credit assets only using financing from government (e.g. bond issue and deposit with C bank)
  - No ability to address structured credit illiquidity
- Central banks also limited (legally) on how much credit risk they can acquire, so may need additional guarantees from government.

# Unorthodox monetary policy implementation



# Aside: the 'debt-deflation' issue

- weakening economy → rising real interest rates → increasing burden of debt → cumulative decline of economic activity
- A concern because of the zero bound on interest rates
  - One solution: remove zero bound
  - But there is *some* combination of (irresponsible?) government fiscal policy and unorthodox monetary policy that will avoid deflation

# Unorthodox policy: asset choices

- Purchase of government debt
  - A shift in composition of state liabilities towards short end
- Credit risky assets ('credit easing')
  - Purchased from banks
  - Could include structured credit tranches, corporate paper, tradeable loans
- Equity
  - Bank equity
  - Corporate equity

# Assessment: possible impact

- Purchase of undervalued assets traded in illiquid markets may be profitable,
  - e.g. purchase of senior ABS tranches
  - But acquiring long term gov debt likely to lose money & have little other real impact (Japan 2001-2005)
- May be used to directly address weakness of bank balance sheets
  - Acquiring loans e.g. \$12 trillion of US bank lending
    - Hits the same problems as TARP: what price? So possible for better quality only
  - Acquiring bank equity. My preference accompanied by
    - Large scale insurance of bank loans, with heavy premium
    - Forced equity issue so (almost) all banks

# Conclusions

- Unorthodox monetary policy (“printing money”) not a cure all
- C Bank purchase of credit risky assets can be very powerful when accompanied by supportive fiscal policy (e.g. insurance arrangements, direct financing)
- Expectations are critical. We need a truly radical policy to turn these around (Requiring commitments of 100% of GDP and massive bank recapitalisation)