The Oxford Institute for Economic Policy (OXONIA)
Website: www.oxonia.org
E-mail: oxonia@oxonia.org

"Exceptional policies for exceptional times"

OXONIA Distinguished Speaker Event

By Huw Pill (Goldman Sachs)

Oxford, 6 November 2012

This seminar was hosted by OXONIA and was made possible through the generous benefaction of Oxford Economics.

Huw Pill shared his interest in the "non-standard" monetary policies that central banks have introduced in response to the financial crisis, such as "enhanced credit support" by the European Central Bank (ECB), "credit easing" by the Federal Reserve, and quantitative easing by the Bank of England. He made clear the significant ways in which these measures deviate from standard monetary policy, which is important to be able to assess their impact, and went on to look at the case of Europe to determine whether the specific measures employed there have 'worked' and at what cost.

Today there are several instruments a central bank can use. As well as the traditional instrument of monetary policy - changing the interest rate level - central banks also have at hand "interest-on-reserves" policy (liquidity management) and "credit policy" (composition of bank asset holdings).

With this broadened set of tools comes a wider range of economic impacts and this has created a grey area between the implementation of fiscal and monetary policy, which comes into tension with treaties in Europe and the US that attempt to ensure distinct separation between the two.

The textbook definition of quantitative easing (a liquidity solving policy) helps to make clear how central banks have been deviating into the realm of fiscal activities recently.

Quantitative easing is defined as purchasing “conventional assets” (such as guilts) by creating reserves, but what the banks are doing in addition is buying unconventional, generally riskier assets in order to try and solve problems around the provision of credit in certain sectors of the economy.

This additional behaviour, which Huw Pill termed “qualitative easing”, is redistributing, and thus fiscal in nature. When a central bank buys assets they can’t help implicitly favouring a certain market from which it buys those assets. For example, buying up toxic subprime loans will favour the housing industry at the expense of others such as the car industry. The central bank is also shifting risk from that sector and placing it on the tax payer who, ultimately, becomes liable.

For these reasons there are concerns about the long term impact of non-standard measures on central bank balance sheets and institutional independence, as well as on the outlook for price stability: “Every hyperinflation in history has two ingredients... a fiscal debt for which there was no politically feasible ability to pay with tax increases or spending cuts and a central bank that was drawn into the task of creating money as the only way to meet the obligations that the fiscal authority could not” Hamilton (2009).

In the short term, however, the measures appear to have ‘worked’, at least in the sense of avoiding a financial cataclysm and providing some marginal stimulus to the economy.

Huw Pill presented a simple general equilibrium model to explore the impact of non-standard monetary policy (layed out in the presentation slides attached). The first result of the model is that liquidity measures are benign, which agrees with the Friedman Rule: the central bank should always satiate private demand for liquidity since it is a ‘good’ that can be produced costlessly. The second result is that credit policy measures can support, and may even be necessary to maintain, price stability when the scope for conventional fiscal support is limited by practical or political constraints. But, as anticipated there are limits and when these are reached there are consequences in terms of outlook for price stability.

Interestingly, by inserting some empirical numbers into the model it indicates that Europe is close to the limit; the net present value of current and future profits made by the ECB could cover just 7 to 8 years of the European deficit.

Huw Pill went on to share his empirical analysis of the ECB’s non-standard measures which have focused on providing central bank intermediation of dysfunctional markets. Following the collapse of Lehman, banks in different European countries could not trust each other, there was an adverse selection problem and it led to the failure of the interbank lending market. The ECB stepped in and replaced the market which had segmented to ensure that banks could access the funding they needed to function.

Overall, counterfactual analysis suggests that the ECB’s actions had a positive, supportive effect on bank and macroeconomic activity, though different sectors did better than others. For example, the measures were particularly effective at replacing

loans to small businesses but much less effective in replacing loans to ‘non-resident’ individuals, showing home bias.

A side effect of the ECB’s actions has been that it has taken on some of the high risks that the banks knew existed and had led to their distrust, and so the ECB has facilitated ‘ever greening’ bad loans where they should have instead been restructured or consolidated. This means that there remains significant risk of financial default, and it is larger than the capacity of the ECB to support it. If this isn’t contained in time and scope, then there will be significant risk of fiscal dominance. And so whilst the non-standard measures appear to have been beneficial so far, inflation may yet plague the already troubled union as a result.

Marloes Nicholls
Seminar Coordinator
The Oxford Institute for Economic Policy (OXONIA)