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Lucrezia Reichlin

Non-Standard Monetary Policy and Financial Stability¹

INTRODUCTION

Since the financial crisis in 2007–08, central bank balance sheets in advanced economies have expanded significantly. This expansion has not led to inflation risks (at least not to date), but it has raised concerns about financial stability, which have been especially vocal in the euro area.

This short piece addresses the issue of the financial stability implications of non-standard monetary policies. It summarises views that Huw Pill and I have expressed in a more extended form in Pill and Reichlin (2017). We have argued that the effect on financial stability of central bank balance sheet expansions is ambiguous that it differs depending on the nature of such expansion, and that it is influenced by other policy actions in a complex way.

MOTIVATIONS FOR BALANCE SHEET EXPANSION AND IMPLICATIONS FOR FINANCIAL STABILITY

In order to provide a framework for understanding the link between non-standard monetary policies and financial stability, it is important to recognise that two different types of such non-standard policies can be distinguished, arising from two distinct motivations, but both in response to situations in which financial markets are dysfunctional and frictions are pervasive. In the first case, central banks step in to provide support to the private sector in order to maintain the functioning of financial markets, which would otherwise cease to operate effectively. The central bank acts in this situation as a “central counterparty of last resort”, enabling transactions that are necessary for the operation of the financial system as a whole, and hence for the wider economy; and which the private sector on its own would otherwise fail to intermediate. Essentially, this is little more than an application of Bageot’s (1873) rule. At times when liquidity in the interbank market dries up, central banks should stand ready to “lend freely to banks, but only against good collateral and at a penalty rate” so as to contain panic and prevent the breakdown of financial intermediation.

In the euro area, a clear example of this was the adoption by the ECB of fixed rate / full allotment tender procedures for its monetary policy operations in October 2008. This was done at a time when the interbank money market had seized up as a result of widespread

concerns about counterparty risk following the failure of Lehman Brothers in mid-September. With its actions the ECB became a *de facto* central counterparty, replacing private interbank intermediation, which had ground to a halt.

Having set its policy terms, the central bank’s role in this type of intervention is essentially *passive*. Private sector institutions – i.e. banks – resort to the central bank’s facilities in response to their own difficulties in dealing with one another. And the extent to which they take advantage of the facilities offered is driven by their own views of market opportunities and risks. Indeed, use of central bank facilities can be seen as a recovery from the abnormally defensive positions, which caused the malfunctioning of the interbank market (i.e. hoarding central bank liquidity and/or reluctance to take on counterparty risk).²

In the second case central banks intervene in financial markets in order to exploit additional channels of monetary policy transmission, beyond the conventional impact of changes in the policy interest rate. They may be particularly prompted to do this when the effectiveness of the traditional channel is blocked or reduced by the zero lower bound.

The leading example of this type of intervention in the euro area is the asset purchase programme initiated by the ECB in 2014, and extended to sovereign debt in March 2015. Such central bank asset purchases – according to the ECB’s explanation of their rationale – are intended to trigger portfolio rebalancing effects. By buying (sovereign) bonds with medium- or long-term maturities, and by lowering the rate at which they pay interest on excess reserves, central banks lower the return on safe assets and increase the incentive for private sector participants to shift their asset portfolios further out along both the credit risk and maturity spectra. Other things being equal, this will push up the prices of riskier assets and promote the expansion of credit creation, thereby supporting growth in economic activity and the price level.

Unlike the first type of non-standard monetary policy intervention, central banks’ implementation of the second type is inherently active. Having announced the remit of an asset purchase programme, the central bank itself initiates the trades that give it effect, and the central bank thereby directly controls the resulting expansion of its balance sheet.

Whereas the first – passive – type of intervention can be seen as setting out to repair a broken or damaged transmission mechanism, and is therefore naturally a complement to conventional monetary policy, the second – active – type, by virtue of the fact that it is seeking to exploit a different transmission mechanism, may be thought of as a potential substitute for conventional monetary policy.

The distinction is important when considering the impact of non-standard monetary policies on financial stability. From this perspective the first, passive type of intervention should be beneficial, as its immediate aim



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¹ This article borrows extensively from Pill and Reichlin (2017).

² For a comprehensive analysis of ‘passive’ monetary policies by the ECB since the autumn of 2008, see Pill and Reichlin (2016).

is to prevent a potentially disastrous collapse in the financial system itself. Any increase in private sector risk-taking can be seen as a return to normality as far as the risk-taking appetite of private sector institutions is concerned, once the system of financial intermediation has been restored. By contrast the second, active type of non-standard monetary policy works explicitly by encouraging private sector market participants to acquire assets that they would otherwise deem either too risky, too expensive or both.

However, even in this case, the effect on financial stability is not unambiguous. However, by acting directly on the longer end of the maturity spectrum, rather than solely via short-term money market interest rates, this type of policy intervention has the effect of flattening and lowering the yield curve, and thereby reducing the incentive for banks and other intermediaries to undertake maturity transformation. So while it is true that such active, quantitative easing policies entail an increase in risk-taking by the private sector as a whole, the effect on banks and other financial intermediaries – and hence for financial stability – should actually be supportive.

It must be stressed that conventional monetary policy easing via a decrease in the interest rate target may also have negative implications for financial stability. In that case, as with asset purchases, the central bank increases the incentive for the private sector to invest in riskier assets. However, while a decrease in the interest rate target and a programme of asset purchases both encourage risk intermediation, standard policy encourages maturity transformation whereas asset purchases do the opposite. The key difference is that while a decrease in the policy rate causes a decline in the equilibrium rate on riskier assets through an increase in the spreads, active balance sheet policies, by lowering the risk premium, have a dampening effect on the spread. Insofar as financial stability risk originates from banks engaging in maturity transformation, asset purchases carry fewer risks for financial stability than traditional monetary policy.³

Paradoxically, when flagging financial stability concerns are related to the ECB's asset purchases, the argument is turned upside down. Rather than emphasising the risk mitigation effects of a flat yield curve, it is observed that the latter, by stressing the profitability of banks and insurance companies and pension funds, actually causes instability. To the extent that banks earn returns from maturity transformation (as is the case for important segments of the European banking sector, and particularly for the mutual and regional banks), the flatter yield curve implied by quantitative easing threatens their earnings outlook. For banks holding legacy portfolios of questionable assets and seeking to re-capitalise by retaining earnings, a flatter yield curve lengthens the period of adjustment (and may even make it infeasible). Moreover, for pension funds and insurance companies that have defined-benefit liabilities (i.e. they have promised a certain positive

return to their customers), holding assets with low or negative returns eats into their capital and reserves. Institutions that were poorly capitalised at the outset are, by nature, particularly vulnerable to these concerns.

PRACTICAL CONSIDERATIONS AND CHALLENGES

The clear cut distinction drawn above between passively providing liquidity and actively boosting the return on risk bearing assets presupposes that the central bank is able to avoid taking credit risk when acting as 'central counterparty of last resort' by insisting on 'good collateral'. However, as it became all too clear during the financial crisis, it is not always easy – or even possible in theory – to distinguish between liquidity and solvency problems in real time. As a result, the central bank aiming to play this role in practice plays the role of 'market maker of last resort', taking positions in the market and accepting risks on its balance sheet in the form of transactions with counterparties of uncertain creditworthiness and/or collateral of uncertain value.

Consequently, the ECB's fixed rate / full allotment programme was not a purely passive intervention of the kind described above. In fact, many of the measures implemented by central banks during the financial crisis can be seen as having elements that are supportive of market functioning, as well as elements that promote portfolio shifts in favour of greater risk-taking and thereby support macroeconomic growth.

Crucially, the actions of the central bank have an effect on the nature of the market failure they are intended to address. Whereas individual banks concerned about idiosyncratic credit risk in their private counterparts are susceptible to a market failure owing to adverse selection,⁴ the central bank – by restoring the market to its normal functioning – changes the nature of the idiosyncratic risk faced by each market participant.

More broadly, this highlights the need to take a general equilibrium approach in order to make an assessment of non-standard monetary policies – understanding their impact on the wider economy, as well as the impact on the financial system of such macroeconomic effects. In this context the ECB has surely been right to argue that, if successful, the beneficial effects of non-standard monetary policies on financial stability via an improvement in overall macroeconomic conditions would surely outweigh any of the short-term negative effects of such policies described above. Specifically, by boosting recovery and staving off the break-up of the euro area, the ECB has more than compensated for the initial adverse impact of some of its unconventional policies on bank profitability.

A broad analysis of the impact of non-standard monetary policies needs to take into account the risk that private sector participants become 'hooked', such that they come to depend on the continuation of such

³ This observation has been recently formalised by Woodford (2016).

⁴ This is the situation analysed by Heider, Hoerova and Holthausen (2015).

policies in normal times. To put it another way, necessary emergency measures should not blunt the incentives for governments, regulators and the private sector to address the underlying structural problems in the financial system and the economy more broadly. Should those incentives to deal with the fundamental weaknesses be absent, central bank intermediation could increase the risk to financial stability over the medium term. While important, this is surely not an argument against the use of non-standard policy measures per se, as the structural agenda can be addressed by other policy interventions in any case.

The relationship between non-standard monetary policy measures on the one hand, and the outlook for financial stability on the other, is thus complex. While it depends crucially only on the character of the non-standard policy, it will also be influenced by other policy actions and the horizon over which an assessment is made.

In the context of the euro area, key areas of policy action are the consolidation of the banking sector, a solution for the stock of non-performing loans and a realistic approach to recapitalising banks. In a fragmented banking sector, with many banks still under-capitalised, potential risks to financial stability stemming from non-standard measures are real and potentially significant, but these problems can and should be addressed with different policy tools.⁵

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⁵ See Reichlin and Valle (2016) for a proposal addressing problems of the banking sector.