HESITANT ATTEMPTS TOWARDS NORMALIZING MONETARY POLICIES

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Abstract

The 2007- 09 crisis was initially called the Great Recession and afterwards the Great Financial Crisis, thus being implicitly acknowledged the determinant role of nominal/monetary economy in igniting the crisis of the real economy. So there has been no 'accident' that the so-called *unconventional monetary policies* (UMP) were the main tools used to stimulate financial and – hopefully – economic recovery. They have basically consisted in extremely low policy interest rates (zero or even negative) and an unprecedented enlargement of central banks' balance sheets. In principle, UMP were considered a temporary measure, useful for a couple of years. The prolonged stagnant recovery that followed the crisis has kept UMP in place for almost a decade (at least until 2017). This obvious abnormality for a 'free market' capitalist economy should have stopped long ago. Our study tries to analyze the peculiarities of this situation and the pros & cons for 'normalizing' monetary policies.

Keywords: unconventional monetary policies (UMP), quantitative (and qualitative) easing, nominal and real interest rates, central banks' balance sheets and unwinding balance sheets.

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The rift between real and nominal facets of the economies that I firstly mentioned at the beginning of the 1990s rapidly deepened and became a major cause of macroeconomic disequilibria, provoking a series of foreign exchange crises in 1997-98. The early 2000s, by a huge speculative financial boom, provoked ever graver unbalances which finally determined the Great Financial Crisis in 2007-09. That time it was quite clear that the *nominal* economy, expressed by monetary and financial stocks and flows, almost totally overwhelmed *real* economy. Consequently central banks were considered as the main potential 'saviour' of the economic activity at both national and international levels. This is why *unconventional monetary policies* (UMP) have rather suddenly been perceived as the major actors of the so-called mix of macroeconomic policies. Basically UMP have consisted of: a drastic decrease of policy interest rates towards 'the lower bound' (zero or even negative); tremendously enlarging central banks' balance sheets; providing substantial financial stimulus to private sectors. Initially (toward the end of 2008), these measures were meant to be short-termed (not more than a couple of years). But after almost nine years (2017), they are still in force. Taking into account the nature and duration of the UMP, it is obvious that the economy based on capital has undergone a structural change/transformation: from the free market economy (in the meaning of David Hume and Adam Smith) to what could be considered a *transnational oligopolistic state capitalism*.

1. The declared aims of UMP were to put an end to a dramatic financial and economic crisis and afterwards to support a vigorous recovery. However the crisis proved to be deeper and longer than any other cyclical downturn since the Great Depression of the 1930s. As in the interwar period, this time the business cycle phases have been coincidental with a secular stagnation (a concept introduced in economics by Alvin Hansen before WW II). Although official statistics marked the end of the crisis around mid-2009, the expected recovery has been very weak, including some comebacks (especially in Western Europe). Despite of being a long recovery (at least until 2016/17), the average GDP growth rate – in most developed economies - has been significantly lower than in the previous recovery / expansions during the post-WW II era. As a relevant example, the US GDP has increased at an average rate of less than 2% per year (mid-2009 to 2016) versus an average pace of over 4% during the previous expansions. According to a traditional view, the longer and deeper a recession or crisis the faster should have been the growth rate that followed (the so-called catch-up process).The present recovery has been a striking exception: after a most serious financial and economic crisis, there has followed an anaemic and hesitant recovery. The following table includes data for the countries with widely elaborated UMP.

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Table 1

GDP growth rates in developed market economies (in %)

	1998-2007	2012-2013	2014-2015	2016	2017 (Q1)
United Kingdom	2,9	1,9	2,6	1,9	0,9
Euro area	2,3	-0,1	1,6	1,9	2,0
USA	3,0	2,0	2,4	1,8	1,2
Japan	1,1	1,6	0,4	1,6	1,0

Source: IMF World Economic Outlook, OECD, Bank of England, et al.

As underlined and analyzed in another study[57], a major explanation lies in the huge debts recorded by the essential layers of economy and society – government, firms, households. The financial crisis determined a deleveraging process, in which "businesses and individuals decreased spending to pay off outstanding debts, which shrank demand, but also limited individuals' and businesses' access to credit as financial institutions significantly diminished lending"[58], in a desperate attempt to decrease their own degree of indebtedness. Under these circumstances, central banks reduced policy interest rates toward zero or even negative levels while quantitative *easing* programmers delivered considerable amounts of monetary means into economy using different financial channels.[59]

On the background of a secular stagnation, UMP could not stimulate economic growth. On the contrary, they contributed to the disequilibrium between savings, spending and investment, which is a crucial correlation for a dynamic and balanced economy, therefore aggravating the scission between the nominal and real facets of the economy. If UMP alleviated somewhat the consequences of the financial crisis, especially by avoiding failures of transnational financial corporations, real economy was generally neglected or the impact on real economy was negligible. Moreover, the tremendous enlargement of central banks' balance sheets has had an important impact on financial markets, on their dimensions, quantitative and qualitative structure and profitability, by deforming yield curves. For example, after eight years of a sinuous recovery, the yield curves are rather flattened, showing some tendency to become inverted, which means skepticism about economic and financial developments.

The Federal Reserve, ECB, Bank of England, Bank of Japan, which are the four largest central banks, have "about $ 13 trillion on their balance sheets, a large proportion of which they believe needs to be roll off".[60] Before the Great Financial Crisis (GFC), the dimensions and structure of a central bank' balance sheet were mainly marked by foreign exchange reserve holdings as regards the *assets side* and by the amount of currency demanded in circulation and bank reserve balances on the *liability side.* After the GFC, the size and structure of central banks' balance sheets have changed dramatically. We illustrate this shocking phenomenon by the data concerning the US Federal Reserve system (FRS). Presently FRS has a $ 4,500 trillion balance sheet with the following components (table 2).

Table 2

Federal Reserve balance sheet (%)

Assets		Liabilities	
Mortgage-backed securities	39,5	Bank deposits	49,6
US Treasury securities	55,1	Currency	33,6
Other	5,4	Reverse repo	9,5
		US Treasury account	4,2
		Other	2,2
		Capital	0,9

Source: Federal Reserve, mid-2017

[57] L. C. Ionescu, "The Economy of Indebtedness", in Journal of Financial and Monetary Economics (JFME), No.1/2014.
[58] J. F. Stupak, Economic growth slower than previous 10 expansions, in CRS INSIGHT, June 30, 2016.
[59] A more detailed presentation could be found in L. C. Ionescu, "The Present Role of Central Banks – unconventional monetary policies", JFME, No.3/2016.
[60] J. Mauldin's newsletter, 9 July 2017.

The astonishing amplification of the shares belonging to mortgage-backed securities and Government bills & bonds has reflected the core of the *quantitative easing* waves (started at end-2008). Although speculative transactions with MBS (mortgage-backed securities) were a crucial trigger for the beginning of GFC, central banks have purchased impressive amounts of this artificially created financial instrument to help 'improving' the qualitative structure of important banks' balance sheets. However the excessive prolonging of these *emergency* monetary policies – year after year – finally and obviously exhausted their potentially stimulative effects. Firstly the reference interest rates reached their lower bound (zero and/or negative), without having a remarkable role in increasing real investments and GDP growth rates. Moreover extremely low interest rates have discouraged savings, which is the *healthiest* source for new investment. Thus in USA, at the end of 2016, personal savings rate was the smallest since the end of 2007 (when the economy had just entered a grave recession).

2. According to initial scenarios, the 'normalization' of monetary policies should have begun not later than a couple of years after the end of the crisis as such: that would have meant 2011/12. The weak and hesitant recovery postponed a clear decision in this sense. However debates have become more intense and intentions to *normalize* have been expressed since 2013. For example, in May that year, Ben Bernanke – the former Chairman of the Federal Reserve Board – firstly mentioned an intention of gradually diminishing or 'tempering' the expansionist trend of the monetary policy, also stating the Fed would not allow monetary conditions to tighten for a long period (at least until 2015). Despite this careful and diplomatic phrasing, international financial markets almost immediately afterwards went through a series of 'temper tantrums' which caused an abrupt jump in bond yields. Only after 3-4 months, financial markets calmed down when it was evident that the Fed did not change the pattern of monetary policy, continuing its $ 85 trillion of monthly bond purchases*. It was a shocking proof that some of the most important economies in the world had already become addicted to UMP!*

In this context, it is not surprising the Annual Report of the Bank for International Settlements (BIS) for 2016/17, after seven years since the 'official' end of the GFC, underlines that "policy normalization presents unprecedented challenges, given the current high debt levels and unusual uncertainty". Therefore, "in determining the pace of normalization, central banks must strike a delicate balance. On the one hand, there is a risk of acting too early and too rapidly (…). On the other hand, there is a risk of acting too late and too gradually." At present (2017) it seems there is a quasi-consensus as regards the stages of the *normalization process* (NP): firstly a gradual increase of the monetary policy interest rates, so that negative or near zero rates would be eliminated step by step (the so-called 'lift off'); secondly the size of central banks' balance sheets would be gradually diminished, hoping to reach the proportions existing in the pre-GFC period, by the *'unwinding'* of balance sheets (quantitative tightening).[61]

Obviously these are only 'desirable' principles, the determinant factor being the effective evolution of the nominal/real tandem, so important for contemporary economies. Consequently the necessity of 'normalization' is perceived with different intensities, varying from a central bank to another. Referring to the central banks this study focused on, a descending order of the NP intensity could be perceived as follows: Federal Reserve System, Bank of England, ECB, Bank of Japan.

In USA, after the strange 'temper tantrums' of 2013, the Fed (chaired by J. Yellen since February 2014) elaborated and published its normalization approach in September 2014 – *Policy Normalization Principles and Plans* (with additional details in March 2015). After seven years of about zero policy rates, Federal Open Market Committee (FOMC) raised the federal funds rate to 0.5% in December 2015. There followed other increases: to 0.75% in December 2016, to 1% in March 2017 and to 1.25% in June 2017. The Fed finished its quantitative easing (QE) program in 2013, but it has still been keeping almost $ 4,500 trillion of debt on its accounting books. However the Fed would not begin selling its debt until it 'normalizes' rates at 2%. Phasing out of deflationary tendencies (inflation rate increased from 0.3 % in 2015 to 1.4% in June 2017) and diminished unemployment rate (although based on a decrease in productivity) have allowed a more advanced NP in USA. Nevertheless there are American experts that consider the present monetary stance as

[61] *A too large expansion of a central bank's balance sheet will reduce the flexibility of the instruments of the monetary policy, having as a result rigidity in the central bank's policy (narrowing its room of maneuver).*

'hawkish': "Deflation in an economy as debt-burdened as ours is could be catastrophic."[62] Indeed, the US total federal debt has represented almost $ 20 trillion in mid-2017 (a 117% increase since 2007).

In UK, despite some debate on NP toward the end of 2016, the sluggish GDP growth in the first half of 2017 (around 1%), against the backdrop of 'Brexit', determined a difficult trade-off between slow growth rate and a jump in inflation rate (from about 1% at end-2016 to almost 3% in mid-2017). Under these conditions, the Bank of England's Monetary Policy Committee (chaired by Mark Carney, Governor) maintained a rather surprisingly low Bank Rate at 0.25% (at its meeting in early August 2017): "Monetary policy cannot prevent either the necessary real adjustment as the United Kingdom moves towards its new international trading arrangements or the weaker real income growth that is likely to accompany that adjustment over the next few years. Attempting to offset fully the effect of weaker sterling on inflation would be achievable only at the cost of higher unemployment and… even weaker income growth."[63] However a split appeared among the Bank of England policy makers, confirming the hesitant stance of the normalization process.

The Eurozone economy witnessed a very sinuous recovery after the GFC. The gradual decrease in the multiple set of interest rates specific to the ECB monetary policy started in November 2008 - from 3.75% to 3.25% for main refinancing operations - and reached 0% in March 2016, including a negative rate for deposit facility (-0.4%). At the same time, ECB's balance sheet impressively expanded to compensate the malfunctioning interbank market. The sovereign debt crisis of 2011-12 determined ECB to lengthen the maturity of its operations to 3 years (in November 2010).

The 'temper tantrums' mentioned earlier had an echo at the EBC: since July 2013, the Governing Council decided to provide *forward guidance* on the path of ECB's monetary policy, especially regarding the interest rates. Taking into consideration the subdued financial and economic climate, the ECB Governing Council has postponed any direct step towards NP. The only relative exception was a reduction of the 'asset purchase programme', from EUR 80 billion to EUR 60 billion of government & corporate bonds per month (at least until December 2017). In fact, Peter Praet, member of the Executive Board, emphasized that "monetary policy can bring output back to its potential level…, but it cannot durably raise long-term growth… That requires further, determined progress with structural and institutional reforms."[64]

The opinion mentioned above was already conformed by the specific evolution of *the Japanese* economy and financial system which anticipated the UMP with over a decade. After the burst of an asset bubble in 1989/90, Japan recorded a 'lost decade' of stagnation & deflation: "As a result, conventional monetary policy tools had been exhausted by around 1997/98, when anxiety about the financial system due to crisis reached its peak."[65]

The first 'traditional' instrument used to counteract the deflationary trend was the Bank rate which decreased from 6% in August 1990 to 0.25% in September 1998 and 0% in February 1999. In fact, that was the start for using *unconventional* monetary policies: in 1998/99, it was set up a comprehensive framework aiming at 'temporary' nationalization and injections of capital based on public funds. The international boom – mainly of a speculative nature – allowed the policy rate to increase to 0.5% in February 2007. But that was a short-lived illusion. The GFC brought back the Bank's rate to 0.1% in December 2008, followed by a 'stagnant recovery'. Therefore the policy rate came back to 0.0% in October 2010 and even -0.1% since February 2016.

It became obvious ever since the early 2000s that the policy rate exhausted its capacity to fight deflationary trend and stagnation. So, between 2001- 06, *quantitative easing* (QE) provided 'ample liquidity' to monetary and financial system (exactly when USA and UE economies witnessed a huge speculative boom). However the burst of GFC worsened the situation of Japan's economy. In April 2013, the Bank of Japan introduced the so-called *quantitative and qualitative easing* (QQE), implying the Bank's strong commitment for price stability and downward pressure on interest rates along all the yield curve through massive purchases of Japanese government bonds (JGB). In January 2013, it was adopted the price stability price target of 2% inflation rate. Yet, at least until

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[62] *J. Mauldin, Thoughts from the Frontline, Newsletter, July 22, 2017.*
[63] *Bank of England, Inflation Report, August 2017.*
[64] *Market Watch, June 8, 2017.*
[65] *H. Nakaso, "Japan's Economy and Monetary Policy", Bank of Japan, July 8, 2014.*

the July 2017 meeting, the Bank of Japan postponed several times the schedule for achieving that price stability price. Within this context, "Japan is seen as a leading indicator of the problems facing advanced world economies[66] Meanwhile the Bank would be continuing its QQE program with Yield Curve Control "as long as it is necessary ". Under these circumstances, any discussion or declaration about tempering or unwinding (balance sheet) could be only hypothetical.

The review of the UMP undertaken by the most representative central banks in the developed economies has showed relevant experiments characterized by many contradictory facts and trends which demonstrates that UMP are no longer an 'emergency' approach for a short term special situation but have become a 'fixing' for a deeply troubled monetary & financial system (both at national and international levels), with a grave impact on real economy. Previously considered an unfortunate 'exception' of the interwar period (especially the 1930s), the famous *liquidity trap* has become a daily fact for many countries. To use Mervyn King's phrasing (Governor of the Bank of England, from 2003 to 2013), "the market economy cannot coordinate spending plans… There are too many missing markets. As a result, a market economy is not self-stabilising, leading to occasional sharp ups and downs in total spending.(…) Even if monetary policy could lower real interest rate into negative territory, there is no guarantee that demand would pick up." [67] It is even shocking that a person who had a high position in the banking system has drawn the following conclusion: "… There is nothing special about finance that requires us to abandon rational argument and leave our future in the hands of the gods of finance. (…) For many centuries, money and banking were financial alchemy, seen as a source of strength when in fact they were the weak link of a capitalist system. A long-term programme for the reform of money and banking and the institutions of the global economy will be driven only by an intellectual revolution."[68]

If this crucial objective would be continuously postponed by the monopolistic financial occult forces, then the 'intellectual revolution' could be replaced by ever graver social turbulences. The serious limits and drastic mistakes of the former soviet-type state socialism will not permanently excuse the excesses and disequilibria specific to transnational oligopolistic state capitalism. As Hyman Minsky peremptorily demonstrated, the central banks and different instruments of financial control appeared and extended as a reaction to the embarrassing incoherence of the financial markets – an incoherence which strikingly indicates that 'free markets' cannot be considered a u*niversal prescription for economic policy* in the case of the economies based on financial capital institutions: *instability is an inherent and unavoidable weakness* for capitalist economy.[69]

The re-creation of the organic interlinks between the nominal and real dimensions of the economy could give a chance to effective *normalizing macroeconomic policies* (not only monetary policies), including a fair relationship between personal, corporative and public proprieties, based on considerations regarding both economic and social criteria.

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[66] *B. Bernanke, "Some reflections on Japanese monetary policy", May 23, 2017.*
[67] *M. King, The End of Alchemy – money, banking and future of the global economy, ed. Little, Brown, London, pp. 301/302.*
[68] *Ibidem, p. 289 and p. 369.*
[69] *H. Minsky, Stabilizing an Unstable Economy, 2008 by H. P. Minsky (especially Part III – Economic Theory).*