Banque Centrale du Congo

# GROWING IMPORTANCE OF Central BankS COMMITMENTS IN RELATION TO THEIR BALANCE SHEETS, INSTRUMENTS AND ADMINISTRATIVE AUTONOMY

## CASE OF UNCONVENTIONAL MONETARY POLICIES

(Lessons for Central Banks and African States)

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# I. Central Bank (CB) RESPONSIBILITIES

1.1 Responsibilities generally entrusted to CB:

- Conduct of monetary policy
- Price stability
- Production stability
- Exchange rate stability
- Monopoly of bank note issue
- State banker
- Ensuring the smooth functioning of inter-banking payment and compensation systems
- Significant involvement in the oversight of the financial system

➢ Other responsibilities

- Exchange rate policy and management of balance of payment problems
- Production of economic and financial statistics

## 1.2 Macroeconomic responsibility of CB and nature of their commitments

- Macroeconomic responsibility of CB progressively acknowledged in the course of history, following the different economic crises, notably:
  - The hyperinflation of the 1920s, the crisis of the 1930s and the stagflation of the 1970s
- Focus on the commitment to achieve price stability and tendency towards the independence of CB:
  - Effect of the stagflation of the 1970s
  - Decisive influence of monetarist and new classical ideas
    - ✓ Neutrality of money assumption
    - ✓ Need to avoid time inconsistency of the monetary policy

## II. BASIS OF GROWING COMMITMENTS OF CENTRAL BANKS

### 2.1 Extension of CB commitments:

- BC-Guarantor of the stability of the financial system
- BC-Guarantor of public debt
- BC-Accountable for growth and recession

### 2.2 Basis of the growing commitments of CB and unconventional policies

- Illiquid financial markets
- Dangerous decline of inter-bank lending
- Decline in the private sector's inclination to borrow
- Revulsion towards risk-taking

- ✓ *CB are key players because of their role as lenders and investors as a last resort*
- ✓ *Need to explore new intervention tools adapted to the context, following the slowdown of conventional instruments and the breakdowns in the traditional monetary policy transmission channels*

# II. BASIS OF GROWING COMMITMENTS OF CENTRAL BANKS

*To face up to the implicit or explicit extension of their commitments, the CB of major advanced economies massively resorted to so-called « unconventional» monetary policies*

## 2.3 Key objectives pursued by the unconventional policies

- Resume inter-bank lending
- Reduce long-term interest rates to encourage investment, consumption and economic activity
- Circumvent the limits of traditional monetary policy transmission channels
- Improve the financing conditions of the economy and stimulate the aggregate demand
- Mitigate the impact of systemic crises on economic activity
- Enable public finance to sustain its adjustment efforts in order to mitigate the impact of the sovereign debt crisis

## III. IMPACT OF GROWING COMMITMENTS OF CENTRAL BANKS ON THEIR BALANCE SHEETS, OPERATIONAL CONTEXTS AND INDEPENDENCE

### 3.1 Typology of unconventional monetary policies

- Two main types : « *Assets policies* » *and* « *Liabilities policies*»

  - Assets policies (credit targeting) : modify the assets of the CB by restructuring the nature or maturity of assets. Action on assets and liabilities is adjusted.

    - ✓ Two forms of actions

      - *Substitution of certain assets with others, with a constant balance sheet size (capital restructuring operation)*

      - *Increase in assets and balance sheet size: massive purchase of securities without substitution*

  - Liabilities policies (targeting the <u>monetary base</u>): increase bank reserves/ Action on assets and liabilities is adjusted.

    - *Purchase of securities held by banks to boost their accounts*

## III. IMPACT OF GROWING COMMITMENTS OF CENTRAL BANKS ON THEIR ASSET SITUATIONS, OPERATIONAL CONTEXTS AND INDEPENDENCE

### 3.2 Some groundbreaking works on unconventional policies

- J-M. Keynes's works during the crisis of the 1930s: stimulate the aggregate demand
- Richard Werner: proposed a new monetary policy that is not based on interest rate but on the purchase of Treasury Bonds and direct loans to businesses (1994)
- Paul Krugman: proposed a monetary policy to Japan characterized by low interest rates to deal with deflation
- Michael Woodford: analyzed the policy choices possible for CB when rates are close to zero? »

The research undertaken by these economists were a source of profound inspiration for unconventional monetary policies implemented since 2007-2008

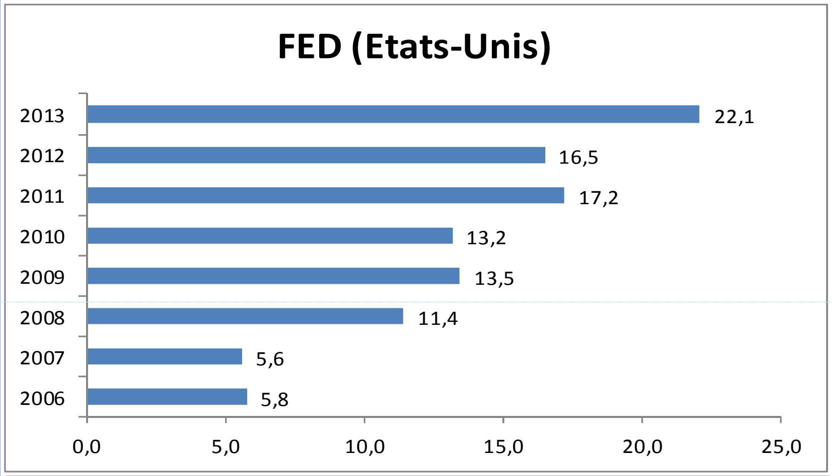
## 3.3 Unconventional policies and expansion of the size of CB balance sheets

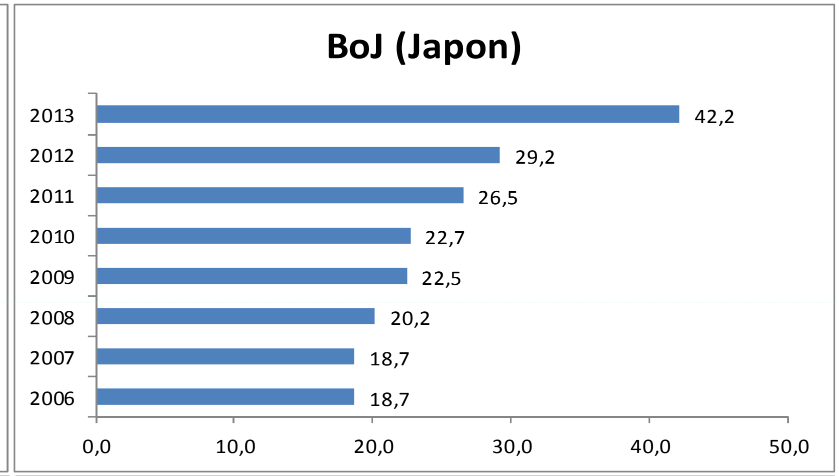
- Instituting programmes for the massive purchase of securities
  - EDF: Early 2010: decision to buy 600 billion USD worth of securities issued by financial institutions. Action pursued with the monthly purchase of 85 billion USD. Gradual slowdown in 2015
  - Bank of England: between March and September 2009 : Purchase of assets from financial institutions and high quality debt securities issued by private businesses worth 165 billion pounds. Increase from this amount to 200 billion pounds in late 2010
  - BCE: decision taken in January 2015 to purchase public or private debts up to September 2016 for the amount of 60 billion euros/month (i.e. 720 billion/year)

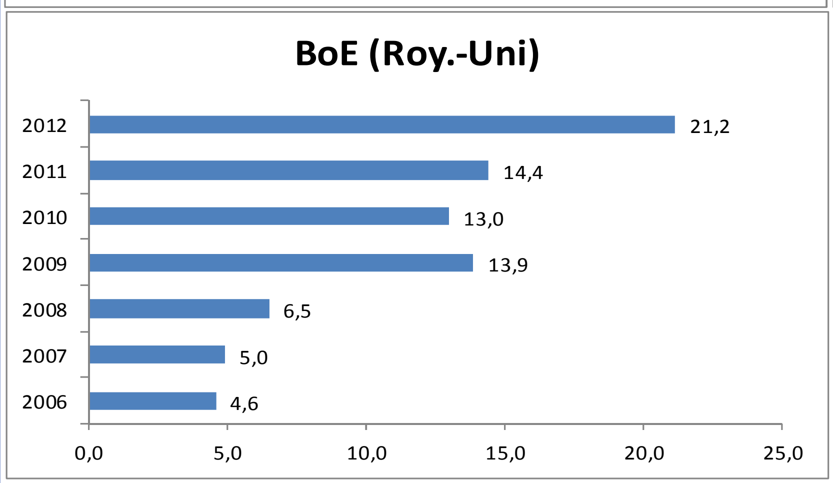
Effect of massive purchases of financial assets by the CB: expansion of balance sheets of Central Banks of the major advanced economies (graph below)

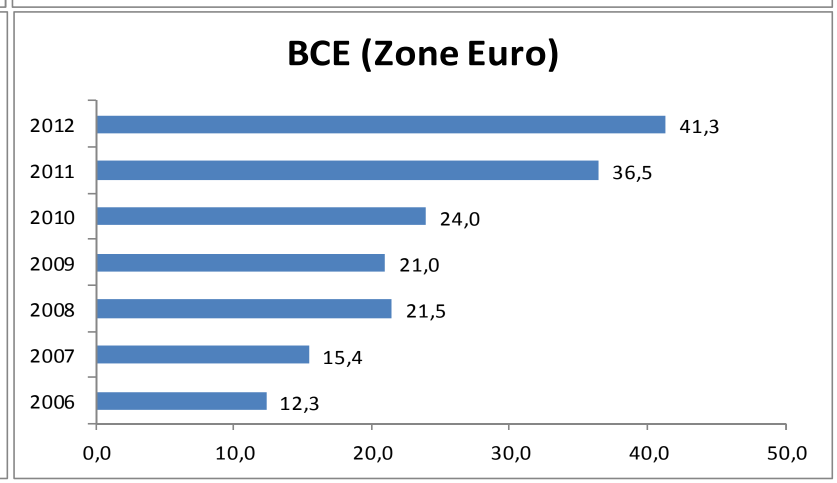
## III. IMPACT OF GROWING COMMITMENTS OF CENTRAL BANKS ON THEIR ASSET SITUATIONS, OPERATIONAL CONTEXTS AND INDEPENDENCE

### ➢ Monetary base (in % of GDP)



## 3.4 Impact of the purchase of assets on the structure of the balance sheet: emergence of property risks

- Significant changes in the capital structure of CB due to
  - the replacement of conventional assets with unconventional assets (replacement of collateralized debts owed to banks with claims on the Treasury; other financial institutions and non-financial businesses)
  - The increase in the weight of unproductive assets (a significant share of purchased assets are of poor quality)

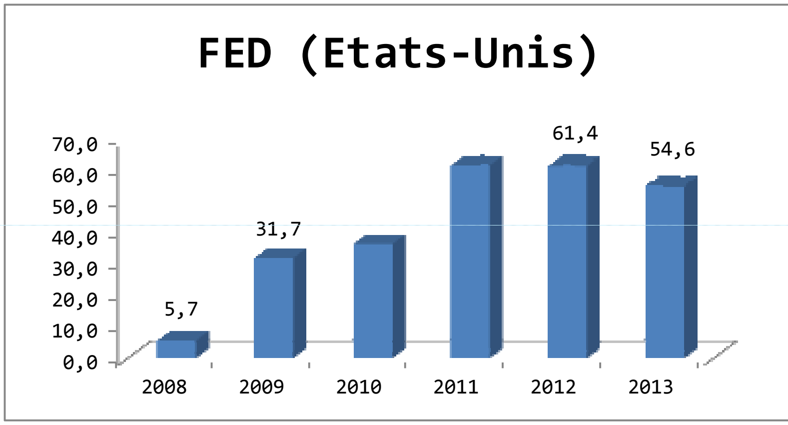
Effects :

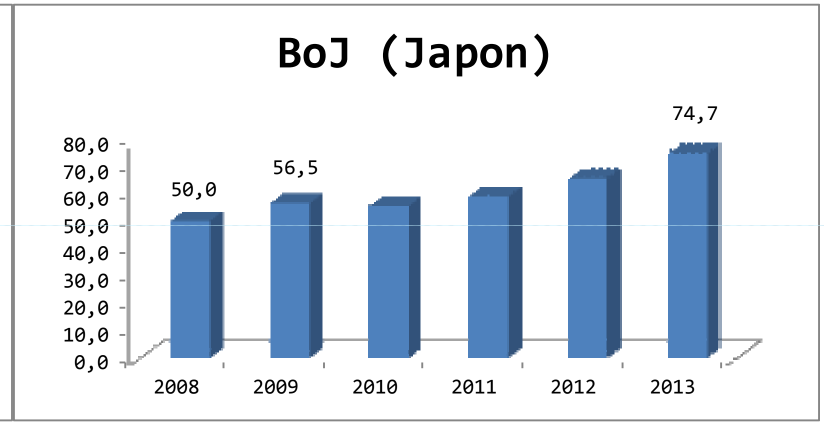
- Decline in the overall quality of assets
- CB exposed to interest rate and financial counterpart risks as well as to financial losses
- Crushing weight of public debt in the structure of the BCC portfolio (Graph below)

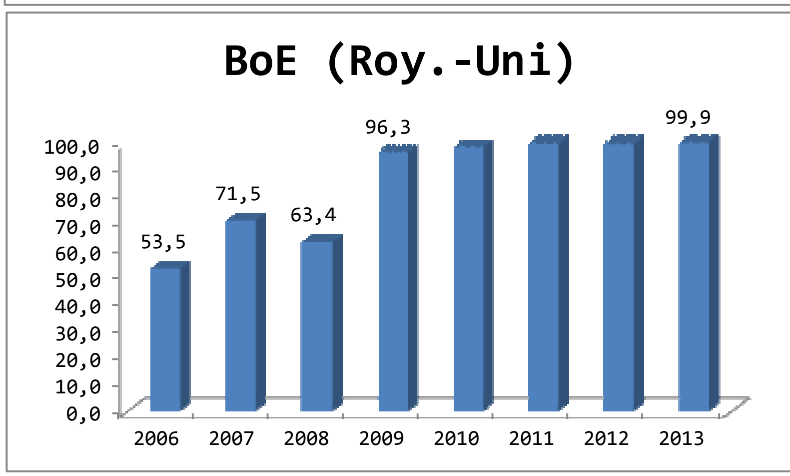
## III. IMPACT OF GROWING COMMITMENTS OF CENTRAL BANKS ON THEIR ASSET SITUATIONS, OPERATIONAL CONTEXTS AND INDEPENDENCE

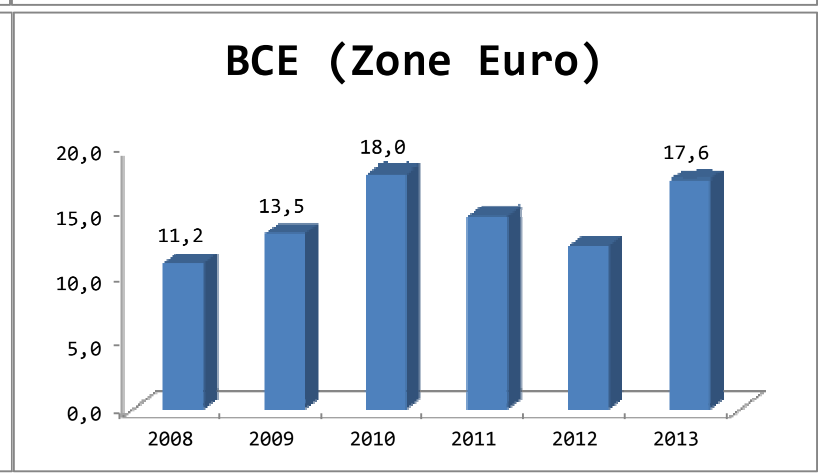
- Crushing weight of claims on the Treasury in the balance sheet

➢ ***PNG (in % of net domestic assets of CB)***



## III. IMPACT OF GROWING COMMITMENTS OF CENTRAL BANKS ON THEIR ASSET SITUATIONS, OPERATIONAL CONTEXTS AND INDEPENDENCE

- *Fortunately :*

- The Central Banks have a noncurrent liability :
  - CB do not incur risks of liquidity or solvency like the other financial intermediaries (which are subject to prudential management standards to preserve their capacity to honour their liabilities (deposits, securities issued, insurance provision, etc.).

- The CB's risk-taking in times of crisis is, implicitly or explicitly, ultimately guaranteed by the State
  - ✓ The CB can therefore create liquidity at will to deal with a systemic crisis
  - ✓ With the current limits of fiscal policy (under pressure from financial markets), the action of CB is decisive.

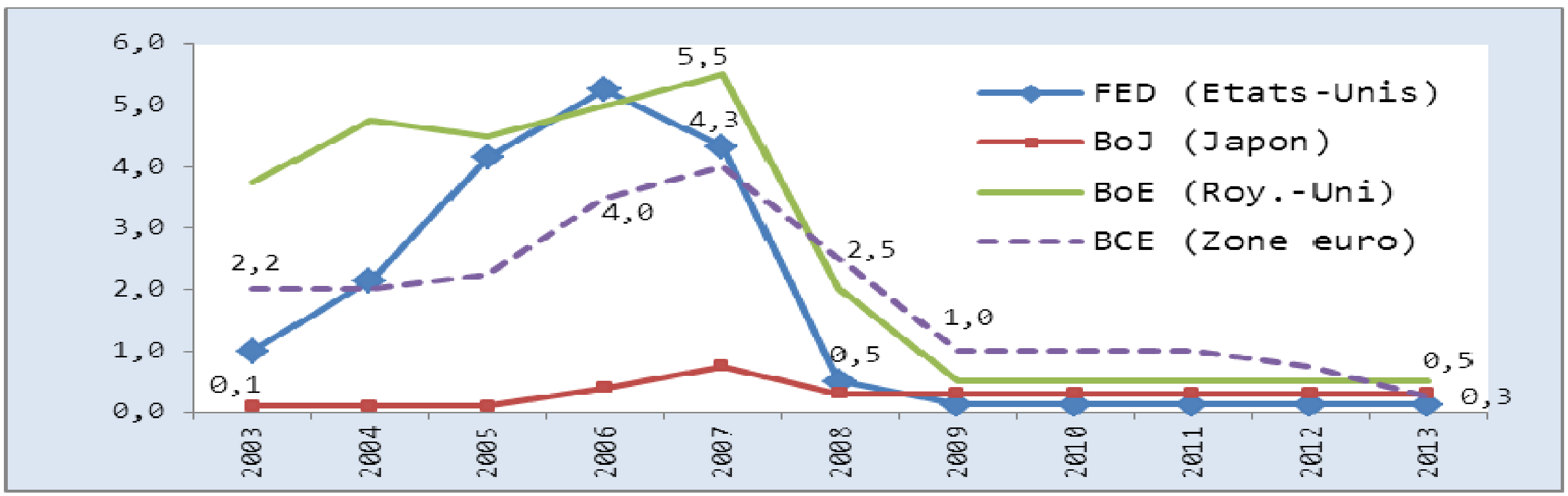
> - The CB can therefore create liquidity at will to deal with a systemic crisis
> - With the current limits of fiscal policy reaction (subject to the surveillance of financial markets), only the action of CB can absorb a liquidity shock in the system.

## 3.5 Growing commitments of CB and changes in the operational contexts of monetary policy

- **New terms and conditions of intervention**

**1. Zero or negative interest rate policy**

*Maintain key interest rates around zero (liquidity trap zone) to act on the long-term rates and encourage investment and consumption. The BCE even fixed the deposit facility rate at -0.15 % to compel the banks to withdraw their surplus liquidity and direct them towards credit*



## 2. Introduction of quantitative easing: quantitative easing (QE) and credit easing (CE)

- Groundbreaking experience of the Bank of Japan (BoJ) at the end of the 1990s to fight against deflation and recession
  - ✓ *Quantitative easing (targeting the monetary base): increasing bank reserves through the massive purchase of securities as from March 2001*
    - *Action suspended in 2006 and resumed in 2007-2008*
- EDF : the choice of credit easing (credit targeting)
  - *Outright purchase of Treasury bonds from CT and MLT*
  - *Purchase of asset-backed securities (notably mortgage loans) belonging to banks, US federal agency securities and those issued by financial institutions other than banks*
  - *Granting access to refinancing to new categories of formerly ineligible agents: investment companies, pension funds, insurance companies, non-financial companies, etc.*

## III. IMPACT OF GROWING COMMITMENTS OF CENTRAL BANKS ON THEIR ASSET SITUATIONS, OPERATIONAL CONTEXTS AND INDEPENDENCE

- The unconventional policy of the BCE
  - Two programmes for the purchase of government bonds
  - Abolition of limits set on amounts subject to refinancing by extending the refinancing maturity (6 months, 1 year, 3 years)
  - Launching the outright purchase of covered bonds
- Quantitative easing according to the Bank of England
  - Repurchasing Treasury debts
  - Purchasing assets (commercial paper) held by financial institutions (not only banks) and high quality debt securities issued by non-financial businesses
- Forward guidance: aggressive communication strategy to guide the agents' expectations:
  - The CB has its hands tied by publicly undertaking to conduct a given policy (rate, etc.) for a period of time, for as long as some of the set objectives are not achieved.
- Strong cooperation and enhanced coordination of monetary policies

## 3.6 Impact of growing commitments of CB on their independence and efficiency

### 3.6.1 Justification of the independence of CB

- Monetary stability is a public commodity which contributes to social stability

  **<u>LENIN</u>**: « *The most effective way of destroying a society is by destroying its currency* »

- Problem of intertemporal inconsistency of the monetary policy.

### 3.6.2 Reminder of the main forms of CB independence (Mishkin):

- *Organic*: independence of managers
- *Operational:* free choice of intermediary objectives and free use of instruments
- *Financial:* elimination of budgetary dominance and solid financial position of Central Banks

### 3.6.3 Risks represented by unconventional monetary policies

- Risk of reducing financial independence and sustainable budgetary dominance (in the form of a free-rider)
  - The massive purchase of Treasury bonds have eroded the border between budgetary and monetary policies
- Risk of reducing the flexibility of monetary policy and of its being essentially subject to future orientations of budgetary policies: risk of loosing the operational independence of CB :
  - The slowness of budgetary adjustments and the difficulties encountered in the restructuring of public debt compel CB to keep treasury securities for a long time.
- Risk that bubbles might appear and excessive risk-taking due to low interest rates
  - Risk currently ruled out: the private sector pays off its debts

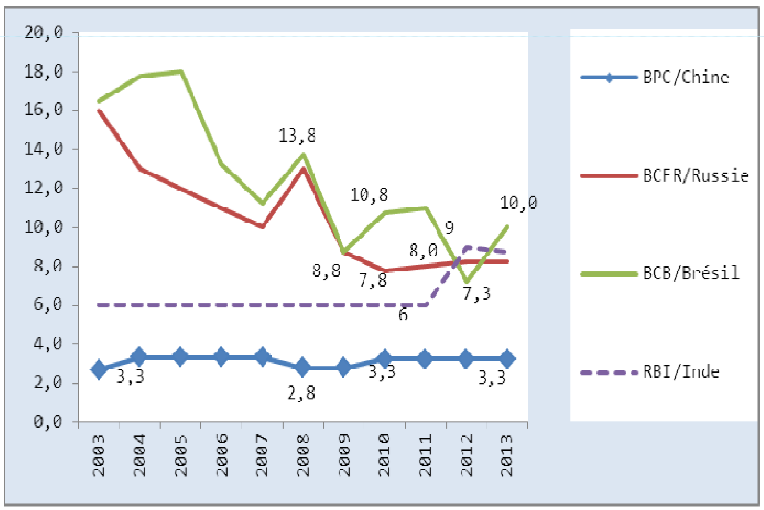
## III. IMPACT OF GROWING COMMITMENTS OF CENTRAL BANKS ON THEIR ASSET SITUATIONS, OPERATIONAL CONTEXTS AND INDEPENDENCE

### 3.6.3 Need to preserve the credibility of CB with regard to their commitments

- To preserve the credibility of CB, there is need
  - To carefully review the conditions for maintaining or withdrawing unconventional policies taking into account the weighting of each risk
    - ✓ Prepare the conditions for a smooth landing
  - To conduct credible public finance reforms to improve their long-term sustainability and restore confidence
    - ✓ Importance of public deficit reduction programmes
  - For States to explicitly guarantee CB losses and provide them with the support they require to meet their commitments.

## III. IMPACT OF GROWING COMMITMENTS OF CENTRAL BANKS ON THEIR ASSET SITUATIONS, OPERATIONAL CONTEXTS AND INDEPENDENCE

- **Economic and financial risks:**
  - **Risk of reviving expectations (inflation, exchange rate, long-term interest rate)**
    - ✓ **Risk ruled out for the time being because of the high unemployment rate (under-utilization of factors)**
  - **Risk of increasing volatility of interest rates, in case the CB suddenly withdraws from Treasury securities and disruptions appear on the emerging markets**




The prospect of ending unconventional policies caused financial turmoil on the markets of emerging countries, where CB were compelled to raise the key interest rates (graph attached).

  - **An increase in rates could result in losses for the CB (risk of decline in the value of purchased Treasury bills), to be combined with the probable losses arising from low quality assets**

## IV. LESSONS TO BE LEARNT FOR CENTRAL BANKS AND AFRICAN STATES

1. Can African CB put in place unconventional instruments?

Yes, …

… because Africa is confronted with many structural problems (lackluster development of physical and financial infrastructure, high unemployment, etc.) which require new financing instruments…

however…

- The nature of unconventional policies adopted in Africa should be different from those of advanced countries to avoid the rise in inflation (in a context marked by low supplies due to structural factors)
- All the risks presented above should be taken into account by African CB.
- Strengthening public finances is a basic prerequisite for the establishment of unconventional instruments in Africa

## IV. LESSONS TO BE LEARNT FOR CENTRAL BANKS AND AFRICAN STATES

- The institutional framework should be defined for unconventional policies in Africa
  - ✓ Direct CB financing carefully and exclusively towards developmental investment projects
  - ✓ Arrangements for the supervision of the private sector which receives the funds so as to avert poor resource allocation
  - ✓ Guarantee risks of CB losses by Governments
- Need to further the reflection on ways of developing the adaptability of the operational frameworks to the special context of Africa (see memo of African Central Bank Governors, Abuja, 2014)

2. CB can explore the conditions for an effective use of a fraction of their foreign exchange reserves to support development funding in Africa instead of assigning them the unique role of absorbing balance of payment shocks
   - Define a solid institutional and financial framework for the judicious allocation of resources and for guaranteeing their reconstitution

## IV. LESSONS TO BE LEARNT FOR CENTRAL BANKS AND AFRICAN STATES

3. African CB should step up their cooperation

   - To contribute more effectively to the economic, financial and monetary integration of Africa and to its development

4. There is need for a solid framework of cooperation between the monetary and budgetary authorities in order to

   - Effectively coordinate the policy mix
   - Maximize the results with regard to monetary and financial stability

5. African CB should strengthen their frameworks for the analysis and evaluation of risks on the economy and on the financial systems

   - To improve the quality of their interventions

6. African CB should implement tools intended to absorb the impacts, on Africa, of the expected withdrawal of unconventional policies

   - To effectively counter the effects of volatile raw material prices

## IV. LESSONS TO BE LEARNT FOR CENTRAL BANKS AND AFRICAN STATES

7. The development by African States, of markets for public and private securities, is a vital element for the implementation of quantitative easing instruments

   - It is difficult to organize securities purchase programmes in a context characterized by the poor development of financial assets markets

8. It is also vital to structure the institutional frameworks for the management of collaterals and securities in order to secure the balance sheets of Central Banks

9. The development of the insurance and pensions fund sectors, loan guarantee (and repurchasing) agencies and investment banks is important for monetary policy

   - With the financial crisis, non-banking financial institutions enabled CB to go beyond the limits of traditional monetary policy transmission channels

10. There is need to have performance-oriented and modern payment systems for the implementation of unconventional monetary policies

**THANK YOU FOR YOUR KIND ATTENTION**