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Monetary Policy and Balance Sheet Adjustment

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Monetary Policy and Balance Sheet Adjustment[1]

Otmar Issing

June 2014

In the wake of the Global Financial Crisis that started in 2007, policymakers were forced to respond quickly and forcefully to a recession caused not by short-term factors, but rather by an over-accumulation of debt by sovereigns, banks, and households: a so-called "balance sheet recession." Though the nature of the crisis was understood relatively early on, policy prescriptions for how to deal with its consequences have continued to diverge.

Normal vs. balance sheet recessions

Already at an early stage of the crisis which erupted in 2007, a broad consensus emerged: all efforts had to be taken to avoid the mistakes of the past, and prevent the global economy from falling into a depression. Monetary policy and fiscal policy reacted quickly and forcefully.

However, it soon became evident that the major countries were not just confronted with a "normal" recession. Concerns of a panic in the financial system were visible in discussions about the threat of a "Minsky moment," that is, a sudden major collapse in asset values. Reinhart and Rogoff (2009) identified high indebtedness as the overriding characteristic of financial disasters in more than 60 countries over a period of eight centuries. The worst case scenario is one where all three sectors—that is, the public, banking and private household sectors—accumulate unsustainable levels of debt, making an adjustment of balance sheets inevitable and necessary. The term "balance sheet recession," coined by Koo (2011), emphasizes this contrast to normal downturns. However, not all balance sheet recessions are the same. The main differences have to do with the number of sectors involved (Brunnermeier and Sannikov 2013a).

[1] I am grateful for valuable suggestions to Allan Meltzer, Massimo Rostagno, and William White.

As short-term crisis management – at least so far – has been successful, discussions have shifted to the question of how long-term crisis resolution should be conducted. While there was a broad consensus as mentioned on the former, concerning the latter the harmony is gone and unusually strong disagreements have emerged (Borio 2014).

Divergent policy advice

What is the reason for a level of divergence in policy advice, which goes beyond what can be regarded as "usual"? For one, the crisis has revealed a dearth of models which are available to both analyze the emergence of the crisis and deliver substantiated advice for monetary policy actions (Bech et al. 2012). For a long time, even the "state of the art" macroeconomic models lacked a relevant financial sector. Improvements currently being presented are still far away from dealing adequately with a system that reacts to shocks in a non-linear and asymmetric fashion. Although there have been attempts to endogenize financial risk in dynamic stochastic general equilibrium models (Christiano *et al*. 2014), it is fair to conclude that this literature is still in its infancy and endogenous risk is therefore all too present (Brunnermeier and Sannikov 2014). As a consequence, there is a high risk in deriving recommendations for monetary policy based on insufficient or even wrong models (White 2009). Experience with balance sheet recessions in modern times is also quite limited, and its usefulness for us today is constrained by the fact that the financial system prevailing at the time of the Great Depression and the system of today differ substantially (Schularick and Taylor 2012).

Challenges for monetary policy

The key challenge for the central bank in crisis management is to prevent the economy from falling into deflation. The danger is not the negative inflation rate per se, but a process of accelerating deflationary expectations. Delaying purchases of goods today, because of expectations of lower prices tomorrow, is hardly observed. The biggest threat is a process of "debt deflation," as analyzed in all its stages and details by Irving Fisher (1932/2012).

A related phenomenon is the zero bound for the reduction of the central bank interest rate. True, avoiding the deflation trap is the foremost duty of the central bank. On the other hand, it is important to understand that disinflation is a necessary and positive corollary of the adjustment process. Disinflation (and even mild deflation) is not the original cause of the downturn, but rather the side effect of a correction process after the collapse of an unsustainable economic and financial boom.

For Hayek (1933/2012), an upswing is characterized by the buildup of distortions driven by credit expansion, and therefore the corresponding downswing has to bring about the necessary adjustments if a lasting recovery is to ensue: “To combat the depression by a forced credit expansion is to attempt to cure the evil by the very means which brought it about…” (p. 21).

The biggest challenge for policy makers, meanwhile, is to find the right balance of smoothing the adjustment process, while not preventing it. As Praet (2013) puts it: “Crisis management has to complement, but should not obstruct, crisis resolution.” The adjustment process following the identification of a balance sheet recession logically requires deleveraging, first and foremost of the financial sector. However, the need to both shrink the balance sheets of banks, and to react positively to low central bank interest rates by extending credit to non-financial firms, are in conflict with each other. Therefore, it is not surprising that, under these circumstances, monetary policy is less effective than in a normal recession (see e.g. White 2013).

A very low central bank interest rate opens up an opportunity for a kind of “stealth recapitalization” by banks (Brunnermeier and Sannikov 2013b), who can exploit the yield curve via purchases of government bonds. If, at the same time, the central bank lowers the conditions for the quality of collateral, it implements a reverse kind of Bagehot’s lender of last resort scenario. In the extreme, “zombie banks” may be kept alive, which would in turn have two very unpleasant consequences. Firstly, it would interfere with the banking sector’s much-needed self-correction process, which is necessary to return to a sustainable base. Secondly, zombie banks have a strong incentive to keep “zombie companies” alive to which they have given credit in the past. As a result, not only would the banking sector not be properly restructured, but neither would the non-financial sector, leading to what has been

called the “Japanese disease.” “Palliative measures” (Fisher 1932/2010) are simply no substitute for remedies.

In this context, it is interesting to note that for Fisher, the stability of the price level is an indispensable condition for a sustainable recovery, whereas Hayek argued that the “stabilizers” had already done harm enough. In our time, this issue is usually discussed under the headline: “is price stability enough?” when it comes to preserving or restoring financial stability.

This also raises the question of how long a policy of very low interest rates should be maintained. If the central bank uses the zero bound as a reason to justify a more accommodative monetary policy, and applies unorthodox measures of monetary easing, the problem becomes more acute. Even a huge increase in central bank money creation might not have the intended effect on the real economy. While the positive impact on the real economy declines, negative side effects will emerge and finally dominate (Borio 2014). The idea that an economy might have only a “corridor of stability” was developed by Leijonhufvud (2009). In such a case, the economy might enter the zone of instability when pushed too far, e.g. by an overly expansionary monetary policy.

Looking beyond the immediate management of the crisis, an orderly exit will be more daunting, the longer the expansionary monetary policy persists. Very low central bank interest rates induce banks to hold an increasing share of fixed income securities –mainly government bonds – which then makes them vulnerable to interest rate increases. A period of very low interest rates triggers a “search for yield” and, therefore, a high incentive to take higher risk.

The process of deleveraging is, if not stopped, at least heavily distorted. And new distortions are building up. There is, for example, the danger that the housing market—which had plunged during the downturn—will overreact, not least due to speculation in such a situation of very low interest rates. The extension of extremely easy monetary policy might end up leading to the repetition of past mistakes. Indeed, looking back over more than two decades, White (2013) identifies a “serial bubble” problem (already identified to some extent by Hayek (1933/2012)).

A striking example is given by Blinder and Reis (2005), who argue that the “mop-up strategy” after the “mega bubble burst” in 2000 was a successful demonstration of how to deal with a financial crisis as no single sizable bank, brokerage or investment bank failed. The implication was clear: if the mopping-up strategy worked so well in the case of what they identify as a “mega-bubble burst,” then it would also work after other, presumably smaller, bubbles burst in the future. But, what followed was instead the bursting of a *much* larger bubble. With this experience in mind, the lesson for the conduct of monetary policy after the collapse of financial markets should be quite different.

Finally, the practice of quantitative easing via outright purchases of government bonds connects monetary policy and fiscal policy in a dangerous way. The cheap financing of public spending might be seen as an effective way to conduct deficit spending, since it makes the fiscal multiplier higher. However, there is a high risk that this situation would hardly create any incentives for fiscal consolidation. Fiscal dominance might be the consequence, which would make it extremely difficult for the central bank to get out of the trap. The independence of the central bank – *de jure* and/or *de facto* – would be under threat.

Some key lessons

It is always difficult not to be overwhelmed by the complexity of a problem, or get lost in its confusing intricacies, when it comes to giving operational policy advice. However, some conclusions for how monetary policy should deal with a post-bubble-bursting situation can be drawn:[2]

1. The immediate reaction of monetary and fiscal policy should be fast and forceful.

2. After successful crisis management, nevertheless, any idea of a “quick fix” is both dangerous and misleading.

3. Balance sheet adjustment is an indispensable element of an encompassing policy approach. However, the deleveraging has to be done in such a way that it strengthens the system. “Bad” or even “ugly” versions must be avoided (Cœuré 2013). Reduction of indebtedness must include all sectors involved. Deleveraging,

[2] For the specific aspects in an EMU context, see Draghi (2014). The international dimension would need a deeper analysis than can be provided here. See e.g. Caruana (2014).

or rather restructuring, the banking sector is the key to sustainable future development. For this purpose, recapitalization of solvable banks is essential, as well as the elimination of institutions without a viable business model.

4. In cases where the financial system is mainly based on bank credit, restructuring of the banking sector should be accompanied by financial innovations outside the banking sector, which could help mitigate the impact of deleveraging on the real sector.

5. The longer the central bank conducts a monetary policy of very low interest rates and applies measures of quantitative easing, the more negative side effects will emerge. As the positive effects decline and become harder to identify, the overall balance of continuing on such an expansionary course might become negative sooner rather than later. Therefore, the central bank must increasingly consider the challenge of how to organize an orderly exit from the expansionary policy.

6. The notion of the central bank as the institution to solve all problems has dangerous implications for the independence of the central bank. To be seen as "the only game in town" might, over time, turn into the role of the scapegoat for anything that goes wrong. In addition, a policy which transgresses the mandate of the central bank, and/or the frontier between monetary and fiscal policy, might raise questions about the legitimacy of the central bank's actions.

7. Looking beyond the horizon of the current crisis, the fundamental challenge for monetary policy is to prevent – as far as possible – the emergence of new bubbles. This can only be achieved if the central bank rejects the "mopping-up-only" strategy and applies an symmetric approach (Issing 2012).

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