Inside Money and Monetary Policy

Central banks can buy financial assets, push large amounts of liquidity into the financial system, dampen yields across the yield curve, but at the end of the day, the banking system can have its own ideas about the creation of inside money. More importantly, none of these policies ensure that banks would lend to sectors that support sustainable growth of the economy. How much credit is created and where that lending is directed is largely a prerogative of the financial system. Distorted incentives often lead to distorted lending which often leads to financial crisis. It is important to keep this in mind when we look at effectiveness of extraordinary policy measures like quantitative easing (QE).

Rising imbalances and narrowing policy space

Unconventional policies have indeed been hugely successful in boosting prices of all types of financial assets by pushing investors into riskier assets in a search of yield and by central banks' buying and taking out of the markets large amounts of safe assets. Central Bank assurance of a prolonged period of easy money have given the markets confidence that asset prices would continue to rise.

But as investors have become increasingly desperate for a decent return on their funds, the risk-taking may have gone in unanticipated directions and exceeded the expectations of central banks. From what we can see, negative interest rates and cheap credit have led to significant flows of savings and leverage into properties and housing. Equities and bond markets have reached levels where even the market participants are showing signs of nervousness. The search for yield has pushed investors into risky products such as leveraged loans and junk bonds issued by already highly-indebted companies.

Only last week, the *Wall Street Journal*[1] carried an article, based on work by *S&P Global Market Intelligence*, which noted that almost 30% of risky leveraged loans in the U.S. in 2007 were "covenant lite." By 2016, that number had increased to 75%. In Europe, that number was just under 8% in 2007, rising to 60% in 2016.

Over the last three to four years, there have been increasing signs of such investor over-stretching for yields. Central banks need to take serious notice of these developments. Otherwise, their unconventional monetary policies are in serious risk of leaving behind a deeply tarnished legacy.

This is particularly important at this time when we are for the first time since the financial crisis seeing more sustained and synchronised growth across the world. Almost a decade of financial repression in much of the developed world and the consequent imbalances could yet trip the global economy again. The imbalances are

---

1 15 June 2017, "Yield Hunt Drives Loan Buyers Crazy"

now global; credit and asset prices have increased across the world. Debt levels are higher and the policy space has narrowed significantly in many countries since the onset of the financial crisis.

Small open economies and the tyranny of global finance

From the perspective of a small open economy like my own, the tyranny of global finance is that only a few currencies can be reserve currencies, and when the world is flooded with those currencies, there are unhappy consequences.

In the post-crisis period, any illusion of independence of monetary policy in small open economies has now largely disappeared. With a globally integrated financial system, you can only fully control your interest rates if you do not care at all about your exchange rate. And as the post-crisis experience has shown, even the developed countries, including the reserve currency economies, do very much care about their exchange rates.

It is for this reason that when you look at the small open economies in Asia, most central banks – even the inflation targeting ones, once you get beyond the rituals of inflation targeting – we are all doing essentially the same things: including relying on a multiplicity of tools because large external flows make it difficult to rely on interest rates alone.

In Malaysia, after the AFC, we bought into the conventional wisdom that deepening our financial system would allow us to better manage these capital flows. The reality has been that with deeper and more open financial systems, you also tend to attract more capital flows. Deeper financial systems do provide a greater capacity to intermediate these flows, but it is not a capacity without limits, and it comes at the cost of greater volatility in the exchange rate. It is no coincidence that the Malaysian ringgit has been one of the most volatile currency in the region after the crisis. So, the irony is that with deeper financial systems, you may need to hold even larger foreign exchange reserves to provide stability.

Some observations and questions on efficacy of unconventional monetary policies

Having not participated in the extreme monetary policies, but being nevertheless affected by them, let me mention a number of observations and questions about their efficacy.

First, despite the labelling of unconventional monetary policy, the monetary frameworks employed by most central banks have remained essentially the same as those that spawned the financial crisis. That being the case, how do we ensure that we do not repeat the same mistakes again?

Second, a related issue has to do with the fact that while too high inflation is a monetary phenomenon, is it also necessarily the case that too low inflation is also a monetary phenomenon? Despite often noting the role of structural reforms and fiscal

policy, the aggressive monetary policy response by the major central banks seems to indicate that there was a strong belief that low inflation was indeed amenable to a monetary cure. However, even after almost a decade of strenuous efforts, central banks are still having trouble achieving their desired inflation rates.

Third, as a matter of strategy, how much liquidity does an economy need? I have always thought of liquidity as a lubricant. When the economy is not running smoothly, some additional lubricant may be helpful. But like a car engine, is it the case that beyond a certain point, adding more lubricant would make the economy run faster or smoother. It does not work for the car engine, should it work for the economy? Particularly, when you understand that an economy could be running badly for many reasons, and adding additional liquidity may not only not solve the underlying problems but may instead create additional ones.

Carrying the car analogy a lit bit further, if you look at the monetary policy speedometer, there is a red line. It is known to us as the zero lower bound on nominal interest rates. The interpretation of that red line in the post-crisis period has been to treat it as a target, something to be achieved, breached or circumvented. I believe that it should be seen as a warning. That once interest rates approach these levels, central banks should exercise great care in pressing the monetary accelerator further, for you risk damaging the long term performance of the economy.

I sense that there is now a growing realisation among central banks that once you go beyond a certain interest rate threshold, the gains from additional cuts in interest rates tend to get smaller and the costs tend to get larger.

Fourth, monetary policy sets the baseline conditions for risk-taking in the economy. Extended periods of low interest rates encourage risky behaviour across the system — with risks popping up in different parts of the economy. Managing these risks would be difficult and could end up being the central banking equivalent of the “Whac-A-Mole” game. There has been much discussions about whether monetary policy should be “leaning against the wind.” I believe that the issue is even more fundamental than that. Monetary policy should not be actively creating financial stability risks in the first place, no matter what the neutral rate is saying.

Here, institutions like the IMF have not been particularly helpful. One day they are cheer-leading central banks to greater heights of monetary easing, and the next day, they are highlighting concerns about global asset prices. You cannot have it both ways – the two issues are related. Spiking asset prices is at the core of monetary strategies like QE.

Fifth, it would appear that once you adopt extreme monetary policies, it becomes difficult to back out. It is like monetary quicksand – easy to jump into but difficult to get out of. The reason for that is that central banks have to weave a narrative to justify their extreme policy measures and those narratives tend to trap central banks when they need to reverse. You need the backing of really strong data to extricate yourself without losing credibility. A related reason is that at such low rates, reversal aversion is strong and favours status quo. That “fear factor” is accentuated by the realisation that unwinding the extreme policy measures in a manner that does not

disrupt economic and financial activity is going to be highly challenging. As a consequence, low interest rates tend to stay around far too long – long after the original motivation is gone.

Sixth, central bank communications and tools like forward guidance are intended to enhance the effectiveness of monetary policy. However, these communications could mean different things to different economic agents. For instance, saying that you are going to maintain low interest rates for an extended period could be perceived by financial markets as a sign of good times ahead, but be seen by real investors and businesses as a worrisome diagnosis that the economy is going to be very sick for an extended period. This divergent messaging may have contributed to the outcomes such as the one of having significant financial investment and only modest real investment.

A final concluding point, the common understanding is that monetary policy cannot have a long-term effect on economic activity and employment. However, looking at the mountain of debt and financial excesses that have gotten even higher since the crisis, I believe that we need to consider the possibility that the cumulative impact of repeated cycles of counter-cyclical monetary policy that has an inherent bias toward easy monetary conditions could lead to the build-up of large imbalances that are detrimental to the long-term growth prospects of the economy.

We can only create long periods of sustained growth if our policies are managed to avoid creating large excesses. A policy strategy of recovering from one period of excesses by creating new excesses is a recipe for transferring growth across time, not for creating sustained growth over time.

Dr. Sukudhew Singh
Deputy Governor
Central Bank of Malaysia