The Big Ease

Monetary Policy: What's Next, What about Structural Reforms and Capital Markets?

The first LSE and Swiss Re financial markets roundtable discussion took place on the 14th of November of 2016 at the London School of Economics and Political Science (LSE) and counted with the presence of a broad audience including market participants, policymakers, academics and financial press. This meeting was part of an LSE and Swiss Re collaborative research programme to investigate the stability of financial markets, the health of private capital markets and, more specifically, the environment in which long-term investors operate.

Executive Summary

Since the onset of the global financial crisis, the way monetary policy is conducted by major central banks across the globe has undergone dramatic changes. The pre-crisis monetary policy toolkits, basically restricted to open market operations to control benchmark interest rates, have been expanded and now include the issuance of interest-paying reserves, communication of the likely paths of future interest rates and the large-scale purchases of risky assets including government bonds and mortgage backed securities. In this roundtable discussion, participants discussed the challenges that this new-style central banking poses for the future of monetary policy, the implementation of structural reforms and for private capital markets.

The meeting was divided in three blocks. In the first block, Professor Ricardo Reis (*A. W. Phillips Professor of Economics at LSE*) presented his Jackson Hole symposium paper which focuses on how the major central Central Banks can finance quantitative easing to target inflation over the next years. In the second block, Dr Simeon Djankov (*Executive Director of LSE's Financial Markets Group*) presented some preliminary results regarding the elasticity of reforms to expansive monetary policy in a low interest rate environment. In the last block, Dr Jérôme Haegeli (*Managing Director at Swiss Re*) presented an overview of the current state of private capital markets and put forward some measures that could be taken to improve their functioning over the next few years.

In terms of what to expect from monetary policy in the future, Professor Reis' presentation highlighted that a market saturated with reserves opens the possibility to use new instruments, such as indexed reserves, for the implementation of monetary policy and that Central Banks

are not of ammunition to achieve their inflation targets in the years to come. Regarding the implementation of structural reforms, results shown by Dr Djankov suggest that a low interest rate environment significantly weakens the incentives to adopt structural reforms in the aftermath of a fiscal crisis. Finally, Dr Haegeli's presentation emphasised that the increased activity of Central Banks in private capital markets lead to important distortions in asset price signals. Among the reforms proposed to ensure that long-term investors can better access risk pools and finance the real economy, Dr Haegeli cited pro-growth structural reforms, creation of a tradable infrastructure asset class, more public-private partnerships, strengthening of investors rights and risk-sharing government bonds.

The Role of the Central-bank Balance Sheets for Capital Markets

Ricardo Reis, A. W. Phillips Professor of Economics

Over the last few years, all of the four major central banks have incorporated Quantitative Easing (QE) to their monetary policy toolkits which led to an enormous increase in the size of their balance sheets. Until now, research and discussions have focused on the implications of QE for real and financial stability and on what central banks buy, at what price, to sell when. In this presentation, Professor Ricardo Reis tries to shift the attention to the funding side of QE and its implications for inflation.

The presentation has four main takeaways. First, the market for bank reserves in the United States has been saturated since about 2011. Second, in an economy saturated with reserves only the interest paid on these reserves but not the size of the balance sheet have an effect on inflation, so they can be used as independent policy tools. Third, empirical estimates suggest that QE has not put the central bank solvency at risk and, hence, the current elevated balance sheet of the Federal Reserve appears to be sustainable. Fourth, the central bank is not out of firepower to affect inflation and it presents three radical proposals for innovating on the future composition of QE, in case inflation starts deviating significantly from target.

During Professor Reis' presentation, roundtable participants asked questions and made some comments. For instance, Dr Simeon Djankov questioned why only some institutions have the right to hold reserves at the Federal Reserve and who decides which institutions are those. Regarding the first question, Reis explained that that traces back to the origins of the Federal Reserve and its creation as a clearing house for the commercial banks and that reserves were precisely the means of exchange at the clearing house and, hence, only depositary institutions could hold them. In addition, Reis also commented that the enormous advances in digital currency technology in the last few years have opened the possibility of letting a larger number of institutions or even individuals to hold deposits at the Central Bank, which could have important implications for monetary policy in the future.

Regarding the lack of impacts of QE on inflation when the market is saturated with reserves, Dr Haegeli enquired whether that is also the case for *asset price* inflation and, if not, whether asset

price inflation could feedback into actual inflation. Reis explained that the existing literature have been quite conclusive about the existence of positive effects of QE on asset price inflation, however, these do not translate into actual inflation because the Phillips Curve is too flat at the moment.

On the proposal of using indexed reserves to pin-down the price level, Dr Stephan Schreckenberg, Head of Risk Research at Swiss Re, asked about the risk characteristics of what the players can deposit as reserves because the arbitrage argument relies on the existence of active players to do the arbitrage between reserves and the other assets. To this point, Reis agreed that indeed the functioning of this mechanism depends crucially on active arbitrage by whoever can hold the reserves and, hence, its important to think who are those institutions - a point that relates to the first question by Dr Djankov. In addition, Professor Reis pointed to the importance of *what* the Central Banks buy and that, in an ideal application, the Central Bank should not only issue these bonds but also buy real indexed bonds of similar maturity so as to not change any risk profile in the market.

Still regarding the indexed reserves proposal, Dr Jérôme Haegeli expressed his concerns that, if implemented, this proposal could choke off any incentives of banks to lend because it would make very attractive to simply hold reserves at the Central Bank. Reis responded to this point arguing that as long as the market for reserves is saturated the remuneration can be kept very low and that Haegeli's point on lending crowding out its only a concern if the excess reserves go to levels way above the market saturation point - estimated to be around 1 trillion dollars for the US. Given the current amount of excess reserves around 3.5 trillion dollars, Haegeli then asked whether it is realistic to move the supply of reserves back to the saturation point at anytime soon without generating a financial chaos. Ricardo replied that the current consensus regarding the Federal Reserve exit strategy is that the reversal should be done slowly, but the main point of his presentation is that, from a monetary perspective, we should not move the supply of reserves back to pre-crisis levels but rather move it to a point where the market for reserves its still saturated because this opens the possibility for new policy tools like indexed reserves, forward reserves and the use of reverse repo rates.

Patrick Liedtke (*Head of Financial Institutions Group EMEA, BlackRock*) pointed out that what we have seen over the last few years is economic factors pointing in the same way as the non-economic ones due to the fact that politicians and policymakers have been managing expectations well. He then questioned what will happen in the moment these two start deviating from each other. Ricardo argued that none of these risk considerations affect any of the arguments presented so far, insofar as they are all about the arbitrage between reserves and overnight repos or at most three months. According to Ricardo, the point raised by Liedtke its important to evaluate whether there is a failure or not of forward guidance and, in that sense, doing forward reserves is a way to eliminate some of these issues or at least those that have to do with Central Bank commitments and mandates.

To conclude the discussion, Jérôme Haegeli asked Ricardo Reis what is more important for Central Banks: hitting their actual inflation target or the actual *process* through which they hit

those targets. Ricardo answered that there are several open questions currently being discussed by the major Central Banks. One of these discussions is what should the supply of reserves be in the years to come and, in that respect, this paper clearly argues that it should not go all the way back to its pre-crisis levels but rather to a point where the market is still saturated. A related discussion is about the pace at which the supply of reserves should be reduced and this has important implications from a financial markets perspective. Finally, there is also a discussion about how the interest payments on excess reserves interact with other forms of reserves, for instance, what should be the reverse repo rates relative to the interest on excess reserves and whether the spread between these two rates can be used as a policy tool to target financial stability.

The Effect of Loose Monetary Policy on Structural Reforms

Dr Simeon Djankov, Executive Director of LSE's Financial Markets Group

When regulatory reforms are more likely to occur? Different periods have been suggested in the academic literature, including times of fiscal crisis (Drazen and Grilli (1993)), when *reforming heroes* are in power (Harberger (1993)), in times of economic convergence (Rodrik (2003, 2011)) or in the period immediately after elections (Williamsom (1994)). In his joint work with Dorina Georgieva (*World Bank*) and Rita Ramalho (*World Bank*), Dr Simeon Djankov uses regulatory reform data collected by the World Bank to empirically test for these four hypothesis and, in particular, to investigate what is the interaction between each of these hypothesis and periods of loose monetary policy in which governments can borrow at extremely low cost.

In the preliminary results presented, fiscal crisis indicators have proven to be significant predictors of the reforms across countries providing strong support for Drazen and Grilli's hypothesis. Interestingly, results also suggest that the positive effect of fiscal crisis on reforms is *weakened* in times of loose monetary policy. The only exception for this general pattern is the case of labor market regulatory reforms where fiscal crisis remain an important predictor for reforms even in times of low interest rates.

Dr Jérôme Haegeli opened the discussion asking Djankov if he had looked to the impact of lending rates on the likelihood of reforms for the subsample of rich countries. Djankov replied that indeed they have looked at those effects and their conclusion is that the weakening effect of monetary policy on likelihood of reforms is more pronounced for rich countries than for poor countries. Djankov then argued that this is in line with some of the development economics literature that suggests that for poor countries the local lending rate is not the relevant indicator to measure the access to liquidity because of the role of the IMF and the World Bank in simultaneously providing liquidity support and incentivising the adoption of reforms.

Martin Scheck (*Chief Executive, ICMA*) asked if the World Bank indicators used in the analysis also take into account reforms in supranational level that affect a large number of countries simultaneously (e.g. EU common policy reform) and if that could bias the results presented.

Djankov clarified that the World Bank data only takes into account reforms and changes in policy at the national level and, hence, that is not a problem for the current set of empirical estimates. Nonetheless, Simeon recognised the importance of also studying also reforms in EU common policies (e.g. environmental policy, labor safety standards etc) and, for that purpose, they are currently trying to incorporate OECD data that captures reforms in such common policies.

Professor Sir Charles Bean (*LSE Centre for Macroeconomics*) pointed that it is hard to infer from the current empirical estimates any causal effects of monetary policy on reform adoption, in particular, he raised the issue of whether the measure of monetary policy could be picking the effects of other confounders (e.g. whether a country is experiencing a sudden stop) rather than the effect of monetary policy *per se.* On this point, Djankov agreed that endogeneity is an issue and the only way they are trying to deal with it so far is by using lagged values of the explanatory variables. Simeon recognised the need to control for more variables like, for example, whether the country is receiving external assistance through an IMF or World Bank programme.

Jérôme Haegeli asked if the Doing Business report data currently being used also includes banking reforms. Djankov said it captures banking reforms only tangentially and this is another reason they are currently trying to incorporate the OECD data that captures these reforms.

Paul Hannon (*Editor, Central Banks, Wall Street Journal*) was surprised by the fact that labor reforms were the only type of reforms for which fiscal crisis remain an important predictor even in times of low interest rates and asked what could be behind that result. Simeon recognised that he himself was surprised by this result which is at odds with some literature dating back to the 80s, which argues that labor reforms tend to take place in expansions, with low unemployment and overall shortage of labor. Maybe a possible explanation lies in a more recent literature on the euro crisis that points to labor and pension reforms as the ones that yield faster results in terms of increasing fiscal revenues or reducing total government expenditures.

Sir Charles also enquired about how could one identify *reforming heroes* to test Harberger's hypothesis. Simeon explained that in the original paper Harberger actually lists the characteristics of such reformers in the context of Latin America. Simeon also pointed that one of the main empirical challenges posed by this hypothesis is the fact the in the 90s in Latin America and Eastern Europe most of the reforms were happening simultaneously to transitions from non-democracy to democracy making it hard to disentangle pure economic reformers from societal reformers. Simeon and his co-authors are currently thinking about how to deal with these challenges in order to test Harberger's hypothesis.

To conclude the discussion, Haegeli asked about the relation between income inequality and the effect of loose monetary policy on reforms. Djankov said that in the preliminary results they tried to include some proxies for income inequality (e.g. Gini coefficient or 90th percentile of income distribution) and these have not proven to be statistically significant. Djankov added that one of the underlying challenges concerning inequality is that very few countries have annual measures of inequality but they will try to explore this more in the sample of OECD countries.

The Case for Strengthening Private Capital Markets

Dr. Jérôme Haegeli, Managing Director at Swiss Re

In the final presentation of the day, Dr Jérôme Haegeli made an assessment of the current conditions of private capital markets and the link between these and the unconventional policies adopted by major Central Banks in the aftermath of the 2008 financial crisis. According to Haegeli, from a private investor's perspective capital markets are broken in the sense that asset price signals are distorted and, in particular, the extremely low interest rates observed in the markets are artificially driven by the increased activity of Central Banks in private capital markets. The final part of the presentation discussed some proposals of what could be done to strengthen private capital markets in the future. The proposals included: pro-growth structural reforms, creation of a tradable infrastructure asset class, more public-private partnerships, strengthening of investors right and risk-sharing government bonds.

During Haegeli's presentation, Sir Charles asked how the financial repression index was constructed and, in particular, given that this is a distortion index, what was the information used to construct the undistorted level. Haegeli recognised the difficulties associated with constructing this undistorted level but argued that it is important to not just look at the index values at a given point in time but also to look at changes in the index over time and, in that sense, the markets nowadays look more distorted than they were 15 years ago and particularly so on the monetary side.

Regarding the increase in aggregate bond market duration, Patrick Liedtke pointed out that it is counterintuitive to see an increase in duration in a period that the yield curve is flattening. However, he wondered whether that increase in duration is all bad news. In particular, Liedtke stressed the fact that now there are more opportunities to buy long duration bonds and this led to a decrease in the duration gap which is positive for long-term insurers. Haegeli agreed that this narrowing of the duration gap represents good news from an asset-liability management perspective, but he expressed his concerns about potential negative spillovers for other investors.

Martin Scheck asked about the Central Bank responses to an eventual decline in the value of bond holdings and the political difficulties associated with such scenario. Sir Charles Bean indicated that that is one of the reasons why the Bank of England can only proceed with asset purchases with the sign-off of the Chancellor of the Exchequer so that if subsequently there were losses in those assets they would have to be backed by the fiscal side. Martin Scheck observed that similar restrictions were imposed to the Swiss National Bank.

Concerning the creation of a tradable infrastructure asset class, Patrick Liedtke asked Haegeli whether that was referring to retail or institutional investors. Haegeli answered that institutions could do it without it being a tradable asset class, but, because of the political risks, he does not think it will ever become mainstream for retail investors if it is not tradable. Liedtke pointed that probably its easier to do it just for institutional investors and that one of the lessons from the Brexit crisis is that is that the average retail investor does not really understand or tolerate the risks associated with tradable illiquid asset classes. Martin Scheck also agreed that it is much more

likely to do it in the institutional spectrum, however, he pointed that even within this spectrum there is a need to standardise the structure and documentation of these assets if they were one day to become mainstream.

To conclude the session, Martin Scheck expressed his agreement with the takeaways from Haegeli's presentation. He also pointed that it is a bit too strong to say that capital markets are broken, because some of these markets have actually being very efficient in terms of capital intermediation. In general, he concluded, things are more nuanced and some markets are more broken than others.