

theirview

The mechanics of central banking

Quantitative easing effectively financed borrowing, conflating the divide between monetary and fiscal policy

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is a civil servant. These are his personal views.

The global financial crisis has generated a keen debate in financial dailies on the primary objective of monetary policy—price stability, employment or financial stability. Despite the general interest surrounding quantitative easing, there is understandably much less focus on the arcane, but equally germane, subject of the policy tools and the mechanics through which monetary policy actions are transmitted to the real economy.

The central bank ordinarily regulates liquidity in financial markets through sales and purchase of financial assets (usually treasury bonds) from depository banks through overnight repo (repurchase) agreements. It then defends this rate in the market through open market operations to ensure that its overnight policy rate becomes the risk-free market rate, thereby influencing the yield curve. The accompanying stylized representation of monetary flows illustrates how the monetary system works.

The currency in circulation and banking reserves together comprise the monetary base. Under fractional banking, depository banks park a small fraction of their resources with the central bank as reserves. This fraction can be used as a monetary policy tool for regulating liquidity. Since no interest is ordinarily payable on reserves, banks tend to park only the mandated amount as reserves. There is, however, nothing to prevent them from parking higher amounts should they turn risk-averse. This is exactly what had happened during the recent global financial crisis, best described as a 'liquidity trap' in which liquidity injected into the financial system by the central bank is washed back as reserves and the money multiplier declines sharply.

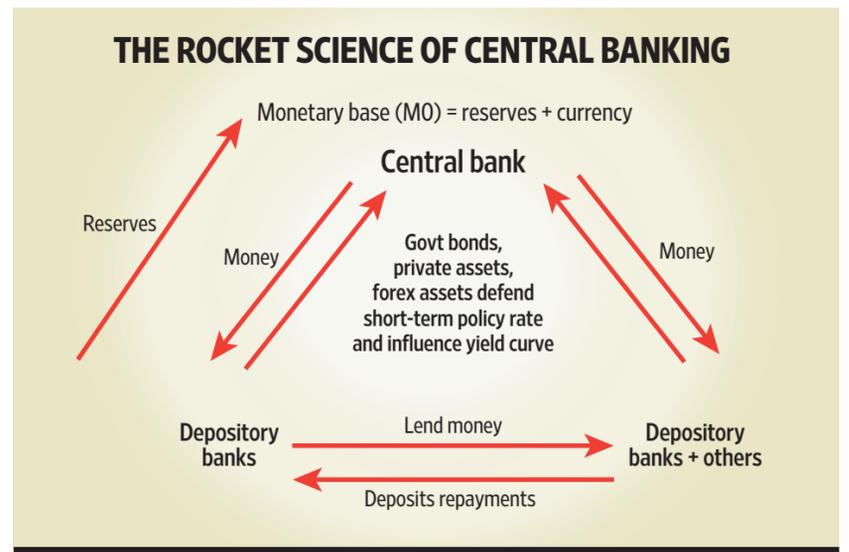
The monetary base is from where

the financial system extends credit. *Ceteris paribus*, expansion of credit leads to an increase in the money multiplier (or the velocity of money, money supply divided by the monetary base), which is money creation by the financial system. There are various measures of money supply, such as M1, M2, M3, depending on what types of deposits and liquid money are included, with M2, or broad money, the most common.

The overnight rate is not the only tool available with central banks. The Bank of Japan was the first to use what is popularly known as 'Quantitative Easing' (QE), or the outright purchase of securities, when the policy rate hit zero in the 1990s. Since 2007, the assets of the US Federal Reserve and the Bank of England have increased five times, those of the Bank of Japan have trebled, and those of the European Central Bank have doubled.

The short-term policy rate influences long-term rates, critical for investment and saving, only indirectly. QE can be used to directly influence long-term rates. Ben Bernanke, former Fed chairman, drew a distinction between 'quantitative easing' and 'credit easing'. The former entails the purchase of bonds by central banks. Credit easing, such as 'operation twist' conducted by the Federal Reserve in September 2011 that entailed selling short-term bonds to purchase long-term ones, affects the yield curve directly without increasing the size of the balance sheet. This distinction is not merely technical. It has a critical bearing on how the central bank balance sheet can be unwound.

There are also other policy tools available with central banks. The process of normalization of monetary policy may constrain them to use some of these other tools, rather than the policy rate, as their main policy instruments. This is



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because only about a quarter of the Fed's asset purchases were financed by newly created money. About three-quarters were financed through excess reserves parked with the Fed on account of risk aversion. Once banks start lending again, or if interest rates were to rise, banks may withdraw these discretionary reserves, which are more than twice the currency in circulation. Most of the monetization of the balance sheet could happen then—unless the Fed increases the mandatory reserve requirements, increases the interest it pays on the excess reserves (IOER), or uses other sterilization instruments such as the reverse repo (RR) or sells assets. These options entail substantial costs, eventually borne by the taxpayer.

One policy tool that captured the public imagination, is little understood and ironically gave 'Helicopter Ben' his popular epithet, was never used during the financial crisis. This is outright money creation, what Milton Friedman described as the 'helicopter drop' of money. This is the nuclear weapon in the central bank arsenal, through which it can

simply print money without the creation of any counterpart public debt liability.

The link between quantitative easing and fiscal policy remains controversial. Central banks in advanced countries have long abandoned monetizing budget deficits. Governments now finance their deficits by borrowing directly from financial markets. It is also clear that the primary objective of QE was financial stability. However, fiscal deficits in advanced economies also widened sharply. While the rise in public leverage was to some extent countervailed by the decline in private leverage, sharp fiscal deterioration should have raised government borrowing costs. This never happened. QE effectively financed the expansion of government borrowing by keeping its costs low, thereby bridging the traditional divide between monetary and fiscal policy. The real monetization of bloated central bank balance sheets, largely comprising treasury bonds, possibly lies ahead.

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