<u>The Evolving Role of Central Banks</u>

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<u>What went wrong?</u>

CBs can create money. Inflation is a monetary phenomenon. So why is there so much difficulty in preventing deflation? We have to analyse before we can move forward.

<u>Unconventional Monetary Measures will change relationship of CB and Treasury.</u>

How will this relationship evolve?

What went wrong?

Relationship between base money and bank deposits broke down.

Table 1

	% change in		
	H	M	Ratio M/H
US 2009	22.5	3.7	-15.3
2010	0.6	3.6	2.9
2011	31.2	9.7	-16.4
2012	2.9	8.2	5.1
2013	39.3	5.4	-24.3
2014	5.9	5.9	0.0
Japan 2009	5.2	2.2	-2.8
2010	7.0	1.8	-4.9
2011	13.8	2.6	-9.8
2012	12.5	2.1	-9.2
2013	47.7	3.3	-30.1
2014	39.1	2.9	-26.1
UK 2009	109.7	5.6	-49.6
2010	-1.3	5.5	6.9
2011	14.0	-3.1	-15.1
2012	50.5	0.2	-33.4
2013	7.6	0.7	-6.5
2014	1.5	-0.1	-1.6
Eurozone 2009	-8.2	-0.5	8.3
2010	2.7	-0.7	-3.3
2011	25.1	2.2	-18.3
2012	22.7	3.0	-16.1
2013	-26.7	0.5	37.1
2014	-0.2	4.8	5.0

Why did this breakdown occur?

- Banks found themselves in a liquidity trap.

- Bonds,
  public sector, interest rate risk;
  private sector, interest and credit risk, capital.

- Loans, capital, credit risk, interest rate risk, lack of demand.

Could we have avoided the Liquidity Trap?

- Negative interest on bank reserves? But currency.

- Introduction of capital requirements could/should have been handled better in Europe.

Whither now?

- Combine easier fiscal policy with monetary policy, i.e. ‘helicopter money’. Some problems.

- Penalise (or abandon) currency usage. Alternative methods.

Treasury/CB Relationships

In prior paper on ‘The Changing Role of Central Banks’, *Financial History Review*, 2011, I identified three stable epochs,

a) Victorian (Gold Standard), 1840s to 1914.
b) Decades of Government Control, 1840s to 1914.
c) Triumph of the Markets, 1980s to 2007/8, with unstable decades, (1920s, 1970s), in between.

In stable epochs, relationship between CB and Treasury became clearly established:-

- (a) and (c), Operational independence within a well-established political context.
- (b) CB is a subsidiary of Treasury.

Intervening periods had a confused and uncertain relationship. We have again returned to such a confused period.

Reasons for Confusion

- QE, and expanded balance sheet, will enhance public sector interest rate risk, borrowing short (relative to long-term liabilities). Such risk will focus on CB.

- CE, and/or LoLR, where CB buys assets with credit risk, will expose CB to politico/economic risks. Taxpayer ultimately bears risk; can CB decide on its own what risks to take?

- Macro-pru will cause CB to become more directly involved with specific asset markets, e.g. housing, CRE. Also the effect of any quantitative control, e.g. margins and down-payments, can be mimicked by a tax/price measure. Perotti and Suarez, (IJCB, 2011). What is balance between monetary macro-pru and fiscal measures? Can macro-pru be limited to bank involvement in markets, (disintermediation)?

So, the scene remains confused. Can oversight Committees help? What do *you* think?