

Re-imagining Central Banking

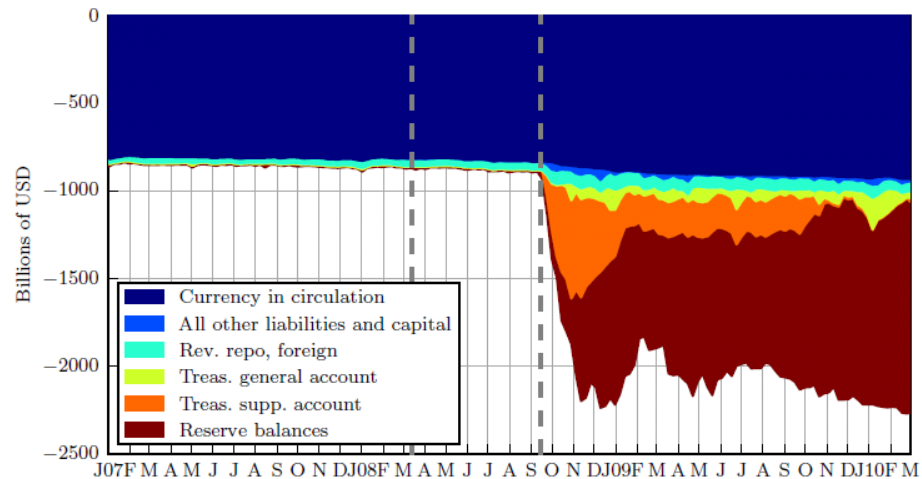
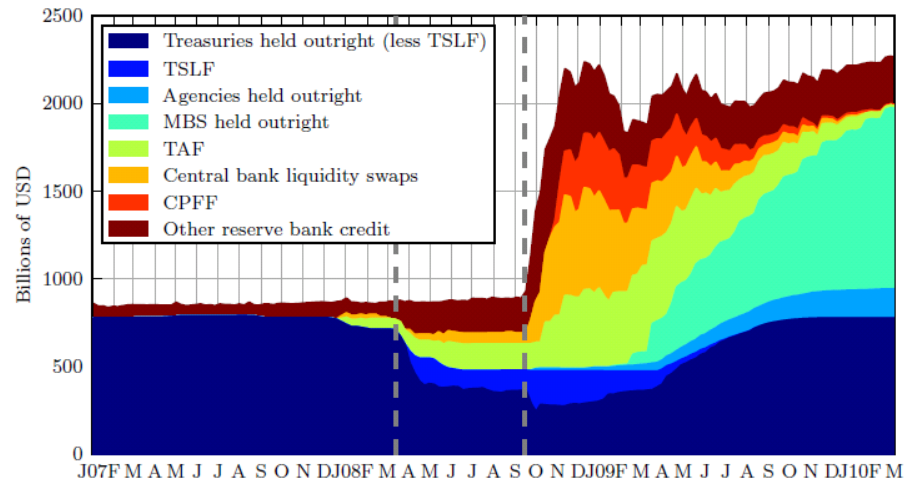
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“Monetary and Fiscal Policy for Growth and
Stability”

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What Have Central Banks Done?

- Zero Interest Rate Policy (ZIRP)
- Quantitative Easing (QE)
 - “Pure” Treasury bills only
 - “Comprehensive” long maturity, non-government
- Forward Guidance
- Distinguish liquidity support, from stimulus
 - Replacing frozen money/capital markets
 - Stimulating private credit

ZIRP, LOLR, DOLR



Stimulus (and Exit?)

March 2010

June 2014

Assets			Liabilities			Assets			Liabilities		
Treasury bonds	.8		.9	Currency		Treasury bonds	2.5		1.3	Currency	
MBS	1.3		1.1	Reserves		MBS	1.8		2.7	Reserves	
Other	.1		.2	Other					.3	Reverse Repo	

- some effect on rates and prices
- not so much effect on quantities
 - private credit, real activity
- unknown effect on “expectations”
- exit challenge
 - “pure” versus “comprehensive” QE
 - price floor versus price target

The Elephant in the Room

- Financial Globalization
 - Dollar funding markets and FX Carry Trades
 - Partial sterilization by foreign central banks
- Market-based Credit System
 - “Money market funding of capital market lending”
 - Price distortion, on both sides, as head-wind for recovery

Can Monetary Policy Work?

“If the interest rate on money, as well as the rates on all other financial assets, were flexible and endogenous, thenthere would be no room for monetary policy to affect aggregate demand.”

Tobin (1969, 26)

Is Credit Productive?

A Payments Perspective

Deficit Agents

Intermediation

Surplus Agents

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
???	Due to	Due from --Business --Household --Gov't	Due to --Business --Household --Gov't	Due from	

- Credit Creation (versus corn model)
 - Surplus may fund Investment (machine, house, road)
 - Surplus may fund Dissaving (profits, wages, taxes)
 - Demand for (risk free) assets may drive supply

What is shadow banking?

“Money market **funding**
of
Capital market **lending**”

- **Global (\$)** funding of **local (FX)** lending
- **Market pricing**, both money and capital
- Key role of **market-making** institutions
- Key role of **central bank as backstop**

Shadow Banking as Global Finance

Shadow Bank

Asset Manager

Assets	Liabilities	Assets	Liabilities
FX Risky Asset Credit Default Swap Interest Rate Swap FX Swap	\$ Repo	\$ Repo	Capital Credit Default Swap Interest Rate Swap FX Swap

Note: Treating “insurance” as contingent asset and liability; alternatively, treat “risk exposure” as contingent asset and liability

Note: What is leverage?

“Making” Markets, Money and Risk

Capital Funding Bank

Global Money Dealer

Asset Manager

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
RMBS CDS IRS	MM funding	MM funding	“deposits”	“deposits”	Capital CDS IRS

Derivative Dealer

Assets	Liabilities
Credit Default Swaps Interest Rate Swaps	Credit Default Swaps Interest Rate Swaps

- Markets (money and risk), not institutions
- Functional differentiation, not institutional

Backstopping Market Making, First Resort

Capital Funding Bank Global Money Dealer Asset Manager

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
RMBS CDS IRS	MM funding	MM funding Reserves	“deposits” Capital	“deposits”	Capital CDS IRS

Derivative Dealer

Assets	Liabilities
CDS IRS Reserves	CDS IRS Capital

Shadow Banking and Traditional Banking

Capital Funding Bank Global Money Dealer Asset Manager

Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
RMBS CDS IRS FXS	MM funding	MM funding Reserves Liquidity put	“deposits” Capital	“deposits”	Capital CDS IRS FXS

Derivative Dealer

Assets	Liabilities
CDS IRS FXS Reserves Liquidity Put	CDS IRS FXS Capital

Backstopping Market-making, Last Resort

- Global Money Dealer
- Derivative Dealer
- Traditional Bank
- **Central Bank (or C5)**

Assets	Liabilities
MM funding Reserves Liquidity put	“deposits”
Assets	Liabilities
CDS IRS FXS Reserves Liquidity put	CDS IRS FXS
Assets	Liabilities
Reserves Liquidity put CB	Liquidity put GMD Liquidity put DD
Assets	Liabilities
	Reserves Liquidity put CB

What do Central Banks Do?

- Lender of Last Resort
- Supervision and Regulation
- Stabilization Policy

The New Bagehot Rule: Market-based Credit System

- Deal freely
- At a wide spread
- Against locally privileged security

Supervision and Regulation: Financial Globalization

- Global Money Dealer
 - Central Bank Swap Lines
 - C6: Fed, BoE, BoJ, ECB, SNB, BoC
 - Bilateral extensions, and IMF
- Derivative Dealer
 - Central Clearing Counterparties/Exchanges
 - Matched book dealing, with liquidity backstop
- National solvency backstops
 - Capital buffers

Stabilization Policy

- Global coordination—C6 funding rates
- Local adaptation
 - C6
 - Periphery (carry trades and UIP)
- Reserve Currency as special case
 - Global funding is dollar funding

Why does Monetary Policy Work?

- Settlement constraint and overnight funding
- Dealer positions and price distortions
 - Money market funding
 - Capital market lending
- Outside spread as new unconventional policy tool?

What does Exit Mean?

- Outside spread, not Inside Spread
 - Tapering, to allow normalization of **capital** market prices
- Outside spread, not Inside Spread
 - Reverse repo, to allow normalization of **money** market funding price