Alternative Monetary Policy Tools: Lessons and Questions from the COVID Crisis

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Agenda

1. To determine the effectiveness, what are the objectives?
2. The key insights learned the during COVID19 response, so far…
3. What are the unintended consequences?
4. What are the limits of the existing tools?
5. What new tools are left, if things get worse?
6. Exit strategies
7. Conclusion

What are the objectives of the new tools?

- Facilitate market functioning – market participants determine prices while the BoC facilitates liquidity. The initial goal of the BoC ✓
- Decreasing risk premiums (term/credit spreads) to ease financial conditions to improve economic growth. The goal of Credit Easing (CE)/Quantitative Easing (QE) ✓
- Consumer price inflation (CPI) near 2% ?
- Financial stability. Investors may be confused about definition ?

Clear public communication is key

Key insights learned during COVID response

- Initial conditions matter, and markets are making relative judgements between countries, so far Canada has benefited:
  - Debt/GDP, overnight rate, inflation, output gap
  - Central bank credibility, independence to use balance sheet
- When at/near the lower bound, go big and go fast. BoC did this.
- Markets currently believe fiscal agents and central banks will do "whatever it takes" in the short term to get through COVID
- Given investors will not "fight the central bank" they will express long-term views on the effectiveness of these tools in markets where the central banks are not currently active (foreign exchange, commodities, equities, etc.)

?

Unintended Consequences

- Easy to fund large companies, hard to fund small ones (SME's). If left uncorrected, this could permanently change competitive landscapes
- Increasing financial stability risk / excessive risk taking / moral hazard
- Rising income inequality
- Misallocation of capital as policy goals replace the profit motive, this could lead to lower productivity and economic growth
- When the central bank is the owner of debt/equity what are the incentives for management, or other governance issues?
- Negative effect on asset management industry. Diminishing returns lead to lower fees; therefore less human capital allocated to critical investment decisions
- Pensions plans and pensioners are facing diminishing returns which will increase asset/liability mismatches promoting "the savings glut"

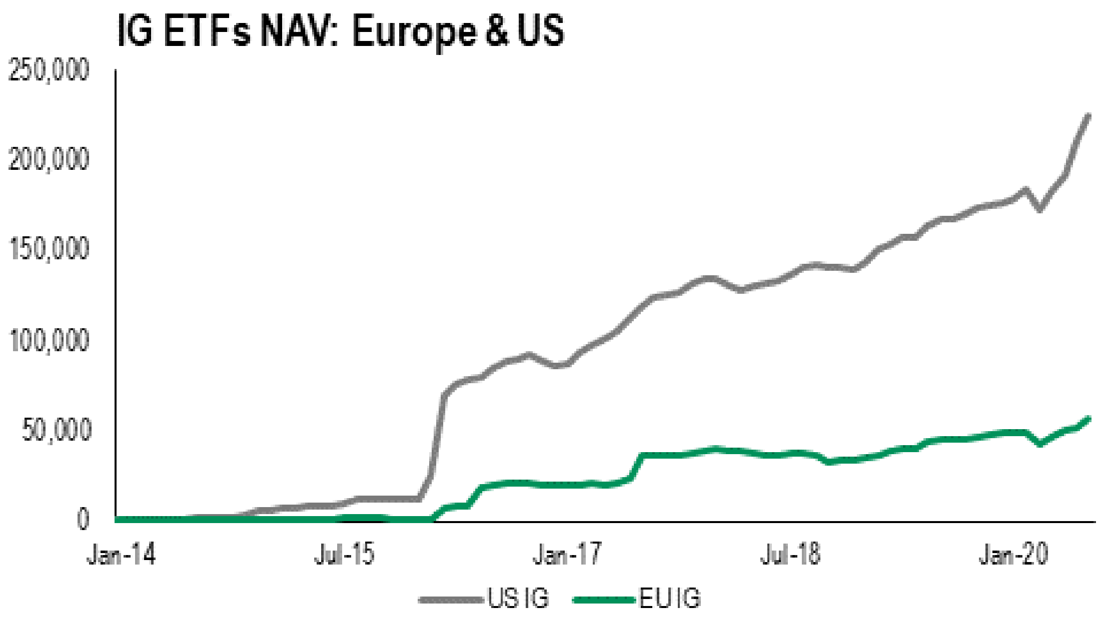
Unintended Consequences: a warning!

- **Passive corporate credit funds are defective products.** Why? Because lending without conducting any assessment of the borrowers' ability to repay is imprudent/reckless
- Bankrupt borrowers need to be liquidated/restructured, passive funds are not designed to do this
- As corporate debt moves from investment grade to high yield to bankruptcy, it moves in/out of various indices potentially causing multiple market disruptions
- Active investors will try to capitalize on forced selling by passive investors potentially causing any market disruptions to be larger
- Typically, defective products are discovered during market crises (e.g. Canadian non-bank ABCP, US non-agency mortgages, portfolio insurance). After the crisis, the defective product goes away
- **During COVID, central bank purchases may bail-out these defective passive credit products in the short-term, allowing the products to proliferate and setting the stage for a larger crisis in the future**

Unintended Consequences: a warning!

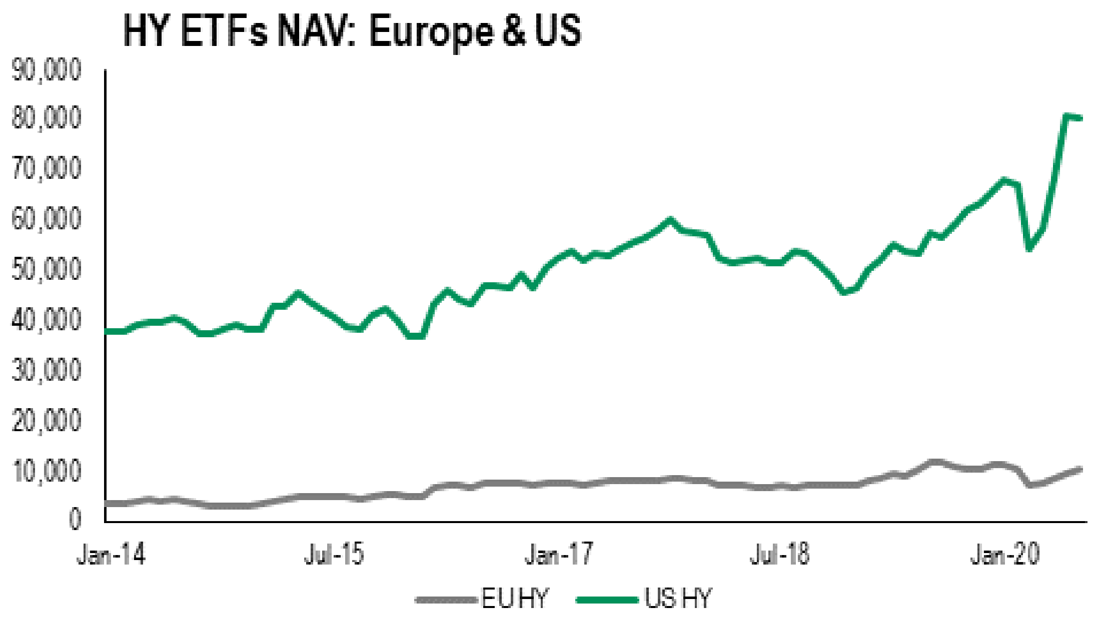
Passive corporate credit AUM growth has created a systemic issue

Y-axis in USD millions



Source: BNP Paribas

Y-axis in USD millions



Source: BNP Paribas

What are the limits of the existing tools?

- Trying to raise CPI via increasing asset prices is very indirect. Watch the velocity of money
- Each existing tool has a diminishing ability to raise consumer/business confidence (given low rates and spread compression). When do the negative unintended consequences outweigh benefits?
- Look at Japan, the benefit of lower borrowing costs is outweighed by the cost of lower expected returns. This is particularly true given demographics, increases in longevity and social safety net insecurities

What new monetary tools are left?

- Refined forward guidance
- Commit to larger sizes for existing announced tools
- Expand Credit Easing (CE) by larger size and lower quality
  - Repo operations
  - Outright purchases
  - Second loss positions (slower to implement, but better market discipline, less moral hazard)
- Yield Curve Control
- Negative interest rates
- FX intervention
- Purchase equities
- Direct central bank funding of federal/provincial deficits

It is not clear the benefits of these tools outweigh the unintended costs

Exit Strategies

- Key is to clearly communicate with the market
- Three classic ways out of excessive debt (“the trap”):
  1. Real Growth
  2. Inflation
  3. Default (not for debt denominated in local currency)
- Is permanent central bank financing of deficits a fourth way out? Or just a bridge to one of the original three?
- How important is central bank independence? Or strictly defined CPI targets? Are we fighting the last war? Should the central banks now focus on cooperating with fiscal agents to implement fiscal policy as monetary policy tools now have diminishing cost/benefit/risk profiles?
- Milton Friedman: inflation is always a monetary phenomenon. Tools should be evaluated through this framework

Conclusion

- The implementation of alternative monetary policy tools have been largely successful meeting short-term objectives
- Paradoxically, the immediate crisis response may have been the easy part
- The hard part may be attaining the long-term inflation target while generating sustainable economic growth given fewer, less effective (and often unproven) monetary policy tools should the economy falter

Given the unusual circumstances:
When in doubt, go big and go fast!