

Unconventional POLICY

PROFESSOR PHILIP MOLYNEUX examines the effects of the unconventional monetary policies implemented by central banks to raise spending and boost growth.

The global financial crisis of 2008-09 resulted in the worst recession seen in advanced economies since the 1930s. While the initial response from central banks was to reduce interest rates sharply, these rates approached zero with little evidence of the hoped-for recovery in nominal spending. So, to provide further stimulus, many central banks began experimenting with a range of unconventional monetary policies (UMP).

Amongst these unconventional measures were Quantitative Easing (QE), where the central bank makes large-scale asset purchases to raise asset prices and increase the supply of bank reserves; targeted asset purchases to alter the relative prices of different assets; and forward guidance to communicate future policy rate paths. Most recently, negative interest rate policy (NIRP) has been added to the UMP toolkit.

But the effectiveness of these policies in driving spending and growth has been at the centre of a vigorous policy debate. And, in late May 2017, the governor of the European Central Bank announced that they would continue with QE to boost growth in the euro area.

MACRO-ECONOMIC EFFECTS

One strand of the growing body of literature on the influence of QE examines the influence of central bank asset purchases on financial markets. Studies focused on the US and UK typically find that the impact varies depending on the type of assets that the central bank acquires. Typically, purchases of mortgage-backed securities have the largest influence on broader financial markets.

Other research looks at the influence of asset purchases on the broader macro-economy – again in the US, UK and in Japan. These studies have the common finding that QE has a modest impact (if any) on broad economic indicators such as output/growth/employment and inflation.

The effects of QE/asset purchases on banks have not had quite the same attention. A handful of studies find that

Japan's QE (between 2001 and 2009) had a modest positive influence on bank lending, and the same is found for similar later analyses on the UK.

All in all, work by both policymakers and academics on the influence of QE tends to focus more on the influence of financial markets and yield curve effects as this appears to be what policymakers view as the main channel of QE/UMP.

LEARNING QE LESSONS

Industry analysts have also been studying prior low-interest rate environments in Japan, the US and UK to try and gauge the impact of the major ECB €1 trillion QE announced in January 2015 and its ongoing effects. In a study of three QE periods in the US, Goldman Sachs (2015) found that bank margins were squeezed because, although funding costs declined, yields on interest bearing assets fell more, reducing profits.

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QE also helped reduce US stock market volatility which (they suggest) is bad for investment banking revenues. There were some initial asset revaluation gains, however, due to the induced lower market interest rates. Various industry commentators have found that euro area banks have experienced margin compression since the ECB announced its €1 trillion QE – and these have been squeezed most in France and Germany.

As well as tightening margins, there has also been pressure on other revenues. Banks with substantial euro area sovereign debt have experienced a one-off asset revaluation benefit as QE has led to a fall in yields. This gain can be counted as Tier 1 capital under



the EU's CRD IV regulation so it has helped strengthen thinly capitalised banks. However, on the downside, previous experience of QE in Japan and the US has resulted in substantial deleveraging (declines in loan-to-deposit ratios) and this also appears to have occurred through 2015-2016.

BELOW ZERO IMPACT

One area where ultra-low interest rate monetary policies have had an impact is on yield curves, the general consensus being that such policies have lowered long-term yields and financial market volatility. Since 2012, six European economies (Denmark, the Euro area, Hungary, Norway, Sweden and Switzerland) and Japan have taken UMP a step further by introducing negative interest rate policy (NIRP). The main aim has been to stabilise inflation expectations and support economic growth. Support for the real economy is expected to be derived by a greater supply and demand for loans, with loan supply increasing as banks run down their (large) excess reserve balances, and loan demand increasing in response to a further fall in lending rates.

The key issue with NIRP (like QE) is whether it is effective in boosting lending and stimulating growth. Sceptics of the policy point to several possible complications, including a limited pass-through to lending rates as banks may hold deposit rates steady to maintain the deposit funding base. Such behaviour has an adverse influence on bank profitability, which can limit credit growth if banks charge higher lending rates or fees to cover losses, or if a diminished capital base makes banks more reluctant to lend. Other associated distortions in asset valuations can create asset price bubbles threatening financial stability.

A recent empirical analysis of NIRP in OECD countries over 2012-2016 provides new evidence that bank lending fared worse in NIRP-adopter countries than it did in countries that did not adopt the policy. The



result holds for total bank lending and separately for mortgage and business lending. Also, bank-specific factors (capitalisation, funding structure, business model, interest rate exposure, competitive conditions) also appear to reduce banks' willingness to lend in a negative interest rate setting. The lack of a positive link between NIRP and bank lending questions its role as an effective policy for boosting growth and employment.

THE FUTURE OF UMP

There is increasing interest in the impact of UMP on the broad macro-economy, financial markets and banking systems. Across studies focusing on both individual countries and international comparisons, UMP appears to have a substantial impact on yield curves and financial markets, but less of an influence on macro-economic indicators. A strong negative influence on

bank lending is also evident (if one factors in the influence of NIRP).

Both QE and NIRP reduce bank margins – simply because banks are loath to reduce depositor rates as much as loan rates for fear of losing core customer funding. While there is some evidence that bank profits were positively impacted by early US Fed asset purchases, evidence from elsewhere suggests that any gain was washed out by the ultra-low interest policy that reduced margins and bank profits.

Evidence strongly suggests that the influence of ultra-low interest rates, NIRP and other QE policy in Japan, US, the euro area and the UK has had a limited observable positive impact on growth, employment (or even inflation). This non-effect seems widespread.

So why do central bankers continue to undertake UMP? The standard counter argument given is that things would be much worse if UMP policy had not been conducted. ¹

Philip Molyneux is Professor of Banking and Finance at Bangor Business School.

¹See Molyneux, P., Reghezza, A., Thornton, J., and Xie, R., (2017) Did negative interest rates impact bank lending, Bangor Business School Working Paper, Bangor University

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