MACROECONOMICS
ADVISORY

MONEY, LIQUIDITY AND CREDIBLE MACRO POLICY FRAMEWORKS

Melbourne Economic Forum

29 May 2023

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QUOTES

- … relatively small operations, sometimes even rumours of operations, by the Federal Open Market Committee, may give rise to such quick and pervasive response not only throughout the money market and the investment markets generally but also in business psychology. Any purchase or sale of Government securities by the Committee adds to or subtracts from the reserves of the member banks and is promptly reflected in the tone of the money market. A relatively small injection of funds through the purchase of bills will ordinarily find a response in the market for long-term securities. Large purchases of bills could scarcely fail to elicit such a response..

  See 'bills only' policy – money market supports capital markets -1952 report of the FOMC's Ad Hoc Subcommittee on the Government Securities Market.

  – **William McChesney Martin Jr (1952**).

- "Lend freely but at a high rate". (against good security /or now collateral)

  – **Walter Bagehot (1873**)

- Money is basically a substitute for any financial asset, but also for any real asset. It operates therefore in all directions by adjustments in relative prices. These adjustments involve relative prices between assets, between assets and their yields, and between existing assets and new production.
- So money works through a vast array of channels and not just **through the narrow** interest rate mechanism i.e. Keynes LM Curve.

  – **Karl Brunner (1988)**

- Much of the macro theory that links supply to the price level depends on concepts that have little relevance to the workings of a modern financial system., .. . **No comparable macroeconomic theory for credit aggregates yet exists**.

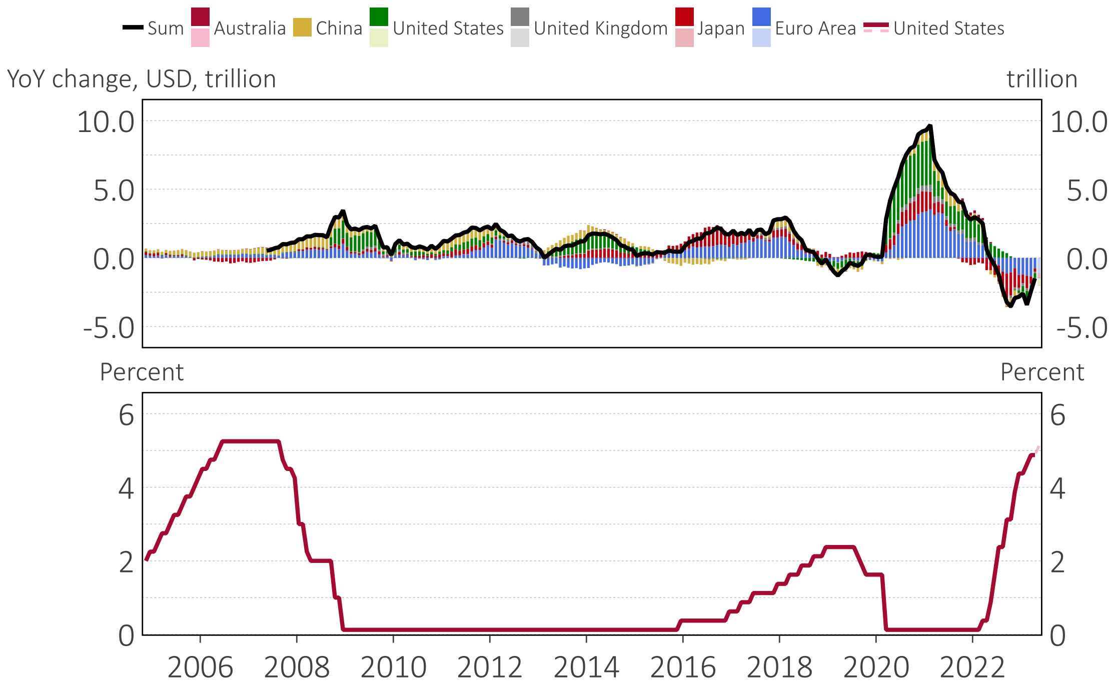
  – **Marcia Stigum (2007**)

OVERVIEW: RBA REVIEW CRITIQUE

- No Campbell Review context or history of crisis.
- One differentiator pre 2016 RBA is *judgement*.
- Tensions between art & science central banking RBA.
  - *State of art* policy making ignores spill overs asset prices / liquidity
  - Ignores *Goodhart (1975)* & *Lucas* (1976) –policy & behaviour change
  - Easing bias in policy / creates blind spots/ easy read for investors
- Embracing approach impacting growth and returns.
- Anchorless & irreversible policy making.

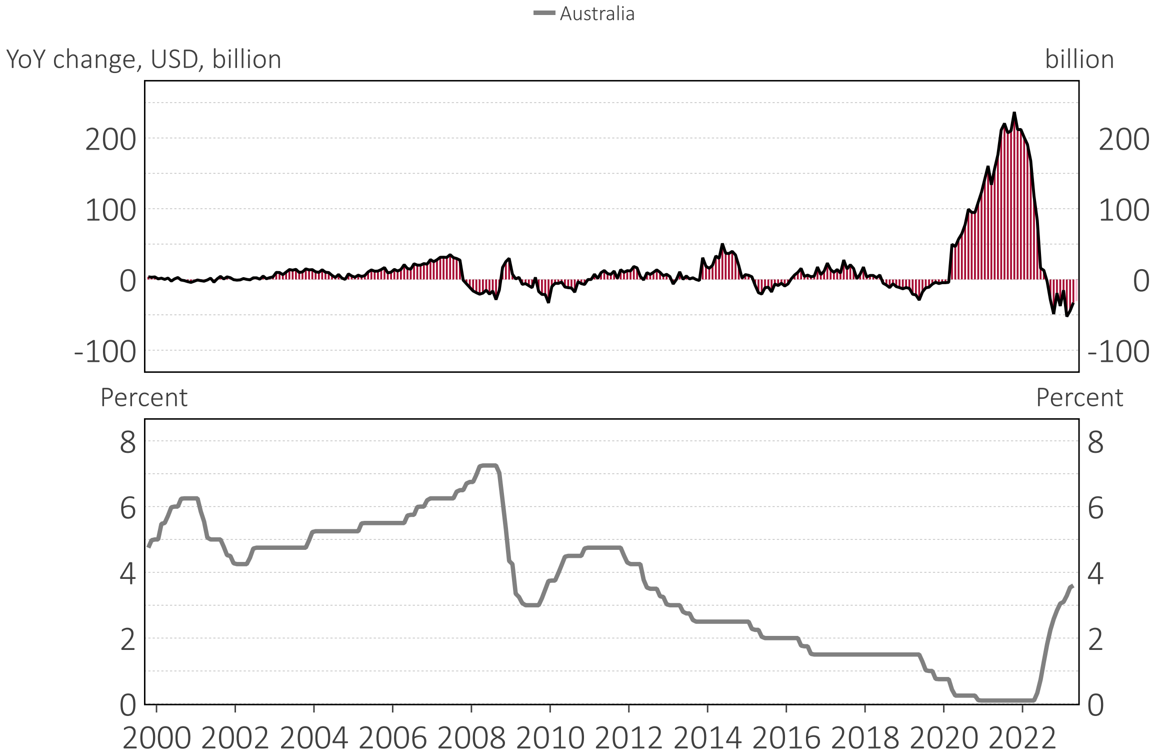
OVERVIEW: CENTRAL BANK QE POLICY

Major Central Bank Balance Sheets (YoY %chg) & Fed Funds



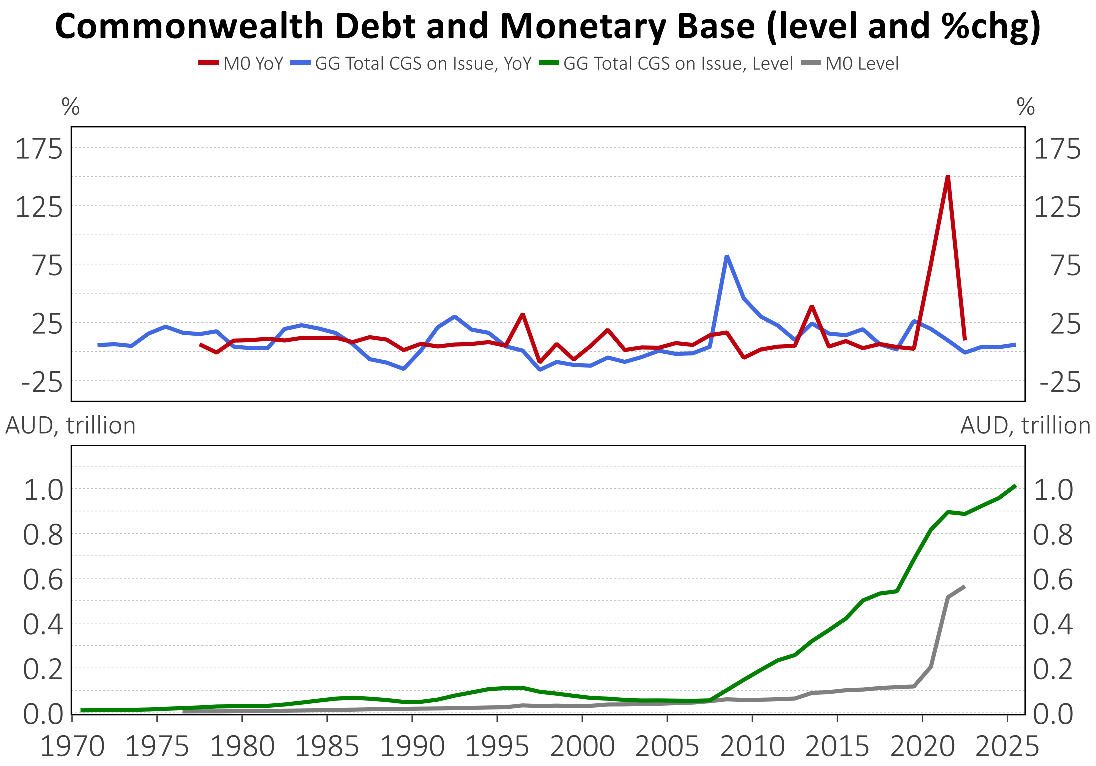
Source: ECB, BOJ, BoE, Fed, PBoC, RBA

RBA Balance Sheet (YoY %chg) & Cash Rate

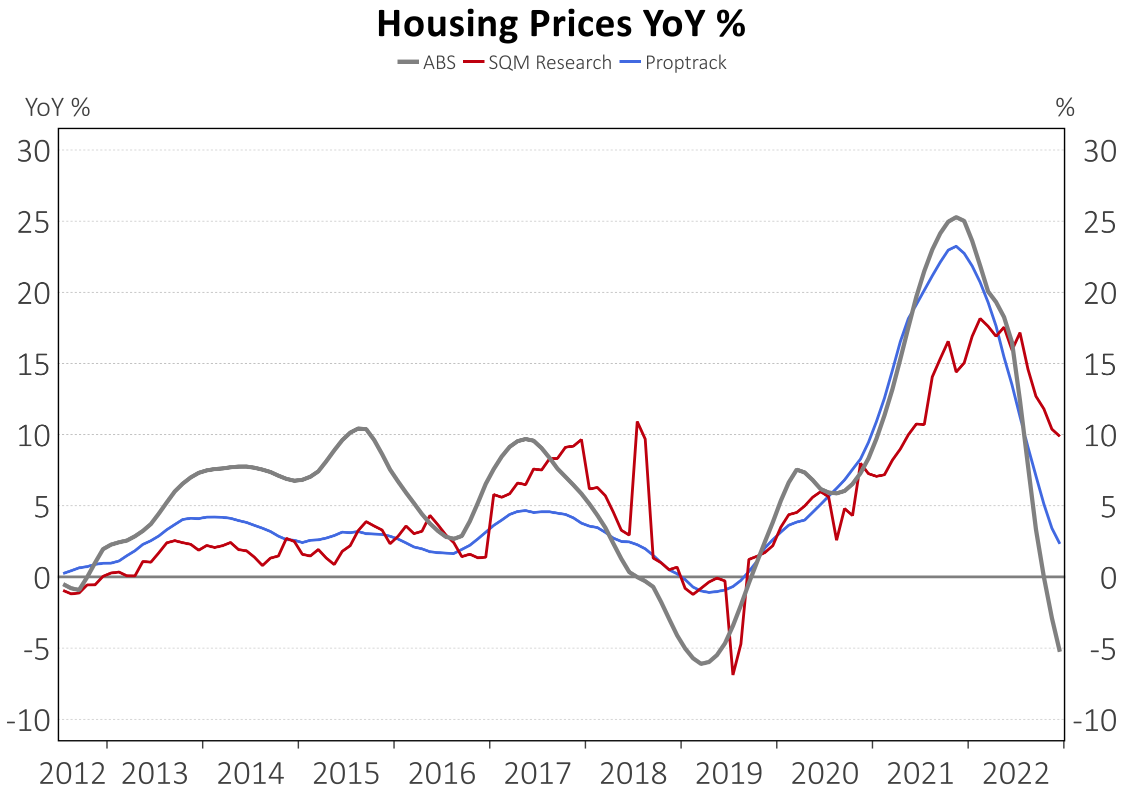


Source: RBA

OVERVIEW: RBA QE POLICY & IMPACTS



Source: Australian Department of the Treasury, RBA



Source: Macrobond, PropTrack, SQM, ABS

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OVERVIEW: ROBUST POLICY

- Credible policy approaches around medium term policy anchors.
- Credible, policy decisions see people quickly adjusting expectations.
- Consumption patterns and behaviour will change rapidly.
- Inflation expectations anchored, realised prices will start to decline.
- No bias in policy –probes imbalances – efficacy low rates.
  - Economies struggle at rates below 2 per cent (Chancellor 2022).
  - Glaring hole in Taylor rule RFs is asset prices. $R = \rho + \pi^e + \alpha(\pi^e - \pi^*) + \beta(Y - Y^F)$
- Monetary policy combines macro stabilisation & liquidity management

ROBUST POLICY VS. LAST TWO DECADES

- **Global Financial Crisis**
- Fed didn't need to store world reserves, so flooding markets with dollars guaranteed low rates (reserves its own liability).
- **Zero bound interest rates & liquidity trap**
- Followed Bernanke *et al* (2004) unconventional toolkit
  - Japanification –moved from ST rates to control LT inflation to being a dealer of last resort to LT capital markets.
  - Fed shifted half wholesale money market onto its balance sheet 2008.
- Ignored McChesney Martin 1952 bills only /liquidation / efficiency costs
- Temporary crisis, 'bad' policy **negative** CAPEX with big CB balance sheet.

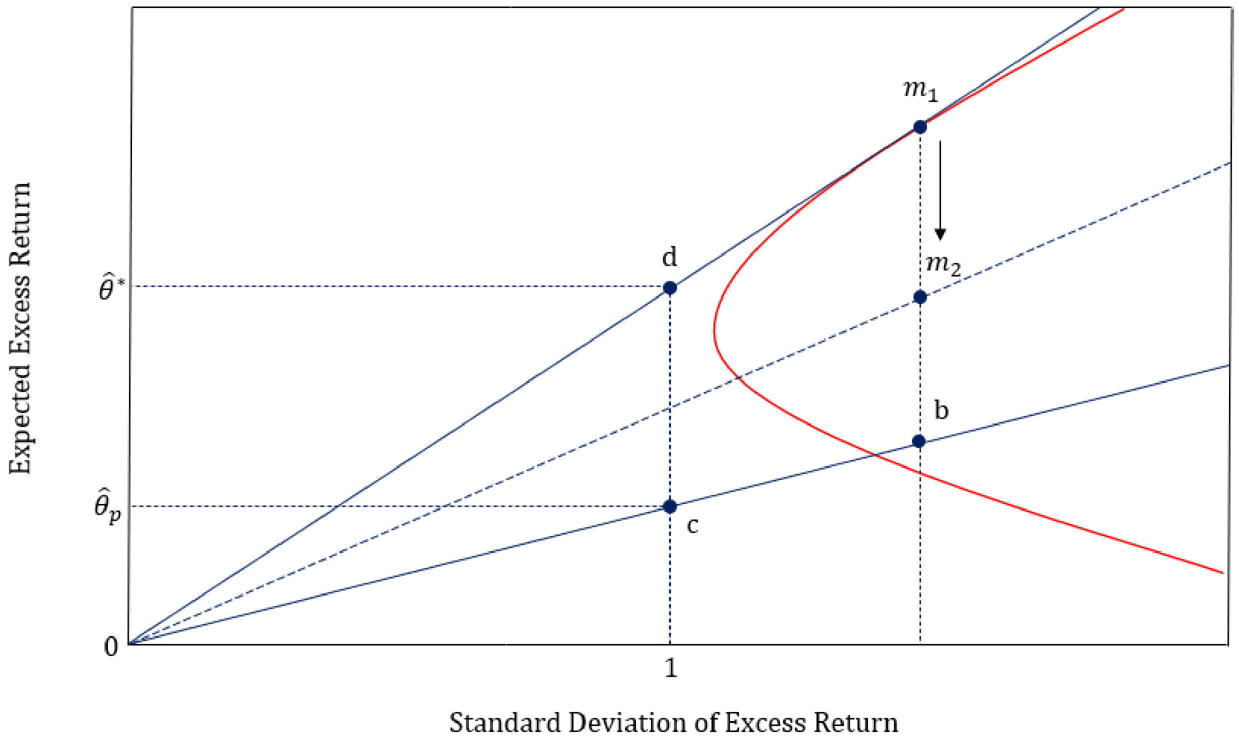
ROBUST POLICY VS. AUS. PANDEMIC

- **Permanent state**: more QE rounds cross countries / big balance sheets / efficiency costs
- **Government between savers and investors as and investment banker actively shifting yield curve**
- OK during GFC. But permanently? In a Pandemic?
- **Enter RBA to party in 2020.**
  – Fiscal policy: $300 billion approx. (12% GDP) - 12m to May 21.
  – Monetary policy: $350 billion (15% GDP) -12m to May 21.
  – Treasurer will not reverse course until unemployment had ‘4%’ in it.

ROBUST POLICY VS ROACH MOTEL

- Another problem only one government, only one budget constraint, no independence monetary and fiscal policy (Prescott, 1999).
- Permanent emergency footings –QE infinity - reversible?
- Roach motel problem & permits policy & growth crawl.
- Rationing intermediation via *too-big-to-fails*.
- Big investors exploit risk-free bank reserves Aschara *et al* (2022).
- Portfolio allocators see QE policies as *fat pitch*. Bauer *et al* (2022).
- **Excess liquidity feeds asset price – especially those that are illiquid such as residential property first – then feedback to CPI prices.**

ANTHONY & YAHYAEI (2022)



Uses Gibbons, Ross, & Shanken (GRS) (1989), to argue how QE policies have distortionary effects on mean-variance efficient portfolios.

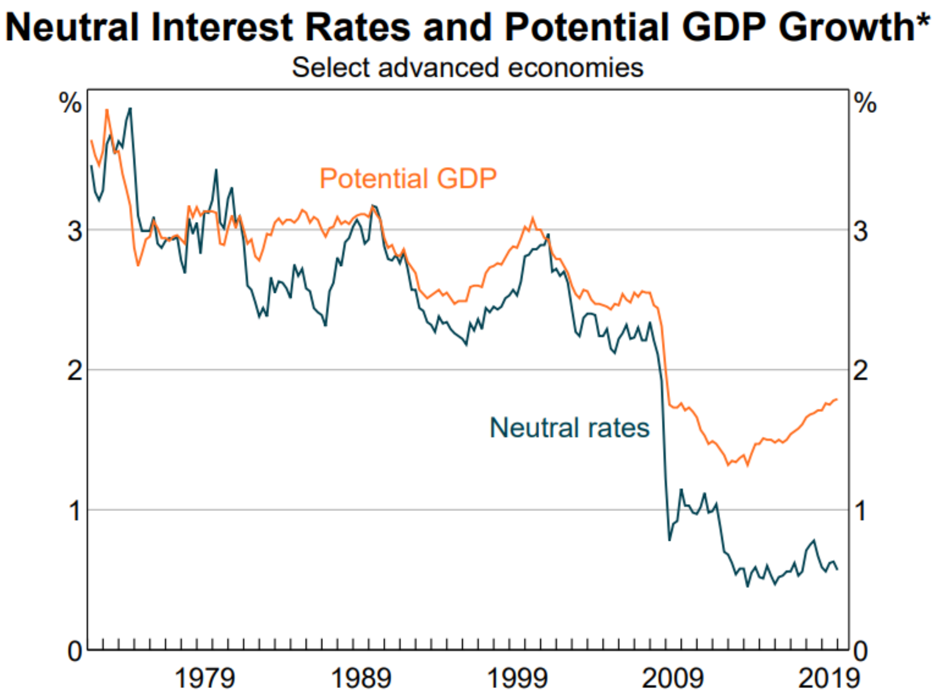
Essentially – QE forces down the risk-free rate significantly, even to negative territory.

Pushes up asset prices, squashes the ex-ante efficient frontier, this means future returns are expected to be smaller.

Affect the composition of portfolios by changing the risk-return set, see relancing of portfolios into potentially riskier assets to sustain required RoR.

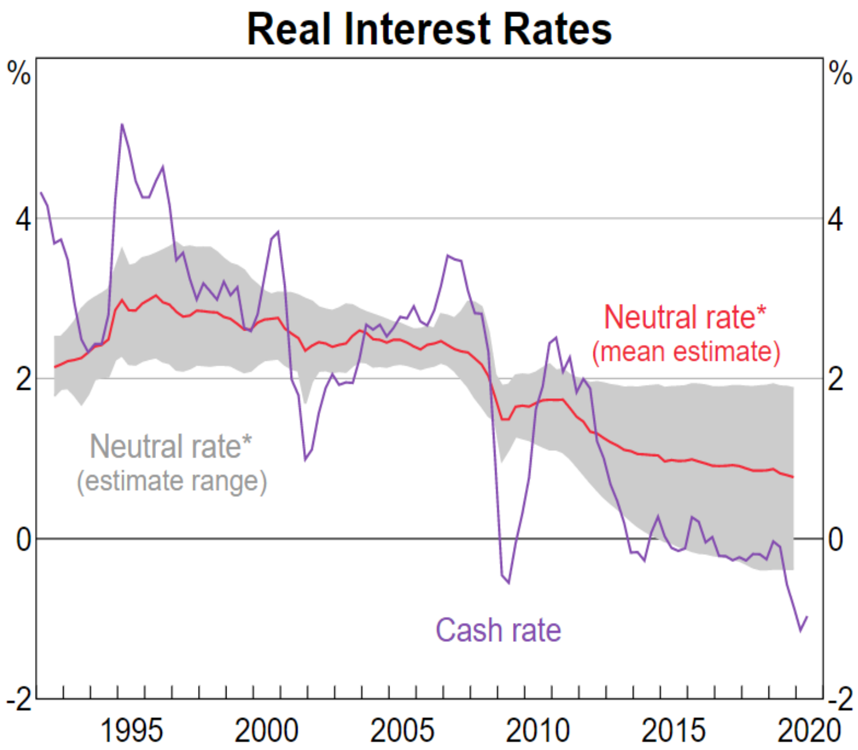
For the same risk, you're now getting a small return – this is **efficiency loss** in the context of a mean-variance efficient portfolio..

MISSING *FOREST* IN RBA THINKING



* United States, euro area, United Kingdom and Canada; PPP-weighted; last data point December 2019

Sources: Holston, Laubach and Williams (2017); RBA



* Estimated up to December 2019

Sources: ABS; RBA

MISSING *FOREST* IN RBA THINKING

- **Modern science** (liquidity free good, intertemporal optimisation, neutral rates, representative agent, singular price targets, stable credit provision, inherently procyclical via **collateralisation**).
- **Art of central banking** (Hawtrey 1923), core money system is dealer network supports liquidity of our security markets, unstable asset prices / credit flows.
- Market-based credit system relies on two-way dealer markets that link funding liquidity in the money market with market liquidity in capital markets
- Here central banks should only operate as a dealer of last resort; only in money markets ONLY at prices worse then lenders / borrowers directly get directly.
- **Ration 'instability' *kill growth* stifling new, coddle old Schumpeter**.
  - *Household hedge funds, tiny SME lending & first homeowners /affordable housing.*
  - *Rule of the rentiers '**unquestionably strong**' & no* productivity linked wages.

POLICY PRIORITIES

- **Governments must leave long term capital allocation to free markets.**
- Target robustness, reversibility and neutrality in macroeconomic policy settings. Need binding medium term targets – fiscal & mon. coordination.
- Eschew policies that fuel asset prices, high debt levels, degrade robust macroeconomic policy – **central banker is gamekeeper, not poacher.**
- Need a more ‘elastic’ monetary and banking system. Only allows the money to grow in automatic response to an increase in demand for credit sensitive to demand from business SMEs and/or first homebuyers.
- Monetary instruments cash rate – reserves growth **flexibility** with NGDP.
- Correct concentration of liquidity in key major financial market players.
- A bigger role for fiscal policy in macro stabilisation.

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THANK YOU & QUESTIONS

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