The Dangerous Channels of Unconventional Monetary Policy

Staff 3net3 Suites. October 2015

Note that non-conventional Monetary Policy involves zero interest rate policy, and qualitative and/or quantitative easing.

Given the non-conventional monetary policy of the United States, there are three possible economic scenarios: 1) the economy falls into a liquidity trap, 2) the economy expands leading to inflation, or 3) the money injection leads to a financial bubble characterized by over leveraged debtors. And for clarification, these three scenarios can all occur in the context of a Nash Equilibrium.

The money flow channel default theories discussed are Fisher's Debt-Deflation Theory and Keynes' Liquidity Trap. Though these two theories are similar, they are (in fact) distinctly different.

The 2007 recession was essentially a credit crunch precipitated by mortgage defaults and universal pessimism in the financial stability of the United States.

While investigating the Great Depression, Fisher hypothesized that recessions were caused by financial instability. To wit, he advocated his Debt-Deflation Theory, where he argued that over-indebtedness can precipitate deflation in later periods and liquidation of collateralized debt (the value of which is determined by the market).

It is known that monetary policy can drive economic conditions to where defaults occur. And the default channel can and does affect the real economy. Inside money that is pumped into the economy by the central bank influences trade and production. If the CB injects an unbounded amount of money, the price level must increase as trade is bounded. Offsetting this is the realization that this condition can lead to lower costs of trading, which can be expansionary. But if there is a perception that there will not be enough money in future periods, the economy may enter the liquidity trap – pushing the short-term interest rates to zero. And, if it is believed that the CB cannot provide enough money in future periods, consumers will expect deflation and hold on to more of their money.

Also, if the Central Bank does not sufficiently increase the future stock of money, and if the leverage ratio in the market for financial assets is high enough, most of the inside money injected will

encourage indebtedness and fuel inflation in assets and collaterals. The financial bubble can lead to debt-deflation over-indebted agents are forced to liquidate physical assets. The selling leads to debt-deflation downward spiral which results in economic collapse (debt defaults). This downward spiral can result from monetary policy itself or a black swan event. Recent empirical evident suggests that Fisher was correct in that high debt levels are potentially dangerous in that there is a high probability of an economic crises. *Ref: Schularick and Taylor (2012), Kumhof and Ranciere (2010) are supportive of Fisher's arguments. Further Reinhart and Rogoff (2009) show that the resulting boom and bust cycles come at a high cost.*

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Gerald and Pottier concluded: "In terms of policy, the consequence of our main result is that, if a central bank wants to facilitate trades by injecting more money and to avoid both a liquidity trap and a financial crash, it needs to take the risk of inflation."

In the absence of a liquidity trap, what enables inflation in commodities to remain bounded despite the increase of liquidity, is the fact that most of the injected liquidity migrates towards financial markets, thus fuelling financial inflation. And the greater financial inflation is, the more attractive collaterals become.

However, by injecting more and more liquidity, the CB runs a greater risk of entering into the dilemma outlined herein. The crash occurs when after pumping in much liquidity to sustain an expansionary path, the CB slows up money injections.

In light of the three aforementioned scenarios, by entering a liquidity trap (money piles up and doesn't flow through normal channels), thereby inflation is avoided. Expansionary injections of money by CBs lead to rising asset prices (over-indebtedness). To wit, the over accumulation of debt eventually leads to an economic crash.

To avoid the big crash, the CB must engage in a program of de-leveraging and accepting inflation. The CB can also pursue a contractionary monetary policy while running the risk of a liquidity trap..

The CBs Dilemma

Clearly, monetary policy and financial markets are strongly linked. In order to avoid a liquidity trap (scenario #1), and after engaging in nonconventional monetary policy designed to expand the monetary base, the CB must convince agents that it is intends to keep interest rates at zero and commitment to more quantitative easy in following periods, or else agents will not be convinced that

they will guarantee future inflation. Consequently, the CB must purse nonconventional approaches or risk entering a liquidity trap or financial instability. Thus, the CB is confronted with a big dilemma. It must pursue ever expansionary policy holding out the promise of future inflation or risk triggering a big crash. Of course, pursuing this irresponsible approach eventually causes the big crash they are attempting to avoid. Unfortunately, given that has the CB made this “irresponsible commitment,” it now has to play it out.