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Monetary Policy Note N°1

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The Times They Are A-Changin' [1]

The most important macroeconomics subject of the last 10 years is without doubt the dramatic expansion of central banks' balance sheets, also known as *quantitative easing* (QE). Prior to the crisis, no-one would have imagined that central banks could ever consider engaging in such a massive creation of money, neither would anyone have imagined how little impact it would have on inflation (see for example Fig. 1 and 2).

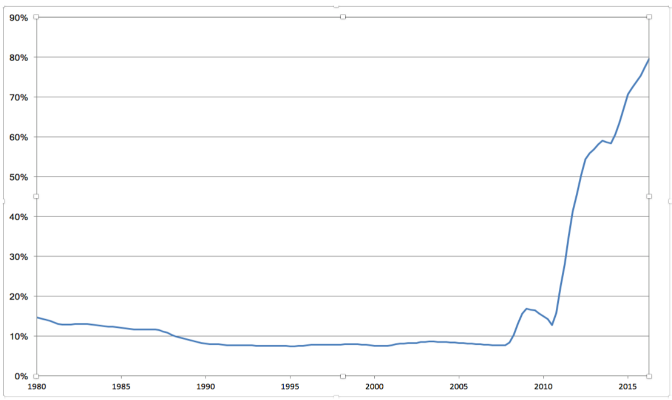

Figure 1 : Swiss monetary base as a percentage of GDP, the largest ratio in the world today (Source: Swiss National Bank).

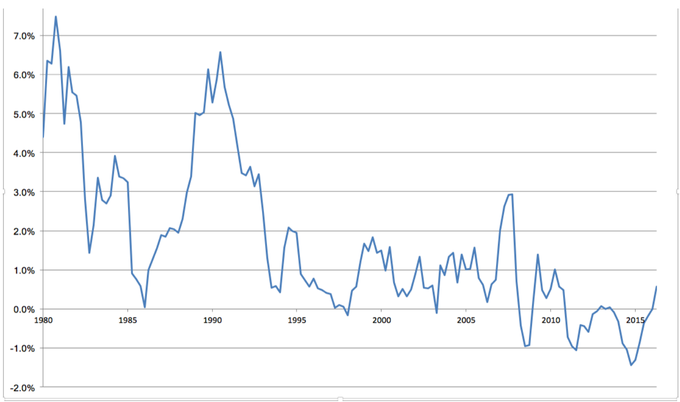

Figure 2 : Swiss inflation rate (Source: Swiss National Bank).

Nearly a decade after these policies were initiated, most economists acknowledge that we still don't really know how QE works. This is not necessarily problematic; thanks to a trial-and-error approach, humans were able to sail around the world thousands of years before the development of fluid mechanics theory. Similarly, in recent years, central bankers have acted on a step-by-step basis, adapting their policies to economic conditions, and have so far succeeded in avoiding what could have been a much deeper and destructive crisis.

Yet, these policies are generating many collateral issues, the growing impact of technocratic decisions on market dynamics or the risks stemming from potentially large imbalances to name only two. Central bankers are feeling more and more uncomfortable with their ever-growing role, all the more so as the economic benefits of their policies seem to reach the few rather than the many, which is unlikely to appease the high level of discontent amongst voters.

The recent signs of a sustainable global recovery are therefore welcomed with great relief. They are providing support for engaging reverse gear and fuelling hope that we will eventually return to a normal monetary environment. The American Federal Reserve (the Fed) is expected to lead the way and to announce the beginning of its *quantitative tightening* at the end of this year. Here again, we can expect a careful, step-by-step implementation, with central banks constantly scrutinizing their instruments, ready to stop or even reverse their actions at any sign of economic weakness. So what are we heading for?

The interactions between central banks' actions, inflation, growth and financial stability are extremely complex and it is well beyond the scope of this note, not to say beyond anyone's abilities, to precisely forecast what will happen; we are truly in uncharted territory. Yet, by looking at the balance sheet of the banking system, it is possible to identify some of the challenges posed by *quantitative tightening*.

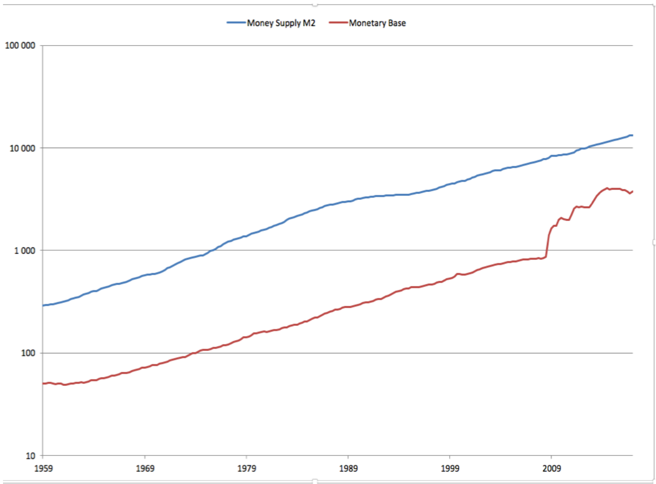

Figure 3 : US monetary base and money supply M2 (Source: Federal Reserve Bank of St. Louis).

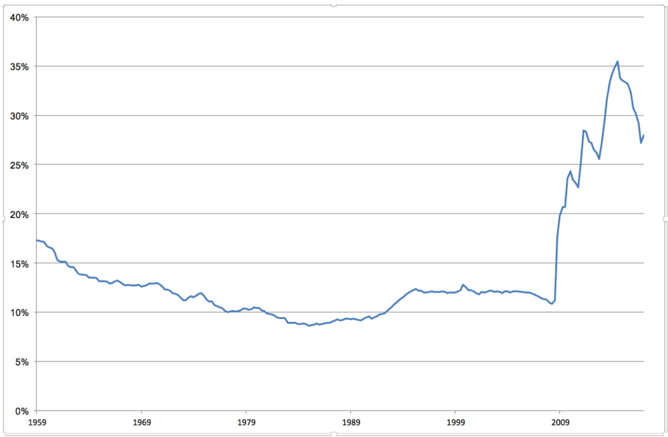

Figure 4 : Ratio between the US monetary base and money supply M2 (Source: Federal Reserve Bank of St. Louis).

Central money, the money created by central banks, mainly sits in the shape of reserves on the asset side of commercial banks' balance sheets. Only a fraction of it is circulating in the economy in the shape of banknotes. Conversely, the vast majority of the money supply at the disposal of economic agents is made of commercial banks' liabilities, the electronic money we have on our bank accounts. These are confusingly called deposits, but are actually promises by the banks to deliver coins and banknotes on demand. The gap between the two is essentially filled on the asset side with loans and other assets held by banks. In other words, the money supply that banks create needs to be matched on their balanced sheet by either central money or risk-bearing assets. Hence, to support growth and positive inflation, any decrease in one has to be more than compensated by an increase in the other. This means that, as can be seen in Fig. 3 and 4, the end of QE in the US has already led to a tightening of monetary conditions, as banks had to keep on growing the money supply without further Fed support.

So, how will the banking system cope with the expected depletion of central bank reserves and its accelerating tightening effect? Will banks be willing, or allowed, to substitute risk-free reserves for risky assets as they keep on growing their balance sheet? What will be the impact on the economy and on the price of financial assets? Are there alternatives to the current policies? These are some of the issues we will address in forthcoming notes on a subject that will keep on dominating macroeconomic discussions for the years to come.

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[1] *Title of a song by Bob Dylan.*

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