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Uncertain Accommodative Policies as Tools for Financial Stability: Recent Developments

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Abstract

The need to address issues pertaining to legal uncertainty, sound governance, public policy considerations – as well as forecasting techniques as a means of mitigating uncertainties in an environment where confidence the inflation target is low, are amongst some of the objectives which this paper aims to address.

Innovative possibilities and opportunities of e digital currencies are then considered – particularly growing considerations of certain central banks to issue their own central bank digital currencies. Questions which still need to be addressed relating to the interest rates to be attached to such currencies and whether or not such interest rates should apply. Further considerations relate to whether the inflation targets should be raised.

These innovative possibilities are considered – with further recommendations for research – before a conclusion is drawn. This paper constitutes a chapter to the volume "Rethinking Regulation and Monetary Policies".

Key words: Leaning Against the Wind Policy; financial stability, monetary policies, interest rates, inflation targeting, stable coins, central banks, regulation, crypto assets

Introduction

In its October 2019 publication, "FSB sets out work to consider Regulatory Issues of Stable Coins", the FSB publication note highlighted that whilst it was important to monitor developments in crypto assets – as well as its existing and emerging risks, it was also realized that introducing on a potentially global scale, "stable coin type arrangements" for domestic and cross border retail payments, could impact recent assessments of the notion that crypto assets do not pose a material risk to financial stability.

The importance of harnessing potential benefits of stable coins whilst being well informed of associated risks, was also linked to the ability to adequately assess and ensure that potential risks to financial stability and market functioning, could be identified and addressed – through comprehensive and adequate regulatory and oversight arrangements.

A consultative report is to be submitted by the Financial Stability Board to G20 Finance Ministers and central bank governors in April 2020 – with a final report due in July 2020.

"Inverted yield curves are the hot topic of the summer, especially as U.K. gilts have followed U.S. treasuries by offering more interest on two-year maturities than you'll get on 10-year notes……… When the sovereign bond world is flipped on its head like this it's often seen as an indicator of looming recession as investors scramble for the relative safety of longer-term debt, which in turn pushes down its yields.

The phenomenon has been seen before the last seven recessions in the U.S.
But what happens in America doesn't necessarily always apply in Britain. As written before on yield curve inversions, they tend to be more of a harbinger of doom the longer they hang around. Briefer periods of things going topsy-turvy aren't as troubling, and we haven't moved beyond that stage yet……."[1]

The aforementioned observations and the phenomenon of the inverted yield curve followed a period of heightened uncertainty whereby the Federal Reserve, around the same time in August 2019, made the unprecedented move of lowering interest rates – much to the concern of investors.

Further corroborating the prevailing environment which was enshrouded in uncertainty, the impact of quantitative easing measures is reflected thus: " The phenomenon may have heralded the last

[1] See Bloomberg (2019). "Britain's Inverted Yield Curve Is Nothing Like America's" 15 August 2019

https://www.bloomberg.com/opinion/articles/2019-08-16/britain-s-yield-curve-is-nothing-like-america-s?srnd=premium-europe

seven U.S. recessions but in Britain it's a different story. Plus QE makes it hard to read the bond market."[2]

This paper is structured as follows:

The next section of this chapter considers the literature review and background to the topic – with a focus on the conceptual framework of global stable coins, distinguishing characteristics which delineate them from other more volatile virtual currencies such as bitcoins, as well as the implications of their growth and popularity for monetary policy. In jurisdictions such as Sweden, their has been a constant declining use of cash over the years – with growing fears that digital currencies may be dominated by private actors – and even more of a concerns, the current framework which is lacking of an acceptable and agreed upon framework for the definition to be attributed to crypto assets. Such definitional and legal uncertainties, further compounded by a lack of central regulatory authority.

The next section then considers those issues to be addressed – as pertains to global stable coins whilst also highlighting their potential benefits and the need to enhance their value . Monetary policy implications of stable coins – particularly for open economies and the susceptibility of such open economies to a payments system impacted by digital currencies that are controlled by private actors - in which case countries such as Sweden, along with countries like Australia, New Zealand, Canada and Norway, are categorized, is furthermore illustrated.

Literature Review and Background to the Topic

Against the backdrop of the vulnerabilities faced by the above-mentioned "open economies", the rationale behind a "temporary" discontinuation of the "Lean Against the Wind" (LAW) policy adopted in Sweden, following the aftermath of the most recent Global Financial Crisis (GFC) – largely attributed to lower than expected levels of inflation – as well as low levels of confidence and expectations is further accentuated by the notion that "The Lean Against the Wind Policy is difficult to apply in an economic environment in which confidence in the inflation target is threatened" .

Are decentralized markets better at judging climate risks than central banks? Given the difficulties of incorporating climate risks in current predictive financial tools, it would appear to be the case. However there are also advocates of the argument that climate risks and regulation should fall within the ambit of governments – rather than central banks. Whilst central banks should undertake some initiatives in ensuring that forecasting tools and instruments of monetary policy incorporate and provide for climate risks, it is also evident that the nature and difficulties associated with

[2] See ibid

quantifying such risks may necessitate the engagement of governmental and also non governmental actors.

The problems associated with central banks – as government delegates and agencies – along with central bank independence is well documented in the literature.

It is further argued, that there are two schools of thought on the approaches that central banks should adopt in "going green".[3] The first it is argued, "encourages policymakers to consider the financial risks thrown up by a warming planet" – with reference to recent stance adopted by the former governor of the Irish central bank who called for central banks to apply the same standards being advocated for private banks, to their own bond purchases.

In this sense, it is further added that:

- "The ECB's corporate bond purchase program would then avoid environmentally unfriendly assets.[4]

The second option put forward, considered more radical, holds that " central banks should finance, directly, the transition to a low carbon economy."[5]

In the light of the above mentioned observations, caution is also given to central banks with the remarks that " preventing financial crises is its job – however re shaping the economy is not – and that further, acting without the support of the Government and the ECB's largest stakeholder (– this case, Germany, being referred to), would be a mistake.

Hence the role and importance of stakeholders – as well as independence of central banks from funding and political influences is also highlighted. Many other jurisdictions are increasingly " Going Green" and engaging in environmentally friendly initiatives – however, the quantification if financial risks, ultimately is one that should be accounted for even where it appears that the costs may appear to be significant in relation to attributed benefits.

Whilst cost benefit considerations ultimately determine and may determine governmental policies, certain environmental costs have greater monetary and non monetary repercussions in terms of delayed failure to act – as well as irreversible repercussions. The question then relates to timing – and how much damage can be mitigated or addressed.

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[3] Financial Times , Financial Times (2019). " How Central Banks Can Tackle Climate Change" November 2019

[4] The dangers of market panics whereby investors could suddenly abandon fossil fuel assets as governments "belatedly act to prevent global warming and meet demands of the Paris Agreement -the volume of oil and gas linked assets outstanding – implying that such a shift could de stabilize the entire financial system," is also highlighted. As a result, gradual shifts from fossil fuels are advocated. See ibid

[5] Reference is then made that the head of the German central bank, Jens Weidmann's rejection of a "green quantitative easing" program and support of " market neutrality", also implied that the sort of "green QE" meant buying corporate bonds directly from renewable energy companies – and extending beyond penalizing brown assets for their climate associated risks – further implying a subsidization of green assets.

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