

# Lecture 1

# Interest and Financial Policy

Lectures in the Theory of Interest and Monetary Policy

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# Summary

1. Introduction: The conduct of monetary policy
2. Financial complexity and the rate of interest
3. Endogeneity of monetary policy
4. Course conclusion

# 1. Introduction: The conduct of monetary policy

- Monetary policy is *pragmatic* (based on latest available economic data).
- Monetary transmission mechanism is measured by lag between monetary policy change and desired (GDP) statistical outcome.
- ‘Situational logic’: central bank will justify monetary policy by reference to government targets.

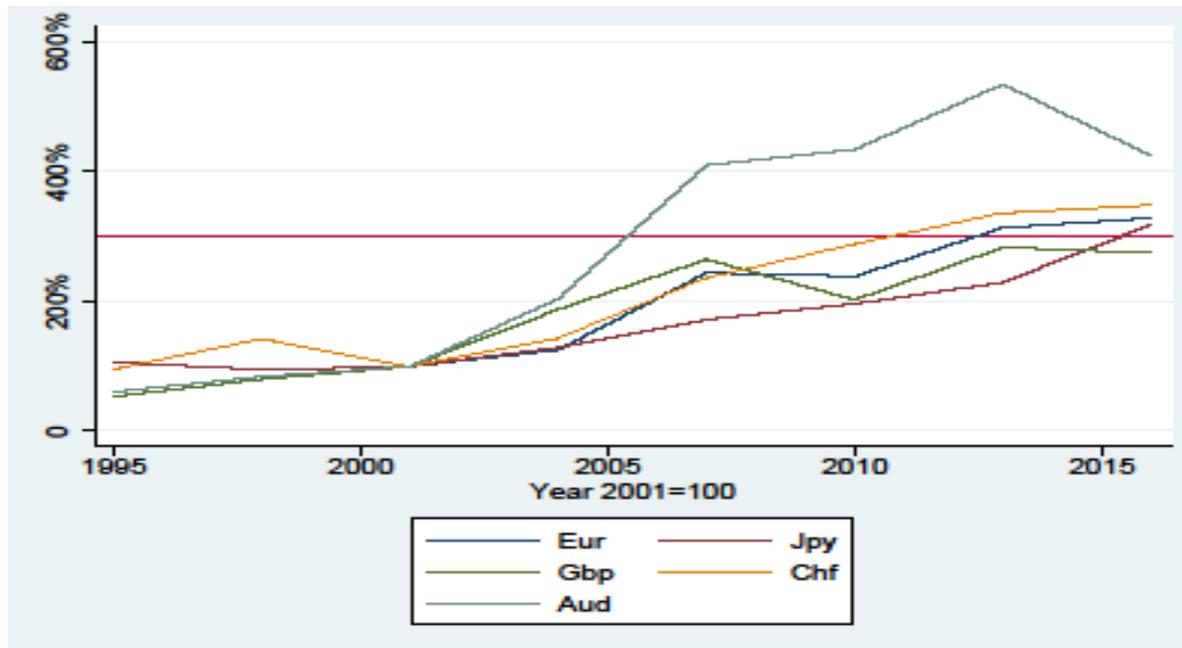
## 2. Financial complexity and the rate of interest

Financial complexity arises because:

- There is more than one way of financing a given economic activity (e.g., short, vs. long-term) → yield curve;
- Rate of interest becomes 'rate of exchange' or 'rate of substitution' of one class of financing for another;
- Monetary policy activism (frequent changes of interest) → interest and exchange rate futures to 'hedge' changes in value of assets and liabilities

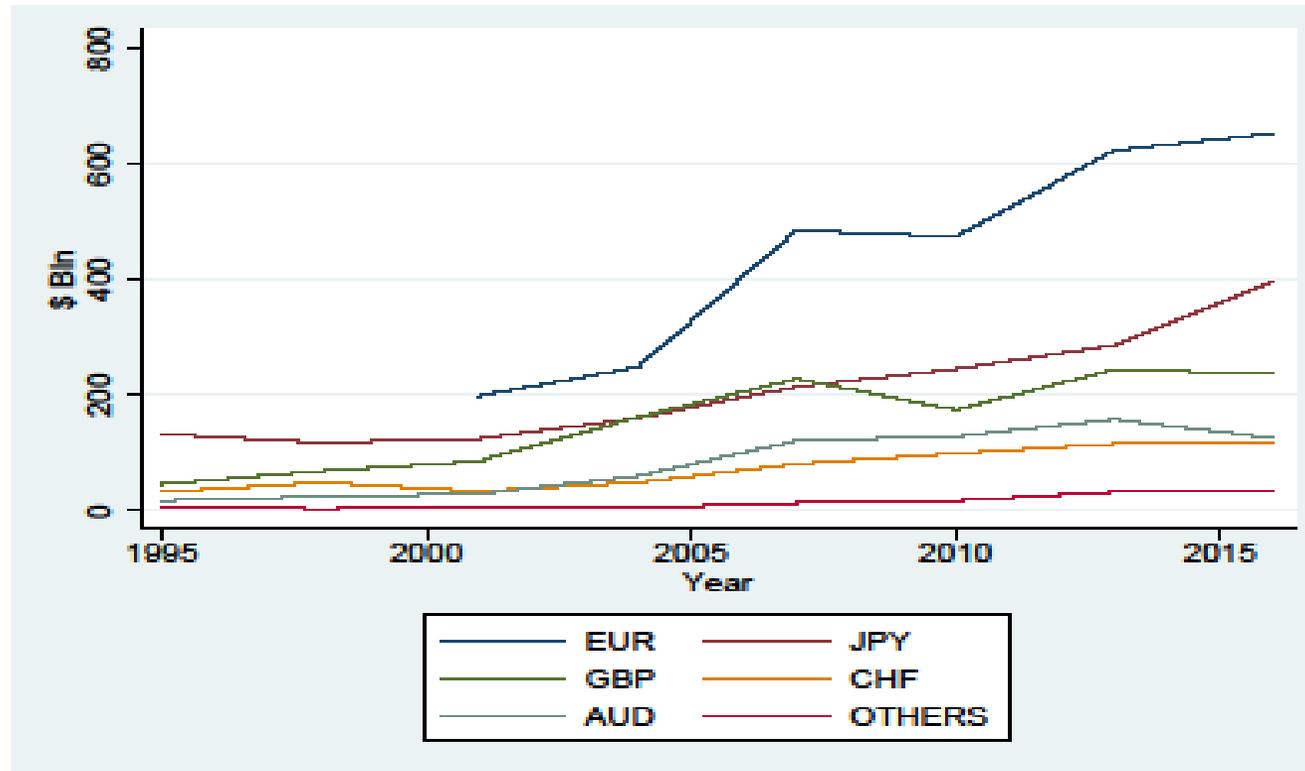
### 3. The role of foreign exchange swaps

The growth of foreign exchange swaps:



Source: Bank for International Settlements

# Foreign exchange swaps by value



Source: Bank for International Settlements

# What is a Foreign Exchange Swap?

- US Bank (Citibank) borrows in US\$ against security of investment grade (AAA – rated) securities (US government bond, corporate bonds).
- US Bank swaps US\$ with Japanese bank (Nomura) for equivalent in ¥ ‘hedged’ by repurchase agreement to sell back ¥ for US\$ in 3 months’ time at the same exchange rate.

# Is this a derivative (shadow banking)?

Official view from the Bank of England:

‘Derivatives are useful for risk management: they can reduce costs, enhance returns and allow investors to manage risks with greater certainty and precision...’

‘... An issuer may find it difficult (or even impossible on account of legal or other restrictions) to issue in a particular currency. However, it may be important – e.g., for hedging purposes or for asset/liability management of the company – to have its liability in that currency. It therefore may choose to borrow in another currency ... and swap the proceeds; this allows the borrower to raise the necessary funds and have the net liability in the chosen currency.’ S. Gray & J. Place *Financial Derivatives* CCBS Handbook, No. 17.

# Swaps for profit?

- Investors use swaps to obtain arbitrage returns:
- Even central banks use swaps for arbitrage returns: Reserve Bank of Australia is engaging in carry trade, building reserves in Yen and swapping into US dollars. (Matthew Klein in Financial Times Alphaville 23 January 2017). BIS engages in swaps.

# Or a Money Market substitute?

- Money markets: the markets for *unhedged* borrowing between banks to regulate liquidity of banks.
- Vs. foreign exchange swaps *hedged* on another currency, swapping a bank deposit in currency  $X$  for a bank deposit in currency  $Y$ , with a commitment to reverse at some future date.
- Currency swap traders sit on money market desk (Lysandrou);

# Basle agreement

## Currency swaps offer

- Cheaper borrowing than the inter-bank market: fee is *margin* between \$ and ¥ interest rates;
- Risk free borrowing (hedged with good security and repurchase agreement) does not require capital backing.

# Decline of inter-bank market

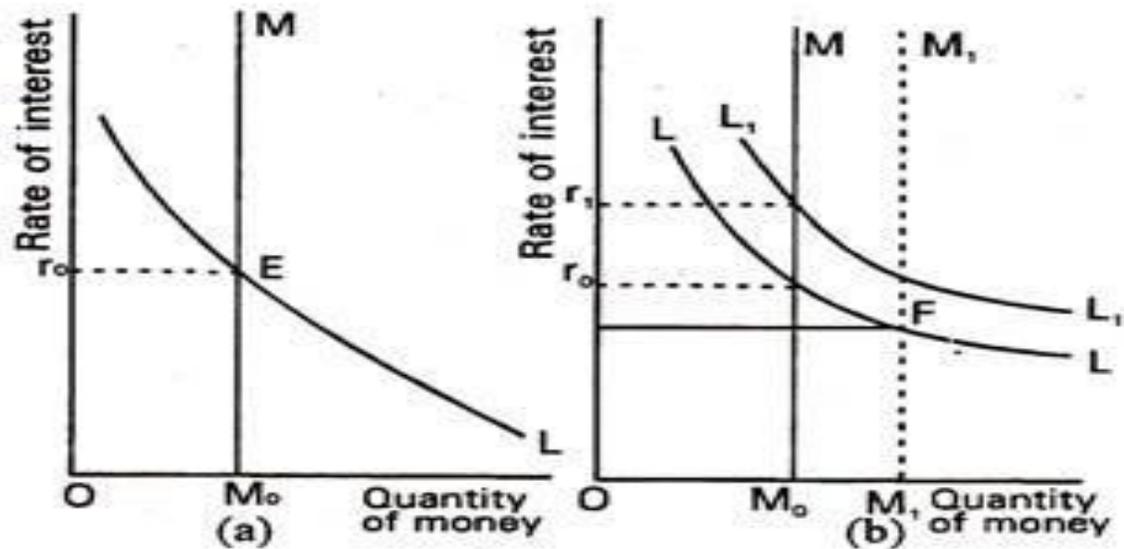
Not declined but migrated (even before 2008) to currency swaps due to:

- Regulation of unhedged borrowing;
- Financial instability;
- Cheaper swaps.

# Since 2008

- Money market is 'absorbed' onto balance sheet of central bank;
- Central bank currency 'swaps' arranged by Fed to assure \$ supplies through European Central Bank, Bank of England, Bank of Japan, Banco de Mexico, Bank of Korea;
- Central Bank swaps resumed in Covid crisis: From March to first week in June, a total of \$447 bn had been swapped (compared to \$583 bn at the height of the American financial crisis in December 2008).

So commercial bank borrowing from central bank:



**Fig. 15.3.** The Determination of the Rate of Interest

# Replaced by foreign exchange swaps;

- And short-term rate of interest as price of liquidity replaced by *margin* over \$ interest rates;
- Initial stage of 'monetary transmission mechanism' not broken, but removed by institutional innovation.

# 4. Endogeneity of monetary policy

- Pragmatic monetary policy ties interest rates to current economic conjuncture;
- Monetary policy activism (hedged or unhedged) causes discounting of interest rate changes in long-term contracts;
- Interest rate changes alter rate of exchange between different types of financing.

# When monetary policy is determined by current

- Or predicted from current data, real economy;
- And affects only composition of the financial system, but not the real economy;
- Monetary policy has become endogenous.

# Meaning that

'The events which I thought I was controlling were in fact controlling me.'

Kyril Bonfiglioli *Don't Point That Thing At Me* (1972).

# Course conclusion

From Classical theory of interest:

‘the rate of interest is not regulated by the abundance or scarcity of money, but by the abundance or scarcity of that part of capital, not consisting of money.’ (David Ricardo)

Through Wicksell, early Keynes, Fisher, Monetary Business Cycle, New Neo-Classical Synthesis, where economic activity is arbitrage between rate of profit (*Real/Natural* rate of interest) and money rate of interest

# Through Keynes and Kalecki

'Purely monetary theory of interest' (unrelated to rate of profit) 'the rate of interest is regulated by the abundance or scarcity of money';

To

'Purely financial theory of interest' – rate of interest reflects liquidity and rate of exchange between different types of financing:

Financial effects of interest are everything; monetary effects are insignificant.

But even if monetary policy is endogenous

And has no effects on the real economy,

Monetary policy can still affect financial stability and asset prices:

(through Quantitative Easing and Open Market Operations; currency swaps).