"The implications of non-bank activities on the transmission of monetary policy"

MONETARY, FINANCIAL AND PRUDENTIAL POLICY INTERACTIONS IN THE POST-CRISIS WORLD

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1) Why does activity happen outside the banking system?

2) How does the presence of this activity generally interact with monetary policy?

3) Are there any special interactions when interest are very low and expected to remain low for some time?

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Why does activity happen outside the banking system?

- Sometimes for very good, benign efficient reasons
  - E.g. unsecured bond market or commercial paper funding

- More worrisome if reasons is to avoid regulation that would apply if an activity occurred inside the banking system

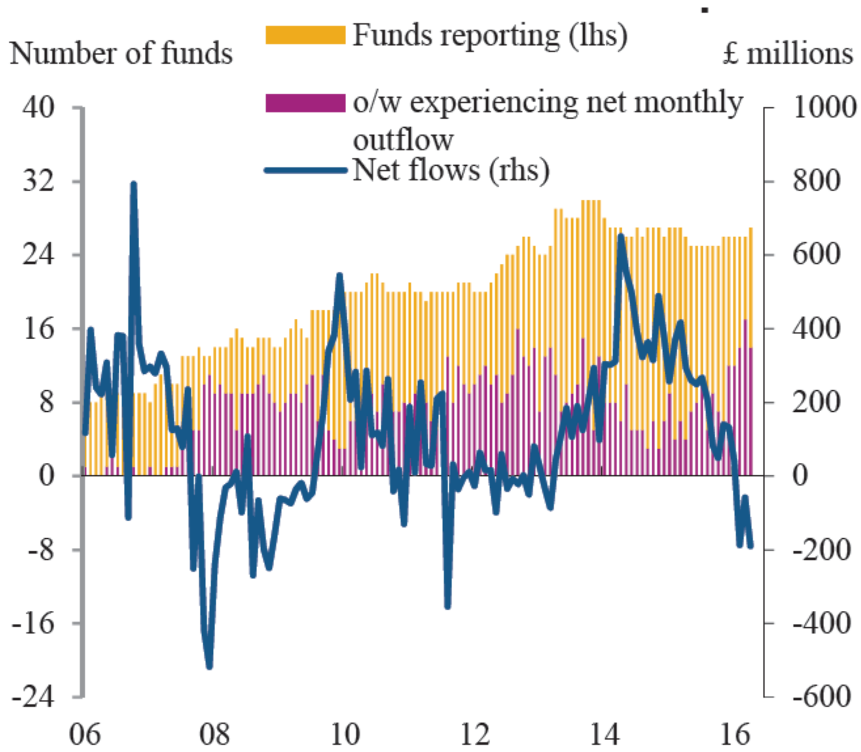
- I will argue that thinking separately about asset and liability side regulatory arbitrage may be helpful

US Style Money Market Mutual Funds

Liability-Side Arbitrage

- Set up to avoid interest rate restrictions on bank deposits
- Nearly economically redundant once rate ceilings vanish, except they remain exempt from some bank restrictions
  - Essentially bank deposits with no capital requirements
- Problem is that they are runnable because assets are not perfectly liquid and owners are paid first come first serve
  - Creates an incentive for me to run if I think you might
- Blew up during the crisis, required guarantees and created follow problems for some European banks

Net flows into UK-domiciled open-ended property funds since 2015



Source: Morningstar

Structured Investment Vehicles

Asset-Side Arbitrage

- Set up to avoid capital requirements
  - Securitization with partial recourse identified in BCBS WP #1!

- Again will be runnable, and if the assets migrate back on the balance sheet as in the crisis, you get a capital crunch

- Estimated $350 billion dollar credit contraction that the banks had to pick up.

Regulatory Arbitrage and Monetary Policy Transmission

- Need to begin with a theory of transmission and decide which financial channels matter

- Liability-side arbitrage will alter funding flows and perhaps interest rate pass through

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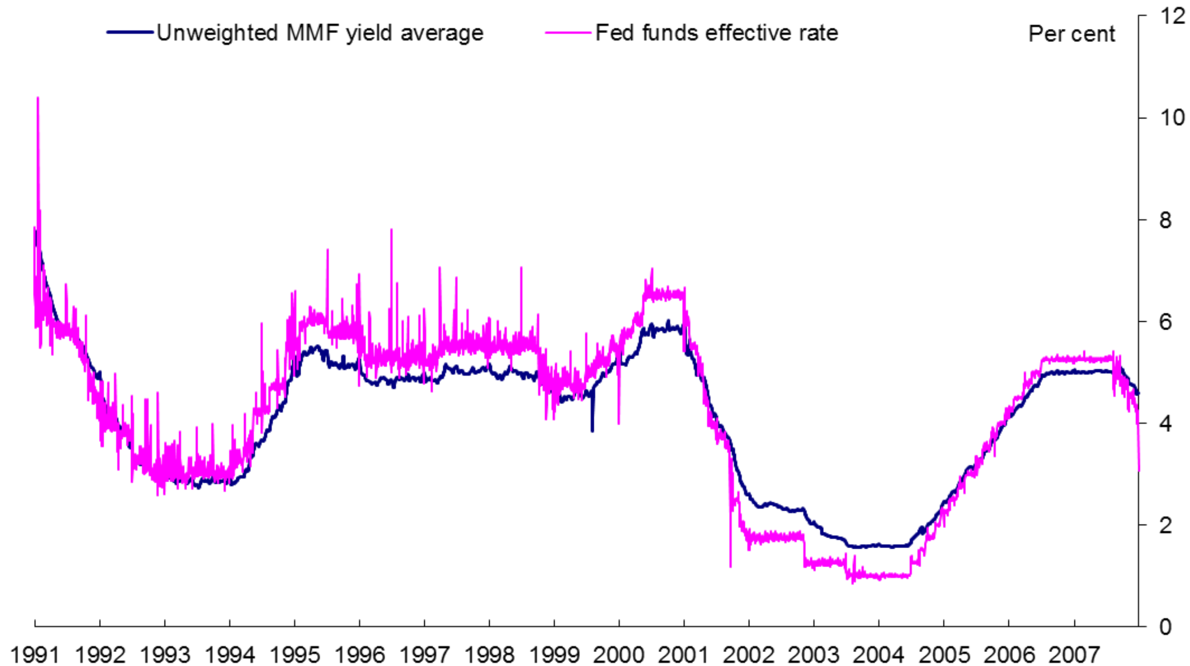
Pass through from Fed Funds Rate to MMMF rates



Sources: Bloomberg, and Bank calculations.
(a) MMF yields are the unweighted average for 10 large prime MMMFs. Data prior to 2005 based on a smaller sample.

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Regulatory Arbitrage and Monetary Policy Transmission

- Asset side arbitrage is perhaps more directly linked to credit supply effects

- In principle shadow banking could amplify or dampen policy effects
  - Undercapitalized banks with debt overhang might not pass through a cut in rates. Shadow banking might help.

  - Suppose MP influences term premia but not the expected path of rates. Now easing may encourage capital structure arbitrage and SIVs <u>may</u> exacerbate this.

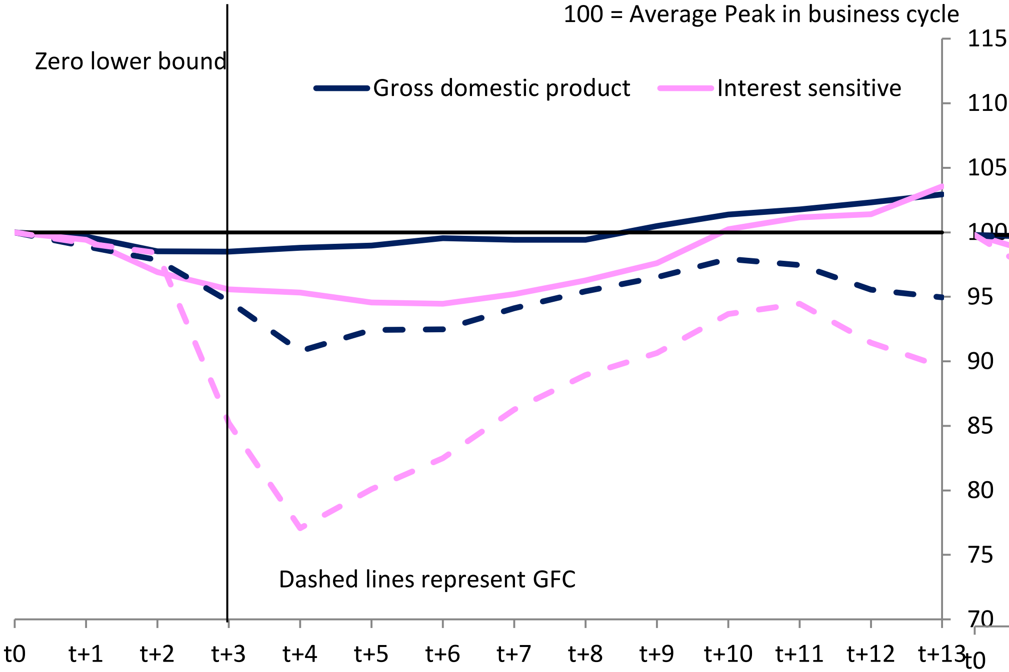
Interactions with low rates

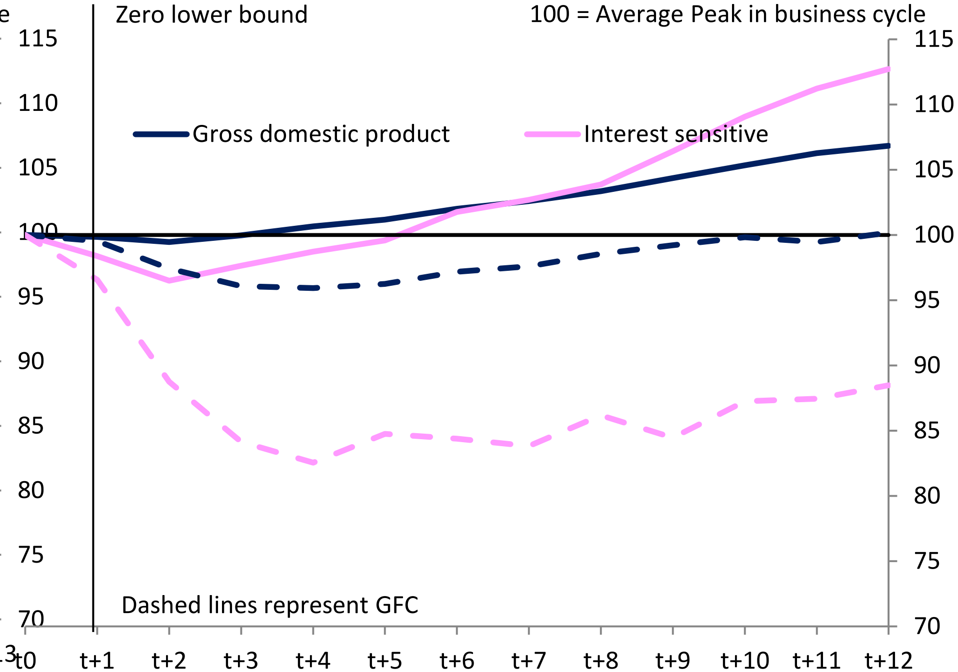
- Is it the duration of low rates or the level and is there anything special about zero?
  - Most theories say going from 25 bp to 15 is the same as going from 10 to 0.
  - How much demand can you pull forward?

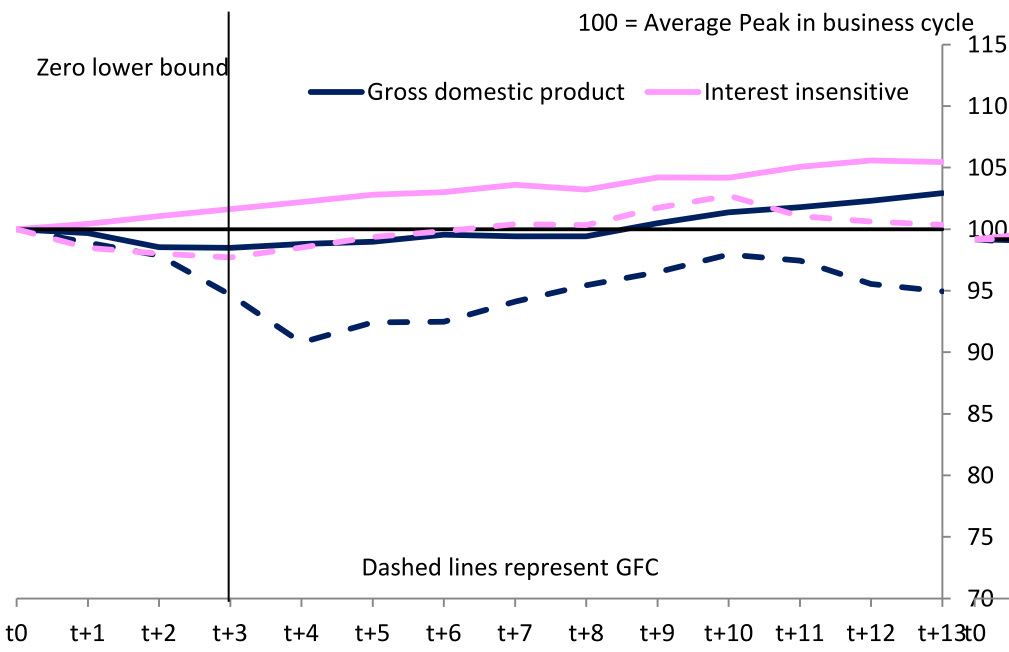
- Do shadow banks reach for yield in special ways?
  - Greenwood, Hanson, Stein asymmetry between falling and rising rates

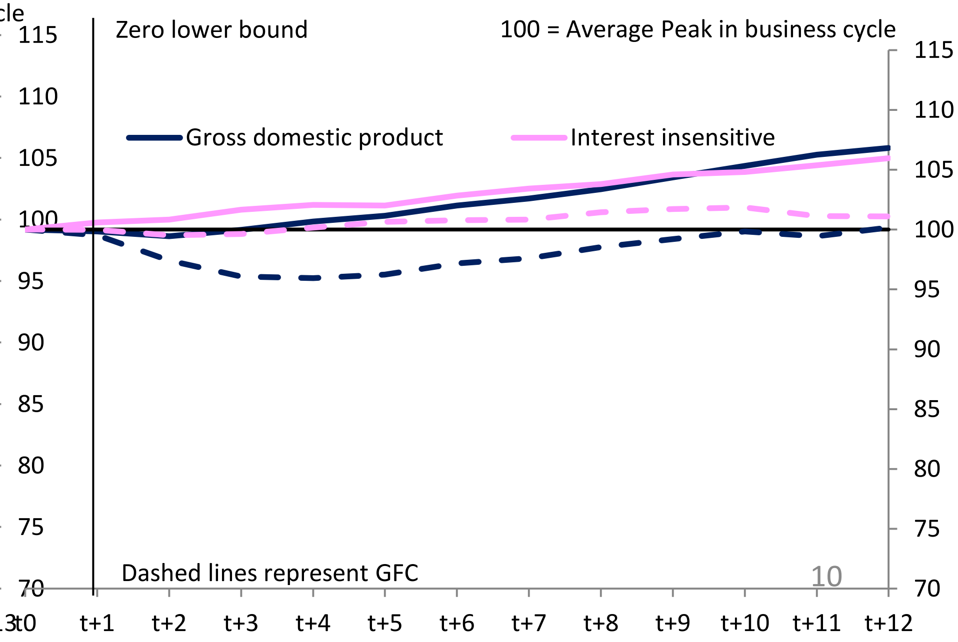
- Does QE interact with presence of shadow banks?
  - Maybe it works more on term premia and promotes more capital structure arbitrage?

Japan Pushing on a String? US

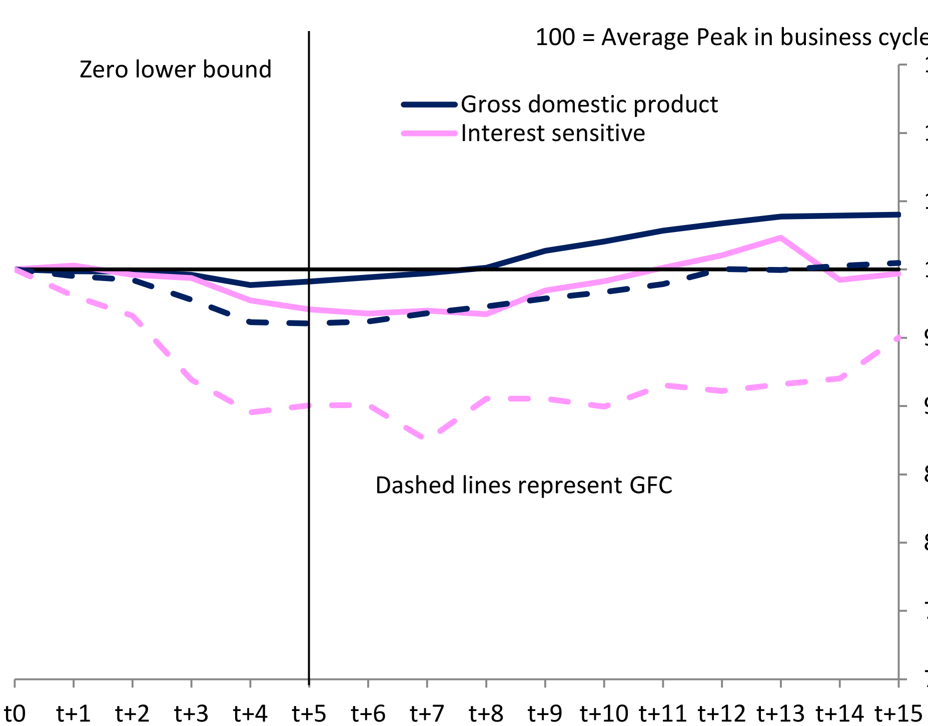


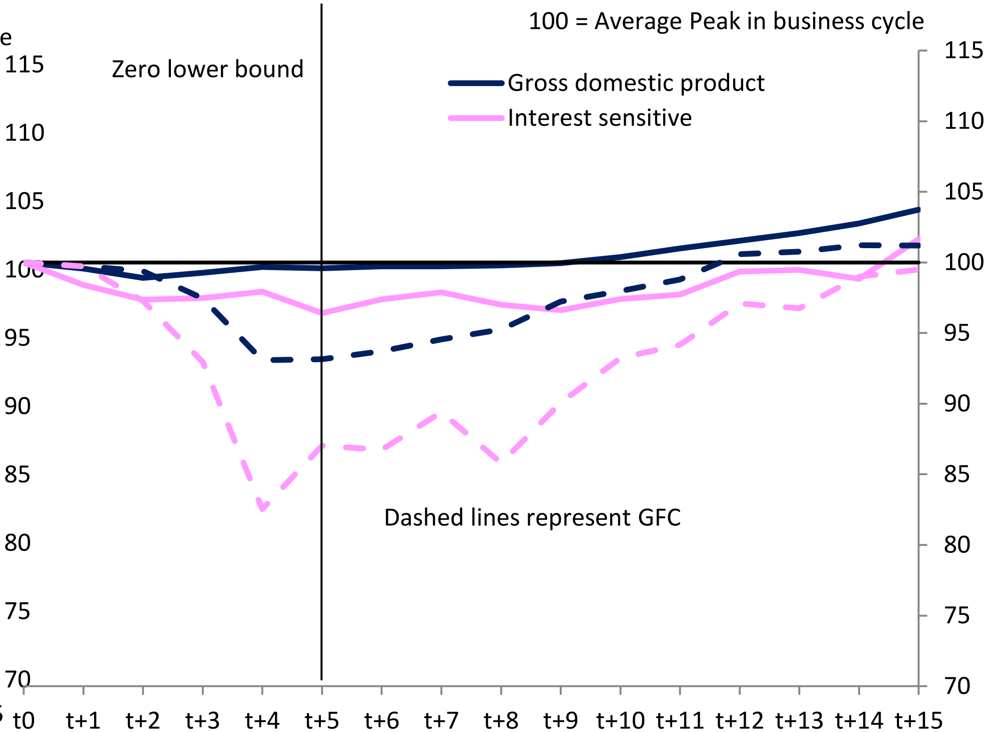


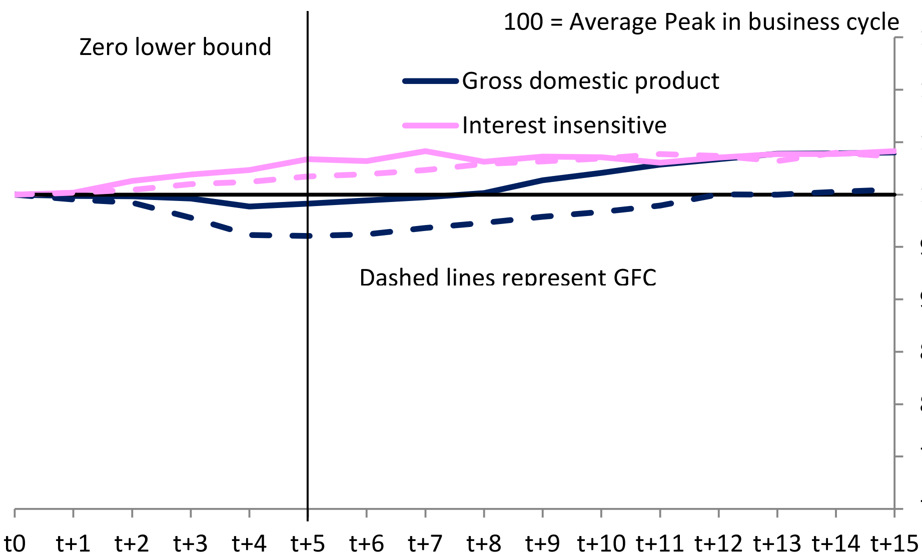


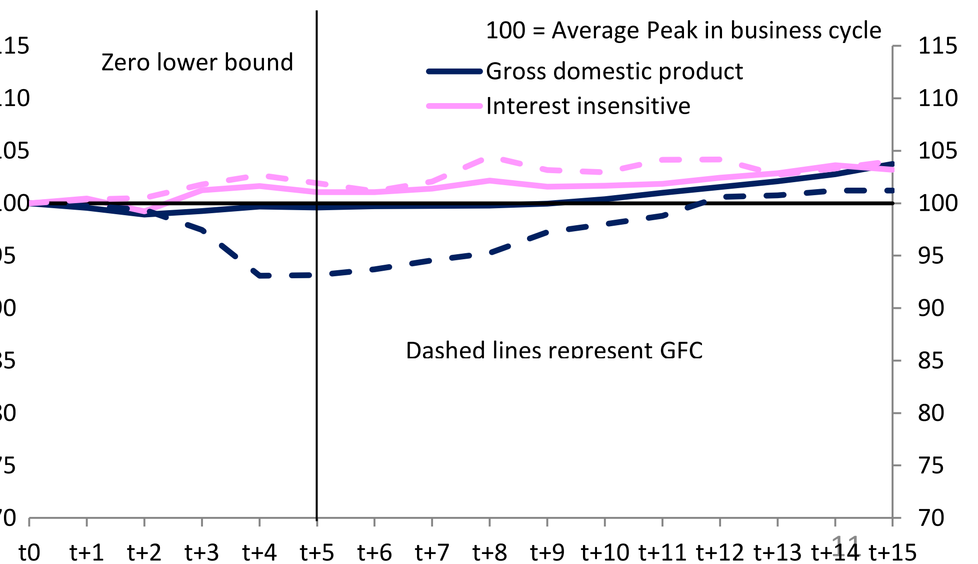


France Pushing on a String? Germany

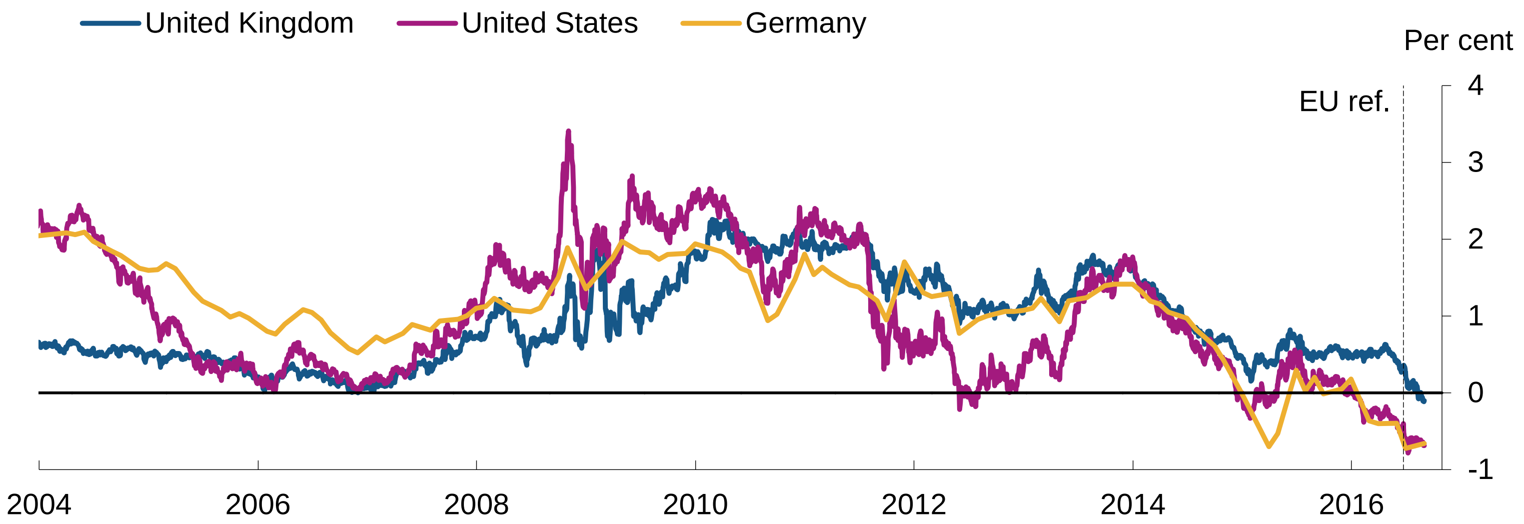








Estimates of term premia for government bonds



Sources: Bloomberg, Federal Reserve Bank of New York and Bank calculations.
(a) UK estimate is derived using the model described in Malik, S., & Meldrum, A. (2016). Evaluating the robustness of UK term structure decompositions using linear regression methods. Journal of Banking & Finance, 67, 85-102. The German series is a preliminary estimate based on the same methodology as the UK estimate.
US estimates are available from www.newyorkfed.org/research/data_indicators/term_premia.html.

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Conclusions

- How about forming a Basel Committee on Shadow Banking?
  - Asset and liability side arbitrage subcommittees should exist too.

- Maybe rising and falling rates play out differently?

- More measurement of some of the non-standard possible channels would be very helpful.

- If we are worried about low rates and transmission channels, then probably we should pay more attention to separating movements in risk premia from other movements.