

Monetary policy, financial stability and capital market resilience



by **Paul Richards**

Summary

Inflation rates in the US, EU and UK rose in 2022 to the highest levels for around 40 years. In the attempt to keep inflation under control and bring it back to target, central bank decisions to raise short-term interest rates had a significant impact in 2022 on international capital markets globally.¹ This assessment considers the background to central bank decisions to tighten monetary policy and the implications for financial stability and the resilience of capital markets. The focus of the assessment is on the pivotal role of three central banks: the Federal Reserve, the ECB and the Bank of England. While their objectives are broadly similar, it is important to recognise that there are significant differences in the conditions they face and the steps they need to take in response.

The objective of price stability

1 The US Federal Reserve, the European Central Bank (ECB) and the Bank of England all have operational independence for achieving target rates of inflation of around 2%.²

2 At Jackson Hole in August 2022, the Chairman of the Federal Reserve drew three lessons from the high and volatile rates of inflation during the 1970s and 1980s, and from the low and stable rates of inflation over the past 25 years:

- “central banks *can* and *should* take responsibility for delivering low and stable inflation”;
- “the public’s expectations about future inflation can play an important role in setting the path of inflation over time”; and
- “we must keep at it until the job is done”.³

3 He defined price stability by reference to a former Federal Reserve Chairman: “For all practical purposes, price stability means that expected changes in the average price level are small enough and gradual enough that they do not materially enter business and household financial decisions.”⁴

The rise in inflation

4 Given that the Federal Reserve, the ECB and the Bank of England all take responsibility for achieving target inflation rates of around 2%, why did inflation rates rise in 2022 well beyond this? One partial explanation is that the three central banks originally considered that price pressures were transitory, while it subsequently became clear that inflation would become persistent and entrenched unless they took decisive steps to tighten monetary policy rapidly. As they originally considered that inflationary pressures were

1. The IMF forecast global inflation to rise from 4.7% in 2021 to 8.8% in 2022, but to decline to 6.5% in 2023 and 4.1% in 2024: *World Economic Outlook*, October 2022.

2. See, for example, Andrew Bailey, Governor of the Bank of England: “Let me be quite clear. There are no ifs or buts in our commitment to the 2% inflation target. That’s our job and that’s what we will do.”: *Bringing Inflation Back to the 2% Target, No Ifs No Buts*: Mansion House Financial and Professional Services Dinner, 19 July 2022.

3. Jerome Powell, Chair of the Board of Governors of the Federal Reserve System: *Monetary Policy and Price Stability*: Jackson Hole, Wyoming, 26 August 2022.

4. Alan Greenspan: Statement before the Committee on Banking, Housing and Urban Affairs, US Senate, 21 February 1989.

transitory, they did not raise short-term interest rates earlier, and they did not end quantitative easing earlier.⁵

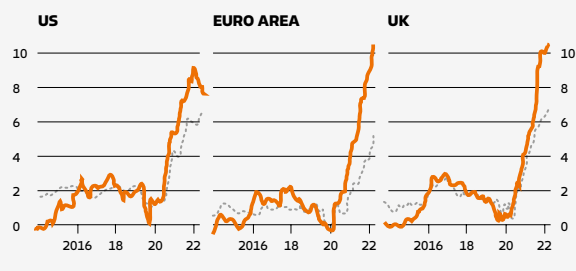
5 But it is also clear that inflation in 2022 rose much higher than it would otherwise have done because of the impact of the Russian invasion of Ukraine, which led to a substantial rise in energy – and in particular gas – as well as food prices globally. It is notable that, in 2022, the impact of the war in Ukraine on the European economy was significantly greater than the US. The impact on inflation was exacerbated by shortages in supply and accompanied by a widespread reconfiguration of supply chains from “just in time” to “just in case”.⁶

6 These supply constraints were accompanied by upward pressure on prices on the demand side. Following the unprecedented nature of the COVID-19 pandemic, when the authorities initially eased fiscal policy (eg through government support for furlough schemes and the equivalent), the economic recovery from the COVID-19 pandemic was more pronounced in some countries (eg the US) than others (eg the UK). But labour markets – particularly though not only in the US – remained comparatively tight.

and 325 basis points respectively, to levels last reached in 2007-2008. While the pace of the rise in rates moderated from regular increases of 75 basis points to 50 basis points in December 2022, the three central banks signalled that, even when inflation peaked, further increases in short-term interest rates were likely to be needed in order to bring inflation back to target.⁷

8 The rise in short-term interest rates started from a very low base. At the beginning of 2022, bond yields were still negative in the case of a relatively wide range of G7 government bonds, and nominal interest rates were strongly negative in real terms. During 2022, in response to the rise in short-term interest rates, yields on 10-year US Treasuries rose by 230 basis points, German Bunds by 270 basis points and UK gilts by 270 basis points. In raising short-term interest rates, the three central banks were aware that tightening monetary policy takes time to work through the economy, and they recognised that it is a relatively blunt economic instrument. It affects demand as a whole, with a lag, but its impact on supply constraints is less clear.⁸

Chart 1: Inflation in the US, euro area and UK: 2016–2022

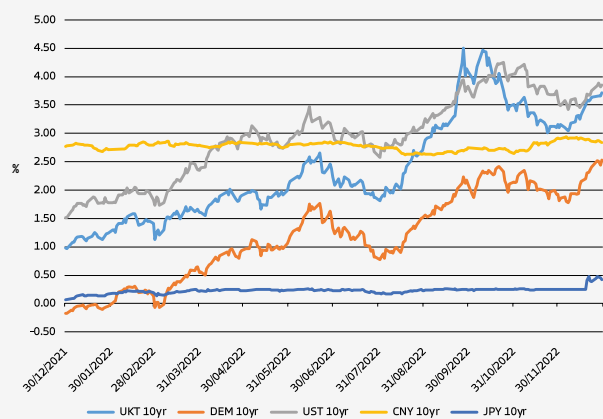


Note: Annual percentage change in CPI and core CPI (excluding food and energy, dotted line). Source: FT

The monetary policy response

7 Against this background, the Federal Reserve, the ECB and the Bank of England raised short-term interest rates forcefully in 2022, by 425 basis points, 250 basis points

Chart 2: 10-year sovereign bond yields: end-2021 to end-2022



Source: ICMA analysis using Bloomberg data

5. Quantitative easing involves central bank purchases of government securities which increase the amount of cash in the market and have the effect of easing monetary conditions. Quantitative tightening involves the reverse.

6. Andrew Bailey, Governor of the Bank of England: “The Russian shock is now the largest contributor to UK inflation by some way. There is an economic cost to the war, and we all have to recognise that, but at the Bank it will not deflect us from setting monetary policy to bring inflation back to the 2% target: *Bringing Inflation Back to the 2% Target, No ifs No Buts*”: Mansion House Financial and Professional Services Dinner, 19 July 2022.

7. See, for example, Jerome Powell, Chairman of the Federal Reserve Board: “We have covered a lot of ground, and the full effects of our rapid tightening so far are yet to be felt. Even so, we have more work to do.”: 14 December 2022. Christine Lagarde, President of the ECB: “The ECB is not pivoting. If you compare us to the Fed, we have more ground to cover.”: 15 December 2022. The Bank of England: “Interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation.”: 15 December 2022.

8. Jerome Powell, Chairman of the Federal Reserve: “There is clearly a job to do in moderating demand to better align with supply. We are committed to doing that job.”: Jackson Hole speech, 26 August 2022.

9 Following a long period of quantitative easing (QE) involving central bank purchases of government securities in unprecedented amounts, the three central banks each needed during 2022 to judge whether and to what extent to introduce quantitative tightening (QT) through securities sales from the stock of securities on their balance sheets. While QT reinforces the message about the need to bring inflation under control, it also adds to funding requirements and risks raising government bond yields further. In addition, the rise in short-term interest rates led to a fall in the market value of the portfolios of government securities accumulated during QE by the three central banks on their balance sheets.

10 It is common ground that the authorities' fiscal policy stance has monetary policy consequences. If capital markets believe that fiscal policy is not sustainable, monetary policy needs to be tightened – through increases in short-term interest rates – by more than would otherwise be necessary in order to meet the inflation target.⁹ Once capital markets believe that fiscal policy is sustainable, measured in particular by its impact on the level of public debt and the cost of debt interest, any premium previously required in government bond yields should begin to decline, though this takes time. In response to market pressure, the change in UK Government policy between two budgets, the first (so-called “mini” budget) at the end of September 2022 and the second in November, is an example of this.

11 For the Federal Reserve, the ECB and the Bank of England, finding the right balance between controlling inflation and preventing an economic recession is fraught with difficulty.¹⁰ In the US in particular, bringing inflation back to target became a higher priority for the Federal Reserve in 2022 than preventing an economic recession. This was reflected in an inversion of the yield curve between short and long-dated government bonds. The rationale was that, if central banks failed to bring inflation back to target, the consequences would be more painful in economic terms in the long run. There would be a risk of a return to stagflation last experienced in the 1970s.¹¹

12 Underlying the response by the three central banks to the rise in inflation is a concern about the risk to their own credibility if they do not succeed relatively quickly in bringing inflation back under control. The three central banks already face the risk of criticism for allowing inflation

to rise substantially above target. But they now also face the risk of criticism if the rise in short-term interest rates needed to bring inflation under control leads directly to economic recession. Whatever the outcome, the operational independence of the three central banks is expected to come under closer political scrutiny. The Governor of the Bank of England said: “From the perspective of monetary policy, these times are the largest challenge to the monetary policy regime of inflation targeting that we have seen in the quarter century since the MPC was created in 1997.”¹²

The implications of monetary policy for financial stability

13 To what extent does the rise in short-term interest rates needed to combat inflation complicate the task of the three central banks in ensuring financial stability? To some extent, this depends on whether the rise in short-term interest rates succeeds in bringing inflation back to target without causing a severe economic recession. But in 2022 the rise in short-term interest rates also affected the financial stability of markets in other ways:

14 First, as the Federal Reserve took the lead in raising short-term interest rates, starting earlier and moving more quickly than the ECB, the US dollar strengthened significantly in the foreign exchange market, at least until later in the year. Given the US dollar's wide international role, this had a particularly significant impact on inflation in many emerging market economies, some of which were already vulnerable owing to the impact of the COVID-19 pandemic. Their import prices and foreign debt stock denominated in US dollars increased in local currency terms, and their debt interest burden rose in response to the rise in US interest rates.

15 Second, the risk of market fragmentation is a concern in the euro area. This is partly because of regulatory divergence (eg between the EU under Capital Markets Union and the UK, whose Chancellor of the Exchequer launched a series of post-Brexit reforms in Edinburgh on 9 December 2022¹³). But it is also because of the differential impact of the rise in short-term euro interest rates within the euro area. For a time during 2022, the spread between core and peripheral euro rates widened appreciably, prompting the ECB to obtain approval to intervene in weak government bond markets, if necessary, to ensure that monetary

9. If governments cap energy prices to reduce headline rates of inflation, there is a cost in terms of increased government borrowing.

10. The IMF forecast that global growth will slow from 6.0% in 2021 to 3.2% in 2022 and 2.7% in 2023, including a US GDP contraction in the first half of 2022 and a euro area contraction in the second half of 2022: *World Economic Outlook*, October 2022.

11. Jerome Powell, Chairman of the Federal Reserve Board: “While higher interest rates, slower growth, and softer labour market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain.” Jackson Hole speech, 26 August 2022.

12. Andrew Bailey, Governor of the Bank of England: Mansion House speech, 19 July 2022.

13. Jeremy Hunt, Chancellor of the Exchequer: *Financial Services: the Edinburgh Reforms*, HM Treasury, 9 December 2022.

policy could be transmitted effectively throughout the euro area.¹⁴ The increase in sovereign bond yields also affected corporate bond yields, and led to a significant rise in the yield differential between corporate credit risks for high grade credits and for high yield credits, with access to the bond market for high yield credits becoming severely limited.

16 Third, the impact of rising gilt yields on liability-driven investment (LDI) is a particular concern for the UK authorities. Under LDI, defined benefit pension schemes hedge the inflation and interest rate risk of their liabilities to pensioners using leverage to free up capital to invest in high-quality securities that pay a premium over gilts, such as corporate bonds or asset-backed securities. While disposals of the schemes' assets take a period of time, margin (ie collateral) requirements on their hedges must be settled daily and mostly in cash. If the schemes' liquidity buffers are not sufficient, the schemes have no alternative but to sell gilts linked to the hedges.¹⁵

17 In the stressed market conditions after the UK Government's mini-budget in September 2022, the Bank of England described how "some LDI funds were creating an amplification mechanism in the long end of the gilt market through which price falls had the potential to trigger forced selling and thereby become self-reinforcing. Such a self-reinforcing price spiral would have resulted in even more severely disrupted gilt market functioning. And that would in turn have led to an excessive and sudden tightening of financing conditions for households and businesses. In response to this threat, the Bank of England intervened on financial stability grounds."¹⁶

18 The Bank of England's intervention highlighted an apparent tension between the quantitative tightening (QT) needed for monetary policy purposes, on the one side, and the need to purchase government securities to ease a critical threat to financial stability, on the other side. In response, the Bank of England made it clear that its intervention was not intended to steer market yields towards some particular level, as in the case of monetary policy, but rather it was intended to prevent them from being distorted by market disruption, so as to ensure financial stability. It is also

important to note that, unlike QE, the Bank of England's financial stability operation was a short-term intervention.¹⁷

Financial stability and capital market resilience

19 Despite the rise in short-term interest rates, the stability of the banking system did not come under undue pressure in 2022. Following the regulatory steps taken in response to the global financial crisis in 2007-2009 and the sovereign debt crisis in the euro area in 2010-2012, banks in advanced economies are much better capitalised and regularly stress-tested. The ECB and the Bank of England now also stress-test banks on their ability to cope with the impact of climate change on their business. In addition, bank profit margins benefit from rising interest rates. This should stand them in better stead to absorb the impact of a rise in business bankruptcies and the impact of a rise in mortgage rates on the housing market.

20 Official concerns about financial stability are currently focused less on the stability of the banking system, and more on the role of non-bank financial intermediation (NBFIs) and the impact of leverage. The authorities' aim is to ensure that NBFIs are sufficiently resilient and appropriately regulated.¹⁸ The resilience of NBFIs initially became a priority for the authorities following the "dash for cash" at the start of the COVID-19 pandemic. Their concerns were highlighted again by the rise in short-term interest rates in 2022. In particular:

- In its report in October 2022, the IMF argues that "market liquidity metrics have worsened across asset classes, including in markets that are generally highly liquid and among standardised and exchange traded products. US Treasury bid-ask spreads have widened significantly, market depth has declined sharply and liquidity premiums have increased."¹⁹
- In its progress report in November 2022, the Financial Stability Board (FSB) focuses on the functioning and resilience of the NBFIs ecosystem, which depends on the availability of liquidity and its effective intermediation under stressed market conditions. The FSB proposes

14. The ECB's transmission protection instrument (TPI) can be activated to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area. A judgment will be needed on whether and if so when activation will be justified. The hope must be that the threat is sufficiently powerful that the TPI does not need to be used.

15. See Abdallah Nauphal, Chief Executive, Insight Investment: *LDI Strategy Has Left DB Pensions in Better Shape*: FT, 21 October 2022.

16. Sarah Breeden, Bank of England: *Risks from Leverage: How did a Small Corner of the Pensions Industry Threaten Financial Stability?* Allen & Overy, London, 7 November 2022.

17. See Andrew Bailey, Governor of the Bank of England: *Monetary Policy and Financial Stability Interventions in Difficult Times*: Washington, 15 October 2022.

18. See, for example, Francois Villeroy de Galhau, Governor of the Banque de France: "It is high time that we moved forward to enhance the regulatory framework for NBFIs that will ensure better liquidity management on financial markets."

19. IMF: *Global Financial Stability Report*, October 2022.

two sets of policies to “reduce excessive spikes in the demand for liquidity by addressing the vulnerabilities that drive those spikes or by mitigating their financial stability impact”. One set of policies focuses on addressing structural liquidity mismatch in open-ended funds and promoting greater inclusion and use of liquidity management tools, including by developing detailed guidance on the design and use of those tools. The second set comprises policy work to address procyclicality of margining in centrally cleared and non-centrally cleared derivatives and securities markets, including by enhancing transparency and the liquidity preparedness of market participants. On the supply side, the report draws attention to the need to increase the availability and use of central clearing for government bond cash and repo transactions; the use of all-to-all trading platforms; and measures to enhance the transparency of bond and repo markets.²⁰

- An additional concern for the authorities in the fourth quarter of 2022 was the collapse of FTX following extreme volatility in crypto markets. While this did not have an immediate impact on the stability of the banking system, in particular because bank participation was in most cases limited, it did make a powerful case for appropriate regulation. The question is how best to achieve this while allowing important initiatives from the FinTech revolution to continue to develop, such as the development of central bank digital currencies (CBDCs) and the use of blockchain to make back-office systems more efficient. The Chair of the Financial Stability Board wrote to G20 Finance Ministers in October 2022 that “the appropriate regulation of crypto assets, based on the principle of “same activity, same risk, same regulation”, will provide a strong basis for harnessing the potential benefits associated with this form of financial innovation while containing its risks.”²¹

21 In considering further regulation of NBFIs, it is important that the authorities also consider the risk that focusing on the regulation of one particular product or another in the market ignores the impact on international capital markets as a whole. The market is interconnected, and an integrated approach is needed by the authorities. Regulating one particular part of the market may have unintended consequences elsewhere.

Conclusion

22 The dramatic rise in short-term interest rates in 2022 had a significant impact on international capital markets, where bond yields were previously at historically very low levels, and negative in the case of a relatively wide range of G7 government bonds. The rise in government bond yields also led to an increase in corporate bond yields, with the development of a significant yield differential between high grade credits and high yield credits, where market access became severely limited. The Federal Reserve, the ECB and the Bank of England are well aware that their decisions to raise short-term interest rates, which are necessary to bring inflation back under control, have important potential consequences, not only for the international economy, but also for financial stability. In taking regulatory steps to enhance the resilience of NBFIs in capital markets, they need to consider any unintended consequences across the market as a whole.



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20. Financial Stability Board: *Progress Report to the G20 on Enhancing the Resilience of Non-Bank Financial Intermediation*, 10 November 2022.

21. Klaas Knot, Chair of the Financial Stability Board: letter to G20 Finance Ministers and Central Bank Governors, 3 October 2022.