

CROSSBORDER CAPITAL LTD – WRITTEN EVIDENCE (QE10004)

QUANTITATIVE EASING INQUIRY

1.0 Background: *CrossBorder Capital* is a London-based investment advisory firm that specialises in the understanding and tracking of money flows around the World for the benefit of its commercial clients. The firm's principals pioneered the original concept of *Global Liquidity* in the mid-1980s, while employed at US investment bank *Salomon Brothers Inc.*, and have since emphasised the idea that capital flows and Central Bank quantitative interventions in markets matter. Much of the firm's work has been focussed outside of the UK, mainly analysing the US, Chinese and Japanese financial systems. However, the analysis is generic and applies equally to the UK monetary system. A recently published book *Capital Wars* (Palgrave Macmillan, 2020) details the global liquidity transmission mechanism, and extrapolates future trends. We volunteer our thoughts on the importance of QE ('quantitative easing').

2.0 Synopsis: QE ('quantitative easing') is a critical component of both monetary transmission and financial stability. This is because the financial system has largely become a re-financing system for existing debts, rather than a new financing system. In a *re-financing system* large balance sheet capacity matters. In a *new financing system*, low interest rates matter. In fact, too low interest rates may even detract from balance sheet capacity and so endanger financial stability. In this context, a policy of negative interest rates would be extremely unwise.

3.0 Discussion: QE ('quantitative easing') can be defined as a deliberate policy, undertaken by the broad monetary authorities, to expand the size of their interventions in money and financial markets. This is conventionally measured through changes in the absolute size of the Central Bank balance sheet. It is considered a separate dimension from (although not necessarily independent of) interest rate policy, and it has become more popular during periods of low interest rates, where the latter is assumed to lack traction. There is no accepted definition of QE that insists on whether and how it affects the specific distribution of assets and liabilities on the Central Bank's balance sheet. However, the US Federal Reserve has often deliberately emphasised the 'assets side' of the balance to highlight its credit easing activities.

3.1 In the book *Capital Wars* (2020) we are careful to categorise the policy intentions of the US Federal Reserve, when it undertakes QE, into: (1) liquidity provision; (2) maturity transformation and (3) credit enhancement. This requires reallocating the Central Bank's operations, as shown in the table reproduced below. In other words, the re-classification highlights the important *qualitative* dimension of QE policies and more clearly emphasises the financial stability implications of QE policies.

Table 7.4 US Federal Reserve balance sheet—reported and reallocated by function, end-2014

US\$ billions	Assets		Liabilities	
(a) Reported				
Bills	0	Currency		1342
Bonds and notes	2461	Reverse repos		346
MBS and agencies	1777	Reserves		2575
Other	305	Other		280
Total	4543	Total		4543
US\$ billions	Assets		Liabilities	
(b) Reallocated by function				
Notional bills/ wholesale funds	4263	Currency, repos and reserves	4263	Liquidity provision (50.1%)
Bonds and notes	2461	Notional bills/ wholesale funds	2461	Maturity transfor- mation (28.9%)
MBS and agencies	1777	Bonds and notes	1777	Credit enhance- ment (20.9%)
Total	8501	Total	8501	

Source US Federal Reserve, *CrossBorder Capital*

3.2 Yet, Central Bank QE must be also put into context as one (important) part of the overall pool of Global Liquidity. We use the term Global Liquidity to emphasise that money is both international and embraces wholesale-based credit-providers that lie beyond the traditional, regulated high street banks. We project that this pool of fast-moving, footloose funds will test US\$180 trillion in 2021, or close to 200% of World GDP, having doubled as a share within the last two decades.

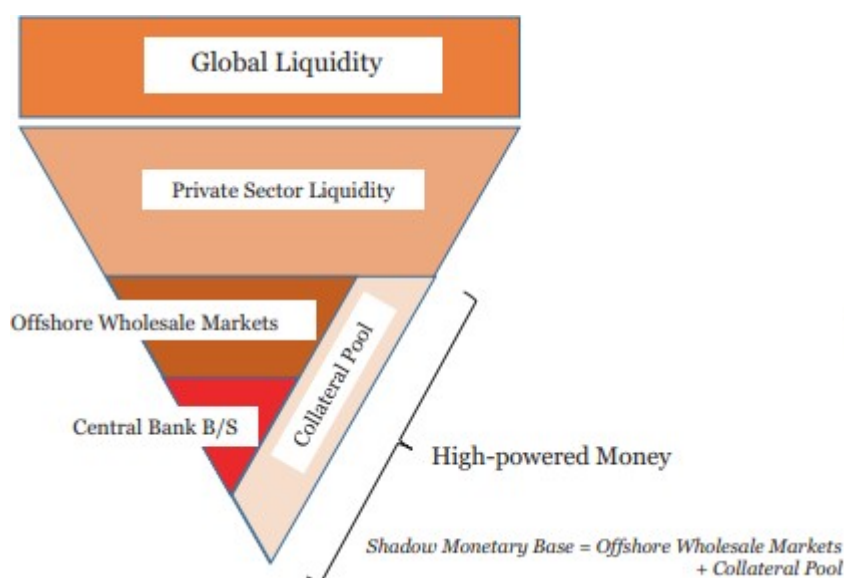
3.3 Global Liquidity can be split functionally, as well as geographically, by type, which helps to isolate its changing quality. In other words, certain components exercise a greater influence over the future size and direction of the total pool than others. We focus on three liquidity components: (1) Central Bank provision, e.g. QE; (2) private sector supply and (3) cross-border inflows.

3.4 We have noted how changes in the size of the Central Bank balance sheet are typically described as QE or 'quantitative easing'. The impact of the Central Bank balance sheet on the financial system is traditionally understood through its liabilities to the private sector, and specifically the amount of currency in circulation and the reserves held by regulated banks at the Central Bank. These taken together comprise the so-called monetary base. Government deposits held at the Central Bank are often a large liability, but as these do not circulate, they are excluded from the definition of the monetary base.

3.5 In the traditional finance model, high street banks use a leveraged balance sheet to recycle private savings. An increase in the **monetary base** is subsequently associated with a greater stock of bank loans. Extra reserves allow banks to proportionately expand their deposit bases and, hence, to make more loans. This textbook framework is out-dated and a poor description of the modern monetary system.

3.6 We have noted earlier that the Central Bank can also affect the broader wholesale money markets and non-bank financial intermediaries through changes to the composition of its assets. For example, via its purchases of government debts and from its repo market activities. A Central Bank that encourages a liquid repo market provides a vital financial stability role, which, in turn, may foster risk-taking by dealer banks. In short, the Central Bank balance sheet has important quantitative and qualitative dimensions.

3.7 The hierarchy of Global Liquidity is drawn up in the chart below. The wider expansion of private sector liquidity at the top of the inverted pyramid rests on a narrower base of **high-powered money** that includes the balance sheet of the Central Bank (i.e. the traditional monetary base), as well as: (1) off-shore wholesale markets, e.g. Eurodollars, and (2) the available pool of private sector collateral. These two additional sources of high-powered money, that lie beyond the traditional definition of the monetary base, can be thought of as the shadow monetary base.



3.8 Wholesale money markets now take on a large part of the modern transmission role, with a collateral/loan multiplier replacing the previous reserve/deposit multiplier. This transmission channel may still require a larger Central Bank balance sheet, i.e. traditional monetary base, when it involves increased repo activity (i.e. the purchase and sale of Treasury notes) between the Central Bank and the dealer banks in the money markets, which allows them to increase their leverage. Assuming that the Central Bank, say, injects funds through repos. This will increase the cash resources of a money market dealer, who will pay away the short-term financing but will keep the coupon payment on the bond, less some margin. This enables the dealer to purchase more bonds in the open market, and potentially to repo them again. This, in turn, should encourage more risk-taking elsewhere in financial markets, including greater demand for loans. Loan supply could be further stimulated by second-round

effects as the value of collateral itself climbs higher. Some experts have worried that this transmission mechanism may be compromised because Central Bank repo activity, by definition, removes precious collateral from the private sector. However, this negative drag seems, from experience, to be more than offset by the subsequent increases in collateral values.

3.9 Low and negative interest rates introduce a potential distortion, because they may adversely affect the profitability of essential repo transactions and so disrupt risk-taking. In other words, the effect of the Central Bank's policy actions on the entire financial sector must be considered, and not just the regulated banks, alone. For example, the adverse impact of low (or negative) policy rates on lowering bond yields and challenging the solvency of insurance funds needs to be thought about.

3.10 We think in terms of three broad liquidity transmission channels, with each one affecting or amplifying risk-taking behaviour. Consider these various channels, in turn:

3.11 First, the sum of domestic Central Bank and private sector liquidity tends to affect the relative prices of 'safe' assets, through a **risk-taking channel**. A 'safe' asset is defined by liability needs, but it typically includes cash and government bonds, and often the benchmark 10-year government bond of reserve currency economies. By reducing the odds of systemic risk, more domestic liquidity increases the term premia on government bonds as the demand for safety falls, while simultaneously reducing the equivalent premia assigned to risk assets. When the 'safe' asset is used internationally, cross-border inflows are also likely to come into play.

3.12 Second, the **exchange rate channel** reflects the changing quality-mix of liquidity between the private and public sectors. More private sector or 'good' liquidity strengthens a currency unit, whereas more Central Bank or 'bad' liquidity weakens it.

3.13 Third, the spill-overs of domestic liquidity from the core economies into outward cross-border capital flows are typically amplified both by offshore funding markets and by other policy-makers in the periphery economies into bigger increases in Global Liquidity and more risk-taking by investors. This latter **cross-border capital flow channel** is shaped by the current institutional make-up of the World economy and embodies many of the structural differences between America and China.

4.0 Summary: In summary, liquidity should be seen as a gross funding concept that represents the size of overall financial balance sheets. We choose to define liquidity broadly to include 'global' or cross-border effects, and deeply, insofar that it extends beyond the traditional retail banking sector, to include corporate cash flows, and repo and wholesale money markets. Today, most credits take the form of collateralised loans that derive from wholesale money markets, not banks; ultimately sourced from corporate and institutional cash pools (CICPs), and which are used mainly for funding, i.e. refinancing of existing positions, rather than borrowings for new investments.

4.1 It is essential to recognise that financial markets have become **large-scale re-financing mechanisms**, rather than just sources of new financings. In a World dominated by funding the **rollover of huge outstanding debts**, rather than the financing of large-scale new capital projects, *balance sheet capacity*, i.e. liquidity, is far more important than the level of interest rates, i.e. the *cost of capital*. Liquidity has both private sector and Central Bank dimensions, with the private sector dependent on being able to bundle up good quality, longer horizon securities as collateral and the Central Bank acting as a liquidity backstop in emergencies. The need to continually refinance our towering debts means that crises can occur when funding stops or slows, which, in turn, may arise because of **a lack of sufficient good-quality collateral and/ or the withdrawal of Central Bank liquidity support**. When both combine, such as in 2007–2008, a significant crisis can unfold.

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