sciendo

UDK: 336.711(4)
DOI: 10.2478/jcbtp-2022-0031

Journal of Central Banking Theory and Practice, 2022, 3, pp. 231-236
Received: 25 February 2019; accepted: 27 June 2019

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Book Review „Central Banking in Turbulent Times“, Oxford University Press, 2018 by Francesco Papadia and Tuomas Välimäki

Papadia's and Välimäki book "Central Banking in Turbulent Times" holds a bilateral comparison between the European Central bank (the ECB) and the Federal Reserve of the United States (the Fed) in confronting the Great Recession (2007-2009) before, during and after the critical years of the Great Financial Crisis. Equipped with 105 monochromatic figures, 6 tables and 16 lengthy inline boxes, the book is organized into three chapters throughout which the authors link the economic practices that were instrumental to both causing and overcoming the Great Recession to the pertinent theoretical background. The aim of this review is to evaluate how economic theoretical background was integrated in the analysis of the practices aimed at recovery from the Great Recession with implications on the binary case study of the ECB and the Fed.

Chapter 1 entitled *Central Banking before the Great Recession* views the objectives of central banks, the theoretical changes to the central bank model and the four categorical reasons behind the Great Recession. Defining price stability, funding of the government, growth/employment and financial stability as the main objectives of central banks, this chapter underpins the theoretical background of each concept to attribute failure to maintain such objectives to the blurred nature of conceptualizing the four key terms. For example, financial stability is an ill-defined concept, in the statutes of both the ECB and the Fed, in terms of its borders and relationships with banking supervision and with the new entry,

macroprudential policy. Enabling macroprudential tools would preserve financial stability by acting on some parameters of the financial market.

Intermittently describing the chronological dimension of the Great Recession, the first manifestation dates back to August of 2007. However, its acute phase flared up with the bankruptcy of the investment bank Lehman Brothers in September of 2008, following the bankruptcy of Bear Sterns. The great recession in Europe was preceded by two periods [the convergence period (1980-1999), which roughly coincides with the Great Moderation, the single monetary policy, and the launch of the euro in 1999; and stability period, which marks the increasing number of countries joining the single currency area]. The third period started with the Great Recession, after the fall of Lehman Brothers, and had its climax at the peak of the euro area sovereign debt crisis in the summer of 2012. The final period may be dated to start with the partial reabsorption of the tensions after the ECB President Mario Draghi delivered his famous speech in London in July of 2012, stating that the bank would do 'whatever it takes' to preserve the euro. Thus household debt increased sharply. In Ireland and Spain, excessive debt took the form of heavy external borrowing and large indebtedness by the domestic private sector. This, however, duly transformed itself into public debt during the crisis, when, to avoid massive bank failures, governments bailed out banks with public funds.

Inflation targeting recognizes that the link between monetary policy and price stability is imprecise and subject to lags. Other factors, such as raw material prices or exogenous wage pushes, have an influence on inflation in the short to medium run. The central bank must see past these disturbances and recognize that the effect of its own actions is not immediate. With regard to the controversial definitions of the price of money (in terms of all the goods and services consumed in the economy, a foreign currency, the exchange rate, and the interest rate), the money multiplier revealed a fairly predictable trend behaviour between 1980 and 1999. Even before the Great Recession, monetary and credit aggregates not only lost much of their value as gauges for monetary policy, but did not even play an important role in detecting brewing financial instability risks. Other than Inflation targeting, the Neo-Wicksellian Approach, Central Bank Reaction Functions and the Taylor Rule and Papadia's and Valimaki's Corridor Approach are discussed as mediating factors of the central bank model.

Consistent with the neo-Wicksellian approach, the quantity of money is promoted as intermediate target given the stable demand for money, supplying it in adequate amount should stabilize its price, that is, the rate of inflation. At the end of last century, the emphasis on quantities, which prevailed in the Fried-

manian approach to monetary policy, was to be found only in some textbooks but not in actual policymaking. The difference between the Wicksell's approach and the Taylor's rule lies in the diverse empirical behaviour of the natural and the financial rate confronting Wicksell and Taylor. In Europe, adherence to the Taylor rule would also have brought about higher rates and a better macroeconomic performance. Implicating on international trade policies, Taylor (2012) emphasizes that entrance of emerging market countries into the global trade and production chains contained price pressures. This further kept inflation low in advanced economies and hence facilitated maintaining low interest rates over a long period of time.

The floor of Papadia's and Valimaki's Corridor is the deposit facility rate, while the ceiling of the corridor is the marginal lending facility rate. The corridor is based on three fundamental tenets: an interest rate corridor, compulsory but remunerated reserves to be respected on average over a so-called maintenance period, and refinancing operations targeted at satisfying the liquidity needs of banks. Applying Papadia's and Valimaki's Corridor Approach to crisis in the USA and Europe, the soft floor (government-sponsored enterprises holding large amounts of liquidity), porous ceiling (borrowing from the Fed under the discount window), and diverse decision-making structure (the Board of Governors of the Federal Open Market Committee determines the Federal Funds Rate) limit the effectiveness of a corridor system in the USA. However, the ECB avoided providing excess liquidity, following the so-called 'benchmark' approach whereby enough liquidity was supplied to cover precisely the liquidity deficits of banks and required reserves. Both the Fed and the ECB obtained major changes of short-term market rates of interest by moving the corridor. At the Fed, this involved the discount rate and the interest on reserves. At the ECB, this was the rate on the deposit facility and the rate on the marginal lending facility.

Chapter 1 concludes with macroeconomic, regulatory, supervisory, and intellectual failings of the Great Recession. The great moderation, macroeconomic failings, regulatory and supervisory failings as well as intellectual failings are enumerated as predisposing factors of the Great Recession. There are safe zones (where the tipping point is high) and dangerous zones (where the tipping point is low). Prior to the crisis, peripheral countries such as Italy, Spain, Greece, Ireland, and Portugal were in dangerous zones; core countries, like Germany, the Netherlands, and France were in safe zones. In the USA, banks were forced to recapitalize, but expectations were also changed by programs of public support, such as the Troubled Asset Relief Program and the financial support of the Fed. The soft and the hard strategy were also followed in the euro area. Peripheral countries enacted a strong correction of domestic and external deficits, while a change in

expectations was engineered by intergovernmental financial support and by the action of the ECB.

The inability to realize the danger that the sheer enormity and complexity of the shadow banking system was creating and the limited supervision and regulation of this sector, regulate two financial innovations that substantially increased the margins of freedom of financial institutions, including banks: asset-backed securities and derivatives, maintain a prevailing national approach to regulating and supervising an increasingly global financial industry, and to beware the competition of the 'shadow banking system' that was pushing banks to take more risks to compete with it contributed to the regulatory and supervisory failings.

Governments, regulators, market professionals in central banks and monetary authorities contributed to igniting the Intellectual Failings of the crisis. In the euro area, wider current account deficits (secondary to globalization in financial and trade markets) increased capital mobility for enabling, funding of larger current account deficits and the domestic imbalances that were behind them, be they fiscal deficits or excessive household debt were claimed to be causative Intellectual Failings. However, none of the above has proven true.

Chapter 2 entitled *Central Banking during the Great Recession* focuses on the actions of central banks during the crisis, in particular the Fed and the ECB. As banks wanted to hoard liquidity for precautionary purposes, control over the short-term interest rate became imprecise, and the ability to lower the interest rate as it reached its lower bound became impaired. It was only then when the Taylor rule could result in a zero or negative rate of interest was embodied.

The quantity level of the action of the ECB and the Fed, which was the real novelty during the crisis, can obviously be seen in terms of both assets and liabilities on the central bank balance sheet. On the liability side of the balance sheet, it was bank reserves which reflected the increase in the asset side. The ECB and the Fed bought assets whose purchases would help monetary policy pursuit. In October 2008, the ECB moved from an auction procedure based on offering banks a fixed quantity of liquidity at a variable rate to a procedure with a fixed rate and a variable quantity. The Fed employed a series of targeted temporary operations, after examining reserves and discount window lending flow through the banking system and financial markets. Given that the substitution of public intermediation for private intermediation became inevitable, it had to move beyond its usual operations: lending short-term liquidity in its own currency to banks in its jurisdiction, consistent with the Bagehot's prescription. Overall, the actions of the two central banks to regain control of short-term rates and counter disorderly spreads

fit well into the paradigm of central banks reacting to the sudden move from a 'good' to a 'bad' equilibrium.

During the Great Recession, central banks participating in the swap network and the joint interest rate reduction provided liquidity in unlimited amounts, and also in foreign currency and to foreign banks in order to avoid another Great Depression. This connection represented a quantum leap in central bank cooperation. Using different approaches, the Fed and the ECB each managed to stabilize money markets and regain control of their operational targets. Therefore, communication became an even more important component of the central bank policy. Under the name of 'forward guidance' it seemed even to have become an independent tool to remedy the impossibility of bringing interest rates lower than the 'lower bound.

Besides conducting extraordinary liquidity operations and cutting rates, the ECB launched its first Asset Purchase Program to encourage banks to maintain and even expand their lending to firms and households, as well as improve market liquidity in the covered bond market segment. The ECB states that it accepts its purchases are to be treated similarly to those of other investors *pari passu* in case of a default. This should have further alleviated the urge among private investors to run for the exit. However, the Fed started to reduce the penalty for discount window borrowing in August 2007. The Fed tried to attenuate a stigma by moral suasion and creating a new facility to encourage term borrowing. As the Fed's balance sheet grew, the American central bank started to also lend its US treasury securities against less liquid debt instruments to free up these high-demand risk-free assets. To resist a bank run-type panic, the Fed agreed to make non-recourse loans to banks that purchased asset-backed commercial paper from the money market funds. With these facilities geared to a larger set of institutions than the traditional banks, the Fed could effectively channel liquidity to non-bank institutions and prevent such institutions from having to sell assets at fire-sale prices. The third group of actions by which the Fed supported credit markets involved purchases of long-term assets. Forward guidance on interest rates and quantitative easing and negative interest rates eased up the monetary policy below the lower bound in both the fed and the ECB.

As for financial stability, consequences of the Great Recession included limited size of the trigger of the crisis, explosion of financial stress, evaporation of market and funding liquidity, instability of short-term interest rates, as well as liquidity hoarding by banks. Implications on the low profitability of banks making the reconstitution of capital by banks and the four waves of losses affecting the balance between banks' increased risk and depleted capital became conspicuous.

Sustained disintermediation by banks, particularly across borders, increased importance of shadow banking and increase in interest rate spreads brought about by dysfunctional markets are some of the effects of the Great Recession on financial stability.

Chapter 3 is concerned with the interest rate, in a Wicksellian approach and logic of the Taylor rule. So no significant change is expected on these two aspects. A discussion follows about possible adaptations of the inflation targeting strategy. The chapter provides proposals which would deliver better monetary policy performance than the inflation targeting strategy. However, further research is recommended to provide unequivocal evidence on such a claim.

To conclude, great strides are made in advancing central banking concepts and in validating the empirical evidence on their basic theoretical principles. Technology-based, liquidity provision and macroprudential policies are some monetary policies that enabled an effective recovery from the Great Recession and its aftermath. Although the book marginalized the unaffected economy of European countries during the Great Recession, like Poland, and skipped the role of international trade on overcoming the global crisis, the analysis of the crisis is epitomical to theoretical and applied economists because it integrates and ventures the basic principles of macro economy into the analysed pre-, post- and intra-Recession phases. The book is therefore highly recommended.

Acknowledgements: None

Funding resources: None

Conflict of Interest: None