

THE PRESENT ROLE OF CENTRAL BANKS – UNCONVENTIONAL MONETARY POLICIES

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Abstract:

The ‘Great Recession/crisis’ (2007-2009) shockingly marked a drastic change in the ways, means and types of monetary policies initiated and operated by central banks in more and more countries. ‘Anticipated’ by Japan in the 1990s, the stagnation-deflation tandem has become a common denominator especially for western developed countries (Northern America and Western Europe). Being initially an ‘exception from the rule’, the so-called *unconventional* monetary policies have gradually evolved into a characteristic/fixture of macroeconomic policy system in most developed economies. This study aims to decipher the determinants, forms and effects of these policies, also including a short ‘study case’, considerations and conclusions.

Key words: central banks’ role; unconventional monetary policies; quantitative easing; deflation; negative interest rate(s).

JEL classification codes: E 58; F 33; G 01.

The turning points of the long cycles of economic history have usually marked profound and extensive changes in both real and nominal dimensions of economic and financial components of human society, including economic policies. If we refer to the 20th century and the first two decades of the 21st century, it is obvious that the most important crucial stages of the world economic history (“*Correlation and interdependence between monetary/nominal and real economy in the context of the international financial crisis*”, in *UFB Review*, no.1/2011, p. 21) were represented by ‘the Great Depression’ during the 1930s and ‘the Great Recession’(or crisis) unleashed in 2007/2008, having deep consequences for at least a decade.

1. The Great Depression determined the coagulation and afterwards proliferation of Keynesian and neo-Keynesian theories and economic policies which, after the World War Two, favoured a new ascending phase for the long economic cycle. The stagnant stage of the 1970s (mainly stagflation) forwarded neomonetarist and neoliberal theories and economic policies which, unfortunately, did their best to justify an aggressive process of so-called liberalization and deregulation of international financial system, especially regarding capital markets and banking sector, during 1980s & 1990s. Initially – but misleadingly – that kind of neoclassical approach regarding the economic policies seemed to stimulate growth and to temper inflation, so that the 1990s and the beginning of 2000s were considered by the ‘mainstream’ economists as ‘the Great Stability’ or ‘the Great Moderation’ (particularly in USA and UK). In fact, that was a period when the surge of the speculative capital and funds only masked the ever deepening of the *rupture between the nominal/monetary economy and the real economy* (L. C. Ionescu, “*Necessity of a new type of symbiosis between the nominal and real economy*”, in *CCFM, Financial Studies*, no.3/2013)

Under these circumstances, the crisis which burst in 2007/08 has proved to be much more violent, widespread and dangerous than any other economic and financial shock since 1930s and the last world war. The contradictory and intricate nature of the crisis is confirmed by the inefficiency of the ‘traditional’ macroeconomic policies (mainly monetary and fiscal). In the postwar period, fiscal and monetary policies were key instruments in fighting inflation and/or unemployment. This time inflation almost disappeared in the western economies, while unemployment has stood high and growth (GDP) rate has been stagnant. Moreover, *deflation* has replaced inflation as a very resilient ‘public enemy’, after a historical pause of over half a century.

This threatening and enduring trio – stagnation, deflation, unemployment – sadly confirms the thesis I have reminded above and which I expressed and argued ever since early 1990s: speculative monetary and financial flows of capital have gradually but swiftly overwhelmed *real* economy, starting in 1980s and 1990s, exacerbated by the so-called liberalization & deregulation, under the pretext of stimulating competition, while in reality the *oligopolistic and monopolistic*

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international structures have suffocated the genuine sources of economic value added. A striking effect of this eroding process has been the declining trend of the rate of return in the developed economies. Based on international statistics, the main asset classes (stock, bonds, commodities) recorded substantial decreases of their rates of return. Referring to a 30-year period, from mid-1970s to mid-2010s, in USA, the composite rate of return (stocks/bonds/commodities) almost halved, from 11.03% to 6.53%. Here are the data comparing the 30-year average annual growth rate to annual growth rate calculated for 2004 – 2014(in %): for stocks from 12.6 to 8.1; for bonds from 8.7 to 4.6; for commodities from 9.79 to -2.77 (D. Shairp, A. Werley, M. Feser, “ Long-term Capital Market Assumptions”, in J. P. Morgan Asset Management, 2015)

The three components of the composite average reflect the interface between nominal/real facets of the economy (US stock), the evolution of the nominal economy (bonds) and the stage of the real economy (commodities). It is significant that the most dramatic decrease was recorded by the rate of return within real sector of economic activity. The analysed period “contained highly unusual economic, financial and global economic policy conditions. Those conditions ranged from financial euphoria and real asset bubbles to the Great Recession in the US and the crisis in the Eurozone, with public policy prescriptions reminiscent of the 1930s. Ultimately, these events and conditions resulted in global asset declines not seen since the 1970s, if not the last 80 years.”(D. Shairp, A. Werley, M. Feser, “ Long-term Capital Market Assumptions”, in J. P. Morgan Asset Management, 2015, p.8)

In such circumstances, the diminishing returns of key components of economic activity (especially those linked directly to real investments) have necessarily led to an almost continuous decline in the level of interest rates. According to the estimate of the former governor of the Bank of England (Marvyn King), the international average 10-year real interest rate fell from about 4% at the end of 1980s to 1.5% when the crisis began (2008) and has steadily fallen further *to around zero (!)*. This situation has not been simply an ‘accident’ for the financial domain, but an extremely serious crossroads in the evolution of the world monetary and financial system, affecting thoroughly both macroeconomic policies and economic theory - economics or political economy (Graph 1 - BIS, Working Paper no. 569/2016).

Alan Greenspan, former chairman of the Federal Reserve, had a highly controversial role in paving the way for the crisis by an ‘easy money’ monetary policy. However, after the crisis burst, Greenspan identified its causality in continuous decline of real long-term interest rates (since early 1990s) which finally engendered the subprime housing bubble. As an apologist of ‘free market virtues’, he wrote: “Markets have become too huge, complex and fast-moving to be subject to twentieth century supervision and regulation. No wonder this globalized behemoth stretches beyond the full comprehension of even the most sophisticated market participants.”(A. Greenspan, “*The Age of Turbulence: adventures in a new world*”, The Penguin Press, New York, 2007, p.489). This type of ideological positions clearly show how the US financial legislation evolved from Glass – Steagall Banking Act of 1933 (separating commercial from investment banking to avoid monetary & financial hyper-speculation) to Gramm – Leach – Bliley Act of 1999 (opening largely the doors for ‘sophisticated’ financial derivatives).

Traditionally the main instruments of the central banks’ monetary policy has consisted in (order of importance) refinancing/reference interest rates, open-market operations (OMO), reserve requirements. In the period of highly proclaimed ‘independence’ of the central banks – 1990s to early 2000s – the attention of various ‘monetary policy committees’ was focused on the so-called refinancing or reference interest rate(s). As long as the interest rate in the real and, consequently, in the nominal economy was significantly positive, the level of the ‘reference’ interest rate established/announced by a central bank could have an effective impact on nominal and, afterwards, on real economy (an increase ‘cooling’ the investment and consumption and a decrease acting as an incentive for economic growth). Once the medium and even longer term interest rates in the economy tended to 0%, the level of the reference interest rate has become ever less relevant for a central bank’s monetary policy. Both practice and theory show that a ‘guiding’ interest rate less than 1% could have only a quite marginal effect on nominal and, especially, real flows of an economy.

Figure 1 – The long-term decline in real interest rates ¹⁾



¹ Real rates are generated by subtracting realised PCE core inflation from nominal interest rates.

Source: National data.

Obviously we are referring mainly to *real* interest rates. However when inflation rate is declining towards very low levels and signs of deflation are identified in the economic evolution, the interest rate has a tendency to become *negative* (examples from 2015-2016: Japan, Sweden, Switzerland, Denmark).

This is a difficult and delicate turning point not only for the central bank's macroeconomic role, but also for the economy as a whole. An extremely low interest rate is 'transmitted' to the commercial banks which, instead of stimulating the saving and, consequently, the investment process, begin to punish the savers (!). Thus the rational connection between saving and investment has been broken. In this dramatic context, the so-called *unconventional monetary policies* have tried to counteract the notorious weakness of a minimal reference interest rate (including 0%) or even negative (which is, in fact, an economic aberration). This is why and how the 'unconventional' monetary policy has come into the picture of macroeconomic policies. It is known that open-market operations (OMO) have their origin in an *unconventional* monetary scheme used by USA Federal Reserve system toward the end of the 1930s and in the 1940s, in the specific conditions of the post-depression period. Similarities between the 1930s depression and the 'Great recession/crisis' (started in 2007/08) aroused again the interest for such unusual monetary policies.

Therefore central banks, in agreement with important international monetary institutions (E.g., IMF Staff Note, November 4, 2009), abandoned the 'orthodox' policy and adopted techniques of supplying cheap liquidity to monetary, banking and financial markets, in a rapidly increasing quantity. In fact, here one can identify the key element of the much debated *quantitative easing* (QE), the term quantitative referring to the growth of money supply and the proportions of central banks' balance sheet, exponentially amplifying assets and liabilities.

Being the first developed economy to witness stubborn stagnation and deflationary trends towards the end of the 1990s, the Bank of Japan already launched a 'QE' experiment in March 2001. By QE procedure, banks may accumulate considerable excess reserves in an attempt to act as an incentive for increasing the volume of credits to economic agents. However the duration, intensity and consequences of the crisis, recession and stagnation in most developed economies have pushed more and more central banks to adopt 'quantitative easing' scenarios. The US Federal Reserve system (Fed) started the QE experiment in November 2008, followed by other 'waves' (QE1- Nov.2008; QE2- Nov.2010; QE3- Dec.2012). The Bank of England joined this trend in March 2009. The European Central Bank (ECB) adopted the QE procedure since May 2009. Ever more central banks have embraced *unconventional monetary policies*, which in fact is a syntagm meant to blur the image of a grand failure of the neoliberal policies and neoclassical theory, reflecting and, at the same time, determining the deepening rupture between nominal and real facets of the socio-economic organism.

If 'normal' open-market operations represented an instrument to monitor money supply, when interest rates are too low (tending to the zero lower bound or even becoming negative), then the risk of a 'liquidity trap' is almost imminent. Consequently, the main component of the monetary policies has changed from an interest rate policy to the so-called *quantitative easing* which already passed through different phases: from tremendously amplifying buying & selling government bonds, *central banks begin to purchase other securities, such as corporate bonds and, recently, shares of stocks in the open market!* This is a serious blow both to the much proclaimed 'independence' of a central bank (let us remember the feverish campaign of the 1990s) and to the core of the neoclassical/neoliberal theories (Table 1 – BIS, Working Paper no. 570/2016).

Therefore quantitative easing has more 'qualitative' elements which send intense signs regarding the necessity of a *profound restructuring* of the economies presently dominated by transnational financial capital, *requiring a new paradigm* for economic theory. The grave rift between nominal/monetary and real economy has ever more blocked the normal flows between the vital centres of the functional & pragmatic triad (of the socio-economic organism) having a dangerous impact on the theoretical & methodological triad, both being determinant for any socio-economic activity of human society (L. C. Ionescu, "*Positive and normative approaches in the evolution of economic theory*", in *Journal of Euro and Competitiveness*, no. 3(7)/2016). Initially, about a decade ago, unconventional monetary policies (UMP) were regarded as measures of *force majeure*. In the meantime, it is obvious they tend to become a rather permanent component of monetary policy system, raising intricate questions on the role of central banks in developed market economies: (i) are these policies compatible with the much proclaimed principles of 'free market' functioning? (ii) do not central banks get too many 'emergency powers' over market economies and, ultimately, over society as a whole?

Table 1

A taxonomy of monetary policy implementation measures

Policy	Description	Examples
Interest rate policy	Setting the policy rate and influencing expectations about its future path	
Forward guidance on interest rates	Communication about the future policy rate path	The central bank "expects the key [...] interest rates to remain at present or lower levels for an extended period" ²
Negative interest rates	Setting the policy rate below zero	Negative deposit interest rate at the ECB and at the BOJ ^{4,5}
Balance sheet policies	Adjusting the size/composition of the central bank balance sheet and influencing expectations about its future path to influence financial conditions beyond the policy rate	
Exchange rate policy	Interventions in the foreign exchange market	
Quasi-debt management policy	Operations that target the market for public sector debt	Purchases of government debt
Credit policy	Operations that target private debt and securities markets (including banks)	Modifying the discount window facility Adjusting the maturity/collateral/counterparties for central bank operations Commercial paper, ABS and corporate bond funding/purchase
Bank reserves policy	Operations that target bank reserves	The central bank conducts "money market operations so that the monetary base will increase at an annual pace of about 60-70 trillion yen" ¹
Forward guidance on the balance sheet	Communication about the future balance sheet path (composition/size)	"The [BOJ] will purchase JGBs so that their amount outstanding will increase at an annual pace of about 50 trillion yen... as long as it is necessary for maintaining [the 2% price stability] target in a stable manner" ³

¹ Bank of Japan, 4 April 2013, http://www.boj.or.jp/en/announcements/release_2013/k130404a.pdf. ² ECB, 4 July 2013, <https://www.ecb.europa.eu/press/pressconf/2013/html/iss130704.en.html>. ³ Bank of Japan, *ibid.* ⁴ Starting on 5 June 2014, https://www.ecb.europa.eu/press/pr/date/2014/html/pr140605_3.en.html. ⁵ Starting on 29 January 2016, http://www.boj.or.jp/en/announcements/release_2016/k160129a.pdf.

2. The quite modest results obtained by UMP experiments (stagnation, deflationary trends, low level of investments, high unemployment) have begun to provoke disappointment and a critical attitude from specialists, but also from public opinion. Martin Feldstein – President Emeritus of the National Bureau of Economic Research (USA) – bluntly declared: "What is now clear... is that unconventional monetary policy and extremely low interest rates have also major financial risks that could hurt the European and US economies in the years ahead, (...) potentially setting the stage for another asset price collapse." (*"The Fed Unconventional Monetary Policy – Why danger lies ahead"*, in *Foreign Affairs*, May/June 2016 issue). By QE schemes, central banks in Northern

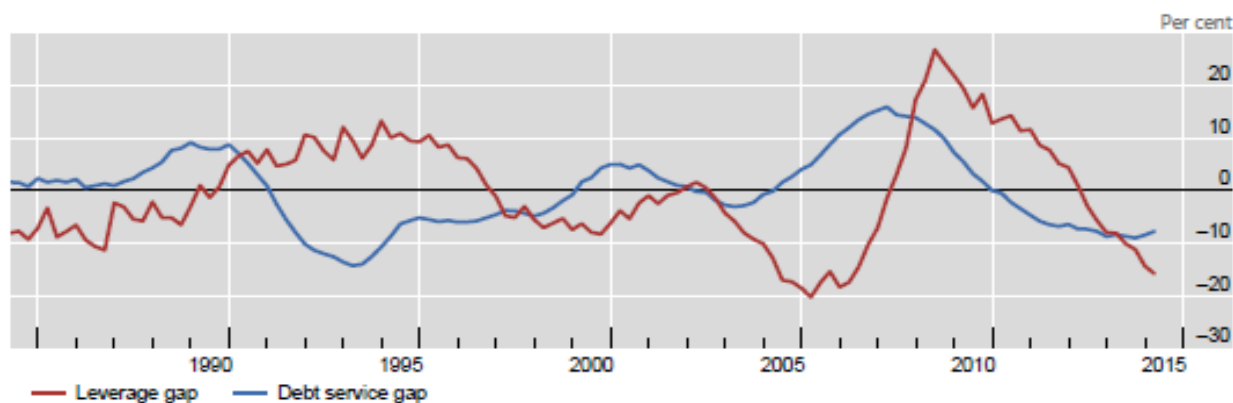
America and Western Europe have accumulated assets which are worth trillions of USD and/or EUR. Such a massive intervention in the financial market mechanism could have contradictory effects: in the short run, it may alleviate some painful post-crisis symptoms (acting as a sort of morphine), but in the long run, unless it is based on a profound restructuring of real economy, it would contribute to mispricing assets, including equities and mortgage-backed securities and real assets such as housing.

As M. Feldstein has underlined, “there is no doubt that unconventional monetary policy has increased the risk of such systemic instability. (...) Despite the close link between quantitative easing and financial instability, the Fed continues to downplay the connection. (...) In both Europe and the US ... macroprudential policy has done little to mitigate the growing risk of financial instability that unconventional monetary policy has caused.”(idem) Therefore, not only the ‘Great Recession/crisis’, but also its aftermath keep conforming H. P. Minsky’s theory and concept of *financial fragility* as inherent to a market economy, especially when dominated by financial capital, based on monopolistic and oligopolistic structures. Moreover, Minsky also draw the attention on the tandem *debt – deflation* (H.P. Minsky, “*Stabilizing an Unstable Economy*”, McGraw-Hill, 1986 (first edition), especially chapters 8 & 9) as a very dangerous circumstance for long stagnant economic environment. The overwhelming dimensions of debt – both public and private in 1990s & 2000s – obviously represented an important prerequisite for the present *malaise* in the world economy (L.C. Ionescu , “*The economy of Indebtedness*”, in *Journal of Financial and Monetary Economics*, no.1/2014, ISSN & ISSN L 2392 – 9685). For example, between mid-1980s and the eve of the financial crisis (2007/08), household debt rose from under 70% to almost 120% of the household income in the USA and from 90% to about 140% in the UK.

The huge size of debts constrained governments to adopt restrictive fiscal policies or austerity programmes aiming to reduce public budget deficits, while the private debt weakened

the investment incentive, postponed inter-firm payments and diminished inter-bank transactions (Graph 2 - BIS, WP no.569.

Figure 2 – Evolution of the leverage and debt service gaps



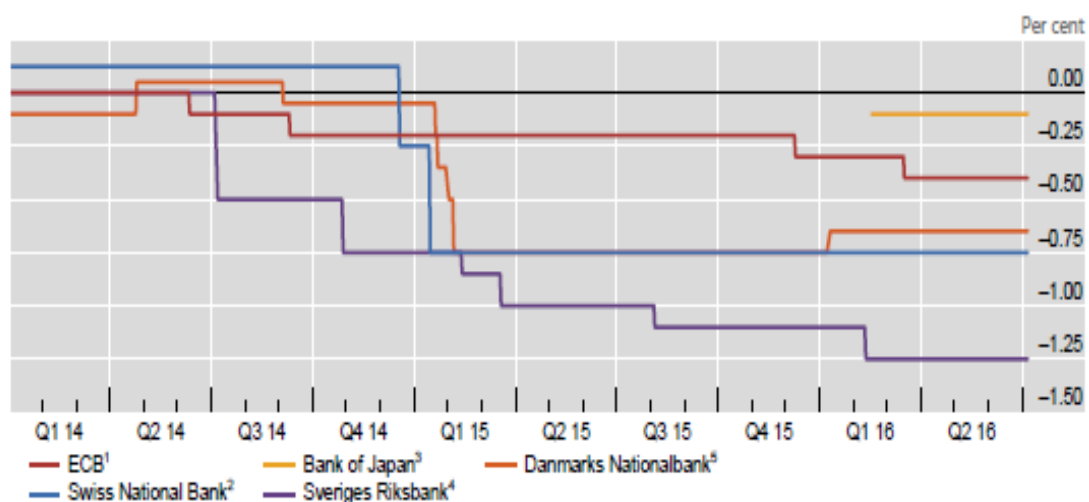
Source: Authors' calculations.

In this peculiar climate, only the central banks have seemed to be able to furnish the necessary liquidity to the economy (firms, banks, households). However, to use Mervyn King' phrasing, this has been ‘alchemy’ of monetary flows via money supply, which may be a temporary alleviation of real economy hardships, but in the long run cannot offer an effective solution for the multiple disequilibria accumulated world-wide.

Although he was the governor of the Bank of England for a decade (2003-2013), M. King has considered that “the fragility of our financial system stems directly from the fact that banks are the main source of money creation; ... most importantly of all, how we can end the alchemy of our present system of money and banking.”(M. King, “*The End of Alchemy – money, banking and the future of the global economy*”, Little, Brown / W.N. Norton, 2016, p.8). In this context, M. King has a justified radical vision: stagnation has again become “synonymous with capitalism”, so that is needed “an intellectual revolution”. In this way, he approaches the core of the present international turbulence: the origin of the 2007/09 crisis has represented a serious “failure of the conception that underpins current economic and financial policymaking”.(ibidem)

Starting from King's explanation, there can be identified one of the main contradictions of the present-day monetary policies: the level of reference interest rates is no longer able to stimulate demand and growth in the short run and it is too low to determine a proper balance between saving and spending or productive investment in the longer term (Graph 3 - BIS, WP no. 570).

Figure 3 – Central bank deposit rates sink into negative territory



¹ Rate on the ECB deposit facility. ² Interest rate charged by the Swiss National Bank on sight deposits. ³ Interest rate on the third tier of excess reserves held at the Bank of Japan. ⁴ Rate of interest banks receive when they deposit funds at the Riksbank. ⁵ Rate on one-week certificates of deposit.

Sources: Bloomberg; Datastream.

In such circumstances, there persists a structural disequilibrium between saving and investment which ignites a misallocation of capital to speculative purposes. Consequently, the burst of the 2007/09 crisis “was not the fault of particular individuals or policies. Rather, it was our collective failure to manage the relationship between finance – the structure of money and banking – and a capitalist system.” (M. King, *The End of Alchemy – money, banking and the future of the global economy*, Little, Brown / W.N. Norton, 2016, p.16).

An edifying example of the misleading nature of the neoliberal deregulation offensive during the 1980s – 1990s consists in the striking difference between its pretended objective and the effective consequences of that campaign: the ‘Big Bang’ of 1986 in UK and the Bleach-Gramm-Bliley Act of 1999 in USA (eliminating the reminiscence of the Glass-Steagall Banking Act of 1933), to mention only the most important legislative changes. Presented by the neoliberal propaganda as efficient measures to enhance competition in the financial sector, in time, it has become obvious that the ‘deregulation and liberalization’ process mainly led to a new gigantic wave of mergers and acquisitions, including takeovers of stockbroking firms and mergers between commercial banks and securities companies. The assets of the big international banks doubled in early 2000s. At the same time, the rapid extension of the interbank trade with ever more sophisticated financial products (mainly complicated ‘derivatives’) determined a higher interdependence among the actors of the financial markets, thus dangerously increasing and internationally spreading a wide range of risks in most financial markets.

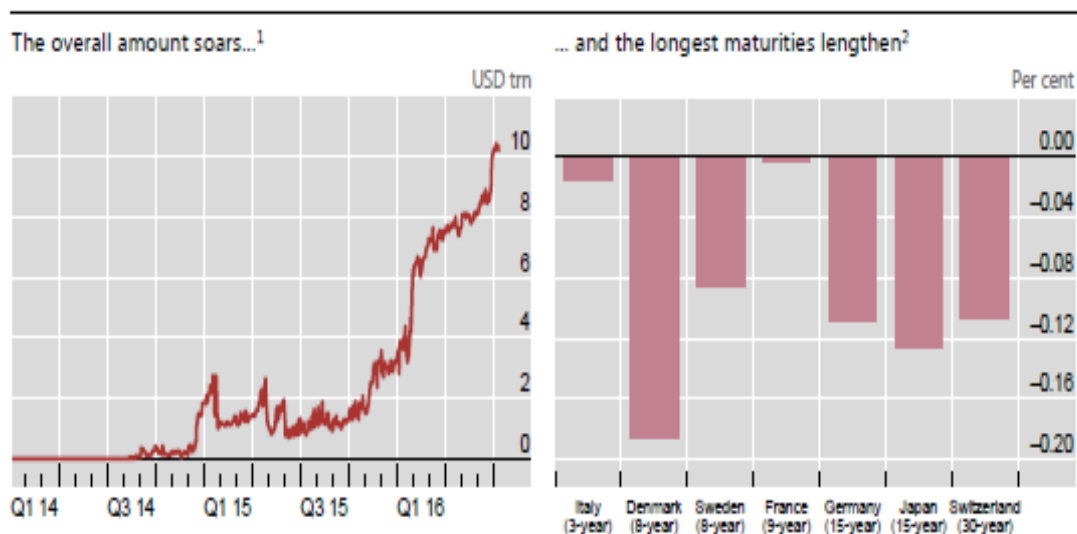
Moreover, after the ‘liberalization’ and ‘deregulation’, many important banks relied less and less on their own resources, preferring more and more borrowing. Leverage has increased dramatically: “With a leverage ratio of even 25%, it would take a fall of only 4% in the average value of bank’s assets to wipe out the whole of the shareholders’ equity and leave it unable to service its debts.” (M. King, *The End of Alchemy – money, banking and the future of the global economy*, Little, Brown / W.N. Norton, 2016, p.24). There lies a major cause for the resounding failure of the much debated and proclaimed ‘Basel II’ accord. Its ‘final’ form was released in mid-2004 and had to be gradually implemented until 2008. But as a historic irony, the provisions of the Basel II did not prevent “the Great Recession/Crisis”; on the contrary, its procyclical nature even worsened the impact of the financial turbulences.

Trying ‘to learn from the bitter lessons’ of the crisis, the Basel Committee on Banking and Regulation published a first form of a ‘Basel III’ accord in the fall of 2010: “...The Basel III accord is the most recent revision to international capital standards for banks. ...The main focus of the changes in Basel III is to increase banks’ equity capital requirements. This emphasis is a reflection of the conclusions drawn from the crisis; that bank fragility is more prevalent than previously thought and the motivation for governments to assist banks in poor financial condition is very strong during a crisis.”(*The Basel Committee’s response to the financial crisis: report to the G 20, Bank for International Settlements, October 2010 and “Economic Brief”, June 2011*) As the Basel II provisions represented ‘too little and too late’ to have a meaningful importance, it is also doubtful that a Basel III accord would really contribute to solving an extremely intricate situation facing the international banking system: the historical replacement of the *intermediation of loanable funds*, specific to the ‘traditional’ bank functioning, by the *financing through money creation*, more and more characteristic for the present-day banking system, when “there are no loanable funds of real resources that bankers can collect and then lend out.”(*M. Kumhof and Z. Jakab, “The Truth about Banks”, in Finance and Development, March 2016, p. 51*) (Graph 4 - BIS, WP no. 570).

For a better understanding and to illustrate the facts and opinions previously presented and analysed, there follows a concise ‘case study’ based on the *minutes of the Monetary Policy Committee* of the Bank of England (Mark Carney – Governor). We have considered that the relevance of the decisions taken, in August 2016, has been enhanced by the fact it was a meeting that took place *after* the UK vote to leave the European Union, therefore mixing the trends in the EU with those in the USA: “The Bank of England’s Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending 3 August 2016, the MPC voted for a package of measures designated to provide additional support to growth and to achieve a sustainable return of inflation to the target.”(*Bank of England, Inflation Report, August 2016, p.i.*)

The ‘package of measures’ consists of: (a) 25 basis point cut in the Bank Rate (from 0.5% to 0.25%); (b) another Term Funding Scheme (TFS) to strengthen the pass-through of the cut in Bank Rate; (c) the purchase of up to GBP 10 billion of UK corporate bonds; (d) an expansion of the asset purchase scheme for UK government bonds of GBP 60 billion, raising the total stock of these asset purchases to GBP 465 billion (!). The fact that *central banking* has entered a ‘new era’ of monetary policy is underlined – inter alia – by the way the last three decisions would be financed: through the *issuance of central bank reserves*. This procedure would have been almost inconceivable a few decades ago.

Figure 4 – Government bonds trade at negative yields



¹ Analysis based on the constituents of the Bank of America Merrill Lynch World Sovereign index as of February 2016. ² Yield per maturity, Bloomberg generic yields, prevailing on 6 July 2016.

Sources: Bank of America Merrill Lynch; Bloomberg; BIS calculations.

As regards the first mentioned measure, a 0.25 percentage point reduction of the reference central bank rate is highly improbable to have an effective impact on real economy. Its main meaning seems to be an 'orientation signal' for monetary and financial markets, announcing the central bank intention to continue its efforts for counteracting deflationary tendencies. In fact, in the minutes of the MPC was evoked the possibility of another cut of 0.1% until the end of the year. It seems to be more a game of 'esoteric' financial terminology than a pragmatic approach of the problems confronting real economy. MPC itself recognizes this confusing situation. 'Normally' the cut in the Bank Rate should lower borrowing costs for businesses and households: "However, as interest rates are close to zero, it is likely to be difficult for... banks and building societies to reduce deposit rates much further, which in turn might limit their ability to cut lending terms..."(idem)

Being aware of this obvious risk, the MPC has launched a TFS (see above), providing funds for banks at rates rather similar to the Bank Rate (0.25%). That would be an attempt to transform QE in *credit easing* for the benefit of firms and, potentially, households. This would be an *indirect* way to stimulate *real economy*. Unfortunately but explicably, quasi-similar initiatives of monetary policy taken after 2009 did not have the anticipated beneficial effects either in the USA or in EU economies, except for a slight alleviation of the crisis impact.

In our view, it is ever more obvious that only a *direct* approach of the real economy problems could have palpable results. Some minor steps have been made: from indexed long-term repo actions, funding for banks and purchase of government bonds to the purchase of corporate bonds, hoping that the money received would be invested in other corporate assets. Nevertheless, real economy and households are not yet benefitting from these QE schemes. For example, small and medium sized enterprises (SMEs) seem to be neglected, despite their 'natural' propensity to productive investment. Another serious brake for the efficiency of the QE programmes is the continuous deepening of social inequality. Helping the rich to become richer cannot contribute to solve the grave social and economic problems, but will amplify speculative capital movements – nationally, internationally, globally.

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