Central Banking and Monetary Policy in the G20

Paradigms and Challenges

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Abbreviations

A

AI: artificial intelligence
ALF: alternative liquidity facility
API: application programming interface
APP: asset purchase program
AQR: asset quality review
ARDL: autoregressive distributed lag
ARFIMA: autoregressive fractional integrated moving average
ARMs: adjustable-rate mortgages
ARRA: American Recovery and Reinvestment Act

B

BAT: Banks Association of Turkey
BCB: Banco Central do Brasil
BCRA: Banco Central de la República Argentina
BdF: Banque de France
BdI: Banca d'Italia
BdM: Banco de Mexico
BI: Bank Indonesia
BİST: Borsa Istanbul (İstanbul Stock Market)
BoE: Bank of England
BoJ: Bank of Japan
BoC: Bank of Canada
BoR: Bank of Russia
BRICS: Brazil, Russia, India, China, South Africa
BRL: Brazilian Real
BRSA: Banking Regulation and Supervision Agency
BU: banking union

C

CAD: Canadian Dollar
CADF*: cross-sectional* augmented Dickey Fuller
CBA: Central Bank of Argentina
CBDC: central bank digital currency
CBs: central banks
CBRT: Central Bank of the Republic of Turkey
CCS: carbon capture and storage; cross-currency swaps
CDC: central deposit certificates
CDOs: collateralized debt obligations
CDS: credit default swap
CEPA: closer economic partnership arrangement
CLS: continuous linked settlement
CMB: Capital Markets Board (of Turkey)
CNY: Chinese Yuan (Renminbi)
CRFPI: climate-related financial policy index
CRST: climate-related stress testing
CSPP: corporate sector purchase program

D

DBB: Deutsche Bundesbank
DCR: differentiated capital requirements
DLT: distributed ledger technology

E

EAPs: economic adjustment programs
EBU: European Banking Union
EC: European Commission
ECB: European Central Bank
EDIS: European deposit insurance scheme
EDS: external debt stock
EEC: European Economic Community
EFSF: European Financial Stability Facility
ELA: emergency liquidity assistance
EMDCs: emerging markets and developing countries
EMI: European Monetary Institute
EMU: European Economic and Monetary Union; European Monetary Union
EMS: European monetary system
EONIA: European overnight interest average
ERM: Exchange rate mechanism
ESCB: European system of central banks
ESG: environmental, social and governance
ESM: European stability mechanism
ETFs: exchange-traded funds
EU: European Union
EVs: electric vehicles

F

FBF: Fédération bancaire Francaise
FDI: foreign direct investment
FED: Federal Reserve Bank
FGDR: Fichiers des guichets domiciliataires
FII: Foreign institutional investor
FIT: Financial instability theory
Fintech: financial technology
FOMC: Federal Open Market Committee
FSC: Financial Stability Committee
FSDC: financial stability and development committee
FX: foreign exchange (forex)

G

G7: group of seven
G20: group of twenty
GAR: green asset ratio
GBP: Great Britain Pound
GDP: gross domestic product
GFC: global financial crisis
GFC: Greek financial crisis
G-M-G: goods-money-goods
GNP: gross national product

H

HE: Hanguk Eunhaeng (S. Korean Central bank)
HICP: harmonized index of consumer prices
HKMA: Hong Kong Monetary Authority
HQLA: high-quality liquid assets

I

IBF: Islamic banking and finance
ICR: internal credit rating
IES: Islamic economic system
IISD: International Institute for Sustainable Development
IME: Islamic monetary economics
IMF: International Monetary fund
INR: national currency Rupee

INSPIRE: international network for sustainable financial policy insights, research and exchange
IPBES: intergovernmental science-policy platform on biodiversity and ecosystem services
IPCC: intergovernmental panel on climate change
IPE: international political economy
IPE: Islamic political economy
IRS: interest rate swap
ITL: Italian lira

J

JPY: Japanese Yen

K

KIC: Korea investment corporation
KYC - know your competitor

L

LEED: leadership in energy and environmental design
LER: large exposure restrictions
LPP: loan pledged program
LPR: loan prime rate
LTI: loan-to-income
LTROs: long-term refinancing operations
LTV: loan-to-value

M

m: million
MB: monetary board
MLF: medium-term lending facility
MOC: market operation committee
MoU: memoranda of understanding
MPSC: monetary policy sub-committee
MROs: Main Refinancing Operations

N

NAFTA: North America Free Trade Agreement
NCBs: national central banks
NDFs: non-deliverable forwards
NDOs: non-deliverable options
NFCs: US national finance centres
NFT: non-fungible token
NGFS: network for greening the financial system - Network for greening the finance system
NICs: newly industrialized countries

O

ODI: outbound direct investment
OECD: Organisation for Economic Co-Operation and Development
OII: overseas institutional investor
OMOs: open market operations
OMT: outright monetary transactions

P

PBoC: People’s Bank of China
PLS: profit and loss sharing
PSI: private sector involvement
PSL: pledged supplementary lending
PSPP: public sector purchase program

Q

QDII: qualified domestic institutional investor
QE: quant easing

R

R&D: research and development
RBA: Reserve Bank of Australia
RBoE-ALFL): Bank of England Alternative Liquidity Facility Ltd.
RBoI: Reserve Bank of India
REITs: real estate investment trusts
RMB: Renminbi
RQFII: RMB qualified foreign institutional investor
RRR: required reserve ratio
RUB: Russian Ruble

S

SAMA: Saudi Arabian Monetary Authority
SAFE: state administration of foreign exchange
SAR: Saudi riyal
SARB: South African Reserve Bank
SBFN: sustainable banking and finance network
SDR: special drawing right
SDDS: special data dissemination standard
SFTZ: Shanghai free trade zone
SIC: Singapore investment corporation
SLF: standing lending facility
SMP: securities market program
SNB: Swiss National Bank
SRF: single resolution fund
SRM: single resolution mechanism
SSCBs: standing swap line central banks
SSM: single supervision mechanism

T

TARP: Troubled Asset Relief program
TCFD: task force on climate-related financial disclosures
TCFR: TCF risks
TCMB: Türkiye Cumhuriyet Merkez Bankası
TEU: treaty on EU
TFEU: treaty on the functioning of the EU
TMLF: targeted MLF
TN: trillion
TPP: third-party service provider
TRY (TL): Turkish Lira

U

UK: United Kingdom
UN: United Nations
US(A): United States (of America)
USD: US Dollar

Acknowledgements and Remembrance

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There is no need to state that the language, expression, citation, plagiarism, etc., responsibilities of each chapter contained herein belong to the authors of that chapter. As authors, editor and publisher, we hope that the Book will be useful to all readers and inspire economics researchers interested in monetary-banking issues.

Please allow me to share with you a memory of mass suffering: While I was continuing the preparations for this book, we experienced a devastating twin earthquakes of 7.7 magnitude on February 6, 2023, in the Turkey's Eastern and Southern regions, including Malatya, the city where I live. Our social psychology and working lives have been turned upside down. Our national universities had to switch to online education for another semester after the global Covid-19 crisis. If the publication process of our book was delayed, it was partly because of this. I consider it my duty to commemorate nearly sixty thousand of my citizens who lost their lives in this "disaster of the century" that badly affected 11 of our cities at the same time, and to thank the aid provided at home and abroad.

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İrfan Kalaycı

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Preface

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The Future of Central Banking and Monetary Policy in a Post-Pandemic World

Central banks have come under considerable scrutiny and criticism post-pandemic. Indeed, with inflation rising to levels not seen in four decades, central banks fell back on the only idea they knew: using interest rates to bring inflation back down to the 2% target, despite the fact there is no empirical support for this target. Indeed, as Benjamin Friedman, from Harvard University – a long-time critic of inflation targeting – once wrote, if central banks focus on an inflation target, "concern for real outcomes will atrophy, or even disappear from policy makers' consideration altogether".[1] More recently, he sharpened his criticism, stating, "there is the arbitrariness surrounding the current 2 percent target. In retrospect, the paucity of serious empirical research underlying the identification of the 2 percent norm, now quite some time back is a professional embarrassment".[2] All this, of course, seems to be of no concern to central bankers.

And so far, central bank policy has been one of the fastest, boldest monetary austerity policies today. Indeed, interest rates have risen the fastest and the highest in decades relative to other inflationary periods – at levels not seen in twenty years. So, in every way, the post-pandemic era is completely different than anything in the last 40 years, during which time a generation of households got accustomed to low levels of both inflation and interest rates, the latter set at near zero.

While output, at least in the United States, does not seem to be affected by the aggressive nature of monetary austerity – indeed growing at 4.9% – it is perhaps a simple question of time before the US economy slows down. Such high growth rates, not seen again in decades, may prove unsustainable.

By the central banks' own admission, the transmission mechanism of these changes in interest rates should be felt some 18 months after the first increase.

[1] Benjamin M. Friedman, "Why the Federal Reserve Should not Adopt Inflation Targeting", *International Finance* 7, 1 (2004): 135.

[2] Benjamin M. Friedman, "The Future of Central Banking," in *The Future of Central Banking: Festschrift in Honour of Vítor Constâncio*, (European Central Bank, 2018), 187.

Since March 2022 until now, there have been eleven increases in the US, and being at the 18-month mark now (November, 2023), we may still yet start feeling the consequences of monetary policy. Indeed, much research shows that while aggregate demand may not react to incremental changes in interest rates, it will eventually react to the cumulative effect of, say, eleven increases. So, the worst, as they say, may still be yet to come.

All of this, of course, must not be surprising. After all, monetary austerity is embedded in New Consensus models by relying precisely on central banks' ability to slow economic activity in the Holy Grail pursuit of a soft landing. In my opening, however, soft landings are virtually impossible to attain. Interest rates are a blunt instrument and it is usually always the same story: too much, too late. Indeed, in his analysis of monetary austerity, David MacDonald concludes that when trying to bring down inflation from such heights, central banks rarely succeed in engineering soft landings.[3]

The story of monetary austerity, however, is flawed from the very start. Underlying the transmission mechanism are a few simple ideas. First, inflation is a monetary phenomenon – or monetary policy phenomenon – and only interest rates can cure it. For this reason, as Abraham Maslow –of the famous Maslow pyramid of needs – has said, "If the only tool you have is a hammer, you tend to see every problem as a nail." In this context, central banks see inflation as being demand-led, and while they do recognize oil and bottlenecks as having played a role (and some even recognize seller's inflation), their rhetoric is all about deflating economic activity – and creating unemployment in the process. There is no discussion of other possible tools, like fiscal policy, to fight inflation.

But what happens if inflation is not the result of demand forces? Recent studies show that demand accounts for only about 25% of overall *post-pandemic*, inflation,[4] while the rest would be attributed to supply-side considerations. In this case, what, then should be the appropriate role of monetary policy?

Second, the transmission mechanism of monetary policy depends on a well-behaved Phillips curve. But the rising consensus seems to be that the Phillips curve has flattened considerably. If this is the case, monetary policy loses its effectiveness. I recognize that some post-pandemic research indicates that this

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[3] David MacDonald, "Canada's Fight Against Inflation: Bank of Cada Could Induce a Recession," *Canadian Centre for Policy Alternatives, The Monitor* (2022).

[4] Andrea Cerrato and Giulia Gitti, "Inflation Since COVID: Demand or Supply", VOX CEPR, June 12, 2023. https://cepr.org/voxeu/columns/inflation-covid-demand-or-supply

curve has steepened, so there needs to be more research on this important issue.

The overall conclusion is that there needs to be considerable new research on central banking. We cannot rely on outdated assumptions about what monetary policy is and what it does. Everything is an empirical question, and in light of this, policy needs to reflect current research. In other words, as Keynes reminds us, we need a 'vigilant observation' of the world in which we live.

In light of this, the contributions in this book are timely and appropriate. The authors poke and prod the issue of central banking in a post-pandemic world. We need to expand the scope of research, and we must investigate more venues. What about income and wealth distribution? Or the Environment? How about gender issues?

The study of central banking and monetary policy indeed is not done. Despite the popularity of these so-called New Consensus models, there seems to be a lack of consensus post-pandemic. This book contributes to the valuable analysis that is so much required.

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INTRODUCTION

Chapter 1

Central Banking and Monetary Policy in the G20: An Introduction

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Abstract

The Group of Twenty (G20) is a political economy formation that brings together the twenty largest economies in the world according to gross national product. Consisting of 19 countries (namely; Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom and the United States) and the European Union, the G20 largely direct and shape global production, trade and finance. There is a need to know the central banks that are behind such a powerful formation. As such, the strategic role of these banks and the effects of their monetary policy practices cannot be denied. This duo is in a dynamic position of lock and key for each other. In this chapter, each of the twenty central banks and their monetary policies are introduced. Thus, all components of the big picture were tried to be shown together. Many central banks within the G20, such as the Fed and the Bundesbank, are famous for their independence and have the power to challenge (or affect) the global economy. The common feature of all of them is to contribute to the sustainability of price and financial stability despite possible global financial crises. In the conclusion, it is suggested that, as a new paradigm (or an alternative), central banks, which have been very helpful to governments in the execution of orthodoxy stabilization programs, should now fight against the actual cost of living as well as inflation and focus on equitable income distribution in a heterodoxy policy scheme.

Keywords: G20, Central Banks, Monetary Policies, Challenges, Paradigms

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Theme: Key and Lock

To engage the readers right from the beginning of this chapter, I need to craft a thought-provoking and engaging opening. Considering that goal, I pose the following question: "*Did money give birth to the central bank, or did the central bank give birth to money?*" Through a reverse logic lens, I lean towards the former being more plausible, yet the latter might hold its own validity. This proposition resembles the perplexing yet intriguing puzzle of "*the chicken or the egg,*" which not only captivates but also holds relevance to the theme of our book. Central banking and monetary policy are intertwined concepts that exist in symbiosis. Where central banking thrives, discussions on monetary policy arise, and vice versa. These parallel subjects, rather than being distinct and unrelated, are interconnected. It is this very interplay between central banking and monetary policy that has garnered significant attention from researchers and experts, leading to numerous studies and publications. Therefore, in this chapter, we undertake an examination of this dynamic duo from the perspective of the Group of Twenty (G20), recognizing its importance and relevance.

Apart from the traditional functions of money as a means of exchange, calculation, and savings, its modern function as a challenging economic policy tool since Keynes paved the way for the mutual key-lock relationship and, of course, the interaction between central banking and monetary policy that has existed for a long time.

Money and the central bank are each an invention in themselves. There is a general opinion that the inventors of the first coin were the Lydians, who lived in the Aegean region of Turkey thousands of years ago, and that the first modern central bank originated in England, after Sweden. By a historical coincidence, the homelands of these two inventions, Turkey and England, are in the G20, called the Group of Twenty.[1] Indeed, the first Central bank (otherwise known as a reserve bank or monetary authority) was the Bank of Sweden in 1668, followed by the Bank of England and others in 1694. The basic duties and powers of central banks are to print banknotes and put them on the market, to ensure monetary and price stability, to be the last institution that lends money to banks, to keep the foreign exchange reserves of the state, to provide financial consultancy to the treasury, etc. Due to their many duties and powers, it is not a coincidence that they are often the first institutions to be criticized when an economic crisis occurs due to inflation, deflation or stagflation. These criticisms

[1] Deutsche Bundesbank, "The 'Invention' of the Coin – Who, When, Where and Why?" (September 2023), https://www.bundesbank.de/resource/blob/616754/1ae3f2eaadc1dab9a311d4492ff03388/mL/the-invention-of-the-coin-data.pdf.; Britannica, "A Brief (and Fascinating) History of Money," https://www.britannica.com/story/a-brief-and-fascinating-history-of-money; Sveriges Riskbank, "History," https://www.riksbank.se/en-gb/about-the-riksbank/history/#:~:text=In%201668%2C%20the%20Riksdag%2C%20Sweden's,the%20world's%20oldest %20central%20bank.

begin to be made at the global level when the crisis breaks out in major economies such as the G20.

G20, which includes the largest economies by world gross domestic product (GDP), is an intergovernmental forum consisting of 19 countries (in alphabetical order, Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States) and the integration of the European Union. Apart from Spain and the Netherlands, some other countries are also represented in the G20 through the African Union. G20 is a strategic economic group and multilateral platform connecting developed and developing economies. As the leading forum for international economic cooperation, the G20, which has a say in shaping and strengthening the global capitalist architecture and governance on all important international economic issues, has an important role in preserving the current free market ideology and ensuring future global economic growth, prosperity and stability.

G20 members represent approximately 85% of world GDP, more than 75% of international trade and 2/3 of the world's population. G20, which started as a meeting attended by finance ministers and central bank governors in 1999 following the 1997-98 Asian financial crisis, has turned into a summit attended by Heads of State and Government every year and has hosted working groups and organized special events throughout the year with various guest states and international organizations.[2]

G20 economies are composed of half the global production and do not act as a single bloc. The members are already politically and economically divided into various blocs or are representative within those blocs. EU, OECD, NAFTA, and Shanghai Cooperation Organisation (SCO) are the most popular blocs. The common features of the countries in the BRICS, MIST and/or MINT groups,[3] which have recently attracted the intense attention of diplomacy, multinational companies, global capital and the academic world, are that they are partially included in the G20 and have high growth potential within the scope of emerging markets. Although central banks in the G20 are based on the universal principles of monetary policy, they generally use monetary instruments at the national or local level in practice. At first glance, this may suggest that each country's central bank is autonomous vis-à-vis another, but it does not change the fact that they interact when it comes to controlling international capital movements. For example, when the US Federal Reserve Bank (Fed) takes a step towards monetary tightening or increasing interest rates to reduce its domestic

[2] G20 Members, (September 2023), https://www.g20.org/en/about-g20/#members.

[3] *BRICS:* Brazil, Russia, India, China, S. Africa. *MIST:* Mexico, Indonesia, S. Korea, Turkey. *MINT:* Mexico, Indonesia, Nigeria and Turkey.

inflation, other G20 central banks may take a new step and take a position against this step. A monetary step taken by the European Central Bank (ECB) or the Bank of Japan (BoJ) may also provoke the Fed to take a new position, and this interaction. The national currencies of some G20 economies, like Argentina and Turkey, which experience dollarization and euroization, are quite weak, resulting in their limited influence on the monetary policies of the Fed and the ECB.

Central banks in the G20 use monetary policies following the aims and tools of conventional and modern central banking. Most of these central banks have political, economic and legal independence. Thanks to the independence of goals and means, they fight inflation or deflation more easily and quickly. In addition to protecting the value of money and price stability, they can also have a say with the government on combating global warming, optimal growth, single-digit unemployment and fiscal discipline. This paradigm change, which seems to be in favour of central banks, also reinforces their challenge to global crises. This observation does not change the fact that when a financial crisis breaks out in the G20, especially the USA, Europe, China and Russia, they are the first to unsettle their central banks and become subject to criticism.

It has been observed that not only the central banks and governments but also the economists of countries like Turkey and Argentina, which are both part of the G20 and experiencing high inflation, face uneasiness and criticism regarding their professional reputation. After all, in the eyes of society, the monetary policymaker, the central bank, the political power, the government, and the academic economists who teach the methods of struggle have all been defeated by the inflation they know best. For now, if inflation is still causing pain, it might be because the lock and key were not properly matched or the wrong key was used in the right lock. However, sooner or later, regardless of how high inflation rises, it will eventually fall from its peak. This is similar to how no plane stays in the air indefinitely; even if it is delayed or crashes, it will ultimately land.

Especially since the 1990s, central banks have focused all their attention and efforts on monetary and price stability, and this stability goal has become - in Mishkin's words - a "mantra" (sacred word) for them.[4] However, if central banks, as monetary policy authorities, do not deal with output fluctuations in the context of production and employment, the possibility of being characterized as "*inflation crazy*"[5] - in King's words - becomes stronger. Although central banks

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[4] Frederic S. Mishkin, *Para Politikası Stratejisi*, çev. Ö. F. Çolak ve A. Zengin (Ankara: Efil Yayınevi, 2014), 78.

[5] Mervyn A. King, "How Should Central Banks Reduce Inflation? - Conceptual Issues," *Economic Review, Federal Reserve Bank of Kansas City* 81, no. Q IV (1996): 25-52, https://www.kansascityfed.org/Jackson %20 Hole/documents/6767/King_JH96.PDF.

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