Which Vested Interests Do Central Banks Really Serve? 
Understanding Central Bank Policy Since the Global Financial Crisis

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Abstract: Inspired by Thorstein Veblen’s ideas, I analyze the behavior of central banks from the perspective of how institutions are captured by vested interests. Since the global financial crisis in 2008, there has been a shift in the conduct of monetary policy. Much like the behavior of asset holders themselves, who, in times of crisis, sought to trade off lower returns with more stable asset values, monetary policy changed from a de facto policy of stabilizing rentier income to one of preserving asset prices or rentier wealth. I analyze this particularly through the lenses of what happened with quantitative easing (QE) in the US, which coincided with a collapse of real interest rates, while asset prices were stabilized. This can also be seen in the way the banking sector was supported by QE where the market for mortgage-backed securities was sustained even as it actually meant a lower profitability for the overall U.S. banking sector during the QE interventions.

Keywords: bank profitability, central banks, monetary policy, quantitative easing, vested interests

JEL Classification Codes: E0, E4, E5

There’s an old saying that in difficult times the return of capital takes precedence over the return on capital.
— Lord J.L.-B.H. Rothschild (2016, 3)

In his Vested Interests and the Common Man, Thorstein Veblen (1919) wrote about the behavior of the wealthy class of financial-asset holders in a modern monetary economy, whose interests stood in stark contrast to those of the “common men.” Veblen emphasized that these asset holders were preoccupied with the capitalized
value of what was deemed to be a “permanent source of free income” (1919, 111), and argued that these rentiers constituted “the vested interest ... who derive an income from the established order of ownership and privilege ... [and who essentially held] a prescriptive right to get something for nothing” (Veblen 1919, 162). Today’s asset holders — namely, typical investors behind various leading investment trusts or banks of the early twenty-first century — represent those same vested interests, whose behavior both Veblen and John Maynard Keynes criticised. However, at the time, Veblen (1919) did not take much heed of the precise institutional role that central banks could play in serving those vested interests.

I seek to describe how central banks have served primarily these same owners of intangible assets, particularly since the global financial crisis of 2008. Veblen would probably have been very comfortable with an analysis based on the “contested terrain” framework found in the works, for instance, of Gerald Epstein (2015) and Edwin Dickens (2013), in which public institutions are captured by representatives of social classes in order to promote particular interests. Indeed, it may be argued that, as much as important rentier asset managers have shifted their concern from primarily targeting high returns to preserving asset values for their owners, the same can be said of monetary policy before and after the global financial crisis. The capture of monetary policy by these financial interests already began in the 1970s, when the primary objective of central banks became to combat inflation by supporting rentier income (Seccareccia and Lavoie 2016). This became institutionally established as these inflation-targeting monetary policy regimes took shape during the early 1990s. However, after 2008, while not officially abandoning inflation targeting, the focus of monetary policy abruptly shifted from sustaining high return on financial capital to largely preserving the value of financial capital. Monetary policy, therefore, shifted from supporting rentier income to, first and foremost, protecting rentier wealth, regardless of its impact on the former.

The Changing Tides of Monetary Policy Prior to the Global Financial Crisis

The rise of monetarism during the latter half of the 1970s — which coincided with an enhanced role and greater degree of policy independence — combined with the strengthening of rentier influence on these institutions, led to a macroeconomic policy framework based on the control of monetary aggregates (see Lavoie and Seccareccia 2006, 2013). With the monetarist debacle of the early 1980s, monetary policy entered a transition phase. Indeed, by the early 1990s, central banks internationally had completely abandoned the monetarist framework and began to conduct explicit interest rate operating rules by targeting the interbank administered rate, so as to control inflation in accordance with a neo-Wicksellian policy framework of either explicit or implicit inflation targeting (Seccareccia 1998).

One of the most celebrated of these neo-Wicksellian reaction functions is the Taylor rule. The essence of these reaction functions is that, whenever the inflation rate moved either upward or downward in relation to its target level, the central bank would move the central-bank-administered money rate and, eventually, the real rate in
the same direction. This would entail a pro-cyclical movement of the money rate of interest and, as a by-product of this central-bank reaction function, there would ensue a relatively stable real rate, as the central bank pursues its inflation targeting policy (Secchireccia 2016). This new conventional monetary policy had implications for the magnitude and stability of real interest rates, as Table 1 shows.

Table 1. Mean and Variance of Real Central Bank Interest Rates, Canada and the United States (1946–2015)

| Source: Federal Reserve Bank of St. Louis (n.d.); Statistics Canada (n.d.). *Note: Data start points are as follows: Canada – 1946; United States – 1948. |
|---|---|---|---|---|
| **Real Bank Rate (Canada)** | | | | |
| Mean | 0.08 | 3.76 | 2.64 | −0.43 |
| Variance | 14.70 | 8.57 | 2.88 | 0.51 |
| **Real Fed Discount Rate (US)** | | | | |
| Mean | 0.49 | 1.69 | 1.25 | −0.68 |
| Variance | 5.11 | 6.31 | 1.95 | 1.6 |

From the descriptive statistics in Table 1, during the earlier postwar era when government commitments to high employment remained strong, the average real rates were low and their variance relatively high, as central banks were more concerned with combating unemployment than inflation. After the oil price shocks of the 1970s and the ensuing high inflation, central banks began to raise real interest rates throughout the late 1970s and 1980s, as combating inflation became a priority. This continued during the inflation-targeting era officially adopted by numerous central banks beginning in the 1990s, while the U.S. Fed pursued an implicit form of inflation targeting. Until the financial crisis, real rates stabilized at higher levels and, accompanying this, there was a significant collapse in the amplitude of fluctuations of these real rates, as measured by their variance. This era of pro-rentier policy of high and stable real interest incomes, however, came to an end with the financial crisis.

As the last column of Table 1 displays, there was a sharp collapse of real rates that then stabilized at their lower bound, thereby giving rise to persistently negative real rates and very low variance around these real rates, as central-bank money rates hovered close to zero. To try to offset the collapse of the aggregate demand, and despite inflation rates that still remained close to target levels after 2009, central banks modified their policy to deal with the crisis. Because of fears of possible deflation, as well as to prevent a collapse of asset prices, some important central banks, such as the U.S. Fed and the European Central Bank (ECB), began to implement “unconventional” policies of quantitative easing (QE).

The Logic of Quantitative Easing: Myth vs. Reality

To sustain asset prices and bring down nominal and real interest rates to their lowest possible levels, central banks borrowed from a toolkit that had already been tried by
the Bank of Japan to combat deflation before the global financial crisis. After 2008, a number of central banks (the most celebrated being the U.S. Fed) engaged in unsterilized large-scale asset purchases to provide further monetary stimulus because implementation of conventional policy of reducing money rates was constrained by the zero lower bound. Massive purchases of government bonds and other securities resulted in the flooding of the banking sector with a mountain of excess reserves. The outcome would be that, to varying degrees, all interest rates along the yield curve would decline, thereby reducing the cost of borrowing.

There are numerous channels that have been traditionally described by defenders of QE. The most important is the asset price channel, emphasized by Ben Bernanke (2016, online), whereby “the Fed’s purchases push up the price and (equivalently) push down the yield of the assets it buys [and whose] effect is transmitted through the system as investors who sold the assets shift into others (such as stocks or corporate bonds).” This portfolio rebalancing effect can eventually give rise to a positive wealth effect and boost private spending (Koo 2015, 76). However, others have emphasized the traditional monetarist channel that increases in bank reserves eventually impact bank loans, and thus the money supply and inflation, as banks seek to “rid” themselves of the excess reserves (Barro 2010; Meltzer 2010).

The first of these channels rests on the belief that important components of private expenditures, such as business investment and household spending on consumer durables, are interest elastic, which may be less important in a recessionary environment, or that wealth effects are significant. On the other hand, the traditional monetarist channel of the “direct effect” on lending from changes in base money has been criticized by heterodox economists for not accounting for the true nature of modern money and banking operations since banks are not reserve-constrained (Lavoie and Seccareccia 2012). Moreover, the banking sector as a whole cannot rid itself of excess reserves since, if a bank makes a loan to an individual — say — to purchase a consumer durable, the retail business will merely deposit the money in another bank by an equivalent amount or, if the business is in debt, it could choose to reduce its outstanding debt to the banking sector. The reserves, however, will not disappear from the banking sector as a whole. This is why, contrary to Robert Barro (2010) and Allan Meltzer (2010) (and even to some well-known post-Keynesian economists like Thomas Palley [2014, 3]), increased reserves neither lead to greater lending nor to more private spending, and are not inflationary in nature. This can easily be ascertained from Figure 1. Starting in 2008, total reserves rose during each of the total QE periods, but bank lending and money stock growth showed no co-movement, thereby suggesting a lack of causal link, as some economists at the Fed had already concluded by 2010 (see Carpenter and Demiralp 2010), thus questioning the whole basis of the money multiplier. Indeed, Figure 1 shows that, when total base money rose, bank lending did not even move in the same direction as, for example, during initial QE1 in 2008-2009.

The Fed QE interventions went primarily to purchases of U.S. government treasuries and mortgage-backed securities (MBSs), as well as to some other agency debt. The build-up of excess reserves had the effect of bringing down the federal funds
rate (FFR) to its lowest level (consistent with the rate that they paid on reserves) regardless of the composition of the QE purchases. Indeed, depending on the precise structure of QE purchases, this would also impact longer-term interest rates all along the yield curve. However, as the FFR declined sharply at the end of 2008, which brought down short-term rates, long-term rates displayed greater reluctance to fall. As Figure 2 indicates, when the FFR was rising before the financial crisis, spreads between the long- and short-term rates would tighten because of a belief in the eventual loosening of monetary policy in the future. With the collapse of the short-term rates, the spreads widened immediately after the financial crises. Indeed, depending on the type of Fed purchases, the spreads were affected in varying degrees. However, the most spectacular fall in the spreads took place after QE2, between June 2011 and December 2012, when the U.S. Fed conducted sterilized asset purchases (described as “Operation Twist”) by purchasing long and selling short—a program identified as the Fed’s “credit easing.” This latter program turned out to be the most successful in narrowing the spread and bringing down long-term interest rates (see Figure 2).

Figure 1. Evolution of Commercial Bank Lending, M2 Money Stock, and Total Reserves in the United States, 2001–2016 (Monthly Observations)

Source: Federal Reserve Bank of St. Louis (n.d.).
Note: All measured are in billions of dollars, with the left ordinate measuring the total bank lending and the M2 money stock, while the right ordinate measures total bank reserves.
The most powerful effect in reducing long-term yields and raising those asset prices was through sterilized purchases via credit easing. However, the composition of those total purchases under QE mattered a great deal not only in how it impacted on the term structure of yields, but also for the type of support that it provided to the banking sector and specific markets, such as those for mortgage debt. Indeed, of strategic importance was the mortgage market that had suffered the greatest strain beginning with the subprime crisis. Figure 3 indicates how important the mortgage market was to QE1 and QE3 (but not to QE2) in the Fed’s Large Scale Asset Purchase Program (LSAP), since over half of the Fed purchases during QE1 and QE3 had been of MBSs. While QE1 was surely not some simple extension of the 2008 Troubled Asset Relief Program (TARP), these trillions of dollars of purchases, especially during QE1, did strengthen the mortgage market and reinforced the financial institutions dealing in those securities, whether it was in the creation or the holding of these MBSs. Actually, an important study by Juan Montecino and Gerald Epstein (2015) analyzed the experience under QE1 of the impact of Fed purchases of MBSs on rates of return on bank assets by using panel data. When controlling for bank specific covariates and other explanatory variables, Montecino and Epstein (2015) found that banks with more MBSs on their balance sheet prior to QE purchases were experiencing capital gains on these assets, hence had higher profits. The authors concluded that “[b]anks that were counterparties to Fed MBS purchases — ‘treatment’ banks — experienced large and statistically significant increases in profits after controlling for standard determinants of bank performance” (Montecino and Epstein...
They also concluded that there were further positive spillover effects in terms of profitability more broadly on the larger banks dealing with MBSs.

**Figure 3. MBSs as Percentage of Total QE Purchases During Official Periods of QE1, QE2, and QE3, 2008–2014 (Quarterly Observations)**

*Source: Federal Reserve Bank of New York (n.d.)*

While the banks directly dealing in the MBS market were now benefiting from asset purchases through the portfolio balance transmission channel, it is less clear if the banking sector as a whole was benefitting in terms of enhanced profitability. In other words, was this true for the complete U.S. banking sector or just the larger banks? To test this, I use a simple model of bank rates of return I had previously adopted to explain bank profit performance (see Seccareccia 2014), based on quarterly U.S. data for the period from 1992 to 2014, by considering separately the purchases of MBSs and U.S. treasuries, as well as total purchases throughout the QE period, as follows:

\[
ROE_t = a_0 + a_1 NI + a_2 IS + a_3 GDP_t + a_4 QEMBS_t (\text{or } a_5 QETR_t \text{ or } a_6 QETOT_t)
\]

In the equation, \(ROE\) means rate of return on equity, \(NI\) means ratio of non-interest income to total bank revenues, \(IS\) is the interest spread (prime rate - CD rate), \(GDP\) is real GDP growth, \(QEMBS\) is QE purchases of MBS, \(QETR\) is QE purchases of treasuries (U.S. government bonds), and \(QETOT\) means QE total purchases.

Because of the non-stationarity of at least one variable (\(ROE\)), I test the model both in levels and in first difference. The results suggest that non-traditional non-
interest revenues are very significant for bank profitability. The interest spread is statistically weak, but with the correct sign. GDP growth is very significant and treasury purchases tend to be non-significant. The MBS (and total) purchases are also quite significant and negative in their overall effect (Tables 2 and 3).

Table 2. Simple Model of Bank Profitability of the Entire U.S. Banking Sector (Estimated in Levels) Using Quarterly Data (1992–2014)

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<tbody>
<tr>
<td>Non-interest share</td>
<td>0.635***</td>
<td>0.585***</td>
<td>0.635***</td>
<td>0.728***</td>
<td>0.671***</td>
<td>0.816***</td>
<td>0.590***</td>
<td>0.810***</td>
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<td>(6.21)</td>
<td>(5.22)</td>
<td>(4.34)</td>
<td>(6.70)</td>
<td>(5.68)</td>
<td>(5.27)</td>
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<td>Interest spread</td>
<td>1.545</td>
<td>0.758</td>
<td>1.578</td>
<td>0.749</td>
<td>1.489</td>
<td>0.766*</td>
<td>1.625</td>
<td>0.768*</td>
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<td>(1.10)</td>
<td>(1.61)</td>
<td>(1.79)</td>
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<td>(1.07)</td>
<td>(1.68)</td>
<td>(1.14)</td>
<td>(1.69)</td>
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<td>GDP growth</td>
<td>2.946***</td>
<td>0.237</td>
<td>3.586***</td>
<td>0.323</td>
<td>2.906***</td>
<td>0.242</td>
<td>3.151***</td>
<td>0.243</td>
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<td>(4.71)</td>
<td>(0.45)</td>
<td>(5.02)</td>
<td>(0.76)</td>
<td>(4.83)</td>
<td>(0.46)</td>
<td>(5.35)</td>
<td>(0.47)</td>
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<tr>
<td>MBS purchases</td>
<td>-1.44E–05** (–2.18)</td>
<td>-9.71E–06* (–1.82)</td>
<td>-1.0E–05** (–2.34)</td>
<td>-8.63E–06 (–1.65)</td>
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<td>Treasuries purchases</td>
<td>-1.64E–06 (–2.25)</td>
<td>-6.84E–06 (–1.47)</td>
<td>5.33E–06 (0.79)</td>
<td>-5.94E–06 (–1.45)</td>
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<td>Total purchases</td>
<td>-7.62E–06* (–1.82)</td>
<td>-7.41E–06** (–2.19)</td>
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AR (1) | 0.570*** (7.19) | 0.892*** (13.28) | 0.879*** (7.67) | 0.881*** (7.98) |

Constant | -22.142*** (–3.81) | -24.748*** (–3.41) | -23.495*** (–3.91) | -21.686*** (–4.51) |

R² | 0.724 | 0.891 | 0.673 | 0.889 | 0.228 | 0.895 | 0.707 | 0.896 |

Adjusted R² | 0.701 | 0.879 | 0.645 | 0.877 | 0.699 | 0.880 | 0.682 | 0.884 |

Durbin-Watson stat | 0.931 | 2.481 | 0.972 | 2.167 | 0.977 | 2.406 | 0.903 | 2.372 |

Notes: All regression estimates are in levels and use White’s heteroscedastic-consistent standard errors. T-Statistics in parenthesis, and *indicates significant at 90 percent, ** at 95 percent, and ***at 99 percent.


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<td>Non-interest share</td>
<td>0.668***</td>
<td>0.566***</td>
<td>0.586***</td>
<td>0.567***</td>
<td>0.688***</td>
<td>0.699***</td>
<td>0.618***</td>
<td>0.631***</td>
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<td>(5.17)</td>
<td>(7.74)</td>
<td>(5.52)</td>
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<td>(4.21)</td>
<td>(7.33)</td>
<td>(4.45)</td>
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<tr>
<td>Interest spread</td>
<td>0.743</td>
<td>0.412</td>
<td>0.736</td>
<td>0.744</td>
<td>0.743</td>
<td>0.425</td>
<td>0.795*</td>
<td>0.438</td>
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<td>(1.70)</td>
<td>(1.14)</td>
<td>(1.57)</td>
<td>(1.25)</td>
<td>(1.16)</td>
<td>(1.72)</td>
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<tr>
<td>GDP growth</td>
<td>0.993***</td>
<td>0.637*</td>
<td>0.857</td>
<td>0.663</td>
<td>0.992***</td>
<td>0.627*</td>
<td>0.760</td>
<td>0.574</td>
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<td>(2.34)</td>
<td>(2.01)</td>
<td>(1.46)</td>
<td>(1.60)</td>
<td>(2.17)</td>
<td>(1.78)</td>
<td>(1.53)</td>
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<tr>
<td>MBS purchases</td>
<td>-1.44E–05** (–3.52)</td>
<td>-1.08E–05** (–2.50)</td>
<td>-1.44E–05** (–2.83)</td>
<td>-1.0E–05** (–2.32)</td>
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<tr>
<td>Treasuries purchases</td>
<td>-4.31E–06 (–1.27)</td>
<td>-1.52E–06 (–0.76)</td>
<td>-3.65E–08 (0.01)</td>
<td>-4.96E–07 (–0.29)</td>
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<tr>
<td>Total purchases</td>
<td>0.073E–06 (–2.69)</td>
<td>-4.39E–06** (–2.34)</td>
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AR (1) | -0.578** (–4.57) | -0.254* (–1.78) | -0.339* (–1.81) | -0.159 (–1.05) | -0.578** (–3.83) | -0.251* (–1.84) | -0.408** (–2.43) |

AR (2) | 0.512*** (3.69) | 0.549*** (3.27) | 0.512*** (3.09) | 0.521*** (3.02) |

Constant | -0.025 (–0.16) | -0.039 (–0.17) | -0.044 (–0.24) | -0.110 (–0.32) | -0.025 (–0.32) | -0.039 (–0.35) | -0.029 (–0.35) | -0.106 (–0.38) |

R² | 0.681 | 0.756 | 0.606 | 0.720 | 0.680 | 0.757 | 0.654 | 0.741 |

Adjusted R² | 0.643 | 0.722 | 0.362 | 0.681 | 0.637 | 0.716 | 0.616 | 0.705 |

Durbin-Watson stat | 1.350 | 1.798 | 1.687 | 1.720 | 1.551 | 1.802 | 1.666 | 1.800 |


Notes: The results were obtained when all models were regressed with all variables in first difference. White’s heteroscedastic-consistent standard errors were used for all models. T-Statistics in parenthesis, and *indicates significant at 90 percent, ** at 95 percent, and ***at 99 percent.
QE is a successful instrument when measured on the basis of sustaining asset prices and bringing down both short-term and, to a lesser extent, long-term interest rates. However, there is a trade-off in the form of lower returns for the individual asset holders (resulting from the lower real interest rate policy) and also because of the effect of QE purchases on the banking sector as a whole. Indeed, the evidence supports the monetary view of heterodox economists: namely, that while individual banks can seek to rid themselves of excess reserves, much like other macroeconomic paradoxes (such as the paradox of thrift), the banking sector as a whole cannot prevent the amassing of excess reserves that were generated by successive QE policy in the US from 2008 to 2014. The Fed did begin to pay interest on reserves in October 2008 to better control the FFR and to make QE more palatable to the banking industry, and its outcome was to make holding of reserves or short-term treasury bonds close substitutes, because of the low returns on both.

The low spreads in returns between the holding of treasury bills and of reserves explains why the coefficient $a_5$ was not significant (even though it is normally negative in sign). On the other hand, because of the much higher returns on MBSs in the banking sector, the growing excess reserves resulting from the removal of these assets actually eroded overall bank profitability ceteris paribus, thereby generating significant negative coefficients for MBS purchases as reflected in $a_4$. The same can be said of total reserves with negative coefficients for $a_6$. Therefore, the trade-off between lower returns and sustained asset values in times of crisis also applied to the total banking industry, since policies of sustaining asset prices through QE did have some negative consequences on overall bank profitability.

References


